State Law & State Taxation Corner

By John A. Biek

California and Illinois Courts Set Limits on Taxpayers Regarding Inclusion of Gains from Short-Term Securities Investments in Their Sales Factors

Introduction

One of the more contentious issues in many state income tax audits is the question of whether a non-domiciliary corporation should be able to include the gross receipts—or just the net gains—from its short-term investments in securities in the denominator of the sales factor that the corporation utilizes to apportion business income within and without the taxing state. The treasury departments of large corporations often invest excess cash in marketable debt or equity securities that the corporation may hold for less than a month so that this capital will be available for use in the corporation's business operations, as needed. Because these short-term investments turn over so often in the tax year, they can generate an enormous amount of gross receipts compared with the sales revenue that the corporation earns from its core business operations.

Based on a plain reading of the apportionment statutes, many corporations include the *gross receipts* from their short-term securities investments in the denominator of the sales factor. This reporting position can be quite beneficial to the corporation because it will significantly reduce the sales factor—and the amount of taxable income—that the corporation reports on the tax returns that it files with the states where it does not conduct its investment activities. State tax auditors who review those tax returns often will attempt to mitigate the dilution of the corporation's sales factor by limiting the corporation to including only the *net gains* from its short-term securities investments in the sales factor.

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Over the past 20 years, two lines of cases have developed on this issue. The first line of cases has held that taxpayers are entitled under the literal wording of the sales factor statute to include gross receipts from their short-term securities investments in the sales factor even if it results in a significant reduction of the sales factor.[1] The other line of cases has allowed the state tax administrator to limit the corporation to including net gains from short-term securities investments in the sales factor in order to avoid distortion of the sales factor.[2]

Because the courts have been evenly divided on this issue, the state tax community has been keenly watching two California Supreme Court cases to see how that influential court would decide the issue. The California Supreme Court has now weighed in on the issue in the *Microsoft*[3] and *General Motors*[4] decisions discussed below. In these two cases, the California Supreme Court held that while the wording of the California sales factor statute would allow Microsoft and General Motors to include the gross receipts from short-term securities investments held to redemption in their sales factors, the California Franchise Tax Board (FTB) could limit the companies to including net gains in the sales factor under the "alternative relief" provision of the California franchise tax statutes if the FTB could show that the companies were distorting their sales factors. The California Supreme Court found the requisite distortion in the *Microsoft* case and remanded the *General Motors* case to give the FTB the opportunity to present its distortion argument.

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The Illinois Appellate Court recently reached a similar conclusion in the *Mead*[5] case discussed below. Although not as thoroughly reasoned as the *Microsoft* decision, the *Mead* decision will lend additional support to state auditors who object to nondomiciliary corporations including gross receipts from short-term securities investments in their sales factors.

The *Microsoft* Case

Microsoft Corporation is an international computer software company headquartered in the State of Washington.[6] In order to earn additional income, Microsoft's treasury department in Washington State invested the company's excess cash in various short-term marketable securities, including commercial paper, corporate bonds, United States Treasury bills and notes, discount notes, United States money market preferred securities, United Kingdom money market preferred securities, fixed rate auction preferred securities, floating rate notes, loan participations, municipal bonds and loan repurchase agreements.[7] Microsoft generally held these securities to maturity, which, in the case of approximately 80 percent of these securities investments, meant a period of 30 days or less.[8]

In the 1991 tax year at issue in the case, Microsoft earned $10.7 million of income and generated $5.7 billion of revenue—or a 0.2 percent margin—from its short-term securities transactions.[9] In comparison, Microsoft's sales of software products generated $659 million of income and gross receipts of $2.1 billion, for a margin of roughly 31 percent.[10] In overall percentage terms, the short-term securities investments produced less than 2 percent of Microsoft's income, but as much as 73 percent of its gross receipts.[11]

Microsoft filed an amended 1991 California franchise tax return that included the entire $5.7 billion of gross receipts from its sales and redemptions of marketable securities in the denominator of its California sales factor.[12] Microsoft did not include any portion of the $5.7 billion of short-term investment receipts in the numerator of the California sales factor because these investment receipts had been generated in Washington State, where Microsoft's treasury function was located. Including the gross receipts in the denominator of the sales factor reduced Microsoft's 1991 California sales factor from approximately 11 percent to 3 percent and cut Microsoft's California franchise tax liability nearly in half.[13]

