

STAFF REPORT, STAFF RECOMMENDATION, AND REQUEST FOR ADOPTION OF PROPOSED REGULATION 25137(c)(1)(D) AS AN ADDITION TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25137, RELATING TO EQUITABLE ADJUSTMENT OF THE STANDARD ALLOCATION AND APPORTIONMENT PROVISIONS

On January 31, 2007, staff held an interested parties meeting to request public input regarding the need for a legislative or regulatory response to the California Supreme Court's decisions in Microsoft v. Franchise Tax Board and General Motors v. Franchise Tax Board. Staff did not propose any specific approach at that time, but rather elicited input from the public regarding whether a response was necessary and what form that response might take. A second interested parties meeting was held on March 30, 2007. This meeting was held to elicit input on two draft regulations and two draft legislative proposals. After this meeting, staff asked the Franchise Tax Board, at its April 4, 2007 meeting, to direct staff as to whether staff should begin the formal regulatory process or proceed with a legislative proposal. The Franchise Tax Board directed staff to begin the formal rulemaking process to adopt a regulation to address the treasury function issue. A formal Notice of Public Hearing was issued on June 29, 2007.

On August 17, 2007, Carl Joseph of the department's Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed regulation. There were 24 attendees at the hearing. Four persons presented comments orally at the hearing. In addition, an extension of time to provide written comments regarding the regulation was allowed, with the comment period for written comments being extended until September 17, 2007. In total, during the formal regulatory process there were comments received from seven different commentators who submitted approximately ten comments in total, orally and in writing.

Included, as Exhibit A to this report, are detailed responses to the comments received during the formal regulatory process. Exhibit B is a study of current cases that staff performed in response to issues raised in the comments. The comments received during the formal regulatory process are attached as Exhibit C to this Report. The transcript of the Regulatory Hearing is included as Exhibit D. The final version of the regulation is included as Exhibit E to this Report. The Economic and Fiscal Impact Statement (Form 399) is included as Exhibit F to this Report.

Staff recommends that the Board authorize the Executive Officer to proceed with the final requirements for the adoption of proposed regulation 25137(c)(1)(D) the language of which is set forth in Exhibit E of this package.

**STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS  
IN CONJUNCTION WITH HEARING OF AUGUST 17, 2007**

**Comments from Morrison Foerster dated July 30, 2007**

1. Please confirm that the regulation will not change, amend or in any way modify the current state of the California law regarding the sales factor for stockbrokers and/or brokerage companies. Generally speaking these companies are allowed to utilize gross receipts in their sales factor calculation and this should not be changed due to concerns regarding treasury function issues.

**Response:**

This regulation is not intended to change the sales factor rules for companies that engage in the trade or business of selling intangible assets. The regulation expressly states:

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, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.

Therefore, the throw out of treasury function receipts will not apply to these taxpayers.

**Recommendation:**

No change to the regulation is necessary.

2. Please confirm that the regulation will not change, amend or in any way modify the current state of the California law regarding the sales factor for banks and /or financial corporations. The sales factor rules for these taxpayers are currently located in regulation 25137-4.2 and should not be changed by this proposed regulation.

**Response:**

The regulation will not change the sales factor rules for banks and financials. The regulation specifically provides for this. Proposed regulation section 25137(c)(1)(D)(2) states:

2. This subsection shall not apply to entities that apportion their income under the rules of regulation 25137-4.2.

The regulation is therefore clearly not applicable to these taxpayers and they will continue to utilize the sales factor rules found in regulation section 25137-4.2.

**Recommendation:**

No change to the regulation is necessary.

**Comment from Silverstein and Pomerantz dated August 16, 2007**

The regulation contains an exception from the rule of throw out for treasury function gross receipts that is based on a taxpayer being "principally engaged in the trade or business of purchasing and selling intangible assets." This exception should be expanded to allow *any* receipts derived purchasing and selling intangible assets to be included in the sales factor so long as the activity is a trade or business of the taxpayer. The use of the term "principally" could result in a taxpayer that derives 49% of its income from selling intangibles to be subject to the regulation's throw out rule, while a similarly situated taxpayer with 51% of its income from the same activity would not. The term "principally" should therefore be removed from the regulation.

**Response:**

The regulation is narrowly tailored to remove from the sales factor all receipts generated as part of a treasury function of the taxpayer. The term "treasury function" is defined as:

. . . 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.

Therefore, a taxpayer that has a separate trade or business that is involved in buying and selling intangibles would normally not be subject to the regulation regardless of whether that trade or business was the principal source of income for the taxpayer. The comment seems to suggest that there is a separate rule contained in the sentence "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, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced[,]" but this sentence is not a separate rule, it simply provides an example which clarifies the intended meaning of the definition of "treasury function." This clarification was requested by some participants in the regulatory process, presumably to assure them that the regulation would be interpreted as intended.

Because the hypothetical company derives 49% of its income from the trade or business of buying and selling intangibles, these activities would not meet the definition of a treasury function. These transactions are not entered into for cash flow needs or for providing a reserve for the business. These activities represent the sale of inventory. Therefore these activities would not be subject to the regulation.

## **Recommendation:**

No change to the regulation is necessary.

## **Comments from Reed Smith dated August 17, 2007**

1. The treasury function issue should be addressed through legislation rather than through regulation. The regulatory approach may be subject to court challenge and greater certainty will result from a legislative fix.

## **Response:**

While a legislative response to this problem is certainly possible, it is not the only means to address the issue. Section 25137 of the Revenue and Taxation Code provides that:

If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factor which will fairly represent the taxpayer's business activity in the state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

This statute provides the authority for the Franchise Tax Board to promulgate the regulation currently under consideration. Other states have utilized this approach. For instance, Haw. Rev. Stat. §235-38 is identical to R&TC section 25137 and Hawaii has promulgated a regulation to reduce treasury function receipts to net income.<sup>1</sup> Other states, including Idaho<sup>2</sup>, New Mexico<sup>3</sup> and Utah<sup>4</sup> all provide for special treatment for treasury function receipts through the use of regulations promulgated under similar statutory provisions. Therefore, there is nothing improper about addressing this issue through a regulation.

Even if a statute were adopted, either the taxpayer or the department would be able to vary from the treatment provided for in the statute by invoking R&TC section 25137. If the taxpayer did not agree with the variance proposed by the department, or the denial

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<sup>1</sup> Haw. Admin. Rules 18-235-38-03(f).

<sup>2</sup> Idaho Admin. Rules 35.01.01.570.03.

<sup>3</sup> N.M. Admin. Code 3.5.19.11(A)(4).

<sup>4</sup> Utah Admin. Rules R865-6F-8(10)(c)(iv).

of a variance they were seeking, they would be able to contest this determination through litigation.

**Recommendation:**

No change to the regulation is necessary.

2. The use of a regulation to address the treatment of treasury function receipts for sales factor purposes is not completely appropriate. There has not been a showing of "qualitative" distortion in all circumstances to justify the use of R&TC section 25137 to remove these receipts from the sales factor. There is a need for a greater distinction between a treasury function that is incidental to a business and those that are part of the principal business of the taxpayer. The regulation does not address this qualitative difference with respect to a taxpayer whose treasury function was not an incidental part of a taxpayer's business, such as when the pooling and management of liquid assets were beyond merely 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 and business acquisitions.

The regulation, to be consistent with Microsoft, should completely address the situation where any taxpayer's treasury function is or becomes part of its core business. This would take into account situations where a taxpayer's treasury function was vital to its survival as a business. For example, because of pending litigation that may severely damage a business, or put it out of business altogether, having adequate cash to keep a company financially afloat would become vital to its survival. In that situation, generating investment income would become a major focus of a business. Including gross receipts from a treasury function in the sales factor in that situation would represent the substantial contribution the treasury function made as a part of the core business. Furthermore, there needs to be a quantitative showing by the Franchise Tax Board to justify the use of section 25137 to all taxpayers with a treasury function.

**Response:**

The proposed regulation already contains language that clearly states that it is not intended to apply to dealers in securities as well as banks and other financial companies. Therefore, the major business activities that involve liquid assets as a core inventory for sale to customers have been explicitly excluded from the operation of the proposed amendments. This will limit the possibility that taxpayers who undertake these activities as a principal line of business will be affected by the regulation. Furthermore, the regulation defines "treasury function" in detail and if a taxpayer can successfully argue that its activities are outside of the definition, then the regulation will not apply to them.

The commentator's argument that there should be a distinction between a treasury function that is incidental to a business and those that are part of the principal business is predicated upon a belief that, under the case law, the gross receipts from a treasury

function can be included if that function is somehow more important to the business than just investing working capital. The court of appeals in The Limited Stores, Inc., et al., v. Franchise Tax Board (2007) 62 Cal Rptr. 3d 191 (The Limited) has specifically rejected this argument. The court stated:

The Limited argues, however, that the appropriate test is whether the treasury activities were “a fundamental segment” and “not 'an incidental part of'” the taxpayer's business. Based on the “consistent year-to-year cyclical need to use the cash flows managed by the treasury function for purchasing its seasonal retail inventory,” The Limited's “treasury function was an integral and fundamental segment of the retail operations, including the California retail operations, and any factual premise that the treasury operations were ancillary to and not a fundamental segment of The Limited's core retail operations is simply wrong.”

We disagree. The function performed by The Limited's treasury function is no different from the one performed by Microsoft's. For each company, the treasury invests excess funds in short-term marketable securities to increase corporate revenue. (Microsoft, supra, 39 Cal.4th at p. 757 & fn. 6.) Whether or not this revenue is used to complement the company's primary business is not the test imposed by Microsoft, nor should it be. It is almost always true that a treasury department's revenue production will be utilized to support or enhance the company's primary business. The qualitative test adopted in Microsoft would be illusory if The Limited's interpretation of it were adopted.

The commentator's use of the phrases "part of its core business" and "vital to its survival as a business" suffers from the same flaws as The Limited's argument characterizing such activities as being a "fundamental segment" of the business.

The taxpayer always has the ability under R&TC section 25137 to petition for relief, even from regulations promulgated under the authority of that section. The Board of Equalization held this to be the case in Appeal of Fluor, 95-SBE-016 (December 12, 1995). Therefore, if the taxpayer believes they have a situation that warrants specific relief, they are certainly able to petition for that relief.

In regards to the showing that must be made to regulate under R&TC section 25137, as will be explained in more detail in response to comment 3 (below), the standard by which a regulation is judged to be valid requires that the regulation be consistent with the statute and reasonably necessary to effectuate the purpose of the statute. (Govt. Code section 11342.2) Government Code section 11349 defines necessity in subdivision (a) as follows:

(a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of

law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

The proposed regulation meets this standard because its purpose is to apply decisions by the courts and the SBE to all taxpayers similarly situated. The decisions all hold that when a treasury function is ancillary, even though "fundamental", to the main line of business of the taxpayer, it is distortive to include gross receipts from such activities and therefore the standard formula should be adjusted under R&TC section 25137. This is precisely what the proposed amendment to the regulation will accomplish. Furthermore, during the regulatory process, input has been received that confirmed that the inclusion of these receipts will be distortive to large groups of taxpayers. This also is evidence meeting the necessity standard. (See comment from Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP dated September 17, 2007)

**Recommendation:**

No change to the regulation is necessary.

3. The FTB staff has not satisfied the appropriate level of burden of proof to justify excluding interest and dividends and overall net gains from the treasury function from the sales factor. The California Supreme Court made it clear that the party seeking to deviate from the standard formula has the burden to prove by clear and convincing evidence that such a deviation is warranted. The court has not limited this burden of proof to ad hoc applications of R&TC section 25137.

In Microsoft Corporation v. Franchise Tax Board, 139 P3d 1169, 47 Cal Rptr 3d 216 (2006) (Microsoft), the factual basis for a finding of distortion was that (1) Microsoft's treasury function was qualitatively different from its principal operations; (2) the investments produced less than 2% of its income but 73% of its gross receipts; (3) the profit margin from these investments was 0.2% while the main line of business had a profit margin of 31%; (4) the non-treasury operations were 155 times more profitable than the treasury operation and (5) the worldwide profit margin was 8.6%, 43 times more profitable than the treasury operation.

FTB staff has not examined evidence along these lines with respect to all or a majority of the taxpayers impacted by this regulatory proposal and therefore staff has not met its burden of proof (clear and convincing evidence) that the regulatory proposal should be applicable to all taxpayers impacted by the proposed regulation.

**Response:**

The commentator is attempting to apply an incorrect standard (clear and convincing evidence) to justify the adoption of the proposed amendments. The standard by which a regulation is judged to be valid requires that the regulation be consistent with the statute and reasonably necessary to effectuate the purpose of the statute. (Govt. Code section

11342.2) Government Code section 11349 defines necessity in subdivision (a) as follows:

(a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

Clearly this is not the "clear and convincing" standard by which the commentator is seeking to judge what is in the record. The FTB has met the proper standard of showing necessity.

However, in an effort to provide more evidence to support the regulation, FTB has reviewed cases where this issue is currently being raised in an attempt to better establish the general fact pattern for treasury function cases. Because the evidence that was examined in the Microsoft case is not readily apparent from tax returns, only cases that have undergone some extended factual development, typically through protest or audit, contain enough information to be helpful in analyzing the applicability of the Microsoft decision. Furthermore, not all cases that contain this issue are fully developed due to evidentiary problems or other issues taking precedent.

The result of this review is set forth in a report attached to this document. Thirty-four cases were found that were developed in enough detail to compare them to the existing case law. These cases involved over fifty tax years. These cases revealed that the average treasury function case is quite similar to the prior cases where distortion has been found. On average, the treasury function produced 50% of the receipts factor and approximately 3% of the income in the cases examined. While this is somewhat less than the Microsoft facts cited by the commentator, these numbers compare favorably with the facts of Appeal of Pacific Telephone and Telegraph, 78-SBE-028 (Pacific Telephone), cited approvingly by the Microsoft court, as well as the facts of The Limited, a Court of Appeals decision that was decided after Microsoft.

The sample also contained eighteen cases with adequate factual development to perform the profit margin analysis that was performed by the court in Microsoft. This analysis showed, on average, a result very similar to that of the Microsoft case. The treasury function margins were several orders of magnitude (approximately 30 times) less than that of the main line of business.

Only one of the cases reviewed did not fit this fact pattern. In that case the investment activity would not meet the definition of treasury function included in the regulation because the activity was not performed for the purpose of satisfying the cash flow needs of the trade or business, but rather was the core part of the taxpayer's business model.

In total, the analysis supports the position of staff that the regulation is needed to apply the court's decision to all taxpayers who perform a treasury function. The Microsoft facts are not unique but reflect an inherent distortion that results when a treasury function activity is included in the sales factor.

The Microsoft decision did not address the question of whether the burden of proof standard applies only to *ad hoc* determinations or to regulatory actions. The Board of Equalization has addressed this question in the Appeal of Fluor, 95-SBE-016 (December 12, 1995), and held that regulations adopted under R&TC section 25137 have the force of the standard statutory rules.

### **Recommendation:**

No change to the regulation is necessary.

4. FTB staff is misinterpreting the California Supreme Court decision in Microsoft as to its applicability to all taxpayers impacted by the regulatory proposal. The Microsoft court found distortion in a specific case, while the FTB staff assumes that in all cases distortion exists with respect to all taxpayers impacted by the regulatory proposal. The FTB staff's position is inconsistent with the law because it is applying a decision based on particular facts to all taxpayers, when the decision itself indicates that it is not always applicable across the board to all taxpayers. The court cautioned "that in other cases the Board's approach may go too far in the opposite direction and fail the test of reasonableness." The regulation therefore may fail the provision of the APA that states that a regulation must be consistent with the law (Govt. Code sections 11349.1 and 11349.3).

### **Response:**

Far from cautioning against the use of a general rule that excludes treasury receipts, the Microsoft court recognized that a rule of general application was preferable to an *ad hoc* approach and invited the adoption of such an approach. The court stated:

In closing, we note the Court of Appeal's argument that policy reasons favor systematic exclusion of the return of capital from investment redemptions, rather than a requirement that the Board document distortions resulting from application of the standard formula on a case-by-case basis. Absent a global redefinition of gross receipts to exclude such returns, smaller distortions insufficient to trigger a reappraisal under section 25137 may slip through the cracks, resulting in underestimation of the tax owed California. This concern may well be valid. Recognizing this problem, numerous other state legislatures have amended their respective income apportionment statutes to expressly exclude investment returns of capital from the definition of gross receipts. Amicus curiae the Multistate Tax Commission has proposed model regulations to likewise exclude

investment returns of capital from gross receipts. The legislature is free to follow these leads.

This regulation is intended to provide the guidance suggested by the court.

The survey of cases performed by FTB indicates that the average fact pattern involving the treasury function is consistent with the facts of the cases already determined to be distortive by the Board or the courts. The regulation is therefore not inconsistent with the holding of the Microsoft court, but applies the holding to all taxpayers that are similarly situated, without the need to resort to costly and prolonged factual inquiries and potential litigation.

Even if the regulation were adopted, taxpayers would still be able to petition for the use of an alternative formula based on their specific facts. If a taxpayer can show by clear and convincing evidence that the application of the regulation results in a failure to fairly reflect their activities in the state, then an alternative methodology would be applied, as long as it is reasonable. The Board of Equalization held this to be the case in Appeal of Fluor, 95-SBE-016 (December 12, 1995). Therefore, the concerns expressed by the California Supreme Court in Microsoft can be addressed regardless of whether the regulation is adopted.

**Recommendation:**

No change to the regulation is necessary.

5. FTB staff's proposal is constitutionally suspect. The "throw out" approach in the proposal effectively spreads the income from a taxpayer's treasury function over the entirety of the sales factor instead of focusing the sales on where they actually took place. This results in under representation of the sales activity in the state where the treasury function took place and over representation for all other states. The staff's approach does not reasonably reflect the sense of how income is generated and is not fair apportionment.

**Response:**

Because the sales factor is part of the three factor formula that has been approved by the U.S. Supreme Court as resulting in fair apportionment, and because the sales factor will still include all sales of inventory, sales of services, or other types of income, and exclude only a narrow subset of receipts that have a very high potential to distort the formula, it is hard to imagine that the standards set forth by the U.S. Supreme Court could be met by a taxpayer challenging the constitutionality of this proposed regulation. Furthermore, it can be argued that the income from the treasury function is more reasonably apportioned by spreading it amongst the locations where the business generates and uses the working capital that is managed by the treasury. The throw out of the treasury receipts will accomplish this result by apportioning the treasury income based on the main line business of the taxpayer. The preeminent scholar in the field of

state taxation, Walter Hellerstein, has supported this rationale. In his treatise on state taxation, Professor Hellerstein states:

A similar analysis applies to the sales factor. Receipts from intangible property are no more geographically determinate than the property from which they are derived. As in the case of intangible property, however, there are conventions for attributing intangible receipts to a particular jurisdiction. With respect to such receipts, the jurisdiction of choice is typically the taxpayer's commercial domicile. However, as in the case of intangible property, this tends to produce arbitrary results, effectively assigning large amounts of intangible income to a single state, despite the plausible claims of other states to a share of such income based on the adoption of some other attribution rule. Accordingly, a rule that assigns intangible receipts on the basis of the factors derived from the taxpayer's other business activities may be the most appropriate way to deal with receipts from operationally connected intangible property.

There is an additional reason for employing a rule that assigns receipts from operationally connected intangible property on the basis of the factors derived from the taxpayer's other business activities. The assignment of receipts to a single state under the widely used commercial domicile rule may have a distorting effect beyond that which has already been identified. This is because there is no necessary correlation between the amount of receipts and the corresponding amount of income from certain types of intangible investments. For example, the purchase at a discount of a thirty-day \$1 million certificate of deposit at the beginning of each month and its sale or redemption at the end of the month would yield \$12 million in receipts during the course of a year whereas the purchase at a discount and subsequent sale or redemption of a one-year \$1 million certificate of deposit would yield only \$1 million. Yet the intangible interest income earned from these investments is likely to be quite similar and clearly will not vary by a factor of twelve.

State taxing authorities have viewed the effect of including the receipts in the apportionment formula (which generally increases the commercial domicile's apportionment percentage while reducing the apportionment percentage of other states in which the taxpayer does business) as distortive. They have sought to deal with the problem by including only the net income from temporary cash investments in the apportionment factors on the basis of the equitable apportionment provision of the corporate income tax statute. Litigation over this question has produced mixed results, and legislatures have sometimes intervened to address the problem. The adoption of a rule that assigns receipts from operationally connected intangible property on the basis of the factors derived from the taxpayer's other business activities rule for intangible receipts would largely eliminate the issue.

Hellerstein & Hellerstein: *State Taxation* (3<sup>rd</sup> Edition), Par. 9.15[3][a][ii].

By throwing out the receipts of the treasury function, the income of the treasury function is effectively assigned in the manner advocated by Professor Hellerstein. The income will be assigned based on the activities of the main line of business. This is a fair apportionment of the income and is therefore constitutional.

Currently, twenty-five states remove receipts like those generated from the treasury function from the calculation of the sales factor. There have been no reported cases successfully challenging these provisions on constitutional grounds. The concept of fair apportionment is embodied in the U.S. Supreme Court's use of the term "external consistency." The U.S. Supreme Court has described this requirement:

The second and more difficult requirement [of a fair apportionment formula] is what might be called external consistency—the factor or factors used must actually reflect a reasonable sense of how income is generated. We will strike down the application of an apportionment formula if the taxpayer can prove “by ‘clear and cogent evidence’ that the income attributed to the State is in fact ‘out of all appropriate proportions to the business transacted in that State’”.

Container Corp. of Am. v. Franchise Tax Bd. (1983) 463 US 159, 169–170, 103 S. Ct. 2933.

**Recommendation:**

No change to the regulation is necessary.

**Comments from Sutherland Asbill and Brennan LLP dated September 17, 2007**

These comments were provided on behalf of a group of companies: The Coca-Cola Company, Comcast Corporation, Ford Motor Company, Microsoft Corporation, Time Warner Inc., United Technologies Corporation, Verizon Communications and Viacom Inc. All of these companies are domiciled outside of California.

1. The FTB's proposal is inconsistent with the statutory definition of "gross receipts" as interpreted and thus improperly usurps both the judicial and legislative functions of government and thus is a violation of the separation of powers doctrine.

The FTB's proposed regulation contradicts multiple court decisions, including the California Supreme Court's recent, controlling decision in Microsoft v. Franchise Tax Board issued barely one year ago on August 17, 2006. (Microsoft Corp. v. Franchise Tax Board, 139 P.3d 1169 (Cal. 2006)). After reviewing the statutory language, legislative history, and agency interpretation behind Section 25120, the court stated,

"We conclude the full redemption price, like the full sales price, must be treated as gross receipts."

**Response:**

This comment fundamentally ignores the function of R&TC section 25137, which specifically allows the Franchise Tax Board to override the standard apportionment rules and apply an alternative apportionment formula in order to fairly represent the extent of the taxpayer's business activity in this state. Therefore, all regulations promulgated under this section are, by their very nature, inconsistent with the normal apportionment rules. This is not a fatal flaw; it is simply the application of the authority granted to the Franchise Tax Board in the statute.

The proposed regulation addresses a particular activity, the treasury function, and applies a different apportionment treatment to receipts that arise from this activity based on the evidence, as exhibited through numerous court decisions, that the receipts from the treasury function are inherently distortive. Contrary to the commentator's assertions, the court in Microsoft did not rule that the state lacked regulatory authority to address the issue. What the court stated was:

In closing, we note the Court of Appeal's argument that policy reasons favor systematic exclusion of the return of capital from investment redemptions, rather than a requirement that the Board document distortions resulting from application of the standard formula on a case-by-case basis. Absent a global redefinition of gross receipts to exclude such returns, smaller distortions insufficient to trigger a reappraisal under section 25137 may slip through the cracks, resulting in underestimation of the tax owed California. This concern may well be valid. Recognizing this problem, numerous other state legislatures have amended their respective income apportionment statutes to expressly exclude investment returns of capital from the definition of gross receipts. Amicus curiae the Multistate Tax Commission has proposed model regulations to likewise exclude investment returns of capital from gross receipts. The Legislature is free to follow these leads.

The argument that this language is an abuse of regulatory authority is incorrect. As evidence of this is the fact that other states have addressed this problem through regulations. For instance, Haw. Rev. Stat. § 235-38 is identical to R&TC section 25137 and Hawaii has promulgated a regulation to reduce treasury function receipts to net income.<sup>5</sup> Other states including Idaho<sup>6</sup>, New Mexico<sup>7</sup> and Utah<sup>8</sup> all provide for special treatment for treasury function receipts through the use of regulations promulgated

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<sup>5</sup> Haw. Admin. Rules 18-235-38-03(f).

<sup>6</sup> Idaho Admin. Rules 35.01.01.570.03.

<sup>7</sup> N.M. Admin. Code 3.5.19.11(A)(4).

<sup>8</sup> Utah Admin. Rules R865-6F-8(10)(c)(iv).

under similar statutory provisions. These regulations have not been overturned, despite similar, if not identical, definitions of "sales."

The use of R&TC section 25137 to remove receipts derived from a treasury function does not in any way negate the definition of sales in R&TC section 25120(e). If a taxpayer derives receipts from intangibles through an activity that is not a treasury function, the receipts will be included in the sales factor. The normal rules are still applicable.

A taxpayer may also petition to not have the proposed regulation apply to them, even if they have a treasury function, if the taxpayer can prove by clear and convincing evidence that the removal of the receipts results in a formula that does not fairly reflect the taxpayer's activities in California.

### **Recommendation:**

No change to the regulation is necessary.

2. The court in Microsoft may have ultimately found that inclusion of the gross proceeds rather than just the net proceeds resulted in distortion, but the court specifically admonished the FTB that this conclusion would be reached on a case-by-case basis and that the decision to include net rather than gross in other cases could itself create distortion. The court stated:

We caution, however, that in other cases the Board's approach may go too far in the opposite direction and fail the test of reasonableness. By mixing net receipts for a particular set of out-of-state transactions with gross receipts for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer's income and exaggerates the resulting California tax.

Not only has the FTB ignored the court's specific warning in proposing its amendment to the regulation, but the FTB actually compounds the problem the court warned against, by excluding the proceeds entirely rather than allowing just the net proceeds. The complete exclusion of such proceeds guarantees that the risk the court notes will occur in even more cases than the court feared.

### **Response:**

The use of throw out should not have a material effect on most taxpayers when compared to net inclusion because most taxpayers simply do not receive large amounts of income from the treasury function and its inclusion in the factor at net income is immaterial to the factor. That clearly was the case in Microsoft, where the receipts generated \$10.7 million of income and were added to a sales factor denominator of \$2.1 billion. (This would change the apportionment percentage by approximately 3 hundreds of 1%.)

