

Report on GM/Microsoft Interested Parties Meetings

The California Supreme Court decisions in Microsoft v. Franchise Tax Board and General Motors v. Franchise Tax Board have prompted industry to request that the staff of the Franchise Tax Board begin to engage in meetings designed to bring about a long term solution to the issue of treasury function activities. Both cases leave issues to be decided on a case-by-case basis and do not provide clear guidance to taxpayers. What we know from the cases is:

- The cases do not appear to establish a bright line quantitative test for distortion; at most we know what was decided in the circumstance of one or two cases.
- The cases did not appear to establish a bright line standard or qualitative test to determine if there is distortion; all we have is an analysis of the facts in one case (*Microsoft*) with the conclusion that the facts presented in that case were distortive.
- We know that receipts from loans include only the interest received and net gains. (*General Motors*) We know that "repos" are loans but there is no clear definition of what else constitutes a loan for purposes of determining gross receipts for the sales factor.
- There may be other issues that have not been explored, such as how to treat deposits with banks or other financial institutions that may or may not be loans.

Many, but not necessarily all, of these issues may be addressed in pending litigation.

The first interested parties meeting was held on January 31, 2007. Forty-nine members of the tax community attended the meeting. Members of industry were in attendance, including representatives of major California based and non-California based companies. Also in attendance were representatives of the California Bankers Association, California Taxpayers' Association, Assembly Committee on Revenue and Taxation, Senate Committee on Revenue and Taxation, California Manufacturers and Technology Association, California Chamber of Commerce, the Department of Finance, BNA and Spidell Publishing.

The input received seemed to lean toward a legislative solution to define treasury function receipts as includable only to the extent of net income, or in the alternative to exclude these receipts from the sales factor in their entirety. In-state industry representatives were strong in their support of this alternative approach. They believe it is consistent with the laws of other states, will be simple to administer, provides certainty for taxpayers, provides equality between in-state and out-of-state taxpayers, and will eliminate any incentive for in-state corporations to move their treasury functions out of California. They expressed reservations about a solution based upon distortion

April 4, 2007

because it could entail significant record keeping costs and be susceptible to a year-by-year variation.

There was also discussion as to the use of a regulation to accomplish this result. Some participants felt this was possible as long as the Department regulated under Revenue and Taxation Code section 25137. This alternative was seen as providing the Department and concerned taxpayers with a quicker solution and greater control over the process than a legislative solution.

A second interested parties meeting is being held on March 30, 2007. This meeting will be used to discuss specific regulatory and statutory language designed to remedy the treasury function/sales factor problem. The participants will review two different regulation proposals and two statutory proposals, as well as any new proposals made by the participants themselves.

Staff will report to the Board regarding the outcome of the second interested parties meeting and request the Board to direct staff as to how the Board wishes staff to proceed. Among the options available to the Board would be:

1. Continue informal discussions with industry on both projects.
2. Direct staff to begin the formal regulatory process for a regulation to address the treasury function issue.
3. Direct staff to develop a legislative proposal to bring back to the Board for its approval at a later meeting.

Report of GM/Microsoft Interested Parties Meeting

The Interested Parties meeting regarding the GM/Microsoft issues was held on Tuesday, January 31, 2007. Forty-nine members of the tax community attended the meeting. Members of industry were in attendance, including representatives of major California based and non-California based companies. Also in attendance were representatives of the California Bankers Association, Assembly Revenue and Taxation, Senate Revenue and Taxation, CMTA, California Chamber of Commerce, the Department of Finance, BNA and Spidell Publishing.

Executive Summary

The meeting was well received by the participants. Many people commented that they liked the process and appreciated the opportunity to voice their concerns and ideas prior to the Department developing a position. The input received seemed to lean toward a legislative solution to define treasury function receipts as includable only to the extent of net income, or in the alternative to exclude these receipts from the sales factor in their entirety. In-state industry representative were strong in their support of such an approach. They believe it is consistent with the laws of other states, provides certainty for taxpayers and equality between in-state and out-of-state taxpayers and will eliminate any incentive for in-state corporations to move their treasury functions out of California. They expressed reservations about a solution based upon distortion because it could entail significant record keeping costs and be susceptible to a year-by-year variation.