When the California FTB audited Microsoft's 1991 amended tax return, the auditor agreed with Microsoft's inclusion of the gross receipts from its *sales* of securities in the denominator of the California sales factor. The auditor took the position, however, that in situations in which Microsoft had held a secu-

rity *to maturity*, Microsoft could only include the *net gain* from the short-term securities redemption (*i.e.,* the difference between the redemption price and the purchase price) in the denominator of the California sales factor. The auditor viewed the excluded portion of the gross receipts as the return of capital on Microsoft's securities redemptions.[14] The FTB assessed more than $1 million of California franchise tax and interest against Microsoft, largely as a result of increasing the company's sales factor back to 11 percent.

Microsoft exhausted its administrative remedies and then filed a refund suit to recover its payment of the California franchise tax assessment. After a bench trial, the California Superior Court for the City and County of San Francisco entered judgment in Microsoft's favor, holding that the entire amount of receipts that Microsoft had received from redeeming securities at maturity was includible in the California sales factor and that the FTB had not demonstrated that distortion of the sales factor would result if Microsoft were permitted to include more than the net gain from its securities redemptions in the sales factor.[15]

The California Court of Appeals reversed the trial court's decision, however, concluding that Microsoft's inclusion of the gross receipts from its securities redemptions in the denominator of its California sales factor had seriously diluted the sales factor. Based on this factual finding, the Court of Appeals allowed the FTB to invoke the "alternative relief" provision of Section 25137 of the California franchise tax statutes[16] to exclude the return of capital portion of Microsoft's investment receipts from its sales factor.[17] The California Supreme Court agreed to review the Court of Appeals decision.

The California Supreme Court turned first to the question of what the California sales factor statute itself provides as the measure of the securities redemption proceeds to be included in the sales factor. Under the California franchise tax statutes, the sales factor is a ratio of the taxpayer's "sales" in a given state to its total sales everywhere.[18] The term "sales" is then defined in the California franchise tax statutes to mean "*all gross receipts* of the taxpayer not allocated [as nonbusiness income] under Sections 25123 through 25127 of this code."[19] Unfortunately the critical term "gross receipts" is not defined either in the California franchise tax statutes or in the Uniform Division of Income for Tax Purposes Act ("UDITPA")[20] on which the California franchise tax statutes are based.

The California Supreme Court agreed, however, with Microsoft's argument that "the meaning of 'gross receipts' in the UDITPA more naturally includes the entire redemption prices 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."[21]

The California Supreme Court rejected the FTB's argument that notwithstanding the generally accepted meaning of "gross receipts," the California franchise tax meaning of the term should only include amounts that the taxpayer received *as consideration* for an income-producing transaction. The FTB contended that amounts that Microsoft had received as a return of principal or capital on its securities investments were not consideration received for making the investment. However, the California Supreme Court considered the example of a 28-day Treasury bill transaction in which the investor exchanges $9,900 now for the right to receive a $10,000 payment from the federal government in 28 days and concluded that:

> The Federal Reserve's consideration is the entire amount it receives now; the investor's consideration is the entire larger, but deferred, amount it receives upon redemption. The transaction occurs because the Federal Reserve views the money it receives now as more valuable than the money it must pay later, while the investor views the money it will receive later as more valuable than the money it has now. The difference between the purchase and redemption price is a measure of either gross income or net receipts, not a measure of consideration. (*Cf. Gray v. Franchise Tax Board* (1991), 235 Cal. App. 3d 36, 42 [286 Cal. Rptr. 453] (gross income is 'the excess of the sales price over the cost of goods sold'); *MCA, Inc. v. Franchise Tax Board* (1981), 115 Cal. App. 3d 185, 197-198 [171 Cal. Rptr. 242] (gross receipts differs from gross income in that the latter subtracts the cost of goods sold).)[22]

The California Supreme Court determined that the legislative history of UDITPA supported a broad measure of the term "gross receipts." An early draft

of UDITPA had defined the term "sales" as "all *income* of the taxpayer" not otherwise allocated, but this "sales" definition was later revised to read "all *gross receipts* of the taxpayer" not otherwise allocated.[23] The California Supreme Court concluded that the drafters of UDITPA had intentionally defined the term "sales" in terms of "gross receipts" instead of "income," with the result that "the drafters had in mind a definition of 'sales' that encompassed more than just gross income."[24]