This is also born out by the study of developed cases attached to this document, where the analysis yielded an average of 3% of income derived from the treasury function while the sales factor included all of the gross receipts (far greater than income) of the business. The court was concerned with situations where the income produced by the activity was more significant than its reflection in the factor, a fact pattern that is simply not the typical treasury function fact pattern.

**Recommendation:**

No change to the regulation is necessary.

3. The FTB has been unsuccessful in getting the statutory definition of gross receipts changed through the legislature. This failure underscores the fact that the legislature either deemed a change in the definition of "sales" or "gross receipts" not to be a priority or has signaled its actual disagreement with the FTB's proposal. The FTB's proposed amendment to its own regulation interpreting a statute that has not changed is therefore an attempt to legislate from the executive branch of government something that cannot be done.

**Response:**

The failure of the legislature to act on a matter is not evidence that a particular interpretation of the law has been rejected. The Board of Equalization addressed this issue in its holding in Appeal of Standard Oil Company of California (83-SBE-068):

Furthermore, as support for its position that section 25140 requires the allocation of dividends to California, respondent relies on the fact that in recent years the Legislature has considered and rejected bills which would have changed that result. In particular, respondent points to the failure of the Legislature to approve Senate Bill 1713 introduced March 8, 1976, as affirmative evidence of legislative agreement with its position on the treatment of dividends. We must reject respondent's unenacted legislation argument on the basis that such legislation has little if any evidentiary value in attempting to discern legislative intent. (Sacramento Newspaper Guild v. Sacramento County Bd. of Suprs., 263 Cal.App.2d 41, 58 [ 69 Cal.Rptr. 480 ] (1968). )

The reasoning of the Board is equally applicable to the commentator's argument.

Whether the Legislature votes to change the definition of gross receipts or not, the Franchise Tax Board has authority under R&TC section 25137 to address activities that are distortive. The authority for the proposed regulation is not R&TC section 25120 and thus no inference can be drawn from the activities of the Legislature regarding that section.

**Recommendation:**

No change to the regulation is necessary.

4. Administrative regulations are a common part of both federal and state taxing schemes. The role of interpretive administrative regulations is to explain and clarify statutory and judicial language in order to facilitate taxpayer understanding and compliance. Such agency guidance must conform to the language contained in the statutes themselves and in court opinions interpreting such statutes. The California Administrative Procedures Act provides that: "Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute." Cal. Gov't Code Section 11342.2. When administrative regulations create new law, change current law, or contradict current law, they cannot be and are not valid.

Unlike the FTB, the Microsoft court recognized its own limitations in any attempted revisions of the existing statutory rule. The court stated that "[i]n the absence of legislative action, however, we are not free judicially to amend the UDITPA to achieve this result [the exclusion of investment returns of capital from the definition of gross receipts]." 139 P3d at 1183. An administrative agency cannot do what the highest court of the state acknowledged it lacks authority to effectuate; yet, that is exactly what the FTB's proposal does. The FTB's proposal directly contradicts the California statute it purports to interpret, as well as binding court language. As such, were the FTB proposal to be enacted, it would most likely be invalidated upon judicial review.

**Response:**

The proposed amendments to regulation 25137 conform, and are consistent with, the statute that they are interpreting. The proposed amendments are consistent with the court and administrative decisions. The proposed regulation does not amend UDITPA to achieve the result of removal of treasury function receipts. Rather it utilizes the existing rules of UDITPA (R&TC section 25137) to remedy a distortion caused by one particular activity, the treasury function, and removes receipts from this activity, on the basis of distortion. R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation

The proposed regulation is not a global redefinition of the term "sales" contained in R&TC section 25120. Any returns of capital realized from an activity not meeting the definition of a treasury function will not be excluded by this regulation, and will be included in the sales factor at gross. Further, if a taxpayer can show that the removal of the receipts result in a formula which does not fairly represent its activities in the state, it can amend the formula.

Other states have utilized this approach. For instance, Haw. Rev. Stat. § 235-38 is identical to R&TC section 25137 and Hawaii has promulgated a regulation to reduce treasury function receipts to net income. Other states including Idaho, New Mexico and Utah all provide for special treatment for treasury function receipts through the use of regulations promulgated under similar statutory provisions. There is nothing improper about addressing this issue through a regulation.

### **Recommendation:**

No change to the regulation is necessary.

5. The proposed amendment to the regulation violates the federal Constitution. The FTB's proposed amendment violates the fair apportionment requirement of the Federal Constitution's Due Process and Commerce Clauses because under its proposal, income is included in the tax base without a representation of the source of the receipts generating that income in the formula used to apportion income to California to tax.

The United States Supreme Court has explained the standard for challenging the validity of an apportionment formula is that a taxpayer must show that "in any aspect of the evidence its income attributable to [the taxing state] was 'out of all appropriate proportion to the business' transacted in that State." Butler Brothers v. McColgan, 315 US 501, 507 (1942). The FTB's proposed universal exclusion of receipts from a particular type of activity (the treasury function) while including the income from this activity in the tax base creates gross distortion and is "out of all appropriate proportion to the business transacted" in California, because it systematically, and for all taxpayers, apportions income based on a sales factor completely unrelated to this income.

While the commentators acknowledge that the FTB need not follow a perfect apportionment formula that includes all possible issues involved in sourcing income from multistate activities; the FTB cannot constitutionally include certain types of income in the California tax base while excluding the receipts associated with this income from the apportionment formula merely because it does not like the result of including the receipts. The UDITPA standard apportionment formula does not require an exact (i.e., mathematically precise) result. In Moorman Manufacturing Co. v. Blair, 437 U.S. 267, 273 (1978), the United States Supreme Court said, "unlike separate accounting, [the formula method of computing taxable income] does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." Moorman, 437 U.S. at 273; see also Butler Brothers v. McColgan, 315 US 501, 506 (1942) (stating, "we read the statute as calling for a method of allocation which is 'fairly calculated' to assign to California that portion of net income 'reasonably attributable' to the business done there"). The formula, albeit imperfect, is designed to be a rough approximation of income apportionable to a state, based on factors related to how and when that income was earned. Moorman

Manufacturing, 437 U.S. at 271. Thus, while the FTB has flexibility in applying an apportionment formula that reaches a "reasonable approximation" of the income earned in the state, any such formula must be based on factors related to how the income was earned. A complete elimination of receipts from taxpayers' treasury functions from the sales factor by regulatory action does not achieve an apportionment formula that is based on factors related to how the income was earned. Instead, the result of the FTB's proposed amendment is that income from a taxpayer's treasury function will be apportioned based on receipts generated from completely different activities. This results in the gross distortion that the three-factor formula was designed to avoid.

### **Response:**

The commentator wishes to apply a constitutional analysis to invalidate the proposed regulation. That is not the standard provided by R&TC section 25137. The standard under R&TC section 25137 is fair representation of activities. The court in Microsoft rejected the use of constitutional standards in the determination of fair representation under R&TC section 25137. While it is true that constitutionality requires only a rough approximation, R&TC section 25137 does not address constitutionality alone. There are many situations where R&TC section 25137 has been utilized, such as special industry regulations, where the goal is not just constitutionality, but rather a better representation of the taxpayer's activities in the state.

While the commentator acknowledges that only "rough approximation" is necessary for constitutional purposes, the comment appears to be based on the belief that all activities that give rise to income subject to apportionment must be reflected in the apportionment formula in order for the formula to be constitutional. There is no such requirement. Many states have removed the very receipts addressed in this regulation and have done so for many years without ever being challenged. Some states have even gone so far as to remove the payroll and property factors entirely. The Supreme Court has expressly approved this as constitutional (Moorman Manufacturing). The three-factor formula more than meets the requirements of the court. As the court stated in Container, "payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." Because California utilizes the three-factor formula and because this formula reflects a reasonable approximation of the taxpayer's activities in the state, the formula is constitutional, with or without the inclusion of the treasury receipts addressed by the regulation.

### **Recommendation:**

No change to the regulation is necessary.

6. The proposed regulation violates administrative and agency practice rules. The FTB has never taken the position that it now seeks to assert in the proposed amendment to the regulation, in any of the reported cases, that proceeds from a treasury function should be completely excluded from the sales factor. Historically, the FTB's administrative practice has been to include proceeds from the sale of securities, prior to

any maturation or redemption date, at gross value and proceeds from the redemption of securities at net value (e.g., excluding the amount representing a return of capital) in calculating the sales factor.

The important point derived from the FTB's historic practice is that it has always included some part of the proceeds in the sales factor and has at least for some transactions acknowledged that "gross" is the rule. Oddly, the FTB claims in its "Initial Statement of Reasons for the Adoption" that the "regulation is a codification of existing Franchise Tax Board administrative policy," yet the FTB provides no support for this assertion and, as noted, this assertion is inconsistent with the litigation position that the FTB has taken in the cases decided to date. That the proposal has not, in fact, been the FTB's historic policy is further evidenced by the fact that the FTB seeks to impose the amended rule only on a prospective basis. The FTB cannot adopt a new administrative policy without a supporting change in the underlying statute or environmental circumstances. It certainly cannot adopt a new policy that effectuates an even greater deviation from the statute than its prior, now clearly invalid, policy.

Response:

The policy of the Franchise Tax Board, as far back as the Appeal of Pacific Telephone, 78-SBE-028 (May 4, 1978), has been that the inclusion of treasury function gross receipts is distortive and should be remedied through the use of R&TC section 25137. This is precisely what this regulation provides. The commentator is correct that the remedy to this distortion, advocated by the FTB in various litigation cases, was not the throw out of the receipts in issue but the inclusion of the net receipts (the income) when the instrument was held to maturity and the inclusion of gross receipts when it was sold prior to maturity. However, the concerns in litigation are different from those in the regulatory process. For instance, uniformity is more of an issue in the regulatory process, and, as pointed out in earlier responses, many states exclude these receipts in their entirety.

The Microsoft court recognized this issue:

A salutary effect of the conclusion that section 25137 applies here is that it achieves uniformity, a central goal of the UDITPA. (See Hoechst, supra, 25 Cal.4th at p. 526; 5 25 138 [UDITPA "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it"]; Keesling & Warren, *California's. Uniform Division of Income for Tax Purposes Act, Part I* (1 968) 15 UCLA L.Rev. 156, 156.) While there is a nationwide split over whether the return of investment capital is included in gross receipts, those states that do include it and have addressed the further application of UDITPA's relief provision uniformly allow use of that provision to ameliorate resulting distortions.

Also, concerns regarding administrability are part of the regulatory process and comments have been received that the throw out is easier to comply with than a net

inclusion requirement. Finally, the throw out does not have a material effect on most taxpayers when compared to net inclusion because most taxpayers simply do not receive large amounts of income from the treasury function and its inclusion in the factor at net income is immaterial to the factor. That clearly was the case in Microsoft, where the receipts generated \$10.7 million and were added to a sales factor denominator of \$2.1 billion. This is also borne out by the study of developed cases attached to this document, where the analysis yielded an average of 3% of income derived from the treasury function while the sales factor includes all of the gross receipts (far greater than income) of the business. In any event, FTB is not constrained by prior litigating positions in the adoption of a regulation.

### **Recommendation:**

No change to the regulation is necessary.

7. The FTB's proposal will neither increase certainty in the calculation of the California Franchise Tax, nor end litigation regarding how to account for receipts from a taxpayer's treasury function. It will potentially increase litigation because the proposal violates so many fundamental constitutional restraints on the state's power to tax interstate income as well as principles of regulatory agency authority. The FTB asserts that one of the reasons for its proposal is that taxpayers want the FTB to increase certainty and reduce litigation. In the FTB's statement of "Potential cost impact on private persons or businesses affected," the FTB notes that "[a]t interested parties meetings held by the Franchise Tax Board staff, comments were made that a failure to regulate would require businesses to address the question of whether the standard formula results in a fair reflection of income on a case-by-case basis every year, and that this would give rise to substantial additional compliance costs for taxpayers. As a result of this comment, the Franchise Tax Board believes that this regulation will reduce this compliance burden by providing further certainty to taxpayers." The undersigned agree that the rule articulated in Microsoft does require a case-by-case analysis. However, circumstances are not as dire as the FTB asserts. Unless the taxpayer's type, volume, and margins relative to its principal business and its treasury function vary drastically from year to year (surely not a typical situation), taxpayers will generally not have to perform such an analysis except when there is a significant change in the business (such as an acquisition).

Microsoft and its progeny have also provided specific qualitative and quantitative factors for determining the existence of distortion for purposes of calculating the receipts from a taxpayer's treasury function included in the sales factor. These factors include (a) the qualitative connection between the taxpayer's principal business and the treasury function activities; (b) the quantitative difference between the margins on the taxpayer's principal business and its treasury function; (c) the quantitative difference between the apportionment percentage when the gross proceeds from the treasury function are included and the alternative proposed; (d) the quantitative difference between the taxpayer's treasury margin and non-treasury margin; and (e) the overall qualitative difference between applying the UDITPA formula including and excluding redemptions in the sales factor. While the undersigned do not propose that these factors are

dispositive or exclusive of other considerations, this judicial guidance may be sufficient in many cases to provide both taxpayers and the FTB with the appropriate analysis to reach the correct conclusion.

When, as here, California statutes and court decisions such as Microsoft are in direct conflict with proposed administrative regulations, taxpayers will likely comply with statutory and judicial law, rather than what are most likely invalid regulations, when it is to the taxpayer's benefit. Finally, regardless of the regulations promulgated by the FTB, taxpayers may always file under an alternative apportionment method if the standard method creates distortion and the taxpayer's alternative is reasonable. To the extent that the proposed amendment completely excludes the source of certain types of taxable income, many taxpayers will find using an alternative calculation necessary and will end up back in litigation with the FTB over the exact same issues, albeit approached from a different angle. Adopting the amendment that is contrary to existing law and that persistently ignores the source of income included in the tax base will naturally result in increased litigation and costs for the FTB as well as taxpayers.

**Response:**

During the regulatory process input has been received that it is necessary to address this situation. A commentator at the regulatory hearing, representing a coalition of companies in favor of the regulation, stated:

We think it's necessary to bring clarity and some certainty to an area that's been fraught with some confusion since the Microsoft and General Motors cases came down from the Supreme Court. We do think that establishing a clear baseline rule, with still some recognition in there that there may be deviations necessary, is the appropriate way to go. We do believe that this rule fits well within the authority of the Franchise Tax Board Section 25137, to promulgate regulations of this kind where appropriate. And we also recognize that the general construct of the rule is the same as in many other states. So there is a conformity aspect of it, too, that we endorse and salute.

The FTB agrees that clarity is needed in this area, as the repeated litigation makes clear. The commentator also agrees that the current law requires a case-by-case analysis but does not believe that this is a burden for taxpayers or the State. The commentator states:

The undersigned agree that the rule articulated in Microsoft does require a case-by-case analysis. However, circumstances are not as dire as the FTB asserts. Unless the taxpayer's type, volume, and margins relative to its principal business and its treasury function vary drastically from year to year (surely not a typical situation), taxpayers will generally not have to perform such an analysis except when there is a significant change in the business (such as an acquisition).

The commentator understates the potential complexity of the inquiry. Under the existing court analysis, the FTB, or the taxpayer, must determine, each year, whether the application of R&TC section 25137 to remove the receipts in issue is proper. There is no bright line standard; the courts and the Board have found distortion in cases with dissimilar fact patterns. Therefore, a taxpayer may not be able to apply, with any certainty, the court's analysis to its facts and make this determination. They can certainly stake out a litigating position, but this is what the regulation is trying to avoid.

In addition, the amount of treasury function receipts is, by and large, under the control of the taxpayer itself. Changes in investment strategies can change the amount of receipts with little effect on income. This is strong support for a general rule excluding these receipts. The California Supreme Court recognized this and stated:

Moreover, as the Board correctly notes, declining to apply UDITPA's relief provision to this type of situation would create a significant loophole exploitable through subtle changes in investment strategy. By shifting investments to shorter and shorter maturities, a unitary group could reduce its state tax liability to near zero, particularly if it placed its treasury department in a state that statutorily excluded the return of investment capital from gross receipts.

This same problem could also be a trap for unwary. By choosing longer-term investments a taxpayer may determine that its receipts are not excludable under the court cases and, if the treasury is in California, end up with a larger tax liability than what they would have paid if they had churned the investments more often.

Letting the status quo continue is untenable. Absent this regulatory action there will be continued litigation, each case being slightly different from the last, with the FTB and taxpayers continuing to argue over slight distinctions in the facts. Because the FTB believes that the vast majority of these cases will eventually conclude that the application of R&TC section 25137 is valid, as has been borne out in all of the cases decided to date, a regulation that changes the rule to throw out is justified.

### **Recommendation:**

No change to the regulation is necessary.

8. The proposed regulation leads to additional non-uniformity among the states that have adopted UDITPA and, thus, is contrary to the purposes of the Act. The relatively widespread adoption of UDITPA by states was effectuated in order to avoid the federal government stepping in and enforcing uniformity on state corporate income tax laws. As noted by California's highest court [in Microsoft]:

The Uniform Division of Income for Tax Purposes Act (UDITPA) attempts to address these problems (the difficulties when autonomous jurisdictions

each try to tax a portion of the same pie) and fairly assess corporate taxes. Adopted by the District of Columbia and 22 states, including California, it seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme - equitable to each jurisdiction, seeking its own fair share, and equitable to the taxpayer, who in the absence of uniform rules faces the prospect of having the same income taxed by two, three, or more different states.

The FTB's proposed amendment to its apportionment regulation not only destroys this uniformity but will actually result in double taxation of taxpayers subject to tax in both California and in other states that incorporate UDITPA, but follow the standard rule that the term "gross receipts" means gross unless the state tax authority proves that unique facts of a specific taxpayer result in distortion.

**Response:**

The commentator's concerns are not supported by the facts. The majority of states, including most of the home states of the very companies represented by the commentator, exclude these receipts in one way or another.

The California Supreme Court in Microsoft stated that the application of R&TC section 25137 *supported* uniformity:

A salutary effect of the conclusion that section 25137 applies here is that it achieves uniformity, a central goal of the UDITPA. (See Hoechst, supra, 25 Cal.4th at p. 526; § 25138 [UDITPA "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it"]; Keesling & Warren, California's Uniform Division of Income for Tax Purposes Act, Part I (1968) 15 UCLA L.Rev. 156, 156.) While there is a nationwide split over whether the return of investment capital is included in gross receipts, those states that do include it and have addressed the further application of UDITPA's relief provision uniformly allow use of that provision to ameliorate resulting distortions.

Because the regulation brings California into line with most other states, the regulation does not raise significant issues of uniformity.

While it is true that if a state included treasury gross receipts in its sales factor there would be a lack of uniformity, and it is technically possible there would be double taxation, the truth is there would much more likely be under taxation. In that circumstance including treasury gross receipts in the California sales factor for non-domiciliaries when the state of domicile does not include such receipts would result in less than all income being apportioned.

**Recommendation:**

No change to the regulation is necessary.

9. The proposed regulation improperly shifts the burden of proof. The California Supreme Court has placed the burden of proof appropriately on the FTB, because it is the FTB that is arguing for a different calculation of the sales factor. Notwithstanding the clear articulation of which party bears the burden, the FTB hereby attempts to alter the standard statutory apportionment formula by regulation and to shift the burden of proof for deviation from itself to taxpayers. The FTB is essentially arguing that it can unilaterally change the standard statutory apportionment formula through a regulation, rather than meeting its heightened burden of proof for deviation from the standard formula on a case-by-case basis. The FTB does not have such authority.

Which party bears this burden of proof is a legal question and cannot be shifted by agency action. The FTB's proposed amendment to the regulation improperly shifts the burden of proof to the taxpayer by requiring the taxpayer to show that (1) the approximation provided by the FTB's alternative formula does not fairly represent the taxpayer's in-state activity, and (2) application of the standard UDITPA sales factor approach (or some other alternative approach proposed by the taxpayer in question) is reasonable. It is not for the FTB to define what the standard formula is -- this has been legislated and subsequently clarified by the California courts. Therefore, if the FTB wants to impose an alternative apportionment rule, such as complete exclusion of receipts from the treasury function, the FTB is the party that bears the burden of proof, which can be met only through submission of clear and convincing evidence. The proposed amendment to the regulation ignores these fundamental requirements. A regulation that ignores, and is contrary to, the law is invalid from the start.

**Response:**

The process through which a regulation is adopted affords the Franchise Tax Board, as well as interested parties, the opportunity to discuss the area that would be addressed by the potential regulation. Through the interaction of the parties and the development of the rulemaking record, there is a history that is developed which is utilized by the Office of Administrative Law (OAL) to determine if the regulation meets the requirements of the Administrative Procedures Act. The OAL must determine that the regulation meets the standard of necessity set forth in Government Code. Government Code section 11349, which defines necessity in subdivision (a) as follows:

(a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

Therefore, the adoption of a regulation requires the Franchise Tax Board to meet a standard of substantial evidence in order for the regulation to be adopted. Once this

standard is met, and the regulation is adopted, it is not unreasonable to shift the burden for overcoming the regulation to the party who wishes to make such an argument.

The Board of Equalization recognized this approach as reasonable and proper in Appeal of Fluor, 95-SBE-016 (December 12, 1995):

In other words, once found to be applicable to the particular situation, the section 25137 regulations will control. On the other hand, we also recognize that regardless of how much expertise the FTB may have in a particular industry, regardless of how much time and effort has been expended in developing a regulation, and regardless of the degree of cooperation with industry representatives in that process, it will be inevitable that some situation will arise where use of a special formula under the section 25137 regulations will not be appropriate and a party may wish to object to the use of the special formula. (See e.g., Appeal of Danny Thomas Productions, Cal. St. Bd. of Equal., Feb. 3, 1977.) Therefore, we also hold that *any* party wishing to deviate from the method prescribed by the regulation, when found to be applicable, must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state.

R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation. Once a regulation is adopted under this type of authority, it is not unusual for such regulations to receive higher deference from the courts.

### **Recommendation:**

No change to the regulation is necessary.

### **Comment from Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP dated September 17, 2007**

This comment is a comment in support of the regulation by Business for Economic Growth in California (BEGC), a coalition of major California-based companies: Applied Materials, Cisco Systems, Health Net, Intel Corporation, Walt Disney Company and Chevron. The comment provides a detailed analysis of the various requirements under the APA that a regulation must meet in order to be valid. The commentator sets forth that the Office of Administrative Law ("OAL") reviews regulations for compliance with six standards: Authority, Reference, Consistency, Clarity, Non-duplication, and Necessity. The commentator concludes that the proposed regulation meets all of the standards and should be approved by the OAL.

#### 1. Authority and Reference.

The "authority" for a regulation is the provision of law that permits the agency to adopt a regulation, and "reference" is the provision of law that the agency implements, interprets, or makes specific by adopting the regulation. Gov. Code sections 11349(b), 11349(e).

In this case, Rev. & Tax. Code section 19503 authorizes the proposed regulation, providing, in relevant part, that the FTB "shall prescribe all rules and regulations necessary for the enforcement of [the income and franchise tax laws]." The provision of law which the FTB is implementing and interpreting is Rev. & Tax. Code section 25137, which states in part:

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 Franchise Tax Board may require . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In promulgating the proposed regulation, the FTB is properly exercising its mandate to interpret and apply section 25137 through regulations, as it has done at least fourteen times before. The regulations previously promulgated by the FTB under Rev. & Tax. Code section 25137 include both industry-specific regulations, such as those applicable to the banking (Cal. Code Regs. tit. 18, § 25137-4.2) and motion picture industries (Cal. Code Regs. tit. 18, § 25137-8), and also generally applicable regulations, such as Cal. Code Regs. tit. 18, § 25137(c)(1)(A), which requires occasional sales producing substantial amounts of gross receipts to be thrown out of the sales factor. The proposed regulation falls into this latter category and, indeed, is closely akin to the aforementioned throw-out rule.

### **Response:**

The authority to regulate in the area of apportionment has been used by the FTB on more than a dozen occasions over the years. There has never been a successful challenge to the promulgation of regulations under R&TC section 25137 based on a lack of authority to regulate. R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation

### 2. Consistency.

A regulation satisfies the "consistency" requirement if it is in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law. Gov. Code section 11349(d). As explained below, the proposed regulation is fully consistent with all relevant provisions of law, including particularly Rev. & Tax. Code sections 25120 and 25137, and the California Supreme Court's decision in Microsoft

Corp. v. Franchise Tax Board, (2006) 39 Cal.4th 750.

Rev. & Tax. Code section 25120 defines the term "sales" that are required to be included in a taxpayer's sales factor as "all gross receipts," and in Microsoft, the court held that in the context of a taxpayer's treasury function, gross receipts means all proceeds from treasury function transactions, not simply the net amount or profit. However, the court went on to hold that inclusion of gross receipts from Microsoft's treasury function was distortive, and further approved the remedy the FTB had selected under Rev. & Tax. Code section 25137 to cure that distortion.

Although technically the Microsoft court had before it only the facts in that case and not a regulation under section 25137, the court's finding and analysis are quite general, referring to "the problem" and "this type of situation." For example:

The SBE and these sister-state courts implicitly recognize that the problem arising from inclusion of the full sale or redemption price of a short-term security is not that the full price is not gross receipts. Rather, the problem is one of scale: short-term securities investments involve margins (i.e., differences between cost and sale price) that may be several orders of magnitude different than those for other commodities. When a short-term marketable security is sold or redeemed, the margin will often be, in absolute terms, quite small (though of course the annualized returns may well be perfectly respectable).

The court continued:

Declining to apply UDITPA's relief provision to this type of situation would create a significant loophole exploitable through subtle changes in investment strategy. By shifting investments to shorter and shorter maturities, a unitary group could reduce its state tax liability to near zero, particularly if it placed its treasury department in a state that statutorily excluded the return of investment capital from gross receipts.

The court went on to explain how "Microsoft's treasury activities provide[d] a perfect illustration" of this phenomenon. However, in stating it would be a "rare instance" when inclusion of treasury function gross receipts was NOT distortive, the court undoubtedly viewed its ultimate conclusion as applying to nearly every corporate taxpayer.

The Microsoft court's findings that including gross proceeds from treasury function transactions is distortive in nearly every case are corroborated by the FTB's long history of applying section 25137 to treasury function receipts on the basis of case specific evidence of distortion. We also understand that as part of this regulatory process the FTB has conducted additional distortion analyses of specific taxpayers' data, and has consistently found that the inclusion of gross proceeds from treasury function activities would be distortive. And, last but not least, the members of BEGC can each confirm that including gross receipts in their sales factors is distortive.

