2024-OTA-130
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MICROSOFT CORPORATION & SUBSIDIARIES**	OTA Case No. 21037336

OPINION

Representing the Parties:

For Appellant: Michael Kelley, State Tax Director
Stephanie Parks, State Tax Counsel

For Respondent: Laurie McElhatton, Tax Counsel V
Delinda Tamagni, Assistant Chief Counsel

For Office of Tax Appeals: Nguyen Dang, Tax Counsel III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Microsoft Corporation & Subsidiaries (appellant) appeals an action by respondent Franchise Tax Board (FTB) denying appellant's claim for refund of $93,901,901 for the fiscal year ending June 30, 2018.

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Sheriene Anne Ridenour, and John O. Johnson held an oral hearing for this matter in Sacramento, California, on April 18, 2023. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether qualifying dividends deducted from income pursuant to R&TC section 24411 are includable in appellant's sales factor.
2. Whether the gross receipts from the qualifying dividends should be excluded from the sales factor as a substantial and occasional sale, pursuant to California Code of Regulations, title 18, (Regulation) section 25137(c)(1)(A).

3. Whether FTB has shown that the use of an alternative apportionment method is warranted, pursuant to R&TC section 25137.

FACTUAL FINDINGS

1. Appellant is a Washington corporation with its principal place of business located in Washington.
2. Appellant and its subsidiaries operate a worldwide unitary business that includes developing, manufacturing, licensing, and selling Microsoft-branded software and other products and services.
3. Appellant elected to file a water's-edge combined report for the tax year at issue. As a result, appellant and certain affiliated entities filed a California Corporation Franchise or Income Tax Return – Water's-Edge Filers (Form 100W) for the fiscal year ending June 30, 2018.[1] Affiliated entities are included in the water's-edge combined report to the extent provided under R&TC section 25110(a) (water's-edge group), which generally provides that domestic entities are included in the water's-edge group and that unitary foreign affiliates are excluded from the group, subject to certain foreign inclusion rules.
4. Appellant was also unitary with controlled foreign corporations (CFCs) that were excluded from appellant's water's-edge group and the Form 100W. The CFCs sell Microsoft-branded software and other products and services outside the United States (U.S.) and are responsible for most of appellant's foreign sales and foreign earnings.
5. Appellant received repatriated dividends from the CFCs outside the water's-edge group.[2] On its return, appellant reported $109,001,169,787 of total previously taxed income (PTI) from the dividends,[3] less $1,235,021 for PTI exchange gain/loss under Internal Revenue Code (IRC) section 986(c), plus taxable dividends distributed from non-previously taxed

[1] The record does not include appellant's federal or California tax returns. The amounts stated in the factual findings were included in appellant's claim for refund and schedules provided by the parties. The parties were provided the opportunity to correct or object to the amounts and did not raise any objections or disputes.

[2] Generally, repatriation is when foreign earnings of a CFC are distributed through dividends to domestic shareholders. (See, e.g., *Rodriguez v. Commissioner* (2013) 722 F.3d 306, 310.)

[3] FTB's schedules state that total dividend income, which includes the $109,001,169,787 for the current year, represents dividend income before state adjustments.

earnings and profits (E&P) of $38,087,839,[4] resulting in total taxable dividend income of $109,038,022,605. After a $219,183,364 reduction for intercompany dividends pursuant to R&TC section 25106, appellant reported dividends of $108,818,839,241 (gross dividends) that qualified for the dividends received deduction (qualifying dividend deduction) under R&TC section 24411.[5]

6. Appellant reported a 75 percent qualifying dividend deduction of $81,614,129,431, which is 75 percent of the qualifying dividends of $108,818,839,241. Appellant reported net foreign dividends of $27,387,040,356 (net dividends).[6]

7. Appellant only included the net dividends of $27,387,040,356 in its reported total/gross sales of $122,086,437,834. After accounting for adjustments, including cost of goods sold (COGS) and deductions, pre-apportioned net income was reported as $44,387,432,997.[7]

8. In computing the single-sales factor apportionment percentage for the Form 100W, appellant included net dividends of $27,387,040,356[8] in the sales factor denominator. This resulted in a sales factor of 5.63 percent using sales in California (numerator) of

[4] As to the adjustment for $1,235,021, IRC section 986(c) provides that foreign currency gain or loss with respect to distributions of previously taxed earnings and profits attributable to movements in exchange rates between the times of deemed and actual distribution shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. As to the adjustment for $38,087,839, this appears to be for distributions from non-previously taxed E&P, pursuant to IRC section 959(c)(3). (See IRS Notice 2019-01.)

[5] FTB's schedules state that the amounts were derived from appellant's response to an information document request, and that it did not examine the amounts. FTB's schedules state that the calculation of total taxable dividend income of $109,038,022,605 is based on amounts from appellant's workpapers. FTB's schedules state that qualifying dividends of $108,818,839,241 pursuant to R&TC section 24411 are from appellant's Form 100W, Schedule H, Dividend Income Deduction for Water's-Edge Filers. FTB asserts that, should appellant prevail on Issue 1, the amount includable as gross receipts would be $108,818,839,241. Appellant does not provide any argument or evidence to show otherwise. Therefore, OTA treats the qualifying dividends totaling $108,818,839,241 as the amount at issue.

[6] The net dividends of $27,387,040,356 appear to be calculated by subtracting $81,614,129,431 ($108,818,839,241 * 75 percent) from $109,001,169,787. Therefore, there appears to be an error in appellant's computation of the net dividends as it should have subtracted $81,614,129,431 from the total qualifying dividends of $108,818,839,241, which accounts for adjustments including the elimination of intercompany dividends of $219,183,364, pursuant to R&TC section 25106.

[7] This net income amount is provided in appellant's schedules from its claim for refund.

[8] FTB's schedules state that appellant's original filing reported net dividends of $27,387,040,350 for a sales factor denominator of $122,086,437,828. However, appellant's claim for refund and FTB's schedules state that appellant's workpapers calculate net dividend income to be $27,387,040,356.

$6,874,544,868 and sales everywhere (denominator) of $122,086,437,834. Appellant paid the reported tax due on the return.

9. Appellant filed a claim for refund for $93,901,901 with FTB, asserting that the foreign dividends should be included in the sales factor denominator without a reduction for the qualifying dividend deduction. In computing its revised California apportionment percentage, appellant included the total PTI dividends of $109,001,169,787 in the sales factor denominator. This resulted in a sales factor of 3.37 percent using sales in California of $6,874,544,868 and sales everywhere of $203,700,567,265.[9]

10. Appellant's sales factor percentages from the prior three years were 5.29 percent, 5.68 percent, and 6.68 percent for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively. For the prior three years, appellant reported total dividend income of $2.9 billion, $4.2 billion, and $4.4 billion for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively. Appellant reported dividend income that included repatriated dividends of $1.3 billion, $609 million, and $1.9 billion for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively.[10] For the current fiscal year, appellant reported $3.3 billion in dividend income from other than the repatriated dividends at issue.

11. FTB denied appellant's claim for refund, and this timely appeal followed.

DISCUSSION

Issue 1: Whether qualifying dividends deducted from income pursuant to R&TC section 24411 are includable in appellant's sales factor.

Background

A taxpayer bears the burden of proving entitlement to a refund claim. (*Appeal of Jali, LLC*, 2019-OTA-204P.) A multistate corporation that is engaged in a unitary business generally

[9] FTB's schedules state that appellant's claim for refund used a sales factor denominator of $203,518,236,719, which includes adjustments to dividends for PTI exchange loss under IRC section 986(c), taxable dividends distributed from non-previously taxed E&P, and intercompany dividends pursuant to R&TC section 25106, totaling $182,330,546. See factual finding number 5 for additional details regarding these adjustments. However, appellant's claim for refund uses $203,700,567,265, which does not include those adjustments to appellant's total taxable dividends.

