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FTB NOTICE – 2006-3

September 28, 2006

SUBJECT: Effect of *Microsoft Corp. v. FTB* (2006) _____ Cal.4th _____ on FTB Notice 2004-5

On August 6, 2004, the Franchise Tax Board (FTB) issued FTB Notice 2004-5, "Asserting a Revenue and Taxation Code Section 25137 Variation in an Original Return Filing: Accuracy-Related Penalties." FTB Notice 2004-5 generally provides that if a taxpayer subject to the "standard apportionment and allocation rules" (i.e., California Revenue & Taxation Code (RTC) sections 25120 – 25136 and the regulations promulgated thereunder, as well as regulations adopted under RTC section 25137) filed its original return taking a position based on RTC section 25137 without the prior approval of the FTB, that taxpayer may be subject to the accuracy-related penalty under RTC section 19164 (incorporating Internal Revenue Code sections 6662 through 6665).

On August 17, 2006, the California Supreme Court issued its decision in *Microsoft Corp. v. FTB* (2006) _____ Cal.4th _____ (*Microsoft*). The Court in *Microsoft* held that the amount realized on the redemption of marketable securities as part of a business' treasury function qualifies as "gross receipts" for purposes of the sales factor and therefore would be included in the sales factor unless including such receipts would unfairly represent the extent of the taxpayer's activity in California. The Court concluded that in the circumstances presented in *Microsoft*, the inclusion of the amount realized on the redemption of marketable securities as part of a treasury function in the sales factor would unfairly reflect Microsoft's activity in California. The Court cited, with approval, the State Board of Equalization decision in the *Appeal of Pacific Telephone & Telegraph*, California State Board of Equalization, May 4, 1978, 78-SBE-028.

For purposes of applying FTB Notice 2004-5, a taxpayer who excludes the amount realized on the redemption of marketable securities as part of its treasury function from the sales factor, and includes only the interest income and net gains from such securities, will not be subject to the accuracy-related penalty under RTC section 19164 (incorporating Internal Revenue Code sections 6662 through 6665) under the authority of the *Microsoft* decision and the *Appeal of Pacific Telephone & Telegraph*.

The determination on whether such receipts should be excluded from the sales factor and whether that exclusion is necessary to provide a fair reflection of a taxpayer's activities in California will remain subject to possible audit and adjustment, and may be adjusted on a case by case basis.

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