There was also discussion as to the use of a regulation to accomplish this result. Some participants felt this was possible as long as the Department regulated under Revenue and Taxation Code section 25137. This alternative was seen as providing the Department and concerned taxpayers with greater control over the process than a legislative solution. A regulation adopted by the state of Hawaii was discussed, with particular concern expressed about the proper definitions of "treasury function" and the term "liquid assets". One participant found the regulatory approach to be inconsistent with the California Supreme Court's decision in Microsoft. He argued that the Court held that some level of inclusion of treasury function receipts above net income was proper and that a regulation that put the function at net would therefore be inconsistent with the Court's ruling. Others dismissed this interpretation of the case as too expansive and pointed out that the Court in no way addressed the use of a regulation to fix the treasury function issue.

The meeting ended with questions about where the process will go in the future. Staff stated that talks would be held with management and the public made aware if another interested parties meeting will be held.

Meeting Minutes

Staff began the meeting by stating that comments that were made at the meeting would be treated as off the record and not for attribution. Staff then explained that the meeting

April 4, 2007

was intended as an opportunity to express suggestions and concerns regarding possible solution to the treasury function issue. Staff also explained that the meeting was not a forum to discuss ongoing litigation or the possible settlement of ongoing disputes. It was explained that the meeting was intended to address a forward-looking solution. Staff also stated that this process was not intended to in any way affect the Department's current approach to stockbrokers or banks and financials as these types of entities are not engaged in ancillary treasury function activities.

Staff then went through the discussion topics that were posted on the website. (Copy attached) This included a discussion regarding what other states had done with this issue, most have reduced treasury function receipts to net or thrown out these receipts entirely. Staff's issue paper suggested that any solution to the issue should be guided by the following principles:

- Equity (treat all taxpayers the same)
- Administrability (clear simple rules that taxpayers and the Department can apply)
- Elimination of as many disputes as possible
- Should promote uniformity with other states

Staff then opened the floor to comments.

Comments were received from members of the audience, largely California-based, that they were in agreement with staff's guiding principles. Comments were made that a rule that reduced the receipts to net, or even threw out the receipts entirely, was consistent with these principles. They also believed that such an approach would make for good policy, as any larger factor inclusion could encourage in-state businesses to move their treasury function to other states. All of these industry representatives were in basic agreement that reduction of the treasury function receipts to either net, or even entirely was the correct answer.

The question was then raised as to whether such a rule would be consistent with the decision of the California Supreme Court in Microsoft. Staff asked whether the comment was directed towards the issue of legislation verses regulation and opined that legislation is a more clear-cut solution but regulation may be possible under 25137.

The discussion then turned to the use of 25137 regulation. Comments were received that this may be possible as long as staff could make a threshold showing that, in general terms, inclusion of gross receipts for treasury function is distortive. Comments were received that a regulation might be better due to the legislation possibly being scored as a tax increase as well. There was input from one member of the audience that such a regulation would have to include a distortion threshold to be consistent with the Court's opinions. Others disagreed with this analysis.

There was limited support for trying to define receipts by regulation. There were concerns that such an approach might be viewed as inconsistent with the statute.

April 4, 2007

The topic turned to an evaluation of regulations verses legislation. The detriments of legislation were listed by a participant as including the risk that it is a tax increase bill, that it could die in committee, that there is not as much control over the proposal. In favor would be public policy that treasury jobs should be encouraged and the current rules could force companies to export these high paying jobs. Also, that the proposal is consistent with other states and is simple to comply with.

Discussion then switched back to the regulation approach. The regulation promulgated by Hawaii was then read and the provisions setting forth the definition of "liquid assets" and "treasury function " were discussed. The issue of the scope of "liquid assets" was seen as important to some participants. They raised concerns about longer-term investments and business activities that are not necessarily related to daily working capital pools. Staff opined that the definition of "treasury function" could well address these concerns.