The California Supreme Court drew additional support for its statutory construction of the term "gross receipts" from decisions of the California State Board of Equalization (SBE), the administrative tribunal that decides California franchise tax cases. In *Appeal of Pacific Telephone & Telegraph,*[25] the taxpayer's treasury department had invested idle cash in short-term securities such as Treasury bills, certificates of deposit, and commercial paper. Pacific Telephone and Telegraph held most of these investments to maturity, just as Microsoft had done. The California Supreme Court noted that the SBE had held that "the gross receipts from these activities come within the literal definition of 'sales' that are includible in the sales factor, and allowed Pacific Telephone and Telegraph to include all of the gross receipts in the determination of its California sales factor."[26]

The California Supreme Court also rejected the FTB's reliance on certain court decisions in other states that had limited the term "gross receipts" to net gains from short-term securities investments. In fact, one line of these out-of-state cases had interpreted "gross receipts" the same way that the California Supreme Court was doing in its *Microsoft* decision.[27] The other line of out-of-state cases had found that interpreting the term "gross receipts" to include the gross receipts from short-term securities investments would produce "absurd results."[28] However, the California Supreme Court observed that:

> There are two problems with these 'absurd results' cases. First, they do violence to the language of the statutes they interpret. In each case, the same language governs both sales of off-the-shelf products and sales of securities. *AT&T* and its progeny offer no explanation why in one instance that language should require inclusion of gross proceeds and in the other require inclusion of only net proceeds. Second, they overlook the fact no absurd result is required. As the Tennessee Court of Appeals has explained: 'With deference to sister jurisdictions, this court is reluctant to apply the same 'absurd result standard.' An absurd result is not necessary for, in spite of the plain language of [the sales factor statute], the commissioner may opt for a different scheme of assessment whenever the resulting apportionment does not fairly represent the taxpayer's business in this state.' *Sherwin-Williams Co. v. Johnson, supra,* 989 S.W.2d at p. 715. The UDITPA contains an equitable relief provision so that, in cases where application of the statutory sales definition results in excessive distortion, an 'absurd result' may be avoided. (See §25137.)[29]

For all of these reasons, the California Supreme Court concluded, as an initial matter, that the meaning of the term "gross receipts" in the California and UDITPA sales factor statutes included the entire amount of proceeds that Microsoft had received from redemptions of short-term securities at maturity.

However, the Supreme Court then went on to explain that "[o]ur conclusion that the full redemption price constitutes gross receipts does not end matters. The UDITPA includes a relief provision for dealing with any unreasonable calculations rote application of the three-factor formula may yield."[30] The Supreme Court was referring to Section 25137, the "alternative relief" provision of the California franchise tax statutes, which provides:

> 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, in respect of 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 factors which will fairly represent the taxpayer's business activity in this state; or
> (d) The employment of any other method to effectuate an equitable allocation or apportionment of the taxpayer's income.[31]

As the party seeking alternative relief under Section 25137, the FTB bore the burden to demonstrate, *by*

clear and convincing evidence, that apportioning Microsoft's business income with a sales factor that included the gross receipts (instead of the net gain) from Microsoft's redemptions of short-term securities investments would "not fairly represent the extent of the taxpayer's business activity [in California]."[32] The California Supreme Court rejected Microsoft's contention, based on certain language in the United States Supreme Court's *Container Corporation* decision,[33] that the FTB needed to show that "the income attributed to [California] is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' or has 'led to a grossly distorted result."[34] The California Supreme Court explained that Microsoft was attempting to hold the state to the constitutional standard that a taxpayer must meet to persuade a court to strike down a tax under the Due Process Clause or Commerce Clause of the United States Constitution. The California Supreme Court determined that the FTB only needed to meet the statutory standard described in Section 25137 in order to utilize an alternative method for computing Microsoft's sales factor.