[10] For the three prior years, FTB's schedules provide total dividend income before state adjustments, and include amounts accounting for "Repatriated Dividends." FTB's schedules also state that the total dividend income amounts include, among other items, "dividends from foreign corporations and other dividends."

must determine its California tax liability based upon a worldwide combined report that includes the income and apportionment factors of all members of the unitary group, wherever located. (R&TC, §§ 25101, 25120-25137.) "A unitary business is generally defined as two or more business entities that are commonly owned and integrated in a way that transfers value among the affiliated entities." (*Citicorp North America, Inc., et al. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1411, fn. 5.) Qualifying taxpayers that constitute a unitary business can elect to file a water's-edge combined report that generally includes the income and apportionment factors of California and U.S. based entities and partially included CFCs, in order to determine income derived from or attributable to California sources. (R&TC, §§ 25110(a), 25113; see *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.* (2004) 120 Cal.App.4th 459, 469 (*Fujitsu*).) A CFC, generally, is a corporation that is organized in a foreign country and is more than 50 percent owned by U.S. shareholders. (IRC, § 957(a).)

The water's-edge election limits the combined report to include only the entities of the unitary business to the extent defined under R&TC section 25110(a).[11] (R&TC, § 25110; Cal. Code Regs., tit. 18, § 25110(d)(1).) A CFC with "Subpart F income," as defined in IRC section 952, is partially included to the extent determined by multiplying the CFC's income and apportionment factors by an "inclusion ratio." (R&TC, § 25110(a)(2)(A)(ii); Cal. Code Regs., tit. 18, § 25110(d)(2)(E).) Subpart F income gets its name from Subpart F of the IRC, as defined in IRC section 952, and includes certain forms of passive income earned by CFCs. (*Fujitsu*, *supra*, 120 Cal.App.4th at p. 469.)

Subpart F of the IRC was enacted to deter U.S. taxpayers from using related foreign companies to accumulate earnings offshore. (*Apple, Inc. v. Franchise Tax Bd.* (2011) 199 Cal.App.4th 1, 8 (*Apple*); see also *Fujitsu*, *supra*, 120 Cal.App.4th at p. 469.) Under the Subpart F rules, a U.S. entity is generally required to include in current taxable income a portion of the U.S. entity's share of the CFC's current income (Subpart F income), even if there has been no actual distribution. (*Apple*, *supra*, 199 Cal.App.4th at p. 8, fn. 5; IRC, § 951.) California does not conform to Subpart F (IRC sections 951 to 965) relating to CFCs, except to the extent

[11] In general, this includes domestic international sales corporations; any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the U.S. is 20 percent or more; corporations that are incorporated in the U.S.; and export trade corporations. (R&TC, § 25110(a)(1)(A)-(D).) Also included are the income and apportionment factors of any corporation not described above, to the extent of its income derived from or attributable to sources within the U.S. and its factors assignable to a location within the U.S. (R&TC, § 25110(a)(2)(A)(i).)

applicable to the water's-edge combined report. (R&TC, § 25110(a)(2)(B); Cal. Code Regs., tit. 18, § 25110(d)(2)(E).)

In 2017, Congress passed the federal Tax Cuts and Jobs Act (TCJA). (P.L. 115-97, 131 Stat. 2054 (2017).) The rules enacted by the TCJA "encourage repatriation of foreign income…." (*Silver v. Internal Revenue Service* (2021) 531 F.Supp.3d 346, 351 (*Silver*); see also H.R. Rep. 115-409, at p. 370 (2017) [the TCJA "will remove tax-driven incentives to keep funds offshore…."].)[12] For instance, "[u]nder the rules enacted by the TCJA, to encourage repatriation of foreign income, 'domestic corporations are in most circumstances entitled to a 100-percent deduction for any dividends received from their foreign subsidiaries [IRC section 245A], which eliminates any U.S. tax liability on the dividend.' " (*Silver*, *supra*, 531 F.Supp.3d at p. 351; IRC, § 245A.)

"To prevent a windfall, 'whereby a domestic corporation could distribute its historical pre-[TCJA] earnings tax free to the [U.S.], the [TCJA] included [IRC] section 965….' " (*Silver*, *supra*, 531 F.Supp.3d at p. 351; see also H.R. Rep. 115-409, *supra*, at p. 375.) Under IRC section 965, previously untaxed foreign earnings of deferred foreign income corporations, such as CFCs, from post-1986 E&P were deemed to be "repatriated" and subject to a one-time federal transition tax, regardless of whether the income was distributed.[13] (See IRC, § 965; see also *Silver*, *supra*, 531 F.Supp.3d at p. 351.)[14] For the tax year at issue in this appeal, appellant was subject to the federal transition tax for deemed dividends attributable to accumulated foreign E&P from its CFCs, pursuant to IRC section 965.

Unless otherwise specifically provided, the IRC as of January 1, 2015, is applicable for purposes of the California Corporation Tax Law (CTL) for the tax year at issue. (R&TC, §§ 23051.5(a)(1), 17024.5(a)(1)(P).) Notwithstanding R&TC section 23051.5(a)(1), when a

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[12] Modified on denial of reconsideration as to statutory standing of one plaintiff in *Silver v. Internal Revenue Service* (2021) 569 F.Supp.3d 5.)

[13] While the transition tax applies to historical earnings, the TCJA also added IRC section 951A "in order to subject intangible income earned by a CFC to U.S. tax on a current basis…." and which acts as a "base protection measure…." (T.D. 9866; 84 FR 29288-01, at p. 29324, citing S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print No. 115-20, at p. 365 (2017).)

[14] Pursuant to IRC section 965(a), in the case of the last taxable year of a deferred foreign income corporation which begins before January 1, 2018, the Subpart F income of such foreign corporation (as otherwise determined for such taxable year under IRC section 952) shall be increased by the greater of the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or December 31, 2017.

water's-edge provision refers to provisions of the IRC that do not otherwise apply for purposes of Part 10.2 of the R&TC (Administration of Franchise and Income Tax Laws) or the CTL, the applicable version of the IRC is the version in effect for federal purposes for the taxable period, except as otherwise specifically provided in the water's-edge provisions. (R&TC, § 25116.) California selectively conforms to the TCJA pursuant to Assembly Bill 91 (2019).[15] However, for instance, California does not conform to IRC sections 965 or 245A, and California's water's-edge provisions do not specifically refer to those statutes.[16]

Under California's water's-edge provisions, members of the water's-edge combined group compute their "total separate net income" which is the total net income from all sources of a member of a combined reporting group from its separate books of account as determined under the R&TC, before allocation and apportionment. (Cal. Code Regs., tit. 18, § 25106.5(c)(1), (b)(18).) Total separate net income shall be determined by the R&TC, subject to modifications, such as intercompany transactions. (Cal. Code Regs., tit. 18, §§ 25106.5(c)(1), 25106.5-1.) "Net income" means gross income, as computed under Chapter 6 of the CTL (commencing with R&TC section 24271), less the deductions allowed under this article and Article 2 (commencing with R&TC section 24401). (R&TC, § 24341.) California generally incorporates Subchapter C of Chapter 1 of Subtitle A of the IRC (IRC, § 301 et seq.), relating to corporate distributions and adjustments, except as otherwise provided. (R&TC, § 24451.) IRC section 316 generally defines a dividend as a distribution of property made to shareholders out of a corporation's current or accumulated E&P. (See IRC, § 316(a); R&TC, § 24451.) In addition, gross income is defined to include dividends. (See IRC, §§ 61(a)(7), 301(c)(1); R&TC, §§ 24271(a), 24451.)

R&TC section 25106(a)(1) provides that "[i]n any case in which the income of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of one or more other corporations with which it is doing or has done a unitary business, all dividends paid by one to another of any of those corporations shall, to the extent those dividends are paid out of the income previously described of the unitary business, be eliminated from the income of the recipient and…shall not be taken into account under [R&TC]

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[15] For example, Assembly Bill 91 amends California's Small Business Method of Accounting provisions to incorporate certain TCJA amendments. (See FTB Notice 2019-03.)