A comment was offered that any regulation that did not include a distortion threshold would not be supported by out of state taxpayers. Others said this position may not be universal and that it would be incorrect to say that all out of state taxpayers would agree on the issue. This was then discussed further, with a comment that anything else would be overruling the Court and that the Court imposed a burden of proof that the FTB would essentially be overruling with the regulation. Staff disagreed, explained that the regulatory process is different from individual case law and that the Court said nothing disparaging about regulations.

There was a discussion about what a regulation could say and where the problems would be in drafting such a regulation. The definition of "liquid assets" was discussed in depth. It was noted that a specific definition might require significant record-keeping burdens similar to what would be required for a distortion analysis given the decision in *General Motors*.

Staff then asked if it was viable to go down the legislative path and the regulatory path at the same time. There was some approval of this as a possible approach.

The meeting ended with question as to how staff would proceed and whether there would be more meetings. Staff stated that it would be up to management what to do next, but staff would appreciate any more comments, even at a later time. Staff emphasized that this was not their decision but a decision to be made by the three-member Board or others.

Finally it was asked whether, if a regulation were completed, FTB would see scenarios where it would argue against the regulation. Staff said this was highly unlikely and that we live with the regulations that we promulgate.

The meeting was then adjourned.

April 4, 2007

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

The results of the prior interested parties meeting indicated that staff should begin to work towards the development of a regulatory solution to the gross receipts/treasury function issue as well as a statutory solution. With this in mind, staff has developed language for a proposed regulation in this area and similar language for a proposed statutory solution. The purpose of the March 30, 2007 meeting will be to discuss this language, and any other alternatives that are offered, in order to develop a proposal that can be taken to the Franchise Tax Board (FTB) for approval to either move forward into the formal regulatory process, or to support an item of legislation.

Comments made at the January meeting indicated that there was stronger support for a regulatory fix under the authority of section 25137 of the Revenue and Taxation Code (RTC) rather than to attempt to regulate under section 25120(e), which contains the definition of sales. FTB staff agrees that RTC section 25137 provides the authority for such a regulation and therefore staff has developed regulations under RTC section 25137.

Regulatory Proposals

The first regulation that staff proposes for discussion is derived from the model regulation adopted by the Multistate Tax Commission. This regulation has already been adopted in other states and provides a reasonable basis for the California regulation as well. Staff also includes a second alternative regulation, which is shorter and specifically excludes hedging activities from the definition of "treasury function". While staff believes that hedging causes the same distortion problems as treasury function investments of working capital, the inclusion of hedging is felt by some to be outside the scope of this particular project. This version also excludes the receipts in issue completely, rather than reducing the receipts to net income.

Staff regulatory proposal 1 raises the following issues for discussion:

Subsection (c)(1)(D) of the regulation sets forth the rule that if the taxpayer has a treasury function, then the receipts derived from liquid assets held by that function are included in the sales factor only to the extent of "overall net gain".

Subsection (c)(1)(D)1. defines the term "liquid assets" and sets forth that stock in unitary subsidiaries, and entities such as suppliers or distributors, are not liquid assets.

1. Is the scope of "liquid assets" reasonable?
2. Would the regulation be easier to apply if it simply stated that liquid assets are "all marketable intangibles", rather than listing specific types of investments?
3. Is there a need to address business/nonbusiness issues in this context, such as pools of funds that are far in excess of what is needed to provide for the day-to-day needs of the business?

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

Subsection (c)(1)(D)2. defines the term "treasury function" as a function that pools together and manages the liquid assets. This definition also includes as a treasury function the activity of managing assets that are reserved for business contingencies and business acquisitions. This subsection also excludes from the definition of "treasury function" those taxpayers whose businesses are principally engaged in the purchasing and selling of liquid assets.

1. Is this definition adequate or should it be broadened to also address other asset management functions such as hedging of raw materials or foreign receivables? Hedging clearly affects the cash flow of the business and can have a similarly distortive effect on the sales factor.
2. Is the exclusion for dealers in intangibles adequate? Should it be modified to define what "principally engaged" means?
3. Are there business/nonbusiness issues that are impacted by this definition?

Subsection (c)(1)(D)3. provides how net income from the treasury function is calculated. This subsection seems straightforward and simply provides that net income means net income for the tax period.