Having decided the burden of proof that the FTB was required to meet, the California Supreme Court determined that apportioning Microsoft's business income with a sales factor diluted by the gross receipts from the company's short-term securities investments would indeed distort the computation of Microsoft's California taxable income by reducing income attributable to California by more than 50 percent. In determining whether Section 25137 could be applied in the treasury operations context, the California Supreme Court discussed the California SBE's decision in *Appeal of Pacific Telephone & Telegraph,*[35] in which:

> [A]s here, the taxpayer corporate group maintained an out-of-state treasury department that invested in short-term securities. These investments produced less than 2 percent of the company's business income, but 36 percent of its gross receipts. The SBE described the sales factor as intended to 'reflect the markets for the taxpayer's goods and services' and asked whether inclusion of all investment receipts would serve that function. *Id.* at p. 14,907-43. It answered in the negative: 'The inclusion of this enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made in all other states, including California, which supply the markets for the . . . services provided by [taxpayer]. *Moreover, we are unable to accept, even for a moment, the notion that more than 11 percent of [taxpayer's] entire unitary business activities should be attributed to any single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses. We conclude, therefore, that UDITPA's normal provisions "do not fairly represent the extent of the taxpayer's business activity in this state," and that [the Board] is authorized, under Section 25137, to require a deviation from the normal rules.*[36]

The California Supreme Court cautioned, however, that it was not giving the FTB a free hand to limit taxpayers' sales factors to net gains from short-term securities investments.

The California Supreme Court found that the facts of the *Microsoft* case presented even greater distortion than the *Pacific Telephone* case did because Microsoft's short-term securities investments were producing less than two percent of the company's overall income, but 73 percent of its gross receipts.[37] Moreover, the inclusion of the gross receipts from Microsoft's short-term securities investment activity in the numerator and denominator of the Washington State sales factor would result in 24 percent of Microsoft's business income being apportioned to Washington State solely as a result of Microsoft's corporate treasury department being located in that state. This distortion was produced, in the California Supreme Court's view, by the significant difference in the profit margins of Microsoft's investment function and its core business of selling computer software products:

> 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). Microsoft's treasury activities provide a perfect illustration. Its 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.[38]

Of course, disparities between the profit margins of a taxpayer's different lines of business arise in countless numbers of unitary business cases, yet the courts have allowed states (and taxpayers) to apportion the combined business income of the unitary group with the group's apportionment fraction. However, the California Supreme Court clearly was more troubled by a corporate treasury department contributing to the disparity in the profit margins and gross receipts of the business segments involved in the apportionment computation and determined that Section 25137 could be applied.

Relying on the more-than-50-percent reduction in income attributable to California resulting from inclusion of Microsoft's gross receipts from treasury operations, the California Supreme Court held that the "stipulated evidence establishes that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity seriously distorts the standard formula's attribution of income to each state . . . . The distortion that the Board has shown here is of both a type and size properly addressed through invocation of Section 25137."[39] The California Supreme Court cautioned, however, that it was not giving the FTB a free hand to limit taxpayers' sales factors to net gains from short-term securities investments. This is a facts and circumstances issue and:

> 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. 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.[40]

The *General Motors* Case

On the same day that the California Supreme Court decided the *Microsoft* case, the court dealt with similar apportionment factor issues in the companion case of *General Motors Corp. v. Franchise Tax Board.*[41] General Motors' treasury department in New York invested the company's idle cash in short-term marketable securities.[42] The General Motors investments included U.S. Treasury bonds, notes and bills, and bank certificates of deposit, which typically turned over every 3.25 days.[43] During the 1986-1988 audit period, the gross proceeds from the treasury department's short-term securities investments amounted to almost $1 trillion, producing $550 million of General Motors' total $7 billion of net income for those three tax years.[44] General Motors derived about 90 percent of its short-term investment proceeds from repurchase agreements, commonly referred to as "repos."[45]

Repo transactions are financing arrangements in which one party provides funds to another party for a short period of time, using marketable securities as collateral. The repurchase agreement describes two interrelated transactions. First, the seller-borrower agrees to transfer securities shares to the buyer-lender in exchange for an amount of cash. Shortly thereafter, or upon demand, the seller-borrower agrees to repurchase the securities from the buyer-lender at the original price plus an agreed amount of "interest."[46] General Motors principally engaged in "reverse repos," which means that it was the party that provided the cash in the transaction and agreed to sell the securities back to the seller-borrower on the date specified in the repurchase agreement.[47]

As in *Microsoft,* the California Supreme Court had to determine what portion of the proceeds that General Motors received from its repo transactions was includible in the denominator of General Motors' California sales factor. General Motors and the FTB agreed that in a transaction involving an actual sale of a marketable security, the entire sales price would constitute the "gross receipts" that belonged in the sales factor. The parties also agreed that in a loan transaction, only the interest proceeds would be treated as "gross receipts" that were includible in the sales factor (*i.e.,* the lender's recovery of the capital it had loaned to the borrower was not a gross receipt).[48] The question was where repo transactions fit within these parameters.