[16] California also does not conform to IRC section 951A, and California's water's-edge provisions do not specifically refer to that statute.

section 24344 or in any other manner in determining the tax of any member of the unitary group."[17]

Taxpayers computing income under R&TC section 25110 are allowed a deduction of 75 percent of qualifying dividends to the extent not otherwise allowed as a deduction or eliminated from income.[18] (R&TC, § 24411(a).) "Qualifying dividends" means those received by the water's-edge group from corporations if both of the following conditions are satisfied: (1) the average of the property, payroll, and sales factors within the U.S. for the corporation is less than 20 percent; and (2) more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly or indirectly by the water's-edge group.[19] (*Ibid.*)

For the year at issue, appellant received repatriated dividends distributed from CFCs which were excluded from the water's-edge group.[20] Intercompany dividends were eliminated from income, pursuant to R&TC section 25106. In addition, a 75 percent deduction was applied to qualifying dividends, pursuant to R&TC section 24411(a).

The water's-edge combined report applies the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC sections 25120 through 25139) to allocate and apportion income to California. (R&TC, §§ 25101, 25110(a)(3); Cal. Code Regs., tit. 18, § 25106.5(b)(8), (b)(9).) UDITPA was adopted by California and certain other states to establish uniform rules for the attribution of a unitary enterprise's business income among the taxing jurisdictions.

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[17] As stated in *Appeal of CTI Holdings, Inc.* (96-SBE-003) 1996 WL 248926, "[R&TC] section 25106 provides that dividends paid out of income from a unitary business to which the dividend declarant and recipient belong are eliminated." *Appeal of CTI Holdings, Inc., supra*, also stated that R&TC section 25106 does not divest or strip dividends of their income characteristics or attributes.

[18] R&TC section 24411 also provides for a 100 percent dividend deduction for qualifying dividends from a construction project, the location of which is not subject to the taxpayer's control. The 100 percent deduction is not at issue here.

[19] In addition, pursuant to R&TC section 24344(c)(1), certain interest expenses incurred for purposes of foreign investment may be offset against dividends deductible under R&TC section 24411.

[20] Under California law, the qualifying dividends are included in appellant's income pursuant to the R&TC, which conforms to IRC sections 316, 301, and 61, as opposed to being treated as deemed dividends subject to the transition tax under IRC section 965, to which California does not conform. In addition, R&TC section 25106 states that, among other requirements, that dividends must be "paid" to be eliminated, and R&TC section 24411 states that qualifying dividends means, among other items, those that are "received." (See also Cal. Code Regs., tit. 18, § 24411(b)(1)(C) ["Qualifying dividends do not include amounts deemed to be dividends pursuant to [IRC] sections 78, 951 et seq., and 1248, or otherwise, unless there is a distribution, actual or constructive, or a provision in the [R&TC] requiring that a dividend be deemed to have been received."]; see also *Apple*, *supra*, 199 Cal.App.4th at p. 8 ["California …focuses on dividends 'paid,'…."].)

(*Appeal of Robert Half International Inc. & Subs*., 2019-OTA-330P (*Robert Half*).) A unitary enterprise's income is divided into business income, which is apportioned among the states according to a formula, and nonbusiness income, which is allocated directly to a single state. (See R&TC, §§ 25120(a), (d), 25123-25127, 25128.7; *Robert Half*, *supra*.)[21]

For tax years beginning on or after January 1, 2013, business income is required to be apportioned to California by multiplying business income by a single-sales apportionment formula (sales factor), unless R&TC section 25128(b) applies. (See R&TC, § 25128.7; Cal Code Regs., tit. 18, § 25106.5(c)(7)(A)1.a.) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year, and the denominator of which is the total sales of the taxpayer everywhere during the tax year. (R&TC, § 25134.) Sales is defined as all gross receipts of the taxpayer not allocated under R&TC sections 25123 to 25127 (as nonbusiness income). (R&TC, § 25120(f)(1).)

For tax years beginning on or after January 1, 2011, R&TC section 25120(f)(2) defines "[g]ross receipts" as: "[T]he gross amounts realized…on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the [U.S.]) under the [IRC], as applicable for purposes of this part." In addition, R&TC section 25120(f)(2) states that gross receipts, even if business income, shall not include items listed in subparagraphs (A) through (L). Items excluded from gross receipts under R&TC section 25120(f)(2) include, for instance, amounts received from transactions in intangible assets held in connection with a treasury function and from hedging transactions involving intangible assets. (See R&TC, § 25120(f)(2)(K), (L).)

<u>Analysis</u>

Appellant contends that the foreign dividends should be included in the sales factor denominator as gross receipts, without a reduction for the qualifying dividend deduction, based on the plain language of the statute, legislative history, and legal authority establishing dividends

[21] There is no dispute that the qualifying dividends under R&TC section 24411 at issue were properly treated as apportionable business income, and there is no dispute that the numerator of the water's-edge group's sales factor was properly computed.

as gross income and gross receipts notwithstanding deductions.[22] FTB contends that 75 percent of the dividends should be excluded from appellant's sales factor, pursuant to FTB Legal Ruling 2006-01 (Ruling 2006-01). Ruling 2006-01 states that a domestic corporation that received dividends from a unitary CFC excluded from the water's-edge group must include in the sales factor denominator only the net dividends after applying the qualifying dividend deduction under R&TC section 24411 because the deducted amount relates to an activity excluded from the tax base apportioned by UDITPA. Ruling 2006-01 states that this reasoning "would be equally true for all activities that do not result in net business income," meaning it would "apply regardless of whether the statute uses the term 'exempted,' 'excluded,' 'deducted,' 'not recognized,' etc." Ruling 2006-01 provides various legal authorities relating to exclusions and exemptions from income and whether those exclusions and exemptions should be reflected in the taxpayers' apportionment formula, including *Chase Brass and Copper Co. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457 (*Chase*).[23]

R&TC section 25120(f)(2) defines gross receipts as " amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the [U.S.]) under the [IRC], as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold." Therefore, R&TC section 25120(f)(2) defines gross receipts as including the gross (rather than net) amounts realized and recognized for the purposes of the CTL.

[22] Appellant also raises arguments challenging FTB's determination on constitutional grounds. OTA declines to consider these constitutional arguments based on a long-established policy of abstaining from deciding constitutional issues. (See *Appeal of Acosta and Castro*, 2022-OTA-235P.) This policy is based upon the absence of any specific statutory authority which would allow FTB to obtain judicial review of a decision in such cases and upon the belief that judicial review should be available for questions of constitutional importance. (*Ibid.*)

[23] Ruling 2006-01 also cites to cases addressing R&TC section 24425, which provides that items are nondeductible when allocable to income that is not included in the measure of tax, such as *Appeal of Zenith National Insurance Co.* (98-SBE-001) 98-SBE-001.

To reach "net income," "gross income" is reduced by deductions, including the qualifying dividend deduction under R&TC section 24411. (See R&TC, § 24341.)[24] Therefore, generally speaking, dividends enter gross receipts and gross income before the application of the deduction. Accordingly, the gross dividends are considered gross income or gross receipts, regardless of the qualifying dividend deduction. (See IRC, §§ 61(a), 316(a), 301(c)(1).) On the other hand, amounts that are "excluded" are not considered gross income or gross receipts. (See R&TC, § 24301; IRC, § 61(b).)[25] As a result, the qualifying dividend deduction does not result in the exclusion of dividends from gross income or gross receipts.

FTB argues that the qualifying dividend deduction should be treated like eliminated intercompany dividends under R&TC section 25106, which are not included in the sales factor. FTB also contends that the deducted dividends have a similar economic reality to eliminated dividends because they both reduce the tax base, such that deducted dividends should be deemed to "eliminate" gross receipts from the sales factor. However, R&TC section 25106 provides for the dividends qualifying under the statute to be "eliminated" from income. In addition, eliminated dividends are not considered in determining tax of any member of the unitary group and are expressly excluded from the sales factor by statute and regulation. (See R&TC, § 25106(a)(1) [the eliminated dividends "shall not be taken into account…in any manner in determining the tax of any member of the unitary group"]; Cal. Code Regs., tit. 18, § 25106.5-1(a)(5)(A)(1) ["Sales attributable to intercompany items are not included in [the] sales factor…."]; *Fujitsu*, *supra*, 120 Cal.App.4th at p. 481.) There is no similar language applicable to the qualifying dividend deduction in R&TC section 24411 or the regulations.