Some commentators claim that the proposed regulation conflicts with California law because section 25120 requires inclusion of gross receipts in the sales factor. However, such a view reflects a misunderstanding of the role of section 25137. Of course, any regulation promulgated under section 25137 is going to reflect a deviation from some other provision of the standard apportionment formula (i.e., UDITPA). The relevant question is whether the particular deviation proposed by the FTB is supported by sufficient evidence that the standard apportionment rule produces distortion, in which case it is a proper application of section 25137 by the FTB. The evidence here confirms that the proposed regulation is such a proper exercise by the FTB.

Finally, the Microsoft court actually invited the FTB to correct the apportionment problem created by corporate treasury functions by promulgating a section 25137 regulation. After explaining that it did not have the authority itself to pronounce a blanket rule to address distortion caused by including the gross receipts from treasury function transactions in the sales factor, the court acknowledged and implicitly blessed not only a statutory amendment, but also a regulatory solution ("Amicus curiae, the Multistate Tax Commission, has proposed model regulations to likewise exclude investment returns of capital from gross receipts.")

**Response:**

The proposed regulation is consistent with prior case law reaching back over thirty years. The remedy to the distortion, that has been acknowledged to exist in all of the various cases, has been modified to obtain consistency with the laws of other states and to provide clarity in application. The input of the BECG that its members would be able to remove these receipts utilizing a distortion analysis is further support for the regulation and is consistent with the FTB's belief that the vast majority of taxpayers are similarly situated.

The fact that the regulation is in conflict with the normal apportionment rule of R&TC section 25120 is of no significance because R&TC section 25137 is specifically designed to allow variations from this section when the standard formula does not fairly reflect the activities of the taxpayer in the state. The arguments made by the commentator are fully consistent with the FTB's view of the issue.

3. Clarity.

Because the proposed regulation is succinct, and readily comprehensible, it satisfies the clarity requirement for promulgating a regulation.

**Response:** No response is required.

4. Non-Duplication.

"Non-duplication" means that a regulation does not serve the same purpose as a state or federal statute or another regulation. Gov. Code section 11349(f). Currently no other regulation, federal or state, already prescribes the rule of the proposed regulation. Therefore, the non-duplication requirement also is satisfied.

**Response:** No response is required.

#### 5. Necessity.

In the absence of the regulation, the party seeking to exclude such gross receipts from the taxpayer's sales factor bears the burden to prove by clear and convincing evidence that distortion exists. In any given case, such an exercise can be extremely expensive and time consuming. However, the burden is multiplied many times because, as explained above, the record in this regulatory proceeding demonstrates that, in the overwhelming preponderance of cases, including gross receipts from a taxpayer's treasury function will be distortive. Requiring case-by-case proof would be extremely inefficient for taxpayers and the FTB alike, and is unnecessary. The proposed regulation is appropriate and advisable in order to avoid these extraordinary costs for taxpayers and the State of California.

The proposed regulation is also necessary to eliminate the opportunity for multistate taxpayers to avoid tax obligations by locating their treasury function out of state, artificially inflating their sales factor. For all of these reasons, the proposed regulation satisfies not only the necessity requirement of the APA but also, collectively, all of the requirements set forth in Gov. Code section 11349, and the proposed regulation should be approved by the OAL.

**Response:**

The commentator is correct that the regulation is necessary as it will provide all taxpayers with a settled rule to apply the decisions of the courts. Rather than having to request relief from the standard formula on a case-by-case basis, taxpayers may utilize the provision of the regulation to remedy the distortion caused by the requirement, under the standard formula, that treasury function receipts be included in the sales factor. The calculation of gross receipts and the arguments necessary to litigate these cases in court are both time consuming endeavors that are unnecessary for the majority of taxpayers. The regulation simply removes these receipts and brings clarity to the area.

The California Supreme Court acknowledged the need for such a rule in its Microsoft opinion and cautioned about the planning possibilities cited by the commentator. The court went as far as inviting a solution to the problem on a global basis rather than continuing on case-by-case. This regulation is necessary to provide all taxpayers with a treasury function the R&TC section 25137 alternative granted to the FTB in Microsoft.

**Comment from Ajalat, Polley, Ayooob & Matarese dated August 16, 2007 on behalf of its client, General Motors**

1. The proposed regulation illegally increases taxes on companies with out-of-state treasuries. For past years, the FTB has included gross receipts from sales of securities (in addition to net receipts from redemptions and other treasury transactions) in the gross receipts factor. In litigation, the FTB conceded that gross receipts from sales of treasury securities must be included as gross receipts in General Motors and other cases and that Section 25137 did not apply to adjust those receipts. In addition, in Microsoft, the California Supreme Court held that in most cases, including either gross receipts or net receipts in the gross receipts factor, does not work. Rather, after stating that mixing only out-of-state treasury net receipts with all other out-of-state gross receipts exaggerates the California tax, the court held that an amount between net and gross receipts should be included:

Consider two sales: a sale for \$10 that yields \$1 in income in state X, and a sale for \$10,000 that yields \$1 of income in state Y. If one includes gross receipts from both sales, one concludes that state Y's contribution to sales is 1,000 times greater than state X's. On the other hand, if one corrects for this by only the net receipts from the second sale - the \$1 - one concludes that state X's contribution to sales is 10 times greater than state Y's contribution. The truth doubtless lies somewhere in between.

The proposed FTB staff regulation ignores the FTB's long-time practices as well as the California Supreme Court's ruling in Microsoft.

**Response:**

The commentator misstates the holding of the Microsoft court and misunderstands the function of R&TC section 25137. The Microsoft court did not hold that the "truth doubtless lies somewhere in between." The court held that removal of the receipts from the treasury department was proper and affirmed the FTB's inclusion of only the net income as a reasonable alternative formula. The quotation cited by the commentator is from a hypothetical posed in a footnote and does not reflect the holding of the court.

The position taken in the regulation is not inconsistent with past FTB policy regarding the distortive effect of the inclusion of gross proceeds from the treasury function. The policy of the Franchise Tax Board, as far back as the Appeal of Pacific Telephone in 1978, has been that the inclusion of treasury function gross receipts is distortive and should be remedied through the use of R&TC section 25137. This is precisely what this regulation provides.

While it is true that the remedy to this distortion, advocated by the FTB in various litigation cases, was not the throw out of the receipts in issue but the inclusion of the net receipts (the income), this is reflective of the different concerns raised in the regulatory environment and not an inconsistency in the basic position. For instance, uniformity is more of an issue in the regulatory process, and, as pointed out in earlier responses,

many states exclude these receipts in their entirety. The Microsoft court recognized this issue:

A salutary effect of the conclusion that section 25137 applies here is that it achieves uniformity, a central goal of the UDITPA. (See Hoechst, supra, 25 Cal.4th at p. 526; 5 25 138 [UDITPA "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it"]; Keesling & Warren, *California's. Uniform Division of Income for Tax Purposes Act, Part I* (1 968) 15 UCLA L.Rev. 156, 156.) While there is a nationwide split over whether the return of investment capital is included in gross receipts, those states that do include it and have addressed the further application of UDITPA's relief provision uniformly allow use of that provision to ameliorate resulting distortions.

The throw out does not have a material effect on most taxpayers when compared to net inclusion because most taxpayers simply do not receive large amounts of income from the treasury function and its inclusion in the factor at net income is immaterial to the factor. That clearly was the case in Microsoft, where the receipts generated \$10.7 million and were added to a sales factor denominator of \$2.1 billion. The addition of \$11 million dollars to the denominator of \$2 billion dollars will have an immaterial effect on the apportionment percentage. This is also borne out by the study of developed cases attached to this document, where the analysis yielded an average of 3% of income being derived from the treasury function while the sales factor included all of the gross receipts (far greater than income) of the business. In any event, FTB is not constrained by prior litigating positions in the adoption of a regulation.

Also, concerns regarding administrability are part of the regulatory process and comments have been received that the throw out is easier to comply with than the net inclusion.

### **Recommendation:**

No change to the regulation is necessary.

2. The proposed regulation is a changed methodology under California Constitution Article XIII A which increases taxes from the FTB's previous methodology of including gross receipts from sales of treasury securities in the sales factor. In addition, instead of following the direction of the Microsoft court and attempting to determine an amount of receipts to include between gross and net (the only legal solution), the proposed regulation excludes all receipts (both gross and net). The proposed regulation's solution certainly does not "lie somewhere in between."

Because, for past years, the FTB has included gross receipts from sales of treasury securities and net receipts from other treasury transactions and because the Supreme Court held that the "truth doubtless lies somewhere in between" gross and net receipts,

the proposed regulation, if legal (which it is not), would increase taxes on all large taxpayers with out-of-state treasury departments and would be a net tax increase.

A regulation cannot increase taxes because a tax increase, by definition, is a change in the law. Only the legislature, not an administrative body like the FTB, can change the law. As the California Supreme Court said in Ontario Community Foundation, Inc. v State Bd. of Equalization (1984) 35 Cal. 3d 811:

"Administrative regulations that violate acts of the Legislature are void and no protestations that they are merely an exercise of administrative discretion can sanctify them.' . . . *Administrative regulations that alter or amend the statute or enlarge or impair its scope are void and courts not only may, but it is their obligation to [;] strike down such regulations.*' (Id, at 748)" (Woods v. Superior Court (1981) 28 Cal. 3d 668,679 italics added.)" Ontario at 81 6-7 (emphasis by the court).

Moreover, excluding all security receipts is an undeniable tax increase as taxpayers have included net receipts or something more than net receipts in the sales factor for several decades. The California Constitution clearly prohibits the FTB by regulation imposing a tax increase:

Section 3. From and after the effective date of this article, any changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto. Whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature." California Constitution Article XIII A, Section 3.

Importantly, as pointed out in the example, merely changing the proposed regulation to include net receipts instead of no receipts does not change the analysis. Such a regulation would still be a tax increase as current law requires the inclusion of something more than net receipts, except in limited circumstances similar to those in Microsoft (see Microsoft: "the truth doubtless lies somewhere in between").

### **Response:**

The commentator's claim that the regulation will result in an illegal tax increase is incorrect. The commentator's position is based on their reasoning that "[a] regulation cannot increase taxes because a tax increase, by definition, is a change in the law. Only the legislature, not an administrative body like the FTB, can change the law." This then leads the commentator to the conclusion that, because the regulation will increase some taxpayer's tax liabilities over what they believed that they owed under their preexisting view of FTB's practices and the law, the regulation must be an illegal change in law.

This reasoning is flawed because it is based on the assumption that taxpayers have a vested interest in their current interpretations of FTB's practices, as well as in their interpretation of the law itself. The commentator cites no support for this assumption. Instead, this assumption is taken to be true, and the rest of the argument flows from it. Even if one were to entertain this notion, it begs the question of whether the commentator's interpretation of the law and existing FTB practices is correct, which it is not. The FTB has not been allowing all out-of state taxpayers to include the gross receipts from treasury functions in their sales factors. There have been numerous litigation cases on this very issue, with the FTB prevailing on distortion grounds in all of them.

The regulation is not a change in law, or new law, rather it is an application of existing statutory authority granted by the Legislature to the FTB. R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation. The regulation is therefore not a change in law at all and is not subject to the constitutional two-thirds of the legislature, voting requirement.

#### **Recommendation:**

No change to the regulation is necessary.

3. The proposed regulation is unconstitutional. By excluding from the apportionment factor all receipts from treasury department security transactions, the FTB seeks to tax the income of out-of-state treasuries without giving the treasuries any representation in the gross receipts factor. Using only operational apportionment factors and applying them to "huge quantities of investment income that have no special connection with the taxpayers in the taxing State" is "clearly...improper." Mobil v Commissioner (1980) 445 U.S. 425, 46 1 (J. Stevens, whose opinion in Mobil was cited with approval by the majority in Container v. Franchise Tax Board (1983) 463 US. 159, 169.) Such taxation without factor representation is unconstitutional as California is attempting to tax income earned outside its borders. As the California Supreme Court said, mixing little or no treasury receipts with gross receipts from all other transactions "exaggerates the resulting [California] tax." Microsoft, at 771.

Further yet, favoring taxpayers with in-state treasuries, as the proposed regulation clearly does, indisputably constitutes discrimination in favor of such taxpayers in violation of the Commerce Clause under classic Commerce Clause doctrine.

#### **Response:**

The commentator wishes to apply a constitutional analysis to invalidate the proposed regulation. This is based on the belief that all activities that give rise to income subject to apportionment must be reflected in the apportionment formula. There is no such

requirement. Many states have removed the very receipts addressed in this regulation from the sales factor and have done so for many years without ever being challenged.<sup>9</sup> Some states have even gone so far as to remove the payroll and property factors entirely. The United States Supreme Court has expressly approved this as constitutional (Moorman Manufacturing). The three-factor formula, which in the case of the treasury function will still include values in the payroll factor even after the proposed regulation is promulgated, more than meets the requirements of the court. As the court stated in Container, “payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated.”

In addition, the commentator's quote from Mobil is incomplete and leaves out the text of Justice Stevens' dissent that is most germane to this discussion. The full quote is as follows:

*We may assume that there are cases in which it would be appropriate to regard modest amounts of investment income as an incidental part of a company's overall operations and to allocate it between the taxing State and other jurisdictions on the basis of the same factors as are used to allocate operating income. But this is not such a case. Mobil's investment income is far greater than its operating income. Clearly, it is improper simply to lump huge quantities of investment income that have no special connection with the taxpayer's operations in the taxing State into the tax base and to apportion it on the basis of factors that are used to allocate operating income. The court does not reject this reasoning; rather, its opinion at least partly disclaims reliance on any such theory.*

(emphasis added)

The treasury function is normally a function that fits into the first category discussed by Justice Stevens. It produces little income and is an incidental part of the companies' overall operations. The hearing officer's study of preexisting cases supports this determination (3% of the income on average and not the main line of business). Justice Stevens finds that is appropriate in such cases to apportion this income on the basis of the same factors used to allocate operating income. This is precisely what this regulation provides.

#### **Recommendation:**

No change to the regulation is necessary.

4. The tax losses due to the exemption of in-state treasuries results in a tax windfall for select companies. Under past FTB practice, direct sales of treasury securities were included as gross receipts and under current law, as explained in Microsoft, taxpayers with California treasuries would include a certain amount of treasury gross receipts in both the numerator and denominator of the gross receipts factor. By including no such

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<sup>9</sup> The Microsoft Court listed many of these provisions in footnote 24 of the decision.

receipts or only net receipts generates a revenue loss in perhaps the hundreds of millions of dollars from these taxpayers, while imposing an even greater tax increase on out-of-state taxpayers. Exemption of the in-state treasuries is a legislative function.

**Response:**

Whether a taxpayer has a treasury located in California or outside of California does not change the rule proposed in this regulation. The rule is predicated upon the inclusion of the treasury function leading to a lack of fair representation in the apportionment formula, regardless of where it is located. The regulation is a codification of existing case law and under existing case law, taxpayers who are in-state could bring a petition to exclude these receipts utilizing the same arguments that FTB has used to exclude these amounts for out-of-state taxpayers. Therefore there is no revenue loss, just a proper application of existing authority. Out-of-state companies would be free to apply the same existing authority, if they so choose, such as in a loss year where a larger apportionment percentage would be advantageous. Rather than continue a case-by-case analysis approach, the regulation makes the existing case law the normal rule and taxpayers who wish to deviate from this rule may do so if they can show a fair reflection problem due to these rules.

**Recommendation:**

No change to the regulation is necessary.

5. Microsoft makes clear that as to treasury security gross receipts, the burden of proof is on the FTB. The FTB does not have authority, after Microsoft, to shift the burden of proof to the taxpayer. Under section 25137, Microsoft makes clear that the FTB has the burden to prove by clear and convincing evidence, on a case-by-case basis, that the standard apportionment formula, with all of its idiosyncrasies, does not fairly reflect the taxpayer's business activities in California and the burden to prove by clear and convincing evidence that an alternative formula -- on a case-by-case basis -- fairly reflects the taxpayer's business activities in California.

It may or may not be in cases where the California Supreme Court has not interpreted the application of section 25137 to a certain area, that the FTB can change the burden of proof. Without statutory authority, however, in an area where the State's highest court has held the burden under existing law is on the party attacking the statutory formula, such as the gross receipts issue, the FTB, by the proposed regulation, cannot shift the burden of proof under the existing statute.

**Response:**

The commentator misstates the burdens imposed on FTB in the Microsoft opinion. The holding of the court was that, as the party invoking R&TC section 25137, FTB had the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is

reasonable. It is incorrect to state that the court held that FTB had the "burden to prove by clear and convincing evidence that an alternative formula -- on a case-by-case basis -- fairly reflects the taxpayer's business activities in California." The court only required that the evidence support that the alternative formula was reasonable. The court's analysis was as follows:

Because the net receipts are so small in comparison with Microsoft's nontreasury income and receipts, the inclusion of net receipts here is reasonable. If the Board's proposal is reasonable, we are not empowered to substitute our own formula. (See Rev. & Tax. Code § 25137; McDonnell Douglas Corp. v. Franchise Tax Board (1968) 69 Cal.2d 506, 514-515.)

The commentator's view of the burdens imposed by the court is overly strenuous and incorrect. Further, the regulatory process does not impose the same standards that a court would impose in reaching a case-by-case determination.

The process through which a regulation is adopted affords the Franchise Tax Board, as well as interested parties, the opportunity to discuss the area that would be addressed by the potential regulation and to provide evidence. Through the interaction of the parties and the development of the regulatory record, there is a history that is developed which is utilized by the Office of Administrative Law (OAL) to determine if the regulation meets the requirements of the Administrative Procedures Act. The OAL must determine that the regulation meets the standard of necessity set forth in the Government Code. Government Code section 11349 defines necessity in subdivision (a) as follows:

(a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion

Therefore, the adoption of a regulation requires the Franchise Tax Board to meet a standard of substantial evidence in order for the regulation to be adopted. Once this standard is met, and the regulation is adopted, it is not unreasonable to shift the burden for overcoming the regulation to the party who wishes to make such an argument.

The Board of Equalization recognized this approach as reasonable and proper in Appeal of Fluor, 95-SBE-016 (December 12, 1995):

In other words, once found to be applicable to the particular situation, the section 25137 regulations will control. On the other hand, we also recognize that regardless of how much expertise the FTB may have in a particular industry, regardless of how much time and effort has been expended in developing a regulation, and regardless of the degree of cooperation with industry representatives in that process, it will be

inevitable that some situation will arise where use of a special formula under the section 25137 regulations will not be appropriate and a party may wish to object to the use of the special formula. (See e.g., Appeal of Danny Thomas Productions, Cal. St. Bd. Of Equal., Feb. 3, 1977.) Therefore, we also hold that *any* party wishing to deviate from the method prescribed by the regulation, when found to be applicable, must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state.

R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation. Once a regulation is adopted under this type of authority, it is not unusual for such regulations to receive higher deference from the courts.

### **Recommendation:**

No change to the regulation is necessary.

6. Any modification in this area must be done by the legislature and in a prospectively modified section 25134. To adopt a regulation under section 25137 is to open the floodgates to separate accounting and other formulas to taxpayers, creating chaos and significantly increasing the burden of FTB staff.

At the end of its opinion in Microsoft, the California Supreme Court noted that the determination under section 25137 as to whether an alternative formula could be used and, if so, what formula, could only be made on a case-by-case basis. The high court noted that if the FTB wanted a rule that applied to most taxpayers, the legislature could modify the law if the FTB did not want to include security gross receipts in the sales factor, but that the court would not judicially modify the statute. Just as the California Supreme Court refused to legislate from the judiciary, the FTB cannot legislate a clear tax increase through regulatory amendments. The FTB simply cannot usurp the role of the legislature and the Governor. The only valid regulatory action under Rev. and Tax. Code section 25137 would be a regulation that includes a sufficient amount of security receipts between gross and net, not one that included only net or excluded all such gross or net receipts.

Even more importantly, utilizing section 25137 to enact a regulation in this area creates chaos and a burden on the FTB that otherwise does not exist under section 25137. The reason for this is that section 25137 has two prongs. First, the person attacking the statutory apportionment formula has to prove that it does not fairly reflect the taxpayer's business activities in California. The second prong is that once the first prong has been shown, a party must show by clear and convincing evidence that an alternative formula fairly reflects the taxpayer's business activities in California.

If the proposed regulation is adopted, it is clear that the first prong of section 25137- whether there is enough distortion that the standard apportionment formula doesn't apply--is always met in this area and taxpayers, for example, can go directly to the second prong. This means that the taxpayer will be able to utilize separate accounting and other formulas to show, beyond the gross receipts issue, what fairly reflects its activities in California.

This would not be true if section 25134 legislatively exempted the treasury gross receipts from the definition of gross receipts, because taxpayers would still have to show the applicability of section 25137 before getting to an alternative formula that fairly reflects the taxpayer's business activity in California. As a result of the proposed regulation under section 25137, all taxpayers who have treasury departments will be able to enter directly into the second prong of the section 25137 test. There will not only be substantive chaos but administrative chaos because, as this is clarified by the courts, section 25137 (contrary to past FTB practice) will be used frequently with taxpayers showing separate profit margins, separate accounting, etc.,. There will be a large number of section 25137 petitions by large companies and the past practice of the FTB that section 25137 should only be used in rare instances will be gone.

**Response:**

The FTB has authority to promulgate regulations under R&TC section 25137. The proposed regulation addresses an area where, for many years, the FTB as well as the State Board of Equalization and now the courts, has found the use of R&TC section 25137 to be warranted. This is not a problem that is specific to one taxpayer; all taxpayers that have a treasury function share it. The function itself is what is distortive. The SBE described the problem:

One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, the taxpayer continuously reinvests a large pool of "working capital," generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business. (See Appeal of Pacific Telephone and Telegraph Company, 78-SBE-028, May 4, 1978.)

Appeal of Crisa Corporation, 2002-SBE-004.

The FTB has the authority to remedy such situations by promulgating a regulation that addresses the activity that gives rise to the problem. This authority has been utilized many times. There are regulations for partnership activities, for long-term contracts, for occasional sales, and many regulations for specific types of businesses. All of these rules serve to make the apportionment formula function to fairly reflect the activities for taxpayers in the state.

The court decisions themselves with respect to treasury function activities have given rise to considerable chaos, and in fact have led to the very process that resulted in the proposed regulation. The regulation will provide certainty for taxpayers and will avoid the need to undergo a year-by-year analysis and potentially seek relief from the standard formula every year.

The parade of horrors raised by the commentator is simply not supported by history. The FTB, as stated, has promulgated many regulations under the authority of R&TC section 25137, and no chaos has ensued. This is because the rules are reasonable and reflect the input of the parties that are subject to the regulations. It is true that occasionally taxpayers raise issues regarding their specific facts, but this is contemplated by the statute and is a proper use of R&TC section 25137. If a taxpayer chooses to make this argument regarding the proposed regulation they are free to do so, but there is no evidence that, given the cases that have come before the SBE and the courts and their treatment of those cases, many will find this necessary.

**Recommendation:**

No change to the regulation is necessary.

**Comment from Nielsen, Merksamer, Parrinello, Mueller & Naylor, LLP dated September 17, 2007**

This comment was sent on behalf of Business for Economic Growth in California ("BEGC"), a coalition of major California-based companies: Applied Materials, Cisco Systems, Health Net, Intel Corporation, Walt Disney Company and Chevron.

1. BEGC strongly supports the Franchise Tax Board's ("FTB's") draft treasury regulation. The recent California Supreme Court opinions in Microsoft and General Motors have created substantial uncertainty among taxpayers regarding inclusion of treasury function gross receipts in the sales factor. The draft regulation is a straightforward solution providing clarity on this matter: resulting in certainty to taxpayers and ease of administration for the FTB. Further, the draft regulation will largely avoid new disputes and conserve FTB and taxpayer resources. It is also an approach similar to that used by a number of other states including New York, the location of GM's Treasury department.

**Response:**

These are precisely the reasons the FTB is seeking a regulation in this area. A regulation provides an authorized response to the possibility of case-by-case consideration of an issue such as the one addressed by the proposal.

2. The remainder of the comment is a response to the comment of Ajalat, Polley, Ayoob & Matarese on behalf of General Motors. The commentator disputes many of the arguments set forth in the GM comments responded to earlier in this document.

Because the remainder of this comment is a series of responses all related to one subject, the GM submission, they are set forth as subsections below.

A. The treasury regulation is not a law change, but an intended exercise of FTB authority that alleviates the distortion in the standard apportionment formula caused by including treasury receipts on a gross basis.

GM in its letter suggests, "only the legislature, not an administrative body like the FTB, can change the law" and that "a regulation that excludes all security receipts is a tax increase that by definition is a change of law." The FTB's proposed regulation does not constitute a law change. A regulation promulgated under a code section that was specifically designed to permit the FTB to adjust the standard apportionment and allocation rules in situations where the standard formula is distortive cannot be construed as a law change.

The standard established by section 25137 as to when the FTB may exercise its statutorily delegated power is very broad, namely whenever "the allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activities in the state." Over the years, the FTB has promulgated many regulations pursuant to the authority granted in section 25137. In some cases, the changes made by regulations promulgated by the FTB applied on an industry basis while in other cases, the modifications made by the FTB have applied to taxpayers in general. The treasury regulation in question is yet another situation where a change in the standard apportionment and allocation rules is generally necessary. The FTB has determined that an adjustment to the standard apportionment and allocation rules regarding the exclusion of the gross receipts from the treasury function is warranted in order to fairly represent the extent of a taxpayer's business activities in the state. The exercise by the FTB of its statutory mandate to adjust the standard apportionment and allocation rules when necessary is not "unconstitutional" as alleged by GM.

**Response:**

The hearing officer agrees with the commentator. The regulation is not a change in law, or new law, rather it is an application of existing statutory authority granted by the Legislature to the FTB. R&TC section 25137 specifically grants FTB the power to require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of another apportionment method to effectuate an equitable allocation and apportionment of the taxpayer's income. It is this authority that authorizes the regulation. The regulation is therefore not a change in law and is therefore not subject to the constitutional two-thirds of the Legislature voting requirement.

B. The GM letter states the court in Microsoft held "that an amount between the net and gross should be included" and that "the truth doubtless lies somewhere in between." This is not an accurate statement of the holding of this case. What the court in Microsoft did hold was that: 1) the term "gross receipts" included the entire redemption price of marketable securities; and 2) the FTB met its burden under Rev. and Tax. Code section 25137 that the standard apportionment and allocation rules did not fairly represent the taxpayer's business activities in the state and its proposed alternative of including net receipts was reasonable. The court did not, as a matter of law, conclude, "an amount between the net and gross should be included." Further, the language that is quoted--"the truth doubtless lies somewhere in between"--refers only to a specific example set forth in footnote 23.