The FTB contended that General Motors' repo transactions were really secured loans, citing the

United States Supreme Court's statement in *Nebraska Department of Revenue v. Loewenstein*[49] that "in economic reality, the [buyer-lenders] receive interest on cash they have lent to the Seller-Borrowers."[50] The U.S. Supreme Court concluded in *Loewenstein* that because this interest was paid by the seller-borrower rather than the federal government, the interest was not exempt from the Nebraska income tax. Several months after the *Loewenstein* case was decided, the California Supreme Court reached the same conclusion in *Bewley v. Franchise Tax Board,*[51] characterizing repos as secured loans for California personal income tax purposes.

General Motors argued, on the other hand, that its repo transactions involved sales of securities, with title passing, first, from the lender-borrower to General Motors, and then back to the lender-borrower on the date specified in the repurchase agreement. General Motors cited a number of federal cases that had characterized a repo as a purchase and sale of a security, although it does not appear any of these were tax cases.[52]

The California Supreme Court observed that there was some merit to both parties' arguments:

> In some circumstances, [a repo transaction] is properly characterized as a secured loan; in others circumstances, it is properly characterized as a purchase and sale of a security. Which characterization fits depends mainly on context; those features of a repo salient in its characterization for bankruptcy purposes, or securities law purposes, or UCC purposes, or even federal tax purposes, are not necessarily the features that will be most salient in characterizing it under UDITPA.[53]

The California Supreme Court concluded that in a true sale of securities, the amount of money that the taxpayer pays for the securities and receives from the redemption of the securities would depend on the changing value of the securities. From this perspective, the Supreme Court concluded that:

> [F]or gross receipts purposes, a repo has the characteristics of a loan, not a sale of a commodity. In a repo, the amount paid depends not on the value of the surrendered security, but on the amount of money the repo buyer paid the repo seller in the front end of the transaction . . . . This means, in a repo, the seller is 'buying' cash (*i.e.,* receiving a loan), while in a sale or redemption, the buyer/issuer is paying for a commodity. Thus, a repo is properly characterized as a secured loan for gross receipts purposes.[54]

Having found that General Motors' repo transactions had the characteristics, for California tax purposes anyway, of a secured loan, the California Supreme Court held that only the interest that General Motors received from the repo sellers-borrowers was a gross receipt includible in General Motors' California sales factor.[55] Therefore, the FTB auditor had correctly handled the repos in the franchise tax audit of General Motors.

However, citing the *Microsoft* case, the California Supreme Court reversed the Court of Appeals' determination that only the net proceeds that General Motors received from securities held to redemption were includible in General Motors' sales factor. The California Supreme Court remanded this issue to the trial court to allow the FTB to present its argument that including the gross receipts from securities redemption transactions in General Motors' sales factor would distort the apportionment of its income within and without California.[56]

The *Mead Corp.* Case

In *Mead Corp. v. Illinois Department of Revenue,*[57] the Illinois Appellate Court recently limited the taxpayer to including the net gains from its sales of investments in the denominator of its Illinois sales factor. Mead Corporation sold the stock of its Mead Data Central, Inc., Lexis, Inc. and Nexis, Inc. subsidiaries (collectively, "Lexis/Nexis") in 1994 for a gain of more than $1 billion.[58] Mead excluded this $1 billion gain on its 1994 Illinois corporate income tax return, taking the position that the gain was nonbusiness income that was allocable to Ohio where Mead's commercial domicile was located. Mead further reduced its 1994 Illinois taxable income by including $4,846,382,229 of gross receipts from its sales of interest-bearing financial instruments in the denominator of its Illinois sales factor. Again, Mead took the position that none of this $4.8 billion of gross receipts from the sales of financial instruments belonged in the numerator of the Illinois sales factor because Mead's investment activities occurred outside Illinois.[59]

The Illinois Department of Revenue reclassified the $1 billion gain from the sale of the stock of the Lexis/Nexis subsidiaries as apportionable business income.[60] The Department also concluded that Mead

should only be including the net gain rather than the gross receipts from the sales of the financial instruments in its sales factor, citing an Illinois income tax regulation providing that "[i]n the case of sales of business intangibles . . . gross receipts shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor."[61] As a result of these audit adjustments, the Department assessed