The court in *Fujitsu* noted the difference between R&TC sections 25106 and 24411, stating that R&TC section 25106 "posits its different treatment of dividends…on whether or not the income from which the dividends are paid has been included in the water's edge combined report…If the subsidiary's dividends are paid out of earnings and profits that have not been included on the combined report, it is nevertheless eligible for the 75 percent dividends received

[24] Deductions are allowed under Articles 1 and 2, Chapter 7 of the CTL, and Article 2 includes the qualifying dividend deduction under R&TC section 24411. (See R&TC, § 24341 ["'Net income' means the gross income . . . less the deductions allowed under this article [1] and Article 2"].)

[25] Exclusions are specified to be in Article 2, Chapter 6 of the CTL, and Article 3, Chapter 6 of the CTL includes "Other Exclusions." (See R&TC, § 24301 ["'gross income' does not include any of the items specified in this article [2]"].)

deduction found in [R&TC] section 24411, subdivision (a)." (*Fujitsu*, *supra*, 120 Cal.App.4th at p. 481.) Specifically, the court in *Fujitsu* stated that R&TC section 25106 "prevents dividends from subsidiaries from being taxed twice—once as earnings of the issuing subsidiary, and once as separate income to the unitary business from receipt of the dividend." (*Fujitsu*, *supra*, 120 Cal.App.4th at p. 477.) Therefore, R&TC sections 24411 and 25106, while "acting in conjunction," each provide a "different treatment of dividends…." (*Id.* at p. 481.)

In support of its arguments, FTB cites *Chase*; however, that case involved a different issue of whether FTB could "exclude" from the taxpayer's sales factor internal (i.e., intercompany) sales made to another member of the unitary combined group. (*Chase*, *supra*, 70 Cal.App.3d at p. 473.) As applicable to the present case, R&TC section 24411 does not provide that qualified dividends are excluded or eliminated from income, but that they are deducted from income. Furthermore, the court noted that former R&TC section 25101, as in effect for the tax years at issue in that case, provided FTB "discretion" to use an apportionment formula that was "fairly calculated" to determine a taxpayer's net income from sources within California, but did not mandate the use of specific factors.[26] (*Chase*, *supra*, 70 Cal.App.3d at pp. 466-468.) R&TC section 25101 now provides the tax "shall be measured by the net income derived from or attributable to sources within [California] in accordance with [UDITPA]." Therefore, the court in *Chase* applied a materially different statute. Accordingly, FTB's reliance on that case is unpersuasive.

FTB also cites *Great Western Finance v. Franchise Tax Bd.* (1971) 4 Cal.3d 1 (*Great Western*); however, that case is not applicable because the issue was whether deductions should be disallowed when allocable to "eliminated" income pursuant to R&TC section 24425, which provides that items are nondeductible when allocable to income that is "not included in the measure of tax…." (*Id.* at p. 6.) This appeal does not involve application of R&TC section 24425 and *Great Western* did not address the issue in this appeal—whether qualifying dividends deducted from income pursuant to R&TC section 24411 should be included or excluded from the sales factor. As such, OTA also finds FTB's reliance on *Great Western* to be unpersuasive.

[26] The court stated that, "[s]ince no net income is produced by the internal sales, it was not required that they be included in the computation. We think the above described methods used by [FTB] were fairly calculated to assign to California only that portion of the net income reasonably attributable to the business done in this state." (*Chase*, *supra*, 70 Cal.App.3d at p. 473.)

In further support, FTB cites *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750 (*Microsoft*), where the court examined the economic reality of the taxpayer's redemptions of marketable securities to determine whether the full redemption price (rather than the net proceeds) should be treated as gross receipts under former R&TC section 25120(e). In *Microsoft*, the court found that the redemption of a short-term marketable security at maturity was equivalent to a sale of the security to a third party before maturity when the transaction was evaluated from the perspective of the taxpayer. (*Id*. at pp. 761-762.) The court noted that when an investor sells a marketable security to a third party, the entire sales price is includible in gross receipts and, therefore, concluded that the entire amount received upon redemption should similarly be included in "gross receipts" for purposes of calculating the sales factor. (*Id*. at pp. 760-761; see also *General Mills v. Franchise Tax Bd*. (2009) 172 Cal.App.4th 1535, 1544.)

The court in *Microsoft* examined R&TC section 25120 before it was amended to define "gross receipts" under subdivision (f)(2). (*Microsoft*, *supra*, 39 Cal.4th at p. 758 ["The term 'gross receipts' is undefined"].) For the tax year at issue in this appeal, the amendment to R&TC section 25120(f)(2) defining gross receipts is applicable. Gross receipts is specifically defined to include dividends, and there is no applicable exclusion. (See R&TC, § 25120(f)(2).) Therefore, the analysis in *Microsoft* and other cases applying R&TC section 25120 before subdivision (f)(2) was added can be distinguished from the present case. Regardless, the court in *Microsoft*, held that "gross" implies the whole amount received, which is consistent with the conclusion in this Opinion. (*Microsoft*, *supra*, 39 Cal.4th at p.759; see also *Robert Half*, *supra* ["gross" implies the whole amount received, without deduction].)

In addition, under these facts, there is no basis to question the economic reality of the dividends as FTB contends. In *Appeal of CTI Holdings, Inc*., (96-SBE-003) 1996 WL 248926, the California Board of Equalization (BOE) examined the economic reality of dividends, stating that "[b]efore income can be recognized, the taxpayer is required to realize an accession to wealth and have control thereof," citing *Commissioner v. Glenshaw Glass* (1955) 348 U.S. 426. The BOE stated that "[t]here is no dispute here that appellant received payments of dividends…over which it had complete control. Thus, it is obvious that appellant realized economic gain and had recognizable income…." (*Appeal of CTI Holdings, Inc*., *supra*.) In this case, appellant received payments of dividends over which it had complete control, and realized economic gain and recognizable income equal to the gross amount received.

FTB further argues that R&TC section 25120(f)(2)(A)-(L) provides a non-exhaustive list of exclusions from gross receipts, including several that are excluded because they do not contribute to the tax base, which demonstrates a "matching principle" that should be applied to exclude the deducted dividends.[27] The plain language of R&TC section 25120, however, does not indicate that the list is non-exhaustive; rather, R&TC section 25120(f)(2) provides amounts includable in gross receipts under the IRC as applicable for purposes of the CTL, and R&TC section 25120(f)(2)(A)-(L) provides a list of exclusions from gross receipts. In this case, the dividends qualify as gross receipts under R&TC section 25120(f)(2) and there is no applicable exclusion in the plain language of the statute.

The legislative history also fails to support FTB's argument that the list of exclusions under R&TC section 25120(f)(2)(A)-(L) is non-exhaustive or that a "matching principle" mandates treating the instant dividends as excluded from gross receipts. The bill analysis relating to the 2011 amendment adding R&TC section 25120(f)(2) states that "[gross receipts] will include all gross amounts…but will explicitly exclude purely financial corporate transactions (such as corporate [t]reasury function or hedging transactions…)." (California Bill Analysis, A.B.X3 15 Sen., 2/14/2009.) By stating so, the California Legislature does not indicate that the list is non-exhaustive and only references the statutory exclusion of certain transactions that have been determined to be distortive when included in the sales factor. (See *Microsoft*, *supra*, 39 Cal.4th 750 [treasury function transactions]; *General Mills v. Franchise Tax Bd*. (2012) 208 Cal.App.4th 1290, 1313 (*General Mills*) [hedging transactions].) The Legislature could have included language in the statute signifying that the list of exclusions was non-exhaustive (e.g., "such as," "and other similar transactions"), but did not do so, which indicates that the Legislature intended for the list to be exhaustive. As a result, there is no basis to conclude that the "matching principle" that FTB describes should be applied to exclude items from gross receipts based upon whether or not they contribute to the tax base.