**Response:**

This comment is consistent with the FTB's views. The footnote cited, as authoritative by the representative for General Motors, is not the holding of the court but dicta addressing a hypothetical example. The court held that the receipts in issue were excludable under the authority of R&TC section 25137 and found the FTB's proposed alternative to be reasonable.

C. The treasury regulation does not interfere with the judicial process. In its letter, GM suggests that the proposed regulation is "an unnecessary interference into the judicial process" noting that there are several cases pending at the trial and appellate levels. This is a false argument for a simple reason: The regulation is prospective only, and applies by its own terms to taxable years beginning on or after January 1, 2007 (proposed regulation 25137(c)(1)(D)(3)).

**Response:**

The commentator is correct. The proposed regulation is prospective only, and will have no effect on taxpayers with outstanding claims in prior years.

D. The treasury regulation is not a tax increase. The treasury regulation does not "increase" or "decrease" anything. It is based upon a finding by the FTB staff that inclusion of treasury receipts in the sales factor does not fairly represent the extent of the business activities of taxpayers in the state. Based upon that conclusion, the treasury regulation "throws out" (excludes) those treasury receipts from the sales factor. However, the treasury regulation clearly provides that a taxpayer who believes that the inclusion of such treasury receipts in the sales factor is warranted may petition to have such receipts included in the sales factor. Thus, any taxpayer may seek relief from this regulation if it believes that it can

demonstrate that the exclusion of such receipts does not fairly represent the extent of its business activities in California.

An "increase" or "decrease" presumes that there is some fixed standard in the law that is changed. This simply is not true here. Rev. and Tax. Code sections 25120 and 25137 currently work together to provide that treasury receipts may be included in the sales factor, either at gross or net, or fully eliminated, depending on what method fairly represents the extent of a taxpayer's business activities in the state. Nothing in the treasury regulation changes that. The adoption of the treasury regulation remedies an upside down and inefficient situation that otherwise would be created where the vast majority of taxpayers would fall within the exception (to exclude treasury gross receipts from the sales factor) while a very small minority of taxpayers would constitute the rule (the inclusion of treasury gross receipts in the sales factor).

Finally, GM in its letter seems to equate the term "tax increase" with "increasing revenues" (see Art. XIII A, sec. 3). However, GM has overlooked the phrase "any changes in State taxes" that precedes the phrase "increasing revenues" in this section of the state Constitution. When read in proper context, this section requires a two-thirds vote of each house of the legislature to pass a legislative act for any changes in state taxes enacted for the purpose of increasing revenues. This constitutional section simply has no relevance here.

### **Response:**

This comment is consistent with the Franchise Tax Board's views. General Motors' comment assumes that taxpayers have a vested interest in their current interpretations of FTB's practices, as well as their litigation position with respect to the law itself, and that any attempts to regulate that are inconsistent with those perceptions are therefore invalid as a tax increase. The BECG commentator is correct. There currently is no set outcome for the inclusion or non-inclusion of treasury receipts. Each case has to be decided separately. While General Motors may feel that the exclusion is incorrect in its particular facts, this is not dispositive of the state of the law for all taxpayers.

The commentator is also correct that taxpayers will maintain the ability to petition for a different outcome even after the regulation is promulgated. However, it is not anticipated that this will happen often, as the vast majority of taxpayers will simply not have fact patterns that justify such a petition. This belief is supported by the review of current cases, which showed an average fact pattern that is quite similar to the cases already decided by the courts.

E. The treasury regulation is constitutional. GM suggests that the "proposed regulation is unconstitutional" since the "FTB [is seeking] to tax the income of out-of-state treasuries without giving the treasuries any

representation in the gross receipts factor." GM is mistaken. Neither the U.S. Supreme Court nor the California Supreme Court has ever held that all items of income must be included in the sales factor.

The very existence of section 25137 negates this notion because it provides relief when the standard apportionment and allocation rules unfairly reflect the extent of a taxpayer's business activities in the state. The FTB has previously promulgated Cal. Code of Regs. section 25137(c)(1)(A), which excludes substantial amounts of gross receipts that arise from an occasional sale of a fixed asset or other property. The treasury regulation, which is also being promulgated pursuant to the authority granted to the FTB under Rev. and Tax. Code section 25137, reflects the FTB's determination (after reviewing taxpayer data) that the inclusion of the treasury receipts in the sales factor is distortive and that the proper remedy is to remove such receipts. It should be noted that even though the treasury receipts are excluded from the apportionment formula, other relevant factors such as the payroll of the treasury personnel are in fact reflected in the apportionment formula.

**Response:**

This comment is consistent with FTB's views. The reflection of all activities giving rise to business income is simply not constitutionally required. The U.S. Supreme Court has approved the use of a formula with no payroll or property factors. (Moorman) California law contains exclusions of other activities, such as intangibles (not included in the property factor), payments to independent contractors (not included in the payroll factor) and occasional sales (not included in the sales factor). The regulation does not raise constitutional issues.

F. GM asserts that the FTB does not have the authority after the Microsoft decision to shift the burden of proof to taxpayers who wish to deviate from the standard apportionment and allocation rules. GM is incorrect. In Microsoft, the court was addressing the specific facts of a particular taxpayer, not a regulation under section 25137. As previously indicated, the court approved the Board's conclusion in Crisa Corp. that the operation of a large treasury department unrelated to a taxpayer's main line of business is an example of a circumstance warranting invocation of section 25137. While it is true that the party seeking to deviate from the standard apportionment and allocation rules has the burden of proving that the standard rules do not fairly represent the extent of a taxpayer's business activities in the state, this rule does not apply when dealing with a regulation under Rev. and Tax. Code section 25137.

**Response:**

This comment is consistent with the Franchise Tax Board's views. The regulation does not override the burden of proof established by the Microsoft court, it simply is not applicable to the regulatory process. The regulatory process contains its own evidentiary requirements established in the Government Code. If a taxpayer wishes to deviate from the method set forth in this regulation the statutory rules will allow them to do so, but, under the SBE decision in Fluor, 95-SBE-016 (December 12, 1995), the taxpayer would have to meet their burden of proof to do so. This seems reasonable given the fact that the regulation, in order to go in effect, has already met the Government Code requirements.

G. GM closes its letter to the FTB by asserting that "to adopt a regulation under section 25137 is to open the floodgates to separate accounting and other formulas to taxpayers creating chaos and significantly increasing the burden on the FTB staff." This is the classic "Parade of Horribles" argument and is completely without merit. If it is intended to scare the FTB from pursuing this regulation, it must fail. As evidenced from all of the cases to date, the vast majority of the taxpayers will remedy an otherwise distortive formula by following the new regulation, thus reducing significantly the number of controversies and case-by-case section 25137 petitions that would otherwise be presented. And for those in the minority of cases where the regulation is not appropriate, current law under section 25137 permits a taxpayer who believes that an adjustment to the apportionment and allocation rules must be made in its particular situation to petition the FTB to have such an adjustment made. The treasury regulation does not in any way deny taxpayers the right to petition for such a change and if requested, the FTB will conduct a thorough review of the taxpayer's petition to determine if a change is warranted.

#### **Response:**

The purpose of the regulation is to bring certainty to an area of the law that has been the subject of much litigation. Now that the lead cases have been decided, it is proper to establish rules based on those decisions. The cases to date have all held that distortion exists when the treasury activities are included at gross receipts. The regulation remedies this distortion by removing the receipts from the sales factor. The commentator suggests that the vast majority of taxpayers will be satisfied with this remedy. The FTB agrees with this opinion. While there may be some cases that still require adjustment under the authority of R&TC section 25137, this will be the exception rather than the rule.

#### **Oral Comments Received at the Regulatory Hearing**

#### **Hearing Transcript - Page 8. Comment from Eric Meithke representing BECG.**

In favor of the regulation, he finds it necessary to bring clarity to this area of the law and supports the removal of the receipts. Further, he opined that the regulation was within the authority of the Franchise Tax Board to promulgate.

**Response:**

This comment is consistent with the Franchise Tax Board's views; therefore, no further response is necessary.

**Hearing Transcript - Page 9. Comment from David Slater of Intel Corporation**

They are supportive of the regulation. No further comments.

**Hearing Transcript - Page 9. Comment from Chris Matarese representing General Motors.**

This comment is essentially the same as the written comments submitted to the hearing officer and no further response is necessary.

**Hearing Transcript - Page 10. Comment from Susan Silvani representing Chevron Corp.**

Chevron is supportive of the regulation and believes the regulation will go a long way toward preventing companies from moving high-paying, quality treasury jobs out of state. The regulation is good tax policy. Chevron disagrees with General Motors and feels that the regulation is within the authority of the Franchise Tax Board and is consistent with past FTB practice in the area.

**Response:**

This comment is consistent with the FTB's views; therefore no further response is necessary.

## TREASURY FUNCTION INVENTORY STUDY

In response to comments received that the proposed regulation is overstepping the reach of the court decisions and would throw out treasury receipts for many taxpayers whose facts would not be found distortive by the courts, the hearing officer undertook an examination of the existing inventory of cases. The objective was to determine whether, on average, the treasury function cases in inventory were similar to the cases already decided by the Board and the courts, or whether these cases were aberrations. Thirty-four cases were reviewed that contained enough information to determine the application of the existing case law<sup>1</sup>. These cases covered over fifty tax years and showed the following:

1. All of the cases examined, except for one<sup>2</sup>, involved a treasury function that was ancillary to the main line of business of the taxpayer. Most of the taxpayers in the sample were either retailers or manufacturers.
2. The inclusion of the treasury receipts in the various claims and/or original returns, generated on average 51.71% of the receipts included in the sales factor denominator. There was not a large variation over the sample and the median of the sample was almost identical, at 50%.
3. The income derived from this treasury activity was quite small. On average, the treasury function produced 3.13% of the income of the taxpayers. The median of the income was 2.35%.
4. For sixteen of the cases reviewed, there was ample factual development to apply the profit margin analysis set forth by the *Microsoft* court. These cases showed an average profit margin for the main line of business of 9.80% with a median of 6.55%, while the treasury function showed a profit margin of 0.34% with a median of 0.10%.

Applying these finding to the case law, the two are quite similar. In all of the cases, but for one, the treasury function was clearly ancillary to the main line of business, which is also the case in all of the case law. Also, *Pacific Telephone* involved a treasury function that provided 33% of the sales factor and 2% of the income. The study showed that, on average, the treasury activity generated approximately 50% of the sales factor and 2.98% of the income. This is also quite similar.

Applying the Board's *Pacific Telephone* analysis, the average case, if the years involved were all single weighted sales factor years like *Pacific Telephone*, would assign over

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<sup>1</sup> There are other cases that contained the treasury issue, but these cases were factually undeveloped and could not be utilized in this study.

<sup>2</sup> The one case that did not fit the standard fact pattern involved a taxpayer where the investment activity was a large part of the main line of business and therefore would not be affected by the regulation because the activity would fall outside the definition of a "treasury function" contained in the regulation.

16% of the income to the location of an ancillary function that provided approximately 3% of the income. This is almost identical to the findings of the Board in *Pacific Telephone*, where the Board held that it was not reflective of the activities of the taxpayer in the state to assign 11% of the income to a function that was ancillary and provided approximately 2% of the income. In both cases, the apportionment formula assigns over five times the income generated by the activity.

Furthermore, the margin analysis for the sample matches the analysis performed by the court in *Microsoft*, where the court found that a large disparity in margins was indicative of a problem in the functioning of the sales factor. In that case the court observed that the main line of business had a profit margin "quantitatively several orders of magnitude different from the rest of a corporation's business." In the sample, the profit margin for the main business was approximately 30 times higher than that of the treasury. This is consistent with the findings in *Microsoft*.

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July 30, 2007

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By Mail and Fax This Date

Colleen Berwick  
Franchise Tax Board  
Legal Branch  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720Re: Proposed Amendments to 18 Cal. Code of Regulations, Section 25137(c)  
August 17, 2007 Public Hearing

Dear Ms. Berwick:

I am writing to you regarding the FTB's proposed regulatory amendments and the public hearing scheduled to be held on August 17, 2007 in the above matter. Specifically, the Informative Digest/Plain English Overview regarding the FTB's proposed regulatory action states in part: "The proposed amendment to Regulation 25137(c) addresses the treatment of receipts derived from a taxpayer's 'treasury function' activity."

The purpose of this letter is to seek confirmation from the FTB regarding the scope of this proposed regulatory action. Specifically, I seek confirmation from the FTB, in the official course of this proceeding, on two points. The first point is whether, by this proposed regulatory action, it is the intention of the FTB to change, amend or in any way modify the current state of the California law regarding the sales factor for stockbrokers and/or brokerage companies, as reflected in FTB's Multistate Audit Technique Manual (*see* MATM § 7800) and in the SBE decision in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989, 1989 Cal. Tax LEXIS 18 ("*Merrill Lynch*"). The second point is whether, by this proposed regulatory action, it is the intention of the FTB to change, amend or in any way modify the current state of the California law regarding the sales factor for banks and/or financial corporations, as now reflected in FTB Regulation 25137-4.2 (Tit. 18 Cal. Code of Regs., § 25137-4.2).

Generally speaking, the current law in California is that stockbrokers and brokerage companies use "gross receipts" for their sales factors, subject to FTB meeting its burden of proof under Revenue and Taxation Code Section 25137 for the use of an alternative

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apportionment methodology. Neither *Microsoft* nor *General Motors* involved the apportionment formula for stockbrokers or brokerage companies, and cases are not authority for propositions not considered. (*People v. Barragan* (2004) 32 Cal.4<sup>th</sup> 236, 243.) Indeed, *Microsoft* went out of its way to distinguish between the so-called *Pac Tel* distortion analysis (*Appeals of Pacific Telephone and Telegraph Company*, 78-SBE-028, May 4, 1978, 1978 Cal. Tax LEXIS 91) and *Merrill Lynch*, citing to *Merrill Lynch* with approval, and noting that there the taxpayer's sale of securities on its own account "was not *qualitatively* different from its main business . . ." (*Microsoft*, at p. 766, emphasis added.)

It appears that FTB, by way of this proposed regulatory action, is intending changes to the current state of the law in the aftermath of *Microsoft* and *General Motor* to exclude receipts from the sales factor derived from a taxpayer's "treasury function" activity. If this is the only intention of the FTB, then it is requested that the FTB make clear in this course of this proceeding that it is not considering or intending any change, amendment or modification to the current state of the California law regarding the sales factor for stockbrokers and/or brokerage companies. (See Proposed Section 25137(c)(1)(D).1.)

Similarly, neither *Microsoft* nor *General Motors* involved the apportionment of the income of banks and/or financial corporations, and special rules for such apportionment already exist in FTB Regulation 25137-4.2. Accordingly, I seek FTB's confirmation that FTB does not intend as part of this proposed regulatory action to make any change, amendment or modification to the current state of the California tax law regarding the sales factor for banks and/or financial corporations. (See Proposed Section 25137(c)(1)(D).2.)

Sincerely,



Eric J. Coffill

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August 16, 2007

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Rancho Cordova, CA 95741-1720

Re: Draft Regulation Section 25137(c)(1)(D) — Apportionment of  
income from treasury functions

Dear Ms. Berwick:

We are pleased to submit the following comment regarding Draft Regulation  
25137(c)(1)(D), which is directed solely at the sentence in subdivision (1) that reads:

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, such as a registered broker-dealer, is not performing a treasury  
function with respect to income so produced.

At the outset, we note that we agree with the underlying premise of this sentence, namely  
to make clear that purchasing and selling assets as a trade or business is not a treasury  
function and, therefore, receipts from such an activity are not subject to the special  
apportionment rule established by the draft regulation. That said, we are concerned about  
inclusion of the word "principally" which, probably inadvertently, appears to place a  
limitation on the receipts that will be deemed not to be subject to the draft regulation's  
special apportionment rule.

Specifically, a plain reading of the sentence quoted above appears to indicate that  
in order for certain receipts of a taxpayer to be exempt from the draft regulation's special  
apportionment rule, the taxpayer would have to engage in a certain threshold level of the  
activity of purchasing and selling securities (perhaps 50% of total receipts) as part of its  
own trade or business. If a taxpayer engaged in less than that threshold level of  
purchasing and selling securities as part of its own trade or business, then any receipts of

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the taxpayer resulting from purchasing and selling assets, whether as part of a treasury function or not, would be subject to the draft regulation's special apportionment rule.

However, for a number of reasons, the exemption from the draft regulation's special apportionment rule should apply to any receipts resulting from purchasing and selling assets as a trade or business and should not be denied to taxpayers that fail to meet the prescribed threshold of receipts.

The main defect in the draft regulation as written is that it potentially produces inequitable results. For example, assuming for purposes of this letter that "principally" might mean "more than 50%," a taxpayer with 49% of its receipts from purchasing and selling assets as a trade or business would be subject to the draft regulation's special apportionment rule as to all of those receipts, while a taxpayer with 51% of its receipts from such activity would be exempt from the regulation for receipts of exactly the same character. In this way, eliminating the word "principally" would result in a regulation that is most narrowly tailored to achieve its purpose.

Collateral effects of the draft regulation also are problematic. For example, the proposed threshold requirement would impose needless administrative costs in that it would require annual classification of taxpayers based on the source of their revenues and, potentially, would prompt disputes between taxpayers and the FTB regarding classification. Likewise, it would invite manipulation by taxpayers, *i.e.*, tax planning to cause an entity to fall short of, or exceed, the revenue threshold in order to achieve a desired result.

For all of these reasons, we respectfully urge the FTB to eliminate the word "principally" from subdivision (1) of the draft regulation. Thank you for your attention to this matter.

Very truly yours,



Amy L. Silverstein

Brian W. Toman  
Direct Phone: +1 415 659 5994  
Email: btoman@reedsmith.com

August 17, 2007

## VIA FAX (916-845-3648) AND U.S. MAIL

Mr. Carl A. Joseph  
State of California  
Franchise Tax Board  
Legal Department  
PO Box 1720  
Rancho Cordova, CA 95741-1720

**Re: Proposed Regulation Section 25137(c)(1)(D)**

Dear Mr. Joseph:

Our comments on the Franchise Tax Board (“FTB”) captioned proposed regulation are as follows.

**1. FTB staff’s proposal for the treatment of Treasury function receipts should be pursued through legislation.**

We continue to believe that FTB staff’s proposal, if it is to go forward, should be in the form of a legislative proposal. As explained in our second comment, *infra*, we believe there is doubt as to the legality of FTB staff’s regulatory proposal. Such doubt could result in a legal challenge to the regulation resulting in it being invalidated by a court.

If, however, FTB staff’s proposal is implemented legislatively, such a legal challenge would most likely not result. Legislation would be the most effective vehicle to establish the principles FTB staff is attempting to put in place under section 25137. In fact, the Court in *Microsoft Corporation v. Franchise Tax Board* (2006) 39 Cal.4<sup>th</sup> 750 [47 Cal.Rptr.3d 216] (“*Microsoft*”) seemed to be of the same opinion as it referred to the Legislature and legislative action to resolve the issue of the treatment of the receipts from a taxpayer’s treasury function for sales factor purposes. See *Microsoft*, *supra* at 772.

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2. **The use of a regulation to address the treatment of Treasury function receipts for sales factor purposes is not completely appropriate.**

We also continue to believe, for the reasons set forth below, that the use of a regulation to address the treatment of treasury function receipts for sales factor purposes is not completely appropriate.

Initially, it does not seem FTB staff has made a showing that there is adequate qualitative “distortion” in all circumstances to justify use of section 25137 across to board to all taxpayers except stockbrokers and banks and financials (“taxpayers impacted by the regulatory proposals”).

In Microsoft, the California Supreme Court made a distinction between treasury operations which were an incidental part of a taxpayer’s business and those which were a part of a taxpayer’s principal business. The Court characterized this as a “qualitative” difference. See Microsoft, supra at 765 and 766.

The proposed regulatory provision does address this qualitative difference to a limited extent, but only with respect to stockbrokers and banks and financial entities. However, the regulation does not address this qualitative difference with respect to a taxpayer whose treasury function was not an incidental part of a taxpayer’s business, such as when the pooling and management of liquid assets were beyond merely 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 and business acquisitions.

The regulation, to be consistent with Microsoft, should completely address the situation where any taxpayer’s treasury function is or becomes part of its core business. This would take into account situations where a taxpayer’s treasury function was vital to its survival as a business. For example, because of pending litigation that may severely damage a business, or put it out of business altogether, having adequate cash to keep a company financially afloat would become vital to its survival. In that situation, generating investment income would become a major focus of a business. Including gross receipts from a treasury function in the sales factor in that situation would represent the substantial contribution the treasury function made as a part of the core business.

Thus, if the regulatory proposal is to properly reflect the decision in Microsoft, there should be some recognition of the distinction between treasury operations which are an incidental part of a taxpayer’s business (complete exclusion of net income and net gains) and those which were a part of a taxpayer’s principal business (inclusion of all gross receipts) for all taxpayers impacted by the regulation.

Furthermore, in Microsoft, the Court also performed several numerical calculations to establish the “quantitative” difference between application of the standard apportionment formula and the special formula the FTB sought to apply. See Microsoft, supra at 765 and 766. It does not seem FTB staff has made a showing that there is adequate quantitative distortion in all circumstances to justify use of section 25137 across the board to all taxpayers impacted by the regulatory proposals. FTB staff has taken a single case decided on its specific facts and circumstances and applied the result to all taxpayers where there was no showing made that all taxpayers are similarly situated from a quantitative “distortion” perspective.

Furthermore, the Court also made it clear that in not all situations would including gross receipts from a taxpayer’s treasury function result in distortion. The Court cited two examples of this situation; one when there was a counter-balancing distortion in another factor in the formula, and another when a significant sale is omitted from the sales factor and an insignificant sale is not. See Microsoft, supra 769 and 771, fn. 23. Not all taxpayers are similarly situated regarding the facts and circumstances surrounding their treasury operations. FTB staff’s regulatory proposal seem to assume they are.

**3. The FTB staff has not satisfied the appropriate level of burden of proof to justify excluding interest and dividends and overall net gains from the Treasury function from the sales factor.**

Furthermore, we continue to believe FTB staff has not satisfied the appropriate level of burden of proof to justify excluding altogether interest, dividends and net gains from a taxpayer’s Treasury function from the sales factor.

The California Supreme Court has recently made it clear that the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted. See Microsoft, supra at 765. In Microsoft, the Court stated:

As the party invoking section 25137, the Board [FTB] has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable (Citations).

Microsoft, supra at 765. (Emphasis added.)

Furthermore, the California Supreme Court has not limited this burden of proof to ad hoc applications of section 25137. As the Court noted, some states may attempt to cure distortions by regulatory revision to the definition of gross receipts, other states may attempt to cure distortions on an ad hoc basis. See Microsoft, supra at 767, fn. 18. In either event, whether

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distortion is addressed by regulatory action or on an ad hoc basis, the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted.

In Microsoft, the factual basis for a finding of “distortion” was that (1) Microsoft’s treasury function was a qualitatively different operation from its principal business; (2) Microsoft’s investments produced less than 2% of its income but 73% of its gross receipts; (3) Microsoft’s profit margin (income/redemptions) was 0.2% for its Treasury operation compared to a profit margin (income/gross receipts) 31% for non-Treasury operations; (3) Microsoft’s non-Treasury operations were 155 times more profitable than its Treasury operations and (5) Microsoft’s average worldwide profit margin was 8.6% - 43 times more profitable than Treasury.

It does not seem evidence was examined along the lines set forth in the preceding paragraph that distortion existed, to the extent it did in Microsoft, with respect to all or a majority of the taxpayers impacted by the regulatory proposal. It seems to us that FTB staff has not met its burden to prove by clear and convincing evidence that the regulatory proposals should be applicable across the board to all taxpayers impacted by the proposed regulations.

**4. FTB staff is effectively misinterpreting the California Supreme Court decision in Microsoft as to its applicability to all taxpayers impacted by the regulatory proposals.**

In Microsoft, the Court held that under the particular facts and circumstances in that case, distortion was proven by the FTB. In its regulatory proposals, FTB staff assumes that in all cases distortion exists with respect to all taxpayers impacted by the regulatory proposals.

One essential Administrative Procedures Act (“APA”) requirement for a proposed regulation to be approved by the Office of Administrative Law (“OAL”) is “consistency with the law.” See Gov. Code §§ 11349.1 and 11349.3. If a proposed regulation is not consistent with the law, the OAL will not approve it and submit it to the Secretary of State for adoption.

We believe FTB staff’s regulatory proposals may violate the APA requirement of consistency with the law because it is taking a Supreme Court decision finding distortion based on particular facts and circumstances and applying it across the board to all taxpayers impacted by the regulatory proposals when, the decision itself, in fact, indicates it is not always applicable across the board to all taxpayers. In fact, the Court cautioned “that in other cases the Board’s approach may go too far in the opposite direction and fail the test of reasonableness.” See Microsoft, supra at 771.

In addition, as indicted above, it seems FTB staff has not satisfied its burden to prove by clear and convincing evidence that distortion exists in all circumstances to permit FTB staff to

Mr. Carl A. Joseph  
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demonstrate that the regulatory proposals are applicable across the board to all taxpayers impacted by the regulatory proposals.<sup>1</sup> Thus, it seems FTB staff's interpretation is not entirely consistent with the law.

**5. FTB staff's proposal is constitutionally suspect.**

FTB staff's proposal to use this "throw out" approach effectively spreads the income from a taxpayer's Treasury function over the entirety of the sales factor instead of focusing the sales on where they actually took place. This results in under-representation of the sales activity in the state where the Treasury function is located, and over-representation of the sales activities in other states where the taxpayer does not have a Treasury function. FTB staff's approach does not reasonably reflect the sense of how income is generated and is not fair apportionment.

Thank you for considering our comments.

Very truly yours

REED SMITH LLP

  
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Brian W. Toman

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<sup>1</sup> The clear and convincing evidence standard for a finding of distortion for consistency with the law purposes (Govt. Code §§ 11349.1 and 11349.3) is different from the substantial evidence standard for a finding of reasonable "necessity" to effectuate the purpose of the statute (Govt. Code § 11342.2). The California Supreme Court has provided the standard to prove "distortion" as a matter of law, and the Government Code provides the standard to prove reasonable necessity for the regulation.