Staff regulatory proposal 2 raises the following issues for discussion:

1. Is this shorter form preferable?
2. Does the elimination of these receipts rather than a reduction to net income seem like a better approach?
3. Is this version's use of the term "intangible assets" preferable to the defined term "liquid assets" included in proposal 1?

Statutory Alternatives

The statutory changes that staff wishes to discuss are based on the regulatory language set forth in proposals 1 and 2. Because these changes could be placed either under RTC section 25120(e) or under RTC section 25137, statutory proposal 1 is set forth as an amendment to RTC section 25120(e) while statutory proposal 2 is set forth as an amendment to RTC section 25137. Similar issues to those raised by the regulations clearly apply to these proposals as well. But in addition, staff would like to solicit input regarding which RTC section, 25120(e) or 25137, is the better choice for the proposed amendments.

Participants at the meeting will be asked to discuss these issues as well as providing their own input regarding the proper regulatory or statutory response to this issue. Staff will then report on this meeting, as well as the first interested parties meeting, to the FTB at its April 4th meeting.

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

Regulatory Proposal 1

Add new subsection (D) to Regulation section 25137(c)(1) to read as follows:

25137(c)(1)(D) If a taxpayer holds liquid assets in connection with the treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for the tax period is included in the sales factor.

1. For purposes of this subsection, a liquid asset is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. Liquid assets include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer's trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds that hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

2. For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

3. Overall net gain refers to the total net gain from all transactions performed by the treasury function for the entire tax period, not the net gain from a specific transaction.

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

Regulatory Proposal 2

Add new subsection (D) to Regulation section 25137(c)(1) as follows:

25137(c)(1)(D) The numerator and denominator of the sales factor shall exclude interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts from the maturity, redemption, sale, exchange or other disposition of such intangible assets.

“Treasury function” is the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. Treasury function does not include a taxpayer's trading function that purchases and sells future contracts, products, or commodities related to the business of the taxpayer, or related to hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function is not performing a treasury function with respect to income so produced.

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

Statutory Proposal 1

Amend RTC section 25120 as follows:

As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this Act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e)(1) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(2)(A) Notwithstanding Section 38006, gross receipts arising from a treasury function shall be limited to the overall net gain, including interest and dividends, realized from transactions undertaken as part of a treasury function.

(B) For purposes of this paragraph, all of the following apply:

(i) "Treasury function" means the pooling, management, and investment of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, including, but not limited to, providing a reserve for business contingencies and business acquisitions.

(ii) "Liquid asset" means a readily marketable intangible, including, but not limited to, stocks, bonds, debentures, options, warrants, future contracts, foreign currency, and mutual funds that hold those intangibles. "Liquid asset" does not mean currency held in bank accounts if that is the currency that the business regularly used in the conduct of its trade or business, unless that currency is an instrument that may be purchased or sold for a gain or loss. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

(iii) An equity interest in a business entity, such as stock in a corporation, that is unitary with the taxpayer, or that has a substantial business relationship with the taxpayer, is not considered a marketable intangible.

(C) A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Franchise Tax Board – Interested Parties Meeting
Topics of Discussion
March 30, 2007

Statutory Proposal 2

Amend Rev. and Tax. Code section 25137 as follows:

(a) If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

~~(a)~~(1) Separate accounting;

~~(b)~~(2) The exclusion of any one or more of the factors;

~~(c)~~(3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

~~(d)~~(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(b) The numerator and denominator of the sales factor shall be modified to exclude interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts from the maturity, redemption, sale, exchange or other disposition of such intangible assets.

(1) "Treasury function" is the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. Treasury function does not include a taxpayer's trading function that purchases and sells future contracts, products, or commodities related to the business of the taxpayer, or related to hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function is not performing a treasury function with respect to income so produced.

(2) Nothing in this subdivision shall preclude a taxpayer from petitioning the Board pursuant to subdivision (a) if the exclusion of gross receipts from intangible assets held in connection with a treasury function of the taxpayer's unitary business does not fairly represent the extent of the taxpayer's business activity in this state.