FTB also contends that the Legislature endorsed Ruling 2006-01 in 2016 when it enacted Senate Bill No. 2. In the bill, the Legislature stated that "[i]t is the intent of the Legislature that Legal Ruling 2006-01…regarding the treatment of apportionment factors attributable to income

[27] FTB argues that COGS are included in the sales factor because they are expenses, whereas deducted dividends should be removed, matching the treatment of those items in the tax base. While R&TC section 25120(f)(2) specifically provides that gross receipts should not be reduced for COGS, it does not specifically provide that gross receipts should be reduced by the qualifying dividend deduction.

exempt from income tax shall apply to…Section 24330 of the [R&TC]….” (Stats. 2015-2016, 2nd Ex. Sess., ch. 2, § 1.) Former R&TC section 24330, however, related to an exclusion from gross income and, therefore, the Legislature’s statement is not applicable to the qualifying dividend deduction under R&TC section 24411, which is a deduction rather than an exclusion. As with Ruling 2006-01, FTB’s arguments and conclusions are based upon legal authorities relating to exclusions and exemptions from income, but FTB does not provide legal authorities establishing that deductions, such as the qualifying dividend deduction at issue in this appeal, should be treated similarly, such that the deducted dividend income is excluded from gross receipts.[28]

FTB argues that OTA should give deference to its interpretation in Ruling 2006-01 that the sales factor includes only the net dividends after applying the qualifying dividend deduction. The weight given to an agency’s interpretation is fundamentally situational. (See *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12 (*Yamaha*).) Here, FTB has expertise and technical knowledge as the administrator of the tax at issue, which weighs in favor of deference to FTB’s interpretation. (*Id.* at p. 12.) However, FTB’s interpretation of R&TC section 25120 is not in a formal regulation; rather, its interpretation is in Ruling 2006-1. In addition, FTB is interpreting a statute promulgated by the Legislature, as opposed to FTB’s own regulation. These factors weigh in favor of less deference to FTB’s interpretation. (*Ibid.*) Furthermore, FTB’s interpretation is inconsistent with well-established law and there is no indication in the plain language or legislative history that R&TC section 25120(f)(2) applies to appellant’s dividends received during the tax year as FTB contends. Accordingly, in applying its independent judgment, OTA finds that FTB’s interpretation is unpersuasive. (*Yamaha*, *supra*, 19 Cal.4th at p. 4.)

Conclusion

Gross receipts from the dividends should not be reduced to account for dividends deducted under R&TC section 24411. Appellant’s total taxable dividend income is $109,038,022,605, and once intercompany dividends are eliminated from gross receipts, the dividends includible in the sales factor total the qualifying dividends of $108,818,839,241. (See

[28] The statutory definitions provided in R&TC section 25120 are prefaced by the phrase “unless the context otherwise requires.” FTB argues that the “context otherwise requires” in this matter; however, FTB has not shown that such language means the deducted dividends should be excluded from gross receipts.

R&TC, § 25106(a)(1); Cal. Code Regs., tit. 18, § 25106.5-1(a)(5)(A)(1); *Fujitsu*, *supra*, 120 Cal.App.4th at p. 481.) As a result, the qualifying dividends of $108,818,839,241 are considered gross receipts includable in the sales factor denominator.

Issue 2: Whether gross receipts from the qualifying dividends should be excluded from the sales factor as a substantial and occasional sale, pursuant to Regulation section 25137(c)(1)(A).

Background

Regulation section 25137(c)(1)(A) provides that, where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. (*Ibid.*) If Regulation section 25137(c)(1)(A) is found to apply, it will be the controlling standard apportionment method. (*Appeal of Fluor Corporation* (95-SBE-016) 1995 WL 799363 (*Fluor*).)

A sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole. (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)1.) A sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently. (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)2.)

Analysis

FTB argues that the distribution of dividends qualifies as a "sale" under Regulation section 25137(c)(1)(A) and, therefore, all the gross receipts from the qualifying dividends should be excluded from the sales factor as arising from a substantial and occasional sale. Specifically, FTB contends that the dividends should be considered a "sale" for purposes of Regulation section 25137(c)(1)(A) because they are included in the "sales" factor.

R&TC section 25120 provides the meaning of terms as used in R&TC sections 25120 to 25139 (UDITPA), inclusive, unless the context otherwise requires. (R&TC, § 25120.) R&TC section 25120(f)(1) defines "sales" as all gross receipts of the taxpayer not allocated under R&TC sections 25123 to 25127, inclusive. R&TC section 25120(f)(2) defines gross receipts as expressly including dividends. Therefore, dividends are "sales" for purposes of UDITPA under

R&TC section 25120(f)(1). However, a dividend is not a "sale" as used in Regulation section 25137(c)(1)(A). Regulation section 25137(c)(1)(A) applies to a "sale of a fixed asset or other property," such as "the sale of a factory, patent, or affiliate's stock." Under R&TC section 25120(f)(1) and (f)(2), sales is defined to include not only amounts from a sale of property, but also from the exchange of property, performance of services, and the use of property or capital (including rents, royalties, interest, and dividends).[29] Therefore, the definition of a "sale" in Regulation section 25137(c)(1)(A) is more limited in scope than the definition of "sales" in R&TC section 25120(f)(1).[30]

FTB contends that the reference in Regulation section 25137(c)(1)(A) to a sale of "other property" can mean the distribution of dividends. In 2001, Regulation section 25137(c)(1)(A) was amended to add the "other property" language to apply the regulation to "sales" of intangible assets, in addition to fixed assets. (See Amendment of Regulation section 25137(c)(1)(A) and new subsections (c)(1)(A)1.-2. filed 1-30-2001; operative 1-1-2001 (Register 2001, No. 5); *Appeals of Amarr Company and Amarr Company (C SGNF)*, 2022-OTA-041P (*Amarr*).) Prior to the amendment, FTB issued Legal Ruling 1997-1, which stated that gross receipts from an incidental or occasional sale of intangible property should not be distinguished from sales of fixed assets for purposes of the substantial and occasional sale rule. (See also *Amarr*, *supra*.) For instance, the 2001 amendment added that a sale could include the sale of a "patent" or "affiliate's stock." (Cal. Code Regs., tit. 18, § 25137(c)(1)(A); *Amarr*, *supra*.) Therefore, as held in *Amarr*, *supra*, Regulation section 25137(c)(1)(A) makes clear that the substantial and occasional sale rule is applicable to "sales" of both tangible assets (i.e., a factory) and intangible assets (i.e., patents or an affiliate's stock).

FTB provides no evidence or legal authorities establishing that the dividends are a sale of property under Regulation section 25137(c)(1)(A). Here, FTB has already determined that the distributions are dividends, as opposed to a sale of property, as it determined they are qualifying dividends, pursuant to R&TC section 24411. Accordingly, appellant's receipt of the dividends

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[29] In addition, Regulation section 25134(a)(1) states that "for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business."

[30] "The terminology identifying the sales or receipts factor varies among the states, but whatever term is used, the factor has a much broader scope than receipts from sales of tangible personal property." (Hellerstein, State Taxation, 9.18.)

does not qualify as a "sale" of property under Regulation section 25137(c)(1)(A) and, as a result, the dividends do not meet the requirement of the regulation that the receipts arise from a "sale."[31]

Conclusion

Regulation section 25137(c)(1)(A) does not apply to exclude the qualifying dividends from the sales factor as a substantial and occasional sale.

Issue 3: Whether FTB has shown that the use of an alternative apportionment method is warranted, pursuant to R&TC section 25137.

Background

R&TC section 25137 provides that if the allocation and apportionment provisions under UDITPA do not fairly represent the extent of the taxpayer's business activity in this state (i.e., there is "distortion"), the taxpayer may petition for or FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (1) separate accounting; (2) the exclusion of any one or more of the factors; (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. Regulation section 25106.5 states that the provided formula for the sales factor of the water's-edge (and worldwide) combined reporting group is applied, "except as modified under Section 25137 of the Revenue and Taxation Code." (Cal. Code Regs., tit. 18, § 25106.5(c)(7)(A)1.b.)