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September 17, 2007

VIA E-MAIL (COLLEEN.BERWICK@FTB.CA.GOV)  
VIA UNITED STATES MAIL

Ms. Colleen Berwick  
Franchise Tax Board Legal Branch  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720

**Re: Proposed Amendment to Regulation 25137**

Dear Ms. Berwick:

The Coca-Cola Company, Comcast Corporation, Ford Motor Cocompany, Microsoft Corporation, Time Warner Inc., United Technologies Corporation, Verizon Communications, Viacom Inc., and Sutherland, Asbill & Brennan, LLP, respectfully request that the Franchise Tax Board (“FTB”) not adopt the staff’s proposed amendment to the California Code of Regulations title 18, Section 25137(c)(1). This letter is a written request under Cal. Gov’t Code § 15702(b) that the FTB Members not consider the proposed regulatory action and neither delegate nor authorize any potential adoption of the proposed amendments to the regulation. The proposed amendment should not be adopted because it is in violation of controlling precedent of California’s highest court, the federal constitution, and the FTB’s own administrative and agency practice rules. Further, the proposal will increase administrative costs and litigation, increase non-uniformity among the states in taxing corporate income, and improperly shift the burden of proof in controversies regarding the underlying tax statute.

**Proposed Amendment to the Rule**

The California Franchise Tax Board is proposing to amend Reg. § 25137(c)(1) to change the calculation of the sales factor. Specifically, the amendment would require exclusion from the “numerator and the denominator of the sales factor”:

- “interest and dividends from intangible assets held in connection with the treasury function of the taxpayer’s unitary business”; and
- “gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of such intangible assets.”

“Treasury function” is defined in the proposed regulations as follows:

the pooling, management, and investment of intangible assets for the purposes 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 treasury function includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A Treasury function does not include a taxpayer's trading function that engages in futures and option transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

The current law, as interpreted by the California Supreme Court is: “that . . . the redemption of marketable securities at maturity generates ‘gross receipts’ that are includible in the formula used to calculate a multistate entity's tax,” but the Franchise Tax Board may prove that an alternate formula should be used because including gross receipts in a particular situation creates distortion by failing to represent the extent of the taxpayer’s business activity in California (either through over- or understatement of such activity and the subsequent franchise tax liability). *Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th 750,759, 139 P.3d 1169, 1174 (2006). The statutes governing the calculation of the sales factor and the situations in which an alternative apportionment formula may be applied have not changed since the court announced this interpretation.

### **Background**

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Revenue and Taxation Code (RTC) § 25120 *et seq.* As noted in the FTB’s Notice of Hearing on the proposed amendment, under UDITPA business income is assigned to a state through the application of a three-factor apportionment formula that separately compares a business’s property, payroll, and sales within California to those values everywhere. These three percentages are then added together and divided by three. For most California taxpayers the sales factor is counted twice (*see* RTC § 25128), and the resulting sum of these four factors is then divided by four. This percentage is then applied to the business income of the taxpayer to determine the percentage of business income attributable to California.

UDITPA, as adopted by California (RTC § 25120(e)), defines “sales” for purposes of the sales factor as: “all gross receipts of the taxpayer.” The term “gross receipts” is not defined. UDITPA, as adopted by California (RTC § 25137), contains a relief provision that allows an alternative apportionment formula “to achieve an equitable result” in those instances where the standard formula fails to “fairly represent the extent of the taxpayer's business activity in this state.”

As the FTB observes, and the undersigned agrees, “[t]he treatment of treasury function activities in the sales factor has given rise to disputes as far back as the Board of Equalization's decision in *Appeal of Pacific Telephone and Telegraph Co.*, 78-SBE-028 (1978).” In that case, the Board of Equalization held that the inclusion of treasury function receipts in the sales factor was distortive and that this distortion could be remedied by the FTB through the use of an alternative apportionment formula. Recently, the FTB has pursued dozens of cases, each of which involves the issue of how to treat proceeds from the maturity, redemption, sale, or other disposition of securities and other intangible assets related to a business taxpayer's treasury function. However, while each of these cases involves the same legal issue, each of the cases involves different facts.

The lead case addressing the issue of the treatment of receipts from the treasury function for purposes of calculating the sales factor of the apportionment formula is *Microsoft Corporation v. Franchise Tax Board*. As discussed below, the California Supreme Court held that under the standard statutory apportionment formula, receipts from a taxpayer's treasury function are to be included in the sales factor based on the gross amount of receipts. After determining what the standard rule was, the court went on to hold that based on the specific facts of the case, it approved the FTB's use of an alternative formula because the inclusion of Microsoft's treasury function receipts in the sales factor denominator was distortive. The court upheld the FTB's suggested alternative formula, which included only net income from the treasury function in the sales factor.

The FTB staff responded to this case with a series of “interested party” meetings to discuss the implications of *Microsoft* and a potential response by the FTB. The FTB staff's response was to amend the FTB's alternative apportionment regulation to completely remove receipts from a taxpayer's treasury function for the calculation of the sales factor. On August 17, 2007, the FTB held a public hearing to consider adoption of the amendment to existing Reg. § 25137(c) under Title 18 of the California Code of Regulations. In its hearing notice, the FTB asserted that “[t]his proposed regulatory action is specifically authorized under section 25137 of the California Revenue and Taxation Code, pertaining to the use of alternative apportionment methodologies.” The section of the Revenue and Taxation Code that the staff of the FTB seeks to amend, Section 25137, provides the FTB with the authority to require, in cases where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state, alternative methods to effectuate an equitable and effective allocation and apportionment of a taxpayer's income. The FTB staff asserts that “the proposed regulatory action interprets, implements, and makes specific Section 25137 of the Revenue and Taxation Code.”

## **Identity of Commentators**

Sutherland Asbill & Brennan, LLP, and the undersigned companies routinely interact with the FTB on corporate franchise tax issues, including the apportionment of treasury function receipts. The undersigned companies are out-of-state domiciled companies that each engage in substantial business in California and are shouldering significant California income tax burdens. They object to the proposed amendment to the regulation for numerous reasons, including:

1. The FTB's proposal is inconsistent with the statutory definition of "gross receipts" as interpreted and thus improperly usurps both the judicial and legislative functions of government and thus is a violation of the separation of powers doctrine.
2. The FTB's proposal violates the federal constitution.
3. The FTB's proposal violates administrative and agency practice rules.
4. The FTB's proposal decreases certainty and increases administrative costs and litigation.
5. The proposed regulation leads to additional non-uniformity among the states that have adopted UDITPA and, thus, is contrary to the purposes of that Act.
6. The FTB's proposal improperly shifts the burden of proof regarding which party must show distortion in order to deviate from the statutory apportionment formula.

Each of these points is discussed in greater detail below.

### **I. Proposed Regulation Is Inconsistent with the Statute and Usurps the Judicial and Legislative Function**

The proposed regulation is in direct conflict with the statutory definition of "gross receipts" as interpreted by the California courts as well as by California revenue officials, including the FTB itself. There has been no change in the statutory definition and therefore changing the FTB's regulatory interpretation of the statute usurps the legislative and judicial functions. The FTB's proposed amendment to the regulation is a violation of the separation of powers doctrine because it usurps the power of both California's judicial and legislative branches.

#### **A. Judiciary**

The FTB's proposed regulation contradicts multiple court decisions, including the California Supreme Court's recent, controlling decision in *Microsoft v. Franchise Tax Board* issued barely one year ago on August 17, 2006. *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006). In ruling on the inclusion of gross receipts in the sales factor, the *Microsoft* court examined the language of Section 25120 which reads, "'Sales' means *all gross receipts* of the taxpayer not allocated under Section 25123 through 25127 of [the California Tax] code." *Id.* at 1174 (emphasis in original). At issue in the court's determination was whether "gross receipts include the entire amount received upon redemption of a marketable security," as Microsoft contended, or whether "gross receipts include only the net difference between the amount received and the original purchase price," as the FTB argued. After reviewing the statutory language, legislative history, and agency interpretation behind Section 25120, the court

stated, “We conclude the full redemption price, like the full sales price, must be treated as gross receipts.” *Id.* at 1175. (emphasis added).

The court began its analysis of the question by examining the plain language of the statute. It stated, “[w]e agree with *Microsoft* that the meaning of ‘gross receipts’ in the UDITPA more naturally includes the entire redemption price of marketable securities. ‘Gross’ implies the whole amount received, not just the amount received in excess of the purchase price. To only consider the net price difference as ‘gross receipts’ is an awkward fit with the statutory language, at best.” *Id.* at 1174. Even though the court ultimately found that inclusion of the gross proceeds rather than just the net proceeds resulted in distortion, the court specifically admonished the FTB that this conclusion would be reached on a case-by-case basis and that the decision to include net rather than gross in other cases could itself create distortion. The court stated:

We caution, however, that in other cases the Board’s approach may go too far in the opposite direction and fail the test of reasonableness. By mixing net receipts for a particular set of out-of-state transactions with gross receipts for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer’s income and exaggerates the resulting California tax.

*Id.* at 1182.

Not only has the FTB ignored the court’s specific warning in proposing its amendment to the regulation, but the FTB actually compounds the problem the court warned against, by excluding the proceeds entirely rather than allowing just the net proceeds. The complete exclusion of such proceeds guarantees that the risk the court notes will occur in even more cases than the court feared.

An analysis of the legislative history of Section 25120 further convinced the court to hold that gross receipts meant the full value of the marketable securities. Specifically, the court pointed out that in the UDITPA drafting process the definition of “sales” was changed from “all income of the taxpayer not otherwise allocated” to “all gross receipts of the taxpayer not otherwise allocated” (emphasis added). *Id.* at 1174. Finally, the court looked to analysis by the State Board of Equalization (SBE) saying “the gross receipts from these activities come within the literal definition of ‘sales’ that are includable in the sales factor” and viewed the agency’s interpretation as influential in its holding. *Id.* at 1175.

The FTB’s discussion of the *Microsoft* case in the “Informative Digest/Plain English Overview” in the FTB’s notice of public hearing is inaccurate and provides a demonstration of how the FTB distorts the holding in *Microsoft* in order to support the FTB’s authority for proposing the amendment at issue. In its discussion, the FTB conveniently ignores the primary holding of the *Microsoft* case – that “gross receipts” means gross, not net. Instead, the FTB focuses solely on the distortion ruling, yet never mentions that this ruling was based solely on the facts and circumstances of a single case and cannot be universally applied without a similar facts-and-circumstances analysis.

In sum, the FTB does not have the authority to adopt and impose the proposed amendment. The FTB's proposed amendment applying an alternative apportionment to all taxpayers is in direct conflict with the controlling precedent of California's highest court. The court has said "gross" means gross unless the specific facts of a situation demonstrate distortion, and only then may an alternative rule be applied. The FTB turns this holding on its head and says that not only does "gross" not mean gross, but "gross" in fact means "zero." And, this corruption of the *Microsoft* holding applies to all taxpayers, such that "alternative" apportionment will no longer be "alternative" – it will be the standard. The court has ruled on the meaning of the statute and the FTB cannot change that ruling through any agency action. The statute means what the court says it means, unless and until the Legislature itself steps in to articulate a different definition or rule.

## **B. Legislative**

For several years, the FTB has attempted but failed to change the statutory definition of "receipts" included in the sales factor with respect to a taxpayer's treasury function through legislation. Legislation is the appropriate method to effect a change in the current definition; but the FTB's attempts at legislative change to this definition have not been successful. The most recent attempt began in 2005 when Steve Westly, the State Controller and FTB Chair, brought A.B. 1037, which attempted to amend the sales factor to include only net gains in the numerator of the sales factor. Notably, this bill was not introduced as a tax increase, thereby avoiding the supermajority requirement for passage. However, even with the simple majority requirement, the bill failed to pass.

As can be seen from this history, the California legislature has failed to pass the FTB's legislative fix on several occasions. The frequency of these attempts adds no strength to FTB's proposed amendment. Repeated introduction of a bill does not lead to the conclusion that it is a wise bill; rather, the FTB's repeated failures in the legislature underscore the fact that the California legislature has either deemed a change in the definition of "sales" or "gross receipts" not to be a priority or has signaled its actual disagreement with the FTB's proposal.

The FTB's proposed amendment to its own regulation interpreting a statute that has not changed is, therefore, an attempt to legislate from the executive branch of government something that cannot be done. Administrative regulations are a common part of both federal and state taxing schemes. The role of interpretive administrative regulations is to explain and clarify statutory and judicial language in order to facilitate taxpayer understanding and compliance. Such agency guidance must conform to the language contained in the statutes themselves and in court opinions interpreting such statutes. The California Administrative Procedures Act provides that: "Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute." Cal. Gov't Code § 11342.2. When administrative regulations create new law, change current law, or contradict current law, they cannot be and are not valid.

The California courts have often addressed the authority of agency regulations and practice as well as the weight that should be accorded such regulations. In *Preston v. SBE*, the California Supreme Court held that formal agency regulations interpreting a statute are “entitled to great weight” but that the court will not apply a regulation unless it “(1) is ‘within the scope of the authority conferred’ and (2) is ‘reasonably necessary to effectuate the purpose of the statute.’” *Preston v. SBE*, 19 P.3d 1148 (2001); see also *Agnew v. SBE*, 21 Cal.4th 310 (1999). In *Preston*, the court applied this principle to strike down a tax regulation that directly conflicted with a statute as to the taxability of a transaction because the regulation exceeded the agency’s authority. In that case, the regulation at issue levied a tax on the transfer of a copyright whenever a tangible work of art or reproduction of a photograph accompanied the transfer. *Preston*, 19 P.3d at 1157. This conflicted directly with the applicable statute that specifically exempted from tax the transfer of a copyright even if that transfer involved a transfer of tangible property. *Id.* In defining the “scope of agency authority conferred,” the California Court of Appeals has explained that “[a]dministrative regulations that alter or amend the statute or enlarge or impair its scope are void, and it is the court’s obligation to strike down such regulations.” Rather than create new law, an agency is authorized to “fill in the details of the statutes enacted by the Legislature.” *Helene Curtis v. Assessment Appeals Board of Los Angeles County*, 76 Cal.App.4th 124 (1999).

Furthermore, regulatory interpretation is not more powerful than judicial interpretation of a statute. *Aerospace Corp. v. SBE*, 218 Cal. App.3d 1300 (1990) (holding that a regulation conflicted with case law when the challenged regulation defining when property used for government projects is exempt from sales and use tax required that “title to property purchased for the performance of a federal contract [only] vests in the government pursuant to the title clause of that contract,” but the case law had established a contrary rule). As described above, the FTB’s authority is to promulgate regulations that carry out the provisions of a statute.

Under this well-established framework, the FTB’s proposal goes far beyond interpreting a statute so as to carry out the statute’s purposes and will therefore be void if adopted. The FTB is trying to do far more than “fill in the details” of a statute. The California courts have all interpreted the statute controlling the regulation at issue to mean something entirely different than what the FTB proposes. For these reasons, the FTB proposal would be not only void but futile.

The FTB’s proposal is also, not unexpectedly, motivated by a concern about the effect the *Microsoft* court’s holding will have on in-state companies that operate a treasury department within the state of California – e.g., potentially increasing the company’s California tax bill through inclusion of gross treasury function receipts in the numerator of the sales factor, as well as the denominator. See FTB Statement: “Significant effect on the creation or elimination of jobs in the state” in notice of public hearing (“At an interested parties meeting, comments were offered that failure to adopt the regulation might cause California-based companies to move their treasury departments out of state, with a resulting loss of jobs within California”). Nevertheless, the FTB’s solution is not the only or even the best method to address such a concern. Tax policy choices, such as whether an existing statute will cause unwanted job losses or decreases in tax revenues, are best addressed by the state’s legislature which is directly accountable to the people.

Even if the FTB is an appropriate place to address such political policy issues, the choice the FTB has proposed here is the wrong choice. First, if inclusion of gross receipts in the sales factor would have such a significant impact on California-based companies, then perhaps those companies meet the standard necessary to prove distortion and are entitled to an alternative apportionment formula on an individual basis. The FTB clearly has discretion to apply Section 25137 alternative apportionment in such instances. Second, apportionment formulas exist to ensure that income taxes are measured by or imposed on income related to in-state activities. To the extent that one taxpayer has a treasury department in California and another taxpayer has its treasury department in another state, those taxpayers should have different amounts of income apportioned to California, and the California-based taxpayer should have more of its income apportioned to California than the non-California taxpayer because the California based taxpayer conducts more income producing activities in the state. Because the proposed solution offered by the FTB completely ignores the different level of activity between in-state and out-of-state taxpayers, the solution itself is contrary to the very goals of an apportionment formula. Finally, California has many other options to protect jobs in the state, and the legislature is much better positioned to analyze the full range of options available to it for this specific purpose.

Unlike the FTB, the *Microsoft* court recognized its own limitations in any attempted revisions of the existing statutory rule. The court stated that “[i]n the absence of legislative action, however, we are not free judicially to amend the UDITPA to achieve this result [the exclusion of investment returns of capital from the definition of gross receipts].” 139 P.3d at 1183. An administrative agency cannot do what the highest court of the state acknowledged it lacks authority to effectuate; yet, that is exactly what the FTB’s proposal does. The FTB’s proposal directly contradicts the California statute it purports to interpret, as well as binding court language. As such, were the FTB proposal to be enacted, it would most likely be invalidated upon judicial review.

## **II. Proposed Amendment to the Regulation Violates the Federal Constitution**

The FTB’s proposed amendment violates the fair apportionment requirement of the Federal Constitution’s Due Process and Commerce Clauses because under its proposal, income is included in the tax base without a representation of the source of the receipts generating that income in the formula used to apportion income to California to tax. “The problem under the Commerce Clause is to determine ‘what portion of an interstate organism may appropriately be attributed to each of the various States in which it functions.’ So far as due process is concerned, the only question is whether the tax in practical operation has relation to opportunities, benefits, or protection conferred or afforded by the taxing State. Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the State.” *Ott v. Mississippi Barge Line*, 336 U.S. 169 (1949) (citation omitted). To be “fair,” “the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.” *Container Corp. of Am. v. FTB*, 463 U.S. 159, 169 (1983)(citations omitted). The FTB’s decision to exclude from the apportionment formula the very receipts directly related to the generation of income from a treasury function fails this test.

The Supreme Court has explained the standard for challenging the validity of an apportionment formula is that a taxpayer must show that “in any aspect of the evidence its

income attributable to [the taxing state] was ‘out of all appropriate proportion to the business’ transacted in that State.” *Butler Brothers v. McColgan*, 315 US 501, 507 (1942). The FTB’s proposed universal exclusion of receipts from a particular type of activity (the treasury function) while including the income from this activity in the tax base creates gross distortion and is “out of all appropriate proportion to the business transacted” in California, because it systematically and for all taxpayers apportions income based on a sales factor completely unrelated to this income.

The undersigned acknowledge that the FTB need not follow a perfect apportionment formula that includes all possible issues involved in sourcing income from multistate activities; however, the FTB cannot constitutionally include certain types of income in the California tax base while excluding the receipts associated with this income from apportionment formula merely because it does not like the result of including the receipts. The UDITPA standard apportionment formula does not require an exact (i.e., mathematically precise) result. In *Moorman Manufacturing Co. v. Blair*, 437 U.S. 267, 273 (1978), the United States Supreme Court said, “unlike separate accounting, [the formula method of computing taxable income] does not purport to identify the precise geographical source of a corporation’s profits; rather, it is employed as a rough approximation of a corporation’s income that is reasonably related to the activities conducted within the taxing State.” *Moorman*, 437 U.S. at 273; *see also Butler Brothers v. McColgan*, 315 US 501, 506 (1942) (stating, “we read the statute as calling for a method of allocation which is ‘fairly calculated’ to assign to California that portion of net income ‘reasonably attributable’ to the business done there”). The formula, albeit imperfect, is designed to be a rough approximation of income apportionable to a state, based on factors related to how and when that income was earned. *Moorman Manufacturing*, 437 U.S. at 271. Thus, while the FTB has flexibility in applying an apportionment formula that reaches a “reasonable approximation” of the income earned in the state, any such formula must be based on factors related to how the income was earned. A regulatory complete elimination of receipts from taxpayers’ treasury functions from the sales factor does not achieve an apportionment formula that is based on factors related to how the income was earned. Instead, the result of the FTB’s proposed amendment is that income from a taxpayer’s treasury function will be apportioned based on receipts generated from completely different activities. This results in the gross distortion that the three-factor formula was designed to avoid.

The constitutional infirmity caused by California’s proposed wholesale exclusion of treasury function receipts from the apportionment formula while including the related income in the apportionable tax base cannot be successfully countered by an argument that including such receipts by itself causes distortion. Whether based on a constitutional or a statutory standard, any hypothetical distortion caused by such inclusion must be shown on a case-by-case basis. *See Hans Rees’ Sons, Inc. v. Maxwell*, 283 U.S. 123 (1931); *Microsoft*, 139 P.3d at 1182 (as discussed fully above). Thus, the FTB cannot constitutionally cure a case-by-case distortion potential with a collective rule that violates the U.S. Constitution by failing to fairly apportion taxpayers’ income.

In addition, the FTB’s proposal may be subject to discrimination claims under the Commerce Clause, as out-of-state domiciled companies are disproportionately affected as compared to their California-based competitors. Inclusion of treasury proceeds in the sales

factor is more likely to dilute the California apportionment factor of an out-of-state domiciled company under California's costs of performance sourcing rules for this type of receipts. Out-of-state companies are potentially harmed by excluding gross receipts from treasury functions in their sales factor, since these receipts would be sourced outside of California. In contrast, an in-state company would benefit from excluding treasury function proceeds since that company's proceeds would likely be sourced to California.

### **III. Proposed Regulation Violates Administrative and Agency Practice Rules**

The FTB has never taken the position that it now seeks to assert in the proposed amendment to the regulation, in any of the reported cases, that proceeds from a treasury function should be completely excluded from the sales factor. Historically, the FTB's administrative practice has been to include proceeds from the sale of securities, prior to any maturation or redemption date, at gross value and proceeds from the redemption of securities at net value (*e.g.*, excluding the amount representing a return of capital) in calculating the sales factor. *See Microsoft*, 139 P.3d at 1182.

The undersigned agree with the court in *Microsoft* that the FTB's distinction between sales prior to maturity and proceeds from redemption at maturity does not necessarily make sense from an economic standpoint. The important point derived from the FTB's historic practice is that it has always included some part of the proceeds in the sales factor and has at least for some transactions acknowledged that "gross" is the rule. Oddly, the FTB claims in its "Initial Statement of Reasons for the Adoption" that the "regulation is a codification of existing Franchise Tax Board administrative policy," yet the FTB provides no support for this assertion and, as noted, this assertion is inconsistent with the litigation position that the FTB has taken in the cases decided to date. That the proposal has not, in fact, been the FTB's historic policy is further evidenced by the fact that the FTB seeks to impose the amended rule only on a prospective basis.

The decision in the *Microsoft* case could serve as the basis for issuance of new interpretive rules by an agency, even in absence of a change in the statute, but the FTB's proposal goes in the wrong direction. Instead of changing its administrative policy of routinely requiring receipts from sales of securities prior to redemption to be included at gross value but receipts from redemption at maturity to be included at net value (which the *Microsoft* court ruled was not the correct interpretation of the statutory rule), to a rule that conforms to the *Microsoft* holding, the FTB instead is attempting to adopt a rule that moves even further from the statutory requirement that the California Supreme Court reaffirmed in *Microsoft*. The FTB is moving from its historic practice, ruled invalid by the *Microsoft* court, to a new practice that is an even greater departure from the required statutory apportionment formula than the FTB's prior, invalid practice. The FTB cannot adopt a new administrative policy without a supporting change in the underlying statute or environmental circumstances. It certainly cannot adopt a new policy that effectuates an even greater deviation from the statute than its prior, now clearly invalid, policy.

#### IV. Proposed Regulation Will Not Increase Certainty or Reduce Litigation

The FTB's proposal will neither increase certainty in the calculation of the California Franchise Tax, nor end litigation regarding how to account for receipts from a taxpayer's treasury function. It will potentially increase litigation because the proposal violates so many fundamental constitutional restraints on the state's power to tax interstate income as well as principles of regulatory agency authority.

The FTB asserts that one of the reasons for its proposal is that taxpayers want the FTB to increase certainty and reduce litigation. In the FTB's statement of "Potential cost impact on private persons or businesses affected," the FTB notes that "[a]t interested parties meetings held by the Franchise Tax Board staff, comments were made that a failure to regulate would require businesses to address the question of whether the standard formula results in a fair reflection of income on a case-by-case basis every year, and that this would give rise to substantial additional compliance costs for taxpayers. As a result of this comment, the Franchise Tax Board believes that this regulation will reduce this compliance burden by providing further certainty to taxpayers." The undersigned agree that the rule articulated in *Microsoft* does require a case-by-case analysis. However, circumstances are not as dire as the FTB asserts. Unless the taxpayer's type, volume, and margins relative to its principal business and its treasury function vary drastically from year to year (surely not a typical situation), taxpayers will generally not have to perform such an analysis except when there is a significant change in the business (such as an acquisition).

*Microsoft* and its progeny have also provided specific qualitative and quantitative factors for determining the existence of distortion for purposes of calculating the receipts from a taxpayer's treasury function included in the sales factor. These factors include (a) the qualitative connection between the taxpayer's principal business and the treasury function activities; (b) the quantitative difference between the margins on the taxpayer's principal business and its treasury function; (c) the quantitative difference between the apportionment percentage when the gross proceeds from the treasury function are included and the alternative proposed; (d) the quantitative difference between the taxpayer's treasury margin and non-treasury margin; and (e) the overall qualitative difference between applying the UDITPA formula including and excluding redemptions in the sales factor. While the undersigned do not propose that these factors are dispositive or exclusive of other considerations, this judicial guidance may be sufficient in many cases to provide both taxpayers and the FTB with the appropriate analysis to reach the correct conclusion.

When, as here, California statutes and court decisions such as *Microsoft* are in direct conflict with proposed administrative regulations, taxpayers will likely comply with statutory and judicial law, rather than what are most likely invalid regulations, when it is to the taxpayer's benefit. Finally, regardless of the regulations promulgated by the FTB, taxpayers may always file under an alternative apportionment method if the standard method creates distortion and the taxpayer's alternative is reasonable. To the extent that the proposed amendment completely excludes the source of certain types of taxable income, many taxpayers will find using an alternative calculation necessary and will end up back in litigation with the FTB over the exact same issues, albeit approached from a different angle. Adopting the amendment that is contrary

to existing law and that persistently ignores the source of income included in the tax base will naturally result in increased litigation and costs for the FTB as well as taxpayers.

#### **V. Proposed Regulation Increases Non-Uniformity with UDITPA**

The proposed regulation leads to additional non-uniformity among the states that have adopted UDITPA and, thus, is contrary to the purposes of the Act. The relatively widespread adoption of UDITPA by states was effectuated in order to avoid the federal government stepping in and enforcing uniformity on state corporate income tax laws. As noted by California's highest court:

The Uniform Division of Income for Tax Purposes Act (UDITPA) attempts to address these problems (the difficulties when autonomous jurisdictions each try to tax a portion of the same pie) and fairly assess corporate taxes. Adopted by the District of Columbia and 22 states, including California, it seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme – equitable to each jurisdiction, seeking its own fair share, and equitable to the taxpayer, who in the absence of uniform rules faces the prospect of having the same income taxed by two, three, or more different states.