As FTB is the party seeking a deviation from the standard apportionment formula, it has the burden of establishing, by clear and convincing evidence, that: (1) application of the standard apportionment formula does not fairly represent appellant's activities in California; and (2) its proposed alternative apportionment methodology is reasonable.[32] (*Microsoft*, *supra*, 39 Cal.4th at p. 765.) A rough approximation under the general UDITPA standards is all that is required. (*Fluor*, *supra*.) Courts have examined the following two factors in deciding whether

[31] Accordingly, there is no need to address whether the receipt of the dividends is substantial and occasional. However, as discussed in Issue 3, the receipt of the repatriated dividends does not qualify as "occasional."

[32] R&TC section 25137 gives "latitude…because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics." (William J. Pierce, The Uniform Division of Income for State Tax Purposes (1957) 35 Taxes 747, 781.)

there is distortion: (1) whether the activities generating the receipts were qualitatively different from the taxpayer's main line of business; and (2) whether the quantitative distortion that arose from the inclusion of the receipts was substantial. (*Microsoft*, *supra*, 39 Cal.4th at p. 766.) The qualitative and quantitative effects do not constitute two separate tests but are examined together in "assessing whether the standard formula fairly represents the company's business activity in California." (*General Mills*, *supra*, 208 Cal.App.4th at p. 1301.) Any one metric alone is not dispositive. (*Id*. at p. 1313.)

Analysis[33]

FTB argues that qualitative and quantitative factors as described in *Microsoft*, *supra*, 39 Cal.4th at p. 766, show that inclusion of the total qualifying dividends in the sales factor denominator results in distortion similar to a substantial and occasional sale. FTB's proposed alternative method is to exclude the dividend gross receipts from the sales factor, analogous to the treatment of a substantial and occasional sale.[34] Accordingly, FTB argues that the sales factor should be approximately 7.30 percent (i.e., $6,874,544,868 ÷ $94,699,397,478), as compared to a sales factor of 3.37 percent which is calculated by including the deducted dividends in the sales factor denominator.[35] FTB points to appellant's sales factor percentages from the last three years of 5.29 percent, 5.68 percent, and 6.68 percent for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively, and contends that the current year percentage of 3.37 breaks the pattern of steady increases. Appellant contends that the change in tax law under the TCJA caused appellant to change its business practices to make actual

[33] The analysis does not address the property and payroll factors because appellant uses the single-sales factor, and the parties make no assertions as to the property or payroll factors.

[34] FTB's proposed method is to exclude all the qualifying dividend from gross receipts, analogous to the treatment that would apply under the substantial and occasional sale provisions provided in Regulation section 25137(c)(1)(A). Appellant's original return included net dividends as gross receipts in the sales factor, and appellant's claim for refund is based on the difference between the net dividends included in the sales factor on the original return, and inclusion of gross dividends as gross receipts in the sales factor in its claim for refund. Therefore, FTB's proposed method would result in appellant owing more tax than is at issue in this appeal. However, OTA can only determine whether to sustain or reverse up to the amount of the claim for refund.

[35] The 3.37 percent sales factor is based on appellant's claim for refund, which included dividends of $109,001,169,787 in the sales factor denominator. As previously discussed, appellant is entitled to include $108,818,839,241 in the sales factor denominator. Therefore, because this Opinion determines that FTB has not shown distortion, the sales factor should be recomputed based upon inclusion of $108,818,839,241 in the sales factor denominator. This appears to result in a sales factor of approximately 3.38 percent (i.e., $6,874,544,868 ÷ $203,518,236,719) rather than 3.37 percent as computed by appellant in its claim for refund.

dividend distributions in the current year and going forward. Appellant argues that, as a result, the repatriation of dividends is now a frequent event and prior year factors do not demonstrate the current year factor is distortive.

As a threshold matter, appellant asserts that if the standard apportionment formula is found to be distortive, any alternative apportionment formula should consider the apportionment factors of the excluded CFCs. FTB asserts that, because appellant elected to use the water's-edge method of reporting, it is bound by that affirmative election pursuant to the "doctrine of elections," citing *Grynberg v. Commissioner* (1984) 83 T.C. 255, 261. FTB states that the doctrine of elections is not codified but applies to "any election that affects the computation of tax" that is made under the CTL, which includes the water's edge rules, citing Senate Bill 1015 (1999). As a result, FTB asserts that the water's-edge rules preclude taking into account the apportionment factors of entities other than to the extent provided by R&TC section 25110(a). Therefore, FTB contends that R&TC section 25137 does not permit the use of an alternative method that would include the apportionment factors of CFCs excluded from the water's-edge group, other than as provided in R&TC section 25110(a). FTB asserts, however, that the water's-edge election does not prevent any request for variance or preclude a determination of whether distortion exists under R&TC section 25137. FTB asserts that distortion must first be shown before an alternative method would be examined and the doctrine of elections would apply to preclude a method contrary to R&TC section 25110(a).[36]

OTA agrees that, based on the language of R&TC section 25137, the issue of whether an alternative method is permitted, such as one that includes the CFC factors in the apportionment formula, does not arise during the distortion examination. It must first be determined if, and on what basis, there is distortion, and only when it is determined that there is distortion can it be determined if an alternative method is reasonable and whether a proposed alternative is precluded by the doctrine of elections. (See *Fluor*, *supra*.) As discussed below, because OTA determines that FTB has not shown distortion, there is no need to address whether an alternative method would be precluded under the doctrine of elections due to appellant's water's-edge election.

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[36] For example, in *Media General Communications, Inc. v. South Carolina Dept. of Revenue* (2010) 388 S.C. 138, 147, the parties stipulated that the standard apportionment formulas did not fairly represent the income of the taxpayer; therefore, the only question was the whether the statute (similar to R&TC section 25137) permitted the proposed alternative apportionment method.

Qualitative Difference

Distortion may be found when the standard formula is biased by a substantial activity that is not related to the taxpayer's main line of business. (*Appeal of Crisa Corporation* (2002-SBE-004) 2002 WL 1400003 (*Crisa Corp*).) In *Microsoft*, the court cited two BOE cases, one where the BOE held that the transactions in question were qualitatively different from the taxpayer's principal business, *Appeals of Pacific Telephone and Telegraph Company* (78-SBE-028) 1978 WL 3941 (*Pacific*), and one where the BOE did not find a qualitative difference in the transactions at issue, *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith, Inc*. (89-SBE-017) 1989 WL 95886 (*Merrill*). (*Microsoft*, *supra*, 39 Cal.4th at p. 765.) With regard to *Pacific*, the court in *Microsoft* stated that the case before the court was "analogous to [*Pacific*]…Microsoft's treasury functions are qualitatively different from its principal business, and the quantitative distortion from inclusion of its investment receipts is substantial."[37] (*Microsoft*, *supra*, 39 Cal.4th at p. 766.) With regard to *Merrill,* the court stated that the "taxpayer's sale of securities on its own account was not qualitatively different from its main business...." (*Ibid*.)

In *Microsoft*, the court found that receipts from Microsoft's treasury department were qualitatively different from the main line of business because, while those functions were important and intended to be profitable, the investment activity was only incidental to the principal corporate business purpose. (*Microsoft*, *supra*, 39 Cal.4th at p. 766.) In *General Mills*, the court found that hedging activities were qualitatively different from the main line of business which sold finished products, and while they served a critical supportive function to the ultimate sales of finished products for profit, they would be economically meaningless if separated from the ultimate sales of products for profit. (*General Mills*, *supra*, 208 Cal.App.4th at pp. 1305-1306.)

FTB contends that the present circumstances are analogous to a substantial and occasional sale because appellant received a large amount of gross receipts from the repatriated dividends, and the repatriated dividends were a one-time event due to the enactment of the TCJA and imposition of the transition tax under IRC section 965, and were not part of appellant's

[37] Other cases have similarly applied *Pacific*, *supra*, or *Merrill*, *supra*. (See *General Mills*, *supra*, 208 Cal.App.4th at p. 1301; *Limited Stores, Inc. v. Franchise Tax Bd*. (2007) 152 Cal.App.4th 1491, 1499 (*Limited*); *In re Buffets Holdings, Inc*. (2011) 455 B.R. 94, 100 (*Buffets*).)

normal course of business. (See Cal. Code Regs., tit. 18, § 25137(c)(1)(A)2.) Therefore, FTB effectively argues there is a qualitative difference because the dividends were “occasional.”