*Microsoft*, 139 P.3d at 1171.

The FTB's proposed amendment to its apportionment regulation not only destroys this uniformity but will actually result in double taxation of taxpayers subject to tax in both California and in other states that incorporate UDITPA, but follow the standard rule that the term "gross receipts" means gross unless the state tax authority proves that unique facts of a specific taxpayer result in distortion. Consider in this regard the following hypothetical:

Corporation X is headquartered in State A – a UDITPA state; performs its Treasury function from its headquarters; and is taxable in California. Assuming a three-factor formula with equally weighted factors for simplicity Corporation X's tax attributes are as follows:

- Total Taxable Income: \$1000
- Total Gross Receipts : \$2000 (including gross receipts from the treasury function)
- State A Gross Receipts : \$1000 (including receipts from the treasury function)
- CA Gross Receipts: \$1000
- Gross Receipts from the Treasury Function: \$500
- State A property factor: 50%
- CA property factor: 50%
- State A payroll factor: 50%
- CA payroll factor: 50%

**A. State A Tax Calculation:**

- Apportionment percentage:  $(.50 + .50 + 1000/2000)/3 = 50\%$
- Taxable income:  $\$1000 \times 50\% = \mathbf{\$500}$

**B. California Tax Calculation:**

Under the FTB's proposed amended regulation, in which neither gross receipts nor net income from a treasury function is accounted for in the sales factor (although included in apportionable income tax base), Corporation X's California tax calculation would be as follows:

- Apportionment percentage:  $(.50 + .50 + 1000/(2000-500))/3$   
 $= (.50 + .50 + .67)/3 = 56\%$
- Taxable income:  $\$1000 \times 56\% = \mathbf{\$560}$

Thus, Corporation A is paying tax on **106%** of its total income even though California and State A have both adopted the identical statute, UDITPA – a statute intended to promote uniformity and prevent over-or under-taxation.

Such double taxation of income between two UDITPA states frustrates the very purposes for which UDITPA was created. It is not within FTB's authority to modify UDITPA or to thwart the policy behind the existence UDITPA as expressly recognized by the FTB's own highest court. Should a problem exist with UDITPA sourcing, the current UDITPA revision project being undertaken by the statute's original drafting organization, the National Conference of Commissioners on Uniform State Laws is the authorized and proper forum to address the concern. (On July 2007 at NCCUSL's Annual Meeting, its Uniform Laws Committee approved a drafting committee to revise UDITPA. As noted on NCCUSL's website: "This committee will revise the Uniform Division of Income for Tax Purposes Act, last amended in 1966. Twenty-five states have adopted UDITPA and a number of others have effectively done so by joining the Multistate Tax Commission. The drafting committee. . . will engage in a comprehensive review of the Act.")

**VI. Proposed Regulation Improperly Shifts the Burden of Proof**

It is undisputed that when any party, either the taxing authority or the taxpayer, requests the use of an apportionment formula other than the standard formula provided by statute, that party bears the burden of proof to demonstrate that (1) the standard apportionment formula yields a result that is distortive and (2) the proposed alternative formula is "reasonable." California's standard apportionment formula, as defined by the state's highest court, requires that proceeds from the treasury function be included in the sales factor at gross value. Thus, any party deviating from the use of gross receipts bears the burden of showing why the deviation is appropriate and that the proposed alternative is reasonable. This burden is also a heightened burden of proof – namely to demonstrate the elements of distortion and reasonableness by clear and convincing evidence.

In each of the cases addressing this issue, the California Supreme Court has placed the burden of proof appropriately on the FTB, because it is the FTB that is arguing for a different calculation of the sales factor. Notwithstanding the clear articulation of which party bears the burden, the FTB hereby attempts to alter the standard statutory apportionment formula by regulation and to shift the burden of proof for deviation from itself to taxpayers. The FTB is essentially arguing that it can unilaterally change the standard statutory apportionment formula through a regulation, rather than meeting its heightened burden of proof for deviation from the standard formula on a case-by-case basis. The FTB does not have such authority.

In *Microsoft* and a subsequent decision by the California Superior Court, *Square D*, the courts explained that the burden of proof in cases involving Section 25137 falls squarely on the FTB. *Microsoft*, 139 P.3d at 1177 (“As the party invoking section 25137, the Board has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable.”); *Square D Company v. FTB*, Dkt. No. CGC 05-442465 (Cal. Super. et. 2007). The party invoking the right to an alternative apportionment formula bears a higher burden of proof than in a standard tax controversy. The party must show that an alternative apportionment formula is appropriate by “clear and convincing evidence.” *See Square D, supra*. “The clear and convincing evidence standard requires a finding of high probability, leaving no substantial doubt.” *Id.*

Which party bears this burden of proof is a legal question and cannot be shifted by agency action. The FTB’s proposed amendment to the regulation improperly shifts the burden of proof to the taxpayer by requiring the taxpayer to show that (1) the approximation provided by the FTB’s alternative formula does not fairly represent the taxpayer’s in-state activity, and (2) application of the standard UDITPA sales factor approach (or some other alternative approach proposed by the taxpayer in question) is reasonable. It is not for the FTB to define what the standard formula is – this has been legislated and subsequently clarified by the California courts. Therefore, if the FTB wants to impose an alternative apportionment rule, such as complete exclusion of receipts from the Treasury function, the FTB is the party that bears the burden of proof which can be met only through submission of clear and convincing evidence. The proposed amendment to the regulation ignores these fundamental requirements. A regulation that ignores and is contrary to the law is invalid from the start.

## **Conclusion**

The undersigned are not unaware of the potential for difficulties created for both taxpayers and the FTB, if the FTB chooses to challenge every taxpayer that follows the statutorily mandated use of gross receipts for purposes of calculating its sales factor. However, as explained above, the proposed amendment to the Section 25137 regulation does not ameliorate or eliminate these difficulties, and any attempt by the FTB to alter the current course of judicial review may, in fact, be premature and counterproductive. Given the very recent genesis of concrete judicial guidance interpreting the scope and considerations in determining whether inclusion of receipts from a taxpayer’s treasury function create distortion, it remains to

be seen whether *Microsoft* and the follow-up cases do, in fact, provide sufficient guidance for taxpayers and the FTB to determine, without recourse to litigation, whether distortion occurs.

While litigation is not always the most cost-effective means to achieve resolution of contested issues, be they legal or factual in nature, judicial decisions are frequently helpful and often the only available method to set parameters for generally applicable legislation, in a complex world in which individual facts and situations are always unique. In many instances, a series of cases, each providing color and depth to a broad statute, will actually provide far more guidance than introducing a problematic new standard with no history of interpretation.

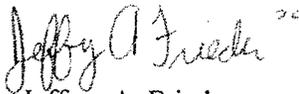
Many aspects of tax law require a facts-and-circumstances analysis. When appropriate guidelines consistent with the existing law set forth the parameters under which the taxpayer's facts and circumstances are to be analyzed, taxpayers have been successful in complying with the tax law with a minimum of compliance cost and effort and litigation. In this case, with the new guidance provided by *Microsoft* and other cases, taxpayers may be able to reach appropriate and generally non-adversarial conclusions regarding the appropriate calculation of the sales factor. Unfortunately, FTB itself is creating some of the problems in applying the guidance provided by the courts on this issue. It appears that the FTB Settlement Bureau is unwilling to engage in facts-and-circumstances analysis, even though that is what has been mandated by the courts. Without the opportunity for settlement, taxpayers have no choice but to pursue litigation. By refusing to follow the existing guidance, the FTB is creating the very litigation problem that it claims it is seeking to avoid.

If the guidance from *Microsoft* and the follow-up cases ultimately proves insufficient for taxpayers and the FTB, corrective legislation is always an option. *Microsoft* was decided just barely one year ago, the follow-up cases are newer still (with many on remand or on appeal), and even more cases are in the litigation pipeline. The tax community has not had time to completely absorb and apply the reasoning in the recent judicial guidance. The California legislature itself has therefore not had the benefit of time to determine if new legislation is in fact necessary. The FTB's proposed regulation is premature, and may ultimately be unnecessary and even counterproductive. The FTB is applying a bad solution to a problem that may not materialize.

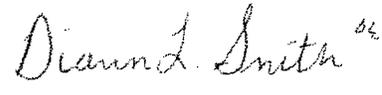
The FTB always has the option of being much more selective in its choice of taxpayers for which it finds the use of the statutory gross receipts rule to be distortive. Apportionment rules are not meant to be, and cannot be, perfect in every situation. As noted above, the UDITPA formula is designed to be a only a "reasonable approximation" of income apportionable to a state, based on factors related to how and when that income was earned. The FTB clearly has discretion in how low, or high, it interprets the threshold for distortion.

In conclusion, the undersigned request that the proposed amendment to Reg. § 25137(c)(1) not be considered and not be adopted, for the fundamental reason that the FTB lacks the authority to impose a regulation that is directly contrary to the holding of the state's highest court regarding a statute the regulation purports to interpret, and for the numerous additional reasons discussed above.

Sincerely,

  
Jeffrey A. Friedman  
Partner

  
Kendall L. Houghton  
Partner

  
Diann L. Smith  
Counsel

JAF/KLH/ge  
Enclosure  
cc: File

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September 17, 2007

Ms. Colleen Berwick  
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 Rancho Cordova, CA 95471-1720

Re: Response to Submission of General Motors Corporation to Proposed  
 Regulation 25137(c)(1)(D) ("Treasury Regulation")

Dear Ms. Berwick:

On behalf of Business for Economic Growth in California ("BEGC"), a coalition of major California-based companies<sup>1</sup>, collectively employing more than seventy-six thousand (76,000) Californians, I am writing to express our strong support for the draft regulation referenced above. Further, this letter addresses certain comments submitted by General Motors Corporation ("GM") on August 16, 2007 through its counsel Ajalat, Polley, Ayoob & Materese. As explained below, these comments are incorrect and misplaced.

#### Overview

BEGC strongly supports the Franchise Tax Board ("FTB")'s draft Treasury Regulation. The recent California Supreme Court opinions in *Microsoft* and *General Motors* have created substantial uncertainty among taxpayers regarding inclusion of treasury function gross receipts in the sales factor. The draft regulation is a straightforward solution providing clarity on this matter, resulting in certainty to taxpayers and ease of administration for the FTB. Further, the draft regulation will largely avoid new disputes and conserve FTB and taxpayer resources. It is also an approach similar to that used by a number of other states including New York, the location of GM's Treasury Department.<sup>2</sup>

BEGC understands that the staff of the FTB has conducted an analysis of corporate taxpayer data and has determined that inclusion of the treasury gross receipts in the sales factor would be distortive under the standards set forth by the State Board of

<sup>1</sup> Applied Materials, Cisco Systems, Health Net, Intel Corporation, Walt Disney Company and Chevron.

<sup>2</sup> *General Motors Corp. v. Franchise Tax Board* (2006) 39 Cal.4<sup>th</sup> 773, 779.

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Equalization in the *Appeal of Pacific Telephone & Telegraph Co.*,<sup>3</sup> *Microsoft Corporation v. Franchise Tax Board*,<sup>4</sup> and *The Limited Stores, Inc. v. Franchise Tax Board*.<sup>5</sup> The members of BEGC would meet the definition of “distortion” in the same manner as those cases relied on by the FTB.

GM asserts that the FTB’s proposed Treasury Regulation is an illegal and unconstitutional tax increase and that the FTB does not have the authority after the recent California Supreme Court (“Court”) decision in *Microsoft* to promulgate such a regulation. As further described below, each of these assertions is incorrect. The Treasury Regulation proposed by the FTB is clearly within the authority granted the agency to promulgate regulations under California Revenue and Taxation Code (“CRTC”) §§ 19503 and 25137. Furthermore, such actions by the FTB are, in fact, consistent with the *Microsoft* ruling and the overall statutory scheme. Finally, such actions are neither unconstitutional nor illegal but are clearly within the FTB’s mandate under CRTC § 25137 to ensure that the apportionment and allocation rules fairly reflect the extent of a taxpayer’s activities in the state. To the extent that it determines an adjustment is warranted to the standard apportionment and allocation rules, the FTB is empowered by CRTC § 25137 to make such adjustments either on an individual taxpayer basis or through the promulgation of regulations. Over the years, the FTB has promulgated numerous regulations setting forth alternatives to the standard apportionment and allocation rules and this proposed regulation is merely another example of such a regulation.

**The Treasury Regulation is not a Law Change, but an Intended Exercise of FTB Authority that Alleviates the Distortion in the Standard Apportionment Formula Caused by Including Treasury Receipts on a Gross Basis**

GM in its letter suggests that “only the Legislature, not an administrative body like the FTB, can change the law” and that “a regulation that excludes all security receipts is a tax increase that by definition is a change of law.” Putting aside for the moment that this regulation is not a tax increase (as discussed later in this letter), the FTB’s proposed regulation does not constitute a law change. A regulation promulgated under a code section that was specifically designed to permit the FTB to adjust the standard apportionment and allocation rules in situations where the standard formula is distortive cannot be construed as a law change. If GM’s assertion were correct, then the multitude of CRTC § 25137 regulations issued by the FTB over the past 35 years would be invalid. Instead, as explained below, the regulation is a permitted and necessary remedy under federal and state law.

<sup>3</sup> Calif. St. Bd. Of Equal., SBE-XXIII-375, 78-SBE-021, May 4, 1978, CCH Calif. Tax Rptr. ¶ 205-858.

<sup>4</sup> (2006) 39 Cal.4<sup>th</sup> 750.

<sup>5</sup> (2005) 2005 Cal.App.Unpub. LEXIS 6572.

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The U. S. Supreme Court has noted that the three-factor apportionment formula employed by California “has become . . . something of a benchmark against which other apportionment formulas are judged.”<sup>6</sup> In *General Motors Corp. v. District of Columbia*,<sup>7</sup> the U.S. Supreme Court noted that the apportionment formula can be justified as “a rough, practical approximation of the distribution of either the corporation’s sources of income or the social costs which it generates.” That being said, however, the standard apportionment and allocation rules are not “set in concrete” such that they cannot be adjusted in appropriate cases. CRTC § 25137 recognizes that there are circumstances when adjustments to the standard apportionment and allocation rules are necessary when these rules do not fairly represent the extent of a taxpayer’s business activities in the state. Pursuant to this provision, the FTB is authorized to modify the apportionment and allocation rules as needed in order to more fairly reflect the extent of a taxpayer’s activities in the state.

The standard established by CRTC § 25137 as to when the FTB may exercise its statutorily delegated power is very broad, namely whenever “the allocation and apportionment provisions do not fairly represent the extent of the taxpayer’s business activities in the state.” CRTC § 25137 sets forth various means by which the FTB may seek to vary the formula, namely separate accounting, exclusion of one or more of the prescribed factors, or inclusion of others “which will fairly represent the taxpayer’s business activity in the state,” or “any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.” The choice of appropriate remedy is left by CRTC § 25137 to the FTB to determine.

To limit the FTB’s authority to promulgate regulations under CRTC § 25137 is not only contrary to the plain wording of section 25137 but is impractical as well. As noted in Hellerstein & Hellerstein, *State Taxation* (3<sup>rd</sup> Ed. 1998), ¶ 9.20[1], there are no reported cases successfully attacking regulations promulgated under Section 18 of UDITPA, CRTC § 25137’s counterpart, on the grounds that they exceed the scope of the authority UDITPA grants to administrators. In describing the power delegated to the taxing authority to promulgate regulations when the allocation and apportionment provisions “do not fairly represent the extent of the taxpayer’s business activities in the state,” Hellerstein has characterized it as “very broad” and “appropriate to the problem at hand.” Even the Court in footnote 21 of the *Microsoft* opinion noted that Professor William J. Pierce, the original drafter of the UDITPA, described Section 18 of UDITPA “as necessary to deal with potentially unconstitutional results, but also as a provision that gave both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved.”<sup>8</sup>

<sup>6</sup> *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159, 170

<sup>7</sup> 380 U.S. 553, 561 (1965)

<sup>8</sup> *Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4<sup>th</sup> 750, 770

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Over the years, the FTB has promulgated many regulations pursuant to the authority granted it under CRTC § 25137. In some cases, the changes made by regulation promulgated by the FTB applied on an industry basis<sup>9</sup> while in other cases, the modifications made by the FTB have applied to taxpayers in general.<sup>10</sup> The Treasury Regulation in question is yet another situation where a change in the standard apportionment and allocation rules is generally necessary. The FTB has determined that an adjustment to the standard apportionment and allocation rules regarding the exclusion of the gross receipts from the treasury function is warranted in order to fairly represent the extent of a taxpayer's business activities in the state. The exercise by the FTB of its statutory mandate to adjust the standard apportionment and allocation rules when necessary is not "unconstitutional" as alleged by GM.

**The Treasury Regulation is Consistent with the Microsoft Holding. The Holding is Misstated by GM.**

The GM letter states the Court in *Microsoft* held "that an amount between the net and gross should be included" and that "the truth doubtless lies somewhere in between." This is not an accurate statement of the holding of this case. What the Court in *Microsoft* did hold was that: 1) the term "gross receipts" included the entire redemption price of marketable securities; and 2) the FTB met its burden under CRTC § 25137 that the standard apportionment and allocation rules did not fairly represent the taxpayer's business activities in the state and its proposed alternative of including net receipts was reasonable. The Court did not as a matter of law conclude that "an amount between the net and gross should be included." Further, the language that is quoted--"the truth doubtless lies somewhere in between"--refers only to a specific example set forth in footnote 23.<sup>11</sup>

In *Microsoft*, the Court was addressing the specific facts of a particular taxpayer, not a regulation under CRTC § 25137. Although not specifically stating a rule of general applicability, the Court did come as close to doing so as it could without so stating when it approvingly noted the State Board of Equalization ("Board")'s conclusion in the *Appeal of Crisa Corp.*, Calif. St. Bd. Of Equal., June 20, 2002, CCH Cal. Tax Rptr. ¶ 403-295. Specifically, that the operation of a large treasury department unrelated to a taxpayer's main line of business is a paradigmatic example of circumstances warranting invocation of CRTC § 25137. The Court noted that the Board included a nonexclusive list of such circumstances:

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<sup>9</sup> See, e.g., California Code of Regulations ("CCR"), title 18, section 25137-2 (dealing with contractors apportioning income on long-term contracts); CCR section 25137-3 (franchisors); CCR section 25137-4.2 (banks and financial corporations); CCR 25137-5 (commercial fishing), etc.

<sup>10</sup> See, e.g., CCR section 25137(c)(1)(A) (where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property).

<sup>11</sup> Id. at 771.

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“[o]ne or more of the standard factors is biased by a substantial activity that is not related to the taxpayer’s main line of business. For example, the taxpayer continuously reinvests a large pool of ‘working capital,’ generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business.”<sup>12</sup>

The Court also cited favorably decisions in other states (*Sherwin-Williams Co. v. Johnson*<sup>13</sup> and *American Telephone & Telegraph Co. v. State Tax Appeal Bd.*<sup>14</sup>) that invoked UDITPA’s relief provision (Section 18) to cure the resulting distortion caused by inclusion of treasury receipts in the sales factor. The Court noted:

“The SBE and these sister-state courts implicitly recognize that the problem arising from inclusion of the full sale or redemption price of a short-term security is not that the full price is not gross receipts. Rather, the problem is one of scale: short-term securities investments involve margins (i.e., differences between cost and sale price) that may be several orders of magnitude different than those for other commodities . . . modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation’s business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation’s business pose a problem . . . in such circumstances, rote application of the standard formula does not fairly represent the extent of a taxpayer’s activity in the state, except in the rare instance when corresponding imprecision in the payroll and property factors may happen to balance out this distortion.”<sup>15</sup>

The Court noted that CRTC § 25137 relief was appropriate in recurring situations and that “declining to apply UDITPA’s relief provision to this type of situation would create a significant loophole exploitable through subtle changes in investment strategy.”<sup>16</sup>

Additional evidence that the Treasury Regulation is not inconsistent with the *Microsoft* ruling can be found within the opinion. In *Microsoft*, the Court noted that some state legislatures remedied the issue of including treasury receipts in the sales factor by amending their respective income apportionment statutes to expressly exclude investment returns of capital from gross receipts. Significantly, the Court also noted that *amicus curiae* Multistate Tax Commission has proposed model regulations to also exclude investment returns of capital from gross receipts. While the Court invited the

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<sup>12</sup> Id. at 766.

<sup>13</sup> (Tenn.Ct.App. 1998) 989 S.W.2d 710

<sup>14</sup> (1990) 241 Mont. 440

<sup>15</sup> *Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4<sup>th</sup> 750, 767-768.

<sup>16</sup> Id. at 770.

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California Legislature to adopt its own solution to this problem, the fact that the Court cited both legislative as well as regulatory solutions as ways to address this problem gives further credence to the FTB's actions proposing this Treasury Regulation. Further, the promulgation of the Treasury Regulation under CRTC § 25137 comports with the Court's desire to "achiev[e] uniformity, a central goal of UDITPA." The Court, after noting that UDITPA shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it, went on to hold:

While there is a nationwide split over whether the return of investment capital is included in gross receipts, those states that do include it and have addressed the further application of UDITPA's relief provision uniformly allow use of that provision to ameliorate resulting distortions.<sup>17</sup>

### **The Treasury Regulation Does Not Interfere with the Judicial Process**

In its letter, GM suggests that the proposed regulation is "an unnecessary interference into the judicial process" noting that there are several cases pending at the trial and appellate levels.

This is a false argument for a simple reason: The regulation is *prospective only*, and applies by its own terms to taxable years beginning on or after January 1, 2007 (Proposed regulation 25137(c)(1)(D)(3)).

### **The Treasury Regulation Is NOT a "Tax Increase"**

GM asserts that the Treasury Regulation "illegally increases the taxes of large taxpayers with out-of-state treasury departments." This assertion is simply false for several reasons.

First, the Treasury Regulation does not "increase" or "decrease" anything. It is based upon a finding by the FTB staff, that inclusion of treasury receipts in the sales factor does not fairly represent the extent of the business activities of taxpayers in the state. Based upon that conclusion, the Treasury Regulation "throws out" (excludes) those treasury receipts from the sales factor. However, the Treasury Regulation clearly provides that a taxpayer who believes that the inclusion of such treasury receipts in the sales factor is warranted may petition to have such receipts included in the sales factor. Thus, any taxpayer may seek relief from this regulation if it believes that it can demonstrate that the exclusion of such receipts does not fairly represent the extent of its business activities in California. Therefore there is no "increase" or "decrease" as GM alleges. GM is simply seeking to quash the FTB's Treasury Regulation to obtain a result which was denied by the Court.

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<sup>17</sup> *Id.* at 766-767.

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Second, an “increase” or “decrease” presumes that there is some fixed standard in the law that is changed. This simply is not true here. CRTC §§ 25120 and 25137 currently work together to provide that treasury receipts may be included in the sales factor, either at gross or net, or fully eliminated, depending on what method fairly represents the extent of a taxpayer’s business activities in the state. Nothing in the Treasury Regulation changes that. The adoption of the Treasury Regulation remedies an upside down and inefficient situation that otherwise would be created where the vast majority of taxpayers would fall within the exception (to exclude treasury gross receipts from the sales factor) while a very small minority of taxpayers would constitute the rule (the inclusion of treasury gross receipts in the sales factor).

Finally, GM in its letter seems to equate the term “tax increase” with “increasing revenues” (see Art. XIII A, sec. 3). However, GM has overlooked the phrase “any changes in State taxes” that precedes the phrase “increasing revenues” in this section of the state Constitution. When read in proper context, this section requires a two-thirds vote of each house of the Legislature to pass a *legislative* act for any changes in state taxes enacted for the purpose of increasing revenues. This constitutional section simply has no relevance here. As explained above, there can be no “change in the law” by an administrative body (the regulation is either consistent with the statute it implements or it isn’t) and even if there were a law change, the staff of the FTB has determined that across all taxpayers, the Treasury Regulation will not have significant impact on state revenues.<sup>18</sup>

### **The Treasury Regulation Is Constitutional**

GM suggests that the “proposed regulation is unconstitutional” since the “FTB [is seeking] to tax the income of out-of-state treasuries without giving the treasuries any representation in the gross receipts factor.” GM then goes on to quote the following from the *Microsoft* decision where California Supreme Court stated “mixing little or no treasury receipts with gross receipts from all other transactions exaggerates the resulting [California] tax.”<sup>19</sup> GM is mistaken.

Neither the U.S. Supreme Court nor the Court has ever held that all items of income must be included in the sales factor. The very existence of CRTC § 25137 negates this notion because it provides relief when the standard apportionment and allocation rules unfairly reflect the extent of a taxpayer’s business activities in the state. The FTB has previously promulgated CCR section 25137(c)(1)(A) which excludes substantial amounts of gross receipts that arise from an occasional sale of a fixed asset or other property. The Treasury Regulation, which is also being promulgated pursuant to

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<sup>18</sup> Initial Statement of Reasons for the Adoption of California Code of Regulations, Title 18, Section 25137(c)(1)(D).

<sup>19</sup> *Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4<sup>th</sup> 750, 771.

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the authority granted to the FTB under CRTC § 25137, reflects the FTB's determination (after reviewing taxpayer data) that the inclusion of the treasury receipts in the sales factor is distortive and that the proper remedy is to remove such receipts. It should be noted that even though the treasury receipts are excluded from the apportionment formula, other relevant factors such as the payroll of the treasury personnel are in fact reflected in the apportionment formula.

Further, with respect to the quotation noted above, GM conveniently fails to quote additional language from this opinion that sheds light on this point. Immediately following the language GM quoted above, the Court provided further explanation of when such "exaggeration" may occur. The Court stated: "If, **unlike here**, treasury operations provide a **substantial portion of a taxpayer's income**, this exaggeration may result in an apportionment that does not fairly represent California business activity."<sup>20</sup> (Emphasis added.) It is clear when these sentences are read in the proper context that the exaggeration that GM asserts will occur if the treasury operations provide a substantial portion of a taxpayer's income. However, when the treasury operations do not provide a substantial portion of a taxpayer's income (as was the case in *Microsoft*), no such exaggeration occurs. Finally, it should be noted that the Treasury Regulation permits taxpayers who believe that the exclusion of the treasury receipts from the sales factor would in fact be distortive in their particular situation to petition the FTB to adjust the sales factor to permit the inclusion of such receipts in the factor.