A sale is occasional if the transaction is outside of the taxpayer’s normal course of business and occurs infrequently. (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)2.) As stated by the court in *Microsoft*, while R&TC section 25137 ordinarily applies to unique and nonrecurring situations, it does not apply only to such situations; the statutory touchstone remains whether the formula fairly represents a unitary business’s activities.[38] (*Microsoft*, *supra*, 39 Cal.4th at p. 770; see also *Crisa Corp*, *supra*.)

In this case, the dividends are not comparable to an “occasional” sale under Regulation section 25137(c)(1)(A). The substantial and occasional sale rules require a separate showing that the sale is “substantial” in addition to a showing that the sale is “occasional.” (See Cal. Code Regs., tit. 18, § 25137(c)(1)(A)1.) As a result, while appellant received a large amount of gross receipts due to the repatriated dividends, the examination of whether the dividends would qualify as occasional under Regulation section 25137(c)(1)(A)2. does not take into consideration the size or amount of the gross receipts. Instead, the examination considers whether the dividends were outside appellant’s normal course of business and occurred infrequently. (See Cal. Code Regs., tit. 18, § 25137(c)(1)(A)2.)

Here, appellant reported dividend income from both the receipt of repatriated dividends, as well as dividend income from other than repatriated dividends, regularly each year.[39] While the enactment of the TCJA impacted the size of the dividends received from the CFCs in the

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[38] In *Microsoft*, the court stated that declining to apply R&TC section 25137 to the circumstances in that case would create a significant loophole exploitable, whereby a unitary group could reduce its state tax liability to near zero through subtle changes in investment strategy. (*Microsoft*, *supra*, 39 Cal.4th at p. 770.) However, the evidence does not establish that the present circumstances are comparable to those circumstances described in *Microsoft*, *supra*, 39 Cal.4th at p. 770. The qualifying dividend deduction reducing apportionable net income is statutorily authorized as a deduction at a set percentage. And the TCJA, which was enacted to change prior law that “encouraged domestic corporations to minimize distributions back to the [U.S.] ….”, is intended to “encourage repatriation of foreign income….” (*Silver*, *supra*, 531 F.Supp.3d at p. 351.) Therefore, the repatriation of the dividends, which are included as a gross amount in the sales factor denominator, is consistent with the intent of the TCJA.

[39] For the prior three years, appellant reported total dividend income of $2.9 billion, $4.2 billion, and $4.4 billion for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively. These dividend income amounts include income from both repatriated dividends and from other than repatriated dividends. Appellant reported dividend income that included repatriated dividends of $1.3 billion, $609 million, and $1.9 billion for fiscal years ending June 30, 2015; June 30, 2016; and June 30, 2017; respectively. For the current fiscal year, appellant reported $3.3 billion in dividend income from other than the repatriated dividends at issue.

current tax year, it does not change the fact that, each year, appellant regularly received dividends, including repatriated dividends, from its various subsidiaries and CFCs. In addition, appellant did not receive only a single dividend distribution each year from a single subsidiary, but numerous dividends from its different subsidiaries and CFCs.[40] Therefore, appellant regularly received dividends, and the receipt of dividends was not an infrequent event.

In addition to the fact that appellant regularly received repatriated and non-repatriated dividends, the repatriated dividends at issue were not irregular or infrequent on the basis that they resulted from the imposition of the transition tax and enactment of the TCJA. Rather, the dividends were consistent with the intent of the TCJA to incentivize companies, such as appellant, to permanently change their business practices to repatriate—and not defer—repatriation of foreign earnings. (See *Silver*, *supra*, 531 F.Supp.3d at p. 351 [the TCJA is intended to "encourage repatriation of foreign income…."].) The transition tax under IRC section 965 was implemented as part of the "transition" to the new tax system under the TCJA. (See H.R. Rep. 115-409, *supra*, at p. 375 [discussing treatment of deferred foreign income upon transition].) As a result, the repatriated dividends reflect the intent of the TCJA to transition to a new tax system and change business practices in not only the current year, but also going forward. FTB does not provide any other argument or evidence to show the dividends would be "occasional" under Regulation section 25137(c)(1)(A)2. Accordingly, these circumstances are not comparable to an "occasional" sale under FTB's proffered analogy.[41]

[40] Dividends are commonly distributed at regular intervals during the year, such as on a quarterly basis. FTB does not provide any evidence regarding the frequency of dividends received by appellant, though FTB states that appellant's CFCs paid dividends to the water's-edge group many times every year.

[41] Because OTA does not find the dividends to be "occasional," this Opinion does not reach the question of whether distortion would be established in this case if, under FTB's analogy, the dividends were found to be both substantial and occasional. As previously noted, the statutory touchstone remains whether the formula fairly represents a unitary business's activities. (*Microsoft*, *supra*, 39 Cal.4th at p. 770.) And as discussed below, this Opinion examines quantitative metrics that take into consideration the amount of dividends included in the sales factor, as described in *Microsoft* and other similar cases, and finds that FTB has not shown sufficient quantitative distortion. (See *Microsoft*, *supra*, 39 Cal.4th at pp. 766-768; *General Mills*, *supra,* 208 Cal.App.4th at pp. 1303, 1308-1312.)

FTB does not provide any other arguments or evidence to establish a qualitative difference. Therefore, FTB has not shown that the activities generating the dividend gross receipts were qualitatively different from appellant's main line of business.[42]

Quantitative Distortion

In *Microsoft*, the court stated that "UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state," which "works well enough in the absence of huge variations in state-to-state margins…." (*Microsoft*, *supra*, 39 Cal.4th at p. 768.) The court added that "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." (*Id*. at p. 767.) The court compared the profit margins from the treasury activities to those of its nontreasury activities and found the multiplier separating the margins to be 170, which it held to be distortive because the separation was by "several orders of magnitude."[43] (*Ibid*.)

FTB provides profit margins based on a 100 percent profit margin for the qualified dividends received and 16 percent for appellant's income excluding all the qualifying dividends, as compared to profit margins of less than 0.2 percent for treasury activities and more than 31 percent for nontreasury activities, as examined by the court in *Microsoft*, *supra*, 39 Cal.4th at p. 767.[44] FTB's profit margins, which are based on the dividend income and the income excluding the dividends, are not separated by "several orders of magnitude," but by a multiplier of 6.25, which is a small measure of separation when compared to the multiplier of 170 found to be

[42] This Opinion does not conclude that a determination of whether a sale is outside the normal course of business, as it pertains to Regulation section 25137(c)(1)(A)2., should be equated with the examination of whether certain activities are qualitatively different than those of the main line of business, as described in *Microsoft*, *supra*, 39 Cal.4th at p. 766, and *General Mills*, *supra*, 208 Cal.App.4th at pp. 1305-1306. Rather, this Opinion concludes that FTB has not shown that the dividends are "occasional" under its analogy and has not shown a qualitative difference and, as a result, there is no need to address the matter further.

[43] One order of magnitude generally means a 10 times difference.

[44] FTB's calculation of the profit margin for the qualifying dividends is not a typical profit margin calculation, as it is calculated using dividends distributed by the CFCs, divided by the same amount. FTB calculates the profit margin for all other gross receipts by dividing net income by gross receipts, excluding the qualifying dividends. If the ratio of net income to gross receipts for the qualifying dividends (25 percent) is compared to the ratio of net income to gross receipts for all other sales excluding the qualifying dividends (16 percent), the difference results in a multiplier of only 1.56 percent.

distortive in *Microsoft* and the multipliers found distortive in similar cases.[45] (*Microsoft*, *supra*, 39 Cal.4th at p. 767.) Therefore, the margins provided do not demonstrate a problem of "scale," as was found in *Microsoft*, where the treasury receipt margins were "quite small" when compared to "much higher" margins for nontreasury activities. (*Ibid.*)

In *Microsoft*, the court also determined that the treasury activities produced "minimal income" (less than 2 percent of Microsoft's business income), but "enormous receipts" (73 percent of gross receipts), which it found to be distortive. (*Microsoft*, *supra*, 39 Cal.4th at p. 771.) Here, the parties provide calculations showing that net dividends after accounting for the deduction are 61 percent of net income, and gross dividends are 53 percent of gross receipts.[46] This is not comparable to *Microsoft*, where "the net receipts are so small in comparison with Microsoft's nontreasury income and receipts…." (*Ibid.*) This is because the net dividends of $27 billion contributed a significant amount to the tax base, which is approximately $17 billion when excluding the net dividends; whereas in *Microsoft*, the net income from the treasury activities was $10.7 million as compared to nontreasury activities which produced income of $659 million. (See *Microsoft*, *supra*, 39 Cal.4th at p. 767.)