### **The FTB Has the Authority to Shift the Burden of Proof to Taxpayers Who Wish to Deviate from the Standard Apportionment and Allocation Rules**

GM asserts that the FTB does not have the authority after the *Microsoft* decision to shift the burden of proof to taxpayers who wish to deviate from the standard apportionment and allocation rules. GM is incorrect.

In *Microsoft*, the Court was addressing the specific facts of a particular taxpayer, not a regulation under CRTC § 25137. As previously indicated, the Court approved the Board's conclusion in *Crisa Corp.* that the operation of a large treasury department unrelated to a taxpayer's main line of business is an example of a circumstance warranting invocation of CRTC § 25137. While it is true that the party seeking to deviate from the standard apportionment and allocation rules has the burden of proving that the standard rules do not fairly represent the extent of a taxpayer's business activities in the state, this rule does not apply when dealing with a regulation under CRTC § 25137. In the *Appeal of Fluor Corporation*,<sup>21</sup> the Board held that:

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<sup>20</sup> Id.

<sup>21</sup> Calif. St. Bd. Of Equal., 95-SBE-016, December 12, 1995, CCH Calif. Tax Rptr. ¶ 402-814.

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“if a relevant special formula is specifically provided for in the section 25137 regulations and the conditions and circumstances delineated in such regulations are satisfied, the method of apportionment prescribed in those regulations shall be the standard by which the parties are to compute the taxpayer’s apportionment formula. In other words, once found to be applicable to the particular situation, the section 25137 regulations will control. . . . [W]e also hold that any party wishing to deviate from the method prescribed by the regulation, when found to be applicable, must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer’s activities in the state. (Citations omitted.)”

The decision in *Microsoft* does not affect this conclusion.

### **GM’s “Parade of Horribles” Is Without Merit**

GM closes its letter to the FTB by asserting that “to adopt a regulation under CRT C § 25137 is to open the floodgates to separate accounting and other formulas to taxpayers creating chaos and significantly increasing the burden on the FTB Staff.” This is the classic “Parade of Horribles” argument and is completely without merit. If it is intended to scare the FTB from pursuing this regulation, it must fail. As evidenced from all of the cases to date, the vast majority of the taxpayers will remedy an otherwise distortive formula by following the new regulation, thus reducing significantly the number of controversies and case-by-case CRT C § 25137 petitions that would otherwise be presented. And for those in the minority of cases where the regulation is not appropriate, current law under CRT C § 25137 permits a taxpayer who believes that an adjustment to the apportionment and allocation rules must be made in its particular situation to petition the FTB to have such an adjustment made. The Treasury Regulation does not in any way deny taxpayers the right to petition for such a change and if requested, the FTB will conduct a thorough review of the taxpayer’s petition to determine if a change is warranted.

### **GM opposes the Treasury Regulation because it would Eliminate its Tax Planning Scheme to Create Untaxed Income**

The foregoing analysis provided by BEGC is based upon an analysis of the current state of the law in California. However, BEGC would be remiss if it did not point out the practical effect of what GM is attempting to do—the creation of “no-where income” that escapes taxation. By shifting income out of California when it seeks only to include the gross receipts from its treasury activities in the denominator of the California sales factor, it creates a “win-win” situation for itself by virtue of the fact that in New York (the location of its treasury department), the same receipts are not included in the numerator of the sales factor. To not adopt the Treasury Regulation would certainly be

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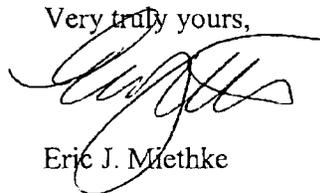
advantageous for GM, but would do so at the expense of good tax policy intended to assure conformity among both in-state and out-of-state taxpayers.

**Conclusion**

BEGC urges that the Treasury Regulation be adopted in order to achieve efficient tax administration and fair and good tax policy.

If you have any questions, please do not hesitate to contact me.

Very truly yours,

A handwritten signature in black ink, appearing to read "Eric J. Miethke", written in a cursive style.

Eric J. Miethke

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August 16, 2007

VIA FACSIMILE AND U.S. MAIL

916-845-3648

Ms. Colleen Berwick  
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**Re: Proposed Amendment to Regulation 25137**

Dear Ms. Berwick:

General Motors respectfully requests that the Franchise Tax Board (the "FTB") not consider nor adopt the FTB staff's proposed Revenue & Taxation Code section 25137 ("Section 25137") regulation. This letter is a written request that the FTB Members not delegate nor authorize any potential adoption of the proposed regulation to the FTB staff.

**FTB'S PROPOSED REGULATION UNDER SECTION 25137 IS AN ILLEGAL AND UNCONSTITUTIONAL TAX INCREASE**Background.

Most large corporations have treasury departments that buy and sell marketable securities. Current law requires a taxpayer to include the gross receipts from a treasury department's sale or redemption of such marketable securities in the gross receipts factor (*see e.g. Microsoft v. Franchise Tax Board* (2006) 39 Cal.4th 750 ("*Microsoft*"). In certain circumstances, the FTB or the taxpayer can utilize Section 25137 to modify the statutory formula.

In *Microsoft*, the FTB argued that including all of Microsoft's security gross receipts in Microsoft's gross receipts factor caused "distortion." The FTB sought to exclude Microsoft's security gross receipts and only include the security net receipts. The California Supreme Court approved the FTB's use of net receipts in the specific Microsoft situation (a treasury department with very high gross receipts and very low income), but warned that "in other cases the Board's approach [using net receipts] may go too far in the opposite direction and fail the test of reasonableness. By mixing net receipts for a particular set of out-of-state transactions [treasury

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Franchise Tax Board Legal Branch  
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transactions] with gross receipts for all other transactions, it minimizes the contributions of those out-of-state transactions to the taxpayer's income and exaggerates the resulting tax." *Microsoft* at 771.

The FTB Staff's proposed regulation under Section 25137 would exclude all treasury department security receipts from the gross receipts factor (the proposed regulation excludes both gross and net receipts). As *Microsoft* noted, this minimizes totally the contributions of out-of-state treasury transactions to taxpayer's income and greatly exaggerates the resulting tax.

The California Supreme Court noted that in most cases the gross receipts factor should include either the statutorily-required gross receipts (except for the unusual situations where Section 25137 applies) or at least something more than net receipts (where Section 25137 applies). Despite the fact that gross receipts or at least some gross receipts must be used, the proposed regulation excludes both net and gross receipts.

Further, the proposed regulation is an unnecessary interference into the judicial process as there are currently several cases pending at the trial and appellate level that will set forth the amount of security receipts to include in the gross receipts factor. In fact, the California Supreme Court remanded *General Motors v. Franchise Tax Board* (2006) 39 Cal.4th 773 ("*General Motors*") for the very purpose of setting forth standards for determining when the FTB has met its burden of proving by clear and convincing evidence not only that Section 25137 applies but setting forth standards for determining when the FTB has met its burden of proving by clear and convincing evidence that a particular alternative formula in a particular case fairly reflects the taxpayer's business activity in California.

#### The Proposed Regulation Illegally Increases Taxes on Companies with Out-of-State Treasuries.

For past years, the FTB has included gross receipts from sales of securities (in addition to net receipts from redemptions and other treasury transactions) in the gross receipts factor.

In litigation, the FTB conceded that gross receipts from sales of treasury securities must be included as gross receipts in *General Motors* and other cases and that Section 25137 did not apply to just those receipts. In addition, in *Microsoft*, the California Supreme Court held that in most cases, including either gross receipts or net receipts in the gross receipts factor, does not work. Rather, after stating that mixing only out-of-state treasury net receipts with all other out-of-state gross receipts exaggerates the California tax (see above), the Court held that an amount between net and gross receipts should be included:

"Consider two sales: a sale for \$10 that yields \$1 in income in state X, and a sale for \$10,000 that yields \$1 of income in state Y. If one includes gross receipts from both sales, one concludes that state Y's contribution to sales is 1,000 times greater than state X's. On the other hand, if one corrects for this by only the net receipts from the second sale – the \$1 – one concludes that state X's contribution to sales is 10 times greater than

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state Y's contribution. **The truth doubtless lies somewhere in between.** (*Microsoft* at 771, emphasis added.)

The proposed FTB staff regulation ignores the FTB's long-time practices as well as the California Supreme Court's ruling in *Microsoft*.

The proposed regulation is a changed methodology under California Constitution Article XIII A which increases taxes from the FTB's previous methodology of including gross receipts from sales of treasury securities in the sales factor. In addition, instead of following the direction of the *Microsoft* Court and attempting to determine an amount of receipts to include between gross and net (the only legal solution), the proposed regulation excludes all receipts (both gross and net). The proposed regulation's solution certainly does not "lie somewhere in between."

Because, for past years, the FTB has included gross receipts from sales of treasury securities and net receipts from other treasury transactions and because the Supreme Court held that the "truth doubtless lies somewhere in between" gross and net receipts, the proposed regulation, if legal (which it is not), would increase taxes on all large taxpayers with out-of-state treasury departments and would be a net tax increase.

Further, the FTB's statement in its Initial Statement of Reasons for the Adoption of the Proposed Regulation that the proposed regulation "will not have a significant overall economic impact on business" because it "is a codification of existing Franchise Tax Board administrative policy" is patently false. The FTB has not excluded all receipts (both gross and net) from dispositions of treasury securities. In fact, during the past several years, the FTB has included gross receipts from sales of securities and net receipts from other security dispositions for taxpayers.

Prior to the *Microsoft* decision, consistent with the FTB's interpretation of the law, taxpayers with out-of-state treasuries included gross receipts from sales of securities in the denominator of the gross receipts fraction of the apportionment formula, but not in the numerator and the FTB even stipulated in court proceedings that this was appropriate. This lowers the overall percentage of income apportioned to California to account for the fact that the treasury income is earned out-of-state. Excluding all such receipts or using only net receipts for all treasury securities including sales, under the proposed staff regulation, lowers the gross receipts factor denominator of taxpayers with out-of-state treasuries. This increases the amount of income apportioned to California and, therefore, increasing taxes on such companies.

An example of the effect was run and showed the following:

- A. Current law, an 18% apportionment.
- B. FTB's practice (net receipts from treasury redemptions and gross receipts from treasury sales), approximately a 19% apportionment.

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- C. Including only net receipts, from all treasury sales and redemptions, a 19.8% apportionment or a 1.8% tax increase.
- D. FTB staff proposed regulation (no treasury net or gross receipts included), a 20% apportionment or a 2% tax increase.<sup>1</sup>

A regulation cannot increase taxes because a tax increase, by definition, is a change in the law. Only the Legislature, not an administrative body like the FTB, can change the law. As the California Supreme Court said in *Ontario Community Foundation, Inc. v. State Bd. of Equalization* (1984) 35 Cal. 3d 811:

“Administrative regulations that violate acts of the Legislature are void and no protestations that they are merely an exercise of administrative discretion can sanctify them.’ . . . *Administrative regulations that alter or amend the statute or enlarge or impair its scope are void and courts not only may, but it is their obligation to [,] strike down such regulations.*’ (*Id.* at 748)” (*Woods v. Superior Court* (1981) 28 Cal. 3d 668, 679 italics added.)” *Ontario* at 816-7 (emphasis by the Court).

Moreover, excluding all security receipts is a undeniable tax increase as taxpayers have included net receipts or something more than net receipts in the sales factor for several decades. The California Constitution clearly prohibits the FTB by regulation imposing a tax increase:

“Section 3. From and after the effective date of this article, any changes in State taxes enacted for the purpose of **increasing revenues** collected pursuant thereto. Whether by increased rates or changes in **methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses** of the Legislature...” California Constitution Article XIII, Section 3 (emphasis added.)

Importantly, as pointed out in the example, merely changing the proposed regulation to include net receipts instead of no receipts does not change the analysis. Such a regulation would still be a tax increase as current law requires the inclusion of something more than net receipts except in limited circumstances similar to those in *Microsoft* (see *Microsoft*: “the truth doubtless lies somewhere in between”).

---

<sup>1</sup> The proposed regulatory change entails large increases from existing law for companies with out-of-state treasuries and large decreases for companies with in-state treasuries. The state has not quantified these increases or decreases, but based on the fact there are more companies in the former category than the latter, a large net tax increase may accrue.

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### The Proposed Regulation Is Unconstitutional.

Further, the proposed regulation is unconstitutional. By excluding from the apportionment factor all receipts from treasury department security transactions, the FTB seeks to tax the income of out-of-state treasuries without giving the treasuries any representation in the gross receipts factor. Using only operational apportionment factors and applying them to “huge quantities of investment income that have no special connection with the taxpayers in the taxing State” is “clearly...improper.” *Mobil v. Commissioner* (1980) 445 U.S. 425, 461 (J. Stevens, whose opinion in *Mobil* was cited with approval by the majority in *Container v. Franchise Tax Board* (1983) 463 U.S. 159, 169.) Such taxation without factor representation is unconstitutional as California is attempting to tax income earned outside its borders. As the California Supreme Court said, mixing little or no treasury receipts with gross receipts from all other transactions “exaggerates the resulting [California] tax.” *Microsoft*, at 771.

Further yet, favoring taxpayers with in-State treasuries, as the proposed regulation clearly does, indisputably constitutes discrimination in favor of such taxpayers in violation of the Commerce Clause under classic Commerce Clause doctrine.

### The Tax Losses Due to the Exemption of In-State Treasuries Results in a Tax Windfall for Select Companies.

Under past FTB practice, direct sales of treasury securities were included as gross receipts and under current law, as explained in *Microsoft*, taxpayers with California treasuries would include a certain amount of treasury gross receipts in both the numerator and denominator of the gross receipts factor. By including no such receipts or only net receipts generates a revenue loss in perhaps the hundreds of millions of dollars from these taxpayers, while imposing an even greater tax increase, as indicated above, on out-of-State taxpayers. Exemption of the in-State treasuries is a Legislative function.

### *Microsoft* Makes Clear the Burden on the FTB as to Treasury Security Gross Receipts UNDER THE EXISTING STATUTE, Is ON THE FTB. The FTB Does Not Have Authority, after *Microsoft*, to Shift the Burden of Proof to the Taxpayer.

Under Section 25137, *Microsoft* makes clear that the FTB has the burden to prove by clear and convincing evidence, on a case-by-case basis, that the standard apportionment formula, with all of its idiosyncrasies, does not fairly reflect the taxpayer’s business activities in California and the burden to prove by clear and convincing evidence that an alternative formula—on a case-by-case basis—fairly reflects the taxpayer’s business activities in California.

It may or may not be in cases where the California Supreme Court has not interpreted the application of Section 25137 to a certain area, that the FTB can change the burden of proof. Without statutory authority, however, in an area where the State’s highest court has held the burden under existing law is on the party attacking the statutory formula, such as the gross

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receipts issue, the FTB, by the proposed regulation, cannot shift such burden of proof under the existing statute. Such existing statute has not changed, nor can its interpretation.

Any Modification in This Area Must Be Done by the Legislature and in a Prospectively-Modified Section 25134. To Adopt a Regulation under Section 25137 Is to Open the Floodgates to Separate Accounting and Other Formulas to Taxpayers, Creating Chaos and Significantly Increasing the Burden on FTB Staff.

At the end of its opinion in *Microsoft*, the California Supreme Court noted that the determination under Section 25137 as to whether an alternative formula could be used and, if so, what formula, could only be made on a "case-by-case" basis. The high court noted that if the FTB wanted a rule that applied to most taxpayers, the Legislature could modify the law if the FTB did not want to include security gross receipts in the sales factor, but that the Court would not judicially modify the statute. Just as the California Supreme Court refused to legislate from the judiciary, the FTB cannot legislate a clear tax increase through regulatory amendments. The FTB simply cannot usurp the role of the Legislature and the Governor. The only valid regulatory action under Revenue and Taxation Code Section 25137 would be a regulation that includes a sufficient amount of security receipts between gross and net, not one that included only net or excluded all such gross or net receipts.

Even more importantly, utilizing Section 25137 to enact a regulation in this area creates chaos and a burden on the FTB that otherwise does not exist under Section 25137. The reason for this is that Section 25137 has two prongs. First, the person attacking the statutory apportionment formula has to prove that it does not fairly reflect the taxpayer's business activities in California. The second prong is that once the first prong has been shown, a party must show by clear and convincing evidence that an alternative formula fairly reflects the taxpayer's business activities in California.

If the proposed regulation is adopted, it is clear that the first prong of Section 25137—whether there is enough distortion that the standard apportionment formula doesn't apply—is always met in this area and taxpayers, for example, can go directly to the second prong. This means that the taxpayer will be able to utilize separate accounting and other formulas to show, beyond the gross receipts issue, what fairly reflects its activities in California.

This would not be true if Section 25134 legislatively exempted the treasury gross receipts from the definition of gross receipts, because taxpayers would still have to show the applicability of Section 25137 before getting to an alternative formula that fairly reflects the taxpayer's business activity in California. As a result of the proposed regulation under Section 25137, all taxpayers who have treasury departments will be able to enter directly into the second prong of the Section 25137 test. There will not only be substantive chaos but administrative chaos because, as this is clarified by the courts, Section 25137 (contrary to past FTB practice) will be used frequently with taxpayers showing separate profit margins, separate accounting, etc. There will be a large

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number of Section 25137 petitions by large companies and the past practice of the FTB that Section 25137 should only be used in rare instances will be gone.

Very truly yours,



Charles R. Ajalat

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September 17, 2007

Ms. Colleen Berwick  
 Franchise Tax Board Legal Branch  
 P.O. Box 1720  
 Rancho Cordova, CA 95471-1720

Re: Proposed Regulation 25137(c)(1)(D) ("Proposed Regulation")

Dear Ms. Berwick:

I am writing this additional letter on behalf of Business for Economic Growth in California ("BEGC"), a coalition of major California-based companies<sup>1</sup>, for the specific purpose of articulating the basis for the Franchise Tax Board's ("FTB") authority to promulgate Proposed Regulation 25137(c)(1)(D).

By way of background, as an agency of the executive branch of California state government, the FTB is subject to the rulemaking procedures in the Administrative Procedure Act (Government Code § 11340 *et seq.*) (hereinafter the "APA"). The APA provides that "[w]henever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute." Gov. Code § 11342.2.

To verify compliance with Gov. Code § 11342.2., the Office of Administrative Law ("OAL") reviews regulations for compliance with six standards: **Authority, Reference, Consistency, Clarity, Non-duplication, and Necessity**. Gov. Code § 11349. In the following paragraphs, we explain the meaning of these terms, and the basis for concluding that the Proposed Regulation meets each of the requirements.

#### **Authority and Reference**

The "authority" for a regulation is the provision of law which permits the agency to adopt a regulation, and "reference" is the provision of law which the agency implements, interprets, or makes specific by adopting the regulation. Gov. Code §§ 11349(b), 11349(e).

<sup>1</sup> Applied Materials, Cisco Systems, Health Net, Intel Corporation, Walt Disney Company and Chevron.

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In this case, Rev. & Tax. Code § 19503 authorizes the Proposed Regulation, providing, in relevant part, that the FTB “shall prescribe all rules and regulations necessary for the enforcement of [the income and franchise tax laws].” The provision of law which the FTB is implementing and interpreting is Rev. & Tax. Code § 25137, which states in part:

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 Franchise Tax Board may require . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In promulgating the Proposed Regulation, the FTB is properly exercising its mandate to interpret and apply section 25137 through regulations, as it has done at least fourteen times before. The regulations previously promulgated by the FTB under Rev. & Tax. Code § 25137 include both industry-specific regulations, such as those applicable to the banking (Cal. Code Regs. tit. 18, § 25137-4.2) and motion picture industries (Cal. Code Regs. tit. 18, § 25137-8), and also generally applicable regulations, such as Cal. Code Regs. tit. 18, § 25137(c)(1)(A) which requires occasional sales producing substantial amounts of gross receipts to be thrown out of the sales factor. The Proposed Regulation falls into this latter category and, indeed, is closely akin to the aforementioned throw-out rule.

### **Consistency**

A regulation satisfies the “consistency” requirement if it is in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law. Gov. Code § 11349(d). As explained below, the Proposed Regulation is fully consistent with all relevant provisions of law, including particularly Rev. & Tax. Code §§ 25120 and 25137, and the California Supreme Court’s decision in *Microsoft Corp. v. Franchise Tax Board*, (2006) 39 Cal.4th 750.

Rev. & Tax. Code § 25120 defines the term “sales” that are required to be included in a taxpayer’s sales factor as “all gross receipts,” and in *Microsoft*, the court held that in the context of a taxpayer’s treasury function, gross receipts means all proceeds from treasury function transactions, not simply the net amount or profit. However, the court went on to hold that inclusion of gross receipts from Microsoft’s treasury function was distortive, and further approved the remedy the FTB had selected under Rev. & Tax. Code § 25137 to cure that distortion.

Although technically the *Microsoft* court had before it only the facts in that case and not a regulation under section 25137, the court’s finding and analysis are quite general, referring to “the problem” and “this type of situation.” For example:

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The SBE and these sister-state courts implicitly recognize that the problem arising from inclusion of the full sale or redemption price of a short-term security is not that the full price is not gross receipts. Rather, the problem is one of scale: short-term securities investments involve margins (i.e., differences between cost and sale price) that may be several orders of magnitude different than those for other commodities. When a short-term marketable security is sold or redeemed, the margin will often be, in absolute terms, quite small (though of course the *annualized* returns may well be perfectly respectable).<sup>2</sup>

The court continued:

Declining to apply UDITPA's relief provision to this type of situation would create a significant loophole exploitable through subtle changes in investment strategy. By shifting investments to shorter and shorter maturities, a unitary group could reduce its state tax liability to near zero, particularly if it placed its treasury department in a state that statutorily excluded the return of investment capital from gross receipts.<sup>3</sup>

The court went on to explain how "Microsoft's treasury activities provide[d] a perfect illustration" of this phenomenon.<sup>4</sup> However, in stating it would be a "rare instance" when inclusion of treasury function gross receipts was NOT distortive, the court undoubtedly viewed its ultimate conclusion as applying to nearly every corporate taxpayer.<sup>5</sup>

The *Microsoft* court's findings that including gross proceeds from treasury function transactions is distortive in nearly every case are corroborated by the FTB's long history of applying section 25137 to treasury function receipts on the basis of case-specific evidence of distortion. We also understand that as part of this regulatory process the FTB has conducted additional distortion analyses of specific taxpayers' data, and has consistently found that the inclusion of gross proceeds from treasury function activities

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<sup>2</sup> *Microsoft Corp. v. Franchise Tax Board*, (2006) 39 Cal.4<sup>th</sup> 750, 767.

<sup>3</sup> *Id* at 770.

<sup>4</sup> This is because Microsoft's "1991 redemptions totaled \$ 5.7 billion, while its income from those investments totaled only \$ 10.7 million--a less than 0.2 percent margin. In contrast, its nontreasury activities produced income of \$ 659 million and gross receipts of \$ 2.1 billion, for a margin of more than 31 percent, roughly 170 times greater."

<sup>5</sup> It is of no moment that the FTB remedy approved by *Microsoft* was to include the receipts in question on a net basis rather than to throw them out of the sales factor entirely. Section 25137 authorizes the FTB to remedy distortion via "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income," and the court must uphold any reasonable remedy chosen by the FTB.

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would be distortive. And, last but not least, the members of BEGC can each confirm that including gross receipts in their sales factors is distortive.

Some commentators claim that the Proposed Regulation conflicts with California law because section 25120 requires inclusion of gross receipts in the sales factor. However, such a view reflects a misunderstanding of the role of section 25137. Of course, any regulation promulgated under section 25137 is going to reflect a deviation from some other provision of the standard apportionment formula (*i.e.*, UDITPA). The relevant question is whether the particular deviation proposed by the FTB is supported by sufficient evidence that the standard apportionment rule produces distortion, in which case it is a proper application of section 25137 by the FTB. The evidence here confirms that the Proposed Regulation is such a proper exercise by the FTB.

Finally, the *Microsoft* court actually *invited* the FTB to correct the apportionment problem created by corporate treasury functions by promulgating a section 25137 regulation. After explaining that it did not have the authority itself to pronounce a blanket rule to address distortion caused by including the gross receipts from treasury function transactions in the sales factor, the court acknowledged and implicitly blessed not only a statutory amendment, but also a regulatory solution (“Amicus curiae, the Multistate Tax Commission, has proposed model regulations to likewise exclude investment returns of capital from gross receipts.”<sup>6</sup>).

In sum, in the absence of a regulation, the FTB would have the burden of proving distortion on a case-by-case basis. However, in the face of the substantial evidence that including treasury function receipts in the sales factor is consistently distortive, the FTB has the power and authority under Rev. & Tax. Code § 25137 to promulgate a regulation presuming distortion, and thereby shift the burden of proof to the party claiming that including the treasury receipts is not distortive. Thus, while the Proposed Regulation establishes a rule that will nearly always result in accurately describing the taxpayer’s business, the rule is rebuttable. Taxpayers that believe the Proposed Regulation’s presumption of distortion and/or the prescribed remedy does not accurately reflect their business activity in California may deviate from the Proposed Regulation (*e.g.*, to include the gross proceeds from their treasury function transactions in their sales factor) if they prove by clear and convincing evidence that the Proposed Regulation is distortive for them.

For all of these reasons, the Proposed Regulation is consistent with existing law.

### Clarity

Clarity means written in a manner that the meaning of regulations will be easily understood by those persons directly affected by them, including those who must enforce and comply with the regulation. Gov. Code § 11349(c); Cal. Code Regs. tit. 1, § 16(b).

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<sup>6</sup> *Id* at 772.

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Because the Proposed Regulation is succinct, and readily comprehensible, it satisfies the clarity requirement for promulgating a regulation.

#### **Non-duplication**

“Non-duplication” means that a regulation does not serve the same purpose as a state or federal statute or another regulation. Gov. Code § 11349(f). Currently no other regulation, federal or state, already prescribes the rule of the Proposed Regulation. Therefore, the non-duplication requirement also is satisfied.

#### **Necessity**

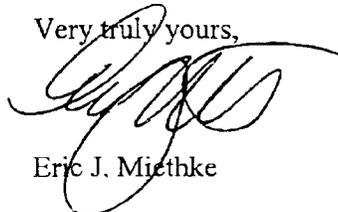
Finally, “necessity” means that the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to facts, studies, and expert opinion. Gov. Code § 11349(a).

In the absence of the Proposed Regulation, the party seeking to exclude such gross receipts from the taxpayer’s sales factor bears the burden to prove by clear and convincing evidence that distortion exists. In any given case, such an exercise can be extremely expensive and time consuming. However, the burden is multiplied many times because, as explained above, the record in this regulatory proceeding demonstrates that, in the overwhelming preponderance of cases, including gross receipts from a taxpayer’s Treasury function will be distortive. Requiring case-by-case proof would be extremely inefficient for taxpayers and the FTB alike, and is unnecessary. The Proposed Regulation is appropriate and advisable in order to avoid these extraordinary costs for taxpayers and the State of California.

The Proposed Regulation is also necessary to eliminate the opportunity for multi-state taxpayers to avoid tax obligations by locating their treasury function out of state, artificially inflating their sales factor. For all of these reasons, the Proposed Regulation satisfies not only the necessity requirement of the APA but also, collectively, all of the requirements set forth in Gov. Code § 11349, and the Proposed Regulation should be approved by the OAL.

If you have any questions, please do not hesitate to contact me.

Very truly yours,



Eric J. Miethke

Item 3c-D.TXT

STATE OF CALIFORNIA

FRANCHISE TAX BOARD

PUBLIC HEARING

ON THE PROPOSED CALIFORNIA CODE OF REGULATIONS  
TITLE 18, SECTION 25137(c)(1)(D)

FRIDAY, AUGUST 17, 2007

FRANCHISE TAX BOARD  
9646 BUTTERFIELD WAY  
TOWN CENTER GOLDEN STATE ROOM  
SACRAMENTO, CALIFORNIA

10:00 A.M.

REPORTED BY:

SANDRA VON HAENEL  
CSR No. 11407

1 APPEARANCES

2

3 FRANCHISE TAX BOARD STAFF:

4 Colleen Berwick  
5 Carl A. Joseph  
6 Patrick Kusiak  
Marcy Jo Mandel  
Benjamin Miller

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Item 3c-D.TXT  
Selvi Stani sl aus

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8

9 PARTICIPANTS:

10 Chris Matarese - General Motors  
11 Eric Miethke - Nielsen, Merksamer, Parriello,  
Muel ler & Nayl or, LLP  
12 Susan Silvani - Chevron  
David Slater - Intel

13

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15 TELEPHONIC PARTICIPANTS:

16 Richard Call -  
Eric Anderson - WTAS  
17 Jackie Orea - WTAS  
Bruce Reid - Microsoft  
18 Gina Rodriguez - Spidel l Publ i shi ng  
Ray Rossi - Intel  
19 Jackie Wiener - CCH Tax & Accounti ng

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SACRAMENTO, CALIFORNIA

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FRIDAY, AUGUST 17, 2006, 10:00 A.M.

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4

MR. JOSEPH: It's a little after 10 o'clock. This is

5

the time that's designated for the regulation hearing on

6

Regulation 25137(c)(1)(D), treasury function reg.

7

Before I begin, is anyone with us on the phone?

8

UNIDENTIFIED SPEAKER: Yes.

9

UNIDENTIFIED SPEAKER: Yes.

10

MR. JOSEPH: Terrific. Great.

11

When I get a little further into my sort of canned

12 beginning here, I would like to have everybody on the phone,  
13 if possible, identify themselves. I don't know how many we  
14 have here, but this is one of the first times I've ever used  
15 it, the multi-line phone, so I hope everybody can hear.

16 Can you hear me okay?

17 UNIDENTIFIED SPEAKER: Perfect.

18 MR. JOSEPH: Okay. Great. All right.

19 My name is Carl Joseph. I'm a tax counsel for the  
20 Franchise Tax Board, and I'm acting as hearing officer for  
21 Proposed California Code of Regulations, Title 18, Section  
22 25137(c)(1)(D), the treasury function regulation.

23 Anyone who wishes to make an oral presentation at this  
24 hearing may do so in a few moments. In addition, anyone who  
25 wishes to submit written materials regarding the proposed

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1 regulation may submit such comments to the Franchise Tax  
2 Board Legal Department, to the attention of Colleen Berwick,  
3 at P.O. Box 1720, Rancho Cordova, or they can fax their  
4 comments in as well.

5 Please note that notwithstanding the original deadline  
6 of written comments set forth in the Notice of Hearing,  
7 we're extending the deadline for the submission of written  
8 comments to September 17th. We have had some people that  
9 have let us know that they either did not receive what they  
10 thought they might receive in the mail, they -- we have a  
11 little bit of a misunderstanding regarding how many people  
12 would be mailed things.

13 So we've extended the comment period to allow everyone  
14 who has any comments that they wish to make to certainly do  
15 so. So, again, that's September 17th, 2007. That's 30  
16 days.

17 Any questions you have regarding the submission of any  
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18 written comments should be directed to Ms. Berwick at  
19 (916) 845-3306. And I think that's also on the notice.  
20 It's on the web.

21 There is a register at the back of the room with  
22 Colleen that will become part of the record of this hearing.  
23 If you haven't done so already, we request that you sign  
24 this register before you leave today.

25 We would also appreciate it if you could leave a

4

1 business card, so we can keep track of everyone who is here.

2 For those who are listening on the telephone, when I  
3 ask, can you please make an identification of yourself. Not  
4 quite yet, but we'll get there.

5 Also, if you're on the phone and you wish to make a  
6 comment, please identify yourself and spell your name for  
7 the record prior to beginning the comment each time, so that  
8 the court reporter present here can properly reflect who is  
9 making the comment in the transcript.

10 I don't know if anyone on the phone wishes to make a  
11 comment, but we'll deal with that at that time.

12 As required by the California Administrative  
13 Procedures Act, on June 29, 2007, a Notice of Hearing was  
14 mailed to members of the public requesting notice of the FTB  
15 regulation changes under Government Code Section 11346.4,  
16 and that notice was published in the Office of  
17 Administrative Law's register of proposed rulemaking  
18 actions. The notice and the proposed amendments to the  
19 regulation also appear on the Franchise Tax Board's website.

20 The purpose of this formal regulatory hearing is to  
21 receive comments from the public concerning this regulation.  
22 Each comment will then receive a formal written response

23 from the Franchise Tax Board as provided in the provisions  
24 of the Administrative Procedures Act.

25 Because we are tape recording the hearing, we will

5

1 have to ask each of you who wish to make comments to come  
2 forward so that we can record them. It will also be better  
3 for people on the phone, if you are going to make a long  
4 comment, to come up here so everyone can hear you.

5 If you just have a question, we'll attempt to repeat  
6 the question so that we can catch that, so you won't have to  
7 come up to a microphone.

8 This hearing is being held pursuant to Government Code  
9 Section 11346.8, to allow members of the public to submit  
10 both oral and written statements. Comments received today  
11 will be considered part of the formal regulatory process.

12 The comments received become part of the record, will  
13 be considered by the staff and addressed by publication on  
14 the Franchise Tax Board website no later than 15 days before  
15 submission to the Office of Administrative Law, and will be  
16 included in the rulemaking file submitted to the Office of  
17 Administrative Law as provided under the AP Act.

18 As of Friday, today -- yes, Ben.

19 MR. MILLER: For the benefit of the hands of the court  
20 reporter --

21 MR. JOSEPH: Slow down?

22 MR. MILLER: -- slow down just a little bit.

23 MR. JOSEPH: I apologize.

24 As of 5 o'clock today -- or yesterday, we have  
25 received one written comment so far, and we did copy that

6

1 and put it at the back of the room. Okay.

2 Now, before I ask if there are any particular comments  
Page 5

3 on the reg, I'd like to request that everyone who is on the  
4 telephone identify themselves. I don't know how many we  
5 have. If it's a lot, I apologize.

6 After we have identified the telephone participants,  
7 we'll take formal comments. So let's see if we can do this.  
8 Go ahead, people on the phone.

9 MR. ANDERSON: This is Eric Anderson from WTAS.

10 MR. ROSSI: This is Ray Rossi, Intel.

11 MR. JOSEPH: Well, slow down just a second.  
12 Did you get the first one, Colleen?

13 MS. BERWICK: The first one is Eric Anderson?

14 MR. JOSEPH: Eric Anderson; correct?

15 MR. ANDERSON: Yes.

16 MR. JOSEPH: WTAS?

17 MR. ANDERSON: Yes.

18 MR. JOSEPH: Okay. And the next one was?

19 MR. ROSSI: Ray Rossi of Intel.

20 MR. JOSEPH: Ray Rossi of Intel.

21 Okay. And the next person?

22 MS. OREA: Jackie Orea at WTAS.

23 MR. JOSEPH: Jackie Orea, WTAS.

24 MS. OREA: Yes.

25 MR. JOSEPH: Who else?

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1 MR. CALL: Richard Call of (unintelligible).

2 MR. JOSEPH: Can you repeat that, please.

3 MR. CALL: Richard Call of (unintelligible). The last  
4 name is C-a-l-l.

5 MR. JOSEPH: If you came up a little closer, I think  
6 you could hear it better.

7 MR. CALL: Okay.

8 MR. JOSEPH: No, no. Not you. Her.  
9 Yeah, you can't even see what I'm doing, huh? Okay.  
10 How about the next person?  
11 MS. WEINER: Sandy Weiner, CCH Tax & Accounting.  
12 MR. JOSEPH: Sandy Weiner.  
13 MS. WEINER: W-e-i-n-e-r.  
14 MR. JOSEPH: Thank you.  
15 MS. BERWICK: And where are you from?  
16 MS. WEINER: CCH Tax & Accounting.  
17 MR. JOSEPH: Terrific.  
18 And the next person?  
19 MR. REID: Bruce Reid, R-e-i-d, Microsoft.  
20 MR. JOSEPH: Bruce Reid.  
21 Thank you for coming, Bruce.  
22 And you got that one, Colleen?  
23 MS. BERWICK: Yes.  
24 MR. JOSEPH: The next person?  
25 MS. RODRIGUEZ: Gina Rodriguez with Spide l

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1 Publ i shi ng.  
2 MR. JOSEPH: There's parking here, Gina.  
3 MS. RODRIGUEZ: There's parking places at the office.  
4 MR. JOSEPH: Anyone else?  
5 All right. Well, perfect. There we go.  
6 That was not too painful.  
7 At this time I will open the floor.  
8 Are there any comments on the proposed regulation?  
9 Please come forward. And we'll use the podium so  
10 everyone can hear.  
11 We've got to start somewhere.  
12 MR. MIETHKE: Somewhere, even if it's me.  
13 MR. JOSEPH: Please state your name for the court

14 reporter.

15 MR. MIETHKE: My name is Eric Miethke -- that's Eric  
16 spelled E-r-i-c, the last name is M-i-e-t-h-k-e -- with the  
17 law firm of Nielsen Merksamer. And I'll leave a card so I  
18 don't need to spell all that out.

19 I'm here today representing Business for Economic  
20 Growth in California, a coalition of California based  
21 companies which include Disney, the Walt Disney Company,  
22 Cisco, Chevron, Health Net, Intel, and Applied Materials.

23 We are here today to speak in support of the  
24 regulation as drafted. We were grateful participants in the  
25 interested parties process, and we are very supportive of

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1 that process as a process. I think it was -- it led to  
2 drafting a very good rule. We like it the way it is. We  
3 think it's necessary to bring clarity and some certainty to  
4 an area that's been fraught with some confusion since the  
5 Microsoft and General Motors cases came down from the  
6 Supreme Court.

7 We do think that establishing a clear baseline rule,  
8 with still some recognition in there that there may be  
9 deviations necessary, is the appropriate way to go. We do  
10 believe that this rule fits well within the authority of the  
11 Franchise Tax Board Section 25137, to promulgate regulations  
12 of this kind where appropriate. And we also recognize that  
13 the general construct of the rule is the same as in many  
14 other states. So there is a conformity aspect of it, too,  
15 that we endorse and salute.

16 And I think, beyond that, it's just we wanted to thank  
17 staff for an excellent job, to thank them for working  
18 closely with all stakeholders, and ask the Board to approve

19 it as presented. Thank you.

20 MR. JOSEPH: Thank you.

21 Okay. Please.

22 Anyone else who wishes to make a comment?

23 MR. SLATER: My name is David Slater with Intel  
24 Corporation. And I'd just like to say for the record that  
25 Intel supports the regulation as proposed.

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1 MR. JOSEPH: Thank you.

2 MR. MATARESE: Chris Matarese from Ajalat, Polley,  
3 Ayoob & Matarese -- I'll leave a card so I don't have to  
4 spell all that out for you -- here representing General  
5 Motors.

6 I wanted to state our continuing objection to the  
7 regulation for numerous reasons.

8 First, we believe the regulation is a clear departure  
9 from prior FTB policy of allowing net receipts from  
10 redemption and gross receipts from direct sales of  
11 securities. The FTB material states that the regulation is  
12 consistent with the FTB administrative policy, and that's  
13 false.

14 The policy for the last several years has been to  
15 allow net receipts, and gross receipts for direct sales. On  
16 audit, FTB has been including net receipts for redemption  
17 and gross receipts for direct sales for many taxpayers.

18 The departure from this FTB policy is a clear tax  
19 increase on in-state companies, and that tax increase is not  
20 permitted under the law, not permitted unless enacted by the  
21 Legislature with a two-thirds vote.

22 We believe the Franchise Tax Board shouldn't legislate  
23 a tax increase through its administrative policy. The  
24 Supreme Court in Microsoft invited the Legislature to

25 prospectively change the law and, of course, didn't want to

11

1 legislate from the bench. And what the FTB is doing through  
2 this regulation is legislating through the administrative  
3 process.

4 Finally, we believe this tax increase on out-of-state  
5 companies is also a tax decrease on select in-state  
6 companies with in-state treasuries, favoring in-state  
7 companies, as those companies -- that policy had been  
8 including net pursuant to the FTB policy.

9 Therefore, we think this regulation is illegal, is not  
10 a valid enactment of current law, as well as an illegal tax  
11 increase prohibited by the Constitution. Thank you.

12 MR. JOSEPH: Thank you.

13 Okay. Anyone else?

14 Please.

15 MS. SILVANI: Hello, everyone.

16 My name is Susan Silvani. I'm the manager of state  
17 tax counsel for Chevron Corporation, and I want to echo the  
18 comment that Eric Miethke made, that Chevron is very  
19 grateful to have been involved in the interested parties  
20 process. We think very good regulations come out of that  
21 process, and we wish to thank FTB staff for that process.

22 This regulation will go a long way toward preventing  
23 companies from moving high-paying, quality treasury jobs out  
24 of the state, and we feel this is a good tax policy.

25 Chevron also strongly supports this regulation.

12

1 And we would note that we strongly disagree with the  
2 representative from General Motors who suggested that this  
3 is not within the Franchise Tax Board's authority.

4 Certainly we believe that it is, and it's legislation  
5 that falls properly within 12537. And FTB policy has, in  
6 fact, been -- this is consistent with FTB policy, in fact,  
7 as we've experienced it certainly.

8 Thank you.

9 MR. JOSEPH: Thank you. All right.

10 Is there anyone else in the room who would like to  
11 make a comment?

12 Okay.

13 Is there anyone on the telephone who would wish to  
14 make a comment at this time?

15 We are a silent bunch.

16 Do we still have the telephone people with us?

17 TELEPHONIC PARTICIPANTS: Yes. Yes. Yes.

18 MR. JOSEPH: Okay. Well, if there are no other  
19 comments, this was rather quick.

20 Anyone else have anything else they wish to add before  
21 we call it a hearing?

22 Okay. Well, since there are no more comments, I will  
23 close the hearing.

24 And it is now approximately 20 after 10 o'clock.

25 The record, obviously, as I started earlier, will

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1 remain open until September 17 at 5 o'clock in the afternoon  
2 for any other further comments that people wish to make in  
3 writing.

4 And I thank you very much for your attendance.

5 (At 10:22 a.m. the proceedings were adjourned.)

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1 REPORTER' S CERTI FI CATE

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STATE OF CALI FORNIA )  
COUNTY OF SACRAMENTO ) ss.

8 I, SANDRA VON HAENEL, certify that I was the  
9 official Court Reporter for the proceedings named herein, and  
10 that as such reporter, I reported in verbatim shorthand  
11 writing the named proceedings;

12 That I thereafter caused my shorthand writing to  
13 be reduced to typewriting, and the pages numbered 1 through  
14 14, inclusive, constitute a complete, true, and correct

15 record of said proceedings: Item 3c-D.TXT

16

17 IN WITNESS WHEREOF, I have subscribed this  
18 certificate at Sacramento, California, on the 30th day of  
19 August, 2007.

20

21

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SANDRA VON HAENEL  
CSR No. 11407

22

23

24

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Section 25137 is amended to read:

§ 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 and overall net gains 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. A treasury function includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A Treasury function does not include a taxpayer's trading function that engages in futures and option transactions for the purpose of 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, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.

2. This subsection shall not apply to entities that apportion their income under the rules of regulation 25137-4.2.

3. This subsection is applicable to taxable years beginning on or after January 1, 2007.

NOTE: Authority cited: Section 19503, Revenue and Taxation Code.  
Reference cited: Section 25137, Revenue and Taxation Code.

**ECONOMIC AND FISCAL IMPACT STATEMENT**  
**(REGULATIONS AND ORDERS)**

STD. 399 (Rev. 2-98)

See SAM Sections 6600 - 6680 for Instructions and Code Citations

DEPARTMENT NAME Franchise Tax Board	CONTACT PERSON Colleen Berwick	TELEPHONE NUMBER (916) 845-3306
DESCRIPTIVE TITLE FROM NOTICE REGISTER OR FORM 400 REGULATION SECTION 25137(c)(1)(D) - SPECIAL RULES SALES FACTOR		NOTICE FILE NUMBER Z

**ECONOMIC IMPACT STATEMENT****A. ESTIMATED PRIVATE SECTOR COST IMPACTS** (Include calculations and assumptions in the rulemaking record.)

1. Check the appropriate box(es) below to indicate whether this regulation:

- a. Impacts businesses and/or employees
  e. Imposes reporting requirements  
 b. Impacts small businesses
  f. Imposes prescriptive instead of performance standards  
 c. Impacts jobs or occupations
  g. Impacts individuals  
 d. Impacts California competitiveness
  h. None of the above (Explain below. Complete the Fiscal Impact Statement as appropriate.)

h. (cont.) \_\_\_\_\_

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: Unknown Describe the types of businesses (Include nonprofits): Multistate firms with some treasury incomeEnter the number or percentage of total businesses impacted that are small businesses: unknown3. Enter the number of businesses that will be created: unknown eliminated: unknown

Explain: \_\_\_\_\_

4. Indicate the geographic extent of impacts:  Statewide  Local or regional (list areas): \_\_\_\_\_5. Enter the number of jobs created: \_\_\_\_\_ or eliminated: \_\_\_\_\_ Describe the types of jobs or occupations impacted: See Statement I.

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

 Yes NoIf yes, explain briefly: See Statement II.**B. ESTIMATED COSTS** (Include calculations and assumptions in the rulemaking record.)1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? \$ 0a. Initial costs for a small business: \$ 0 Annual ongoing costs: \$ 0 Years: 0b. Initial costs for a typical business: \$ 0 Annual ongoing costs: \$ 0 Years: 0c. Initial costs for an individual: \$ 0 Annual ongoing costs: \$ 0 Years: 0d. Describe other economic costs that may occur: This regulation will, generally, reduce tax compliance costs because 1) it is mechanically simple, and 2) it provides certainty relative to current law.

**ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 2-98)**

2. If multiple industries are impacted, enter the share of total costs for each industry: \_\_\_\_\_  
\_\_\_\_\_

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. (Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.): \$ \_\_\_\_\_

4. Will this regulation directly impact housing costs?  Yes  No If yes, enter the annual dollar cost per housing unit: \$ \_\_\_\_\_ and the number of units: \_\_\_\_\_

5. Are there comparable Federal regulations?  Yes  No Explain the need for State regulation given the existence or absence of Federal regulations: Federal corporation income tax does not involve the apportionment of income.

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: \$ none

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**C. ESTIMATED BENEFITS** (Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)

1. Briefly summarize the benefits that may result from this regulation and who will benefit: Certainty regarding the application of the law.  
Rational approach to apportionment of income, consistent with general multistate apportionment principles.  
Reduced taxes for certain California corporations.

2. Are the benefits the result of:  specific statutory requirements, or  goals developed by the agency based on broad statutory authority?  
Explain: \_\_\_\_\_

3. What are the total statewide benefits from this regulation over its lifetime? \$ unknown

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**D. ALTERNATIVES TO THE REGULATION** (Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: \$ _____	Cost: \$ _____
Alternative 1:	Benefit: \$ _____	Cost: \$ _____
Alternative 2:	Benefit: \$ _____	Cost: \$ _____

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs?  Yes  No  
Explain: \_\_\_\_\_

---

**E. MAJOR REGULATIONS** (Include calculations and assumptions in the rulemaking record.)  
Cal/EPA boards, offices and departments are subject to the following additional requirements per Health and Safety Code section 57005.

ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 2-98)

1. Will the estimated costs of this regulation to California business enterprises exceed \$10 million?  Yes  No (If No, skip the rest of this section)

2. Briefly describe each equally as effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

Alternative 1: \_\_\_\_\_

Alternative 2: \_\_\_\_\_

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation: \$ \_\_\_\_\_ Cost-effectiveness ratio: \_\_\_\_\_

Alternative 1: \$ \_\_\_\_\_ Cost-effectiveness ratio: \_\_\_\_\_

Alternative 2: \$ \_\_\_\_\_ Cost-effectiveness ratio: \_\_\_\_\_

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT (Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years)

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

a. is provided in (Item \_\_\_\_\_, Budget Act of \_\_\_\_\_) or (Chapter \_\_\_\_\_, Statutes of \_\_\_\_\_)

b. will be requested in the \_\_\_\_\_ (FISCAL YEAR) Governor's Budget for appropriation in Budget Act of \_\_\_\_\_.

2. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

a. implements the Federal mandate contained in \_\_\_\_\_

b. implements the court mandate set forth by the \_\_\_\_\_ court in the case of \_\_\_\_\_ vs. \_\_\_\_\_

c. implements a mandate of the people of this State expressed in their approval of Proposition No. \_\_\_\_\_ at the \_\_\_\_\_ election; (DATE)

d. is issued only in response to a specific request from the \_\_\_\_\_, which is/are the only local entity(s) affected;

e. will be fully financed from the \_\_\_\_\_ (FEES, REVENUE, ETC.) authorized by Section \_\_\_\_\_ of the \_\_\_\_\_ Code;

f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit.

3. Savings of approximately \$ \_\_\_\_\_ annually.

4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law and regulations.

**ECONOMIC AND FISCAL IMPACT STATEMENT cont. (STD. 399, Rev. 2-98)**

5. No fiscal impact exists because this regulation does not affect any local entity or program.
6. Other.

**B. FISCAL EFFECT ON STATE GOVERNMENT** *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year. It is anticipated that State agencies will:
- a. be able to absorb these additional costs within their existing budgets and resources.
- b. request an increase in the currently authorized budget level for the \_\_\_\_\_ fiscal year.
2. Savings of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any State agency or program.
4. Other. *See Statement III*

**C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS** *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

1. Additional expenditures of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
2. Savings of approximately \$ \_\_\_\_\_ in the current State Fiscal Year.
3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.
4. Other.

SIGNATURE		TITLE
<i>Sohn Stanzler</i>		Executive Officer
AGENCY SECRETARY <sup>1</sup>	<i>Evelyn M. Mattheis</i>	DATE
APPROVAL/CONCURRENCE		6/13/07
DEPARTMENT OF FINANCE <sup>2</sup>	PROGRAM BUDGET MANAGER	DATE
APPROVAL/CONCURRENCE	<i>[Signature]</i>	

1. The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.
2. Finance approval and signature is required when SAM sections 6600-6670 require completion of the Fiscal Impact Statement in the STD. 399.

Statements attached to Std Form 399 – Regulation Section 25137(c)(1)(D) - Special rules sales factor

Statement I

This regulation is unlikely to directly cause the creation or elimination of a significant number of jobs. However, at an interested parties meeting comments were offered that failure to adopt the regulation might cause California based companies to move their treasury departments out of state with a resulting loss of jobs.

Statement II

This regulation will tend to increase the income taxes paid by corporations domiciled outside of California and to decrease the income taxes paid by corporations domiciled inside California. Under current law and FTB practice, corporations are required, in most cases, to report treasury function receipts in the sales factor on a net basis, rather than on a gross basis.<sup>1</sup> The proposed regulation would require that treasury income be excluded entirely from the sales factor. This will tend to increase the tax liability, by increasing the sales factor, of those corporations who have treasury functions outside the state. This will also tend to reduce the tax liability, by reducing the sales factor, of those corporations who have treasury functions inside the state.

Statement III

This proposed regulation would have a very small impact on the amount of tax liability for corporate taxpayers relative to current law and FTB practice. The change from reporting treasury income in the sales factor at net to the complete exclusion of treasury income from the sales factor is generally not significant. However, there are two aspects of this proposed regulation that could have a significant impact of the state's general fund revenue over several years. The fact that this proposed regulation states plainly that treasury income is to be excluded from the sales factor provides clarity relative to the current state of the law. Pursuant to the 2006 California Supreme Court decision in *Microsoft v FTB*, treasury receipts are to be reported at gross, unless they are distortive. However, in most cases FTB considers reporting treasury receipts at gross to be distortive. Because of the ambiguity inherent in the current state of the law, there is still a significant amount of revenue in dispute as taxpayers and FTB attempt to determine through litigation the parameters of what defines distortion. Because of this ambiguity, some taxpayers (generally out-of-state corporations) are likely to continue to file their tax returns with treasury income reported at gross. In these situations, the revenue that California would have received from these corporations is reduced until such time that

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<sup>1</sup> The reason for the "in most cases" caveat is that, in order for a taxpayer to be allowed to report its treasury function income on a gross basis it would have to be the case that the FTB could not show that reporting at gross is distortive. FTB legal believes that such cases would be rare and involve only small changes in tax liability

the corporation is audited, assessed, and, often, been denied protest and appeal relief. At that point, if the taxpayer wishes to litigate, they must first pay the disputed amounts. Because of this, it is anticipated that the promulgation of this regulation will accelerate the disputed revenue by about 2 years.

Additionally, this proposed regulation would declare that commodity-hedging transactions, in cases in which the commodity whose price is being hedged is an integral part of the main business of the corporation, are not part of the treasury function. While this language, according to FTB legal department, does not alter the ability of corporations to report hedging transactions at gross, it is possible that this language will encourage some taxpayers to file in such a way as to treat commodity hedging transactions at gross. In a reversal of the impact of the main provision of this proposed regulation, this provision will tend to delay the receipt of tax revenue.

Once this regulation is promulgated, it is anticipated that the main provision will accelerate revenue of about \$36 million, by two years. The hedging provision, on the other hand, is expected to decelerate revenue of about \$1 million, by two years. It is anticipated that the California general fund would, on net, benefit by about \$35 million each in the first two fiscal years after promulgation and that the net benefit after two years would diminish to about \$3 million per year.