In *Microsoft*, the court considered the amount of the business activities attributed to a single state due to inclusion of the treasury function receipts in the sales factor, noting that its analysis was based on *Pacific*, *supra*. (*Microsoft*, *supra*, 39 Cal.4th at p. 765.) In *Pacific*, the BOE found that, because investment activities accounted for 2 percent of net income but 34 percent of total gross receipts, the proportional difference was distortive because an "incidental" part of the business was being attributed a large amount of activity which caused a single state to be assigned approximately 11 percent of Pacific's business income. (*Pacific*, *supra*.) Here, while inclusion of the gross dividends in the sales factor causes 53 percent of appellant's business activities to be attributed to foreign jurisdictions, the dividends account for 61 percent of net income subject to apportionment and, therefore, comprise a significant amount

[45] Examples of other profit margin multipliers found to be distortive include 460, 53, and 81. (See *Limited*, *supra*, 152 Cal.App.4th at p. 1500; *Buffets*, *supra*, 455 B.R. at pp. 100-101; *General Mills*, *supra*, 208 Cal.App.4th at pp. 1311-1312.).

[46] $27,387,040,356 of the dividends included in net income divided by total net income of $44,387,432,997 = approximately 61 percent; $108,818,839,241 of the dividends included as gross receipts, divided by total gross receipts of $203,518,236,719 = approximately 53 percent.

of income to be apportioned.[47] As a result, these circumstances are not comparable to cases such as *Pacific* or *Microsoft*, where it was found that the location of a qualitatively different part of the business was attributed an "enormous volume" of activity which "substantially overloads the sales factor" and inadequately reflects the states' contributions.[48] (See *Pacific*, *supra*; *Microsoft*, *supra*, 39 Cal.4th at pp. 765-766.)

Quantitative distortion has also been examined by considering the degree to which inclusion of the challenged activity ultimately affects the result under the standard apportionment formula. (See *General Mills*, *supra*, 208 Cal.App.4th at p. 1312.) In *Merrill*, *supra*, calculations showing a 5.86 percent to 3.43 percent change in the apportionment formula, i.e., a 41 percent decrease, and calculations showing a 36 percent difference between apportionment formulas, were not enough to establish distortion. The BOE stated that the difference was "certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business." (*Merrill*, *supra*.) Here, the change in the apportionment formula is from 5.63 percent to 3.37 percent, a 40 percent decrease, which is comparable to the percent change in *Merrill*. As stated in *Merrill*, distortion is not established just because "the statutory method results in a bigger denominator and a smaller numerator than would occur under the [proposed] method." (*Ibid.*)

FTB contends that the sales factors from the prior three years show a steady pattern of increases that is disrupted by significant gross receipts in the denominator of the current year sales factor.[49] However, a change in the apportionment formula alone is "unavailing" and does

[47] See footnote 46.

[48] In *Pacific*, *supra*, the receipts from investments activities accounted for 34 percent of total receipts, with 11 percent of income assigned to the investment activity location (34 percent ÷ 3 for a single-weighted factor) and the treasury activity accounting for 2 percent of the company's net income. In *Microsoft*, the court found that 24 percent of the unitary business would be attributable to the state of Washington and would inadequately reflect the contributions made by all other states (24 percent = [total redemptions of $5.7 billion ÷ total sales of $7.8 billion] ÷ 3 for a single-weighted factor). (*Microsoft*, *supra*, 39 Cal.4th at pp. 767, 769, fn. 19.) In addition, the treasury department investments accounted for $10.7 million (1.6 percent) of the net income subject to apportionment which totaled approximately $670 million ($10.7 million + $659 million). (*Microsoft*, at p. 767.)

[49] In *Crisa Corp*, *supra*, the BOE provided examples of unusual fact situations that may cause distortion, including when the factors in the standard formula are mismatched to the time during which the income is generated, citing *Appeal of Donald M. Drake Company* (77-SBE-012) 1977 WL 3823 (*Drake*). In *Drake*, *supra*, the BOE held there was distortion because the "income from the joint ventures, although recognized and apportioned in the year of completion, was actually earned at least partially through business activity in a prior year or years." FTB does not argue or provide evidence of distortion for the reasons provided in *Drake*. Instead, FTB points to prior years and argues they demonstrate distortion due to the current year factor breaking the trend of increases in prior year factors.

not prove distortion; rather, it must be shown that the standard method does not fairly reflect the taxpayer's business activity. (*Merrill*, *supra*.) The dividend repatriation was the result of a widespread change in tax law which was intended to incentivize companies to change business practices so that foreign subsidiaries would make dividend distributions to U.S. shareholders. The prior rules "encouraged domestic corporations to minimize distributions back to the [U.S.] and to accumulate substantial earnings offshore," whereas "the rules enacted by the TCJA… encourage repatriation of foreign income…." (*Silver*, *supra*, 531 F.Supp.3d at p. 351; see also H.R. Rep. 115-409, *supra*, at p. 370 [TCJA "will remove tax-driven incentives to keep funds offshore"].) As a result, appellant's repatriation of earnings was consistent with the intent of the TCJA. In addition, because the TCJA incentivizes companies to repatriate earnings in years after the year at issue, companies such as appellant are incentivized to change their business practices going forward. As a result, the pattern in the sales factors for prior years is not dispositive here in showing distortion. In addition, the change in the apportionment percentage is consistent with the change in business practice to repatriate dividends. Accordingly, FTB has not shown that the inclusion of the repatriated dividends in the sales factor results in quantitative distortion.[50]

Conclusion

FTB has not met its burden to show by clear and convincing evidence that the standard apportionment formula does not fairly represent appellant's activity in California.[51]

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[50] A determination under R&TC section 25137 is a fact-specific inquiry and depends on the circumstances of the case. (See *Amarr*, *supra*.) Therefore, while FTB has not shown distortion here, that does not mean distortion could not be found in other circumstances involving repatriated dividends subject to the qualifying dividend deduction, where gross repatriated dividends are included in the apportionment formula and net repatriated dividends are included in apportionable net income.

[51] Because distortion has not been shown, there is no need to address whether FTB's proposed alternative method is reasonable.

HOLDINGS

1. Qualifying dividends deducted from income pursuant to R&TC section 24411 are includable in appellant's sales factor.
2. Gross receipts from the qualifying dividends should not be excluded from the sales factor as a substantial and occasional sale, pursuant to Regulation section 25137(c)(1)(A).
3. FTB has not shown that the use of an alternative apportionment method is warranted, pursuant to R&TC section 25137.

DISPOSITION

FTB's action denying the claim for refund is partially reversed to recompute the sales factor to increase gross receipts included in the sales factor denominator to include the total amount of qualifying dividends of $108,818,839,241. FTB's action is otherwise sustained.[52]

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge

Date Issued: 7/27/2023

[52] Appellant filed a claim for refund for tax of $93,901,901 with FTB, based on the inclusion of $109,001,169,787 in the sales factor denominator. As determined in Issue 1 of this Opinion, qualifying dividends of $108,818,839,241 are considered gross receipts includable in the sales factor denominator. Therefore, appellant is entitled to a refund of tax to be computed based on the holding of this Opinion to include $108,818,839,241 in the sales factor denominator. To the extent the tax for which appellant claimed a refund exceeds the amount of tax as determined pursuant to the holding of this Opinion, FTB's action in denying the claim for refund is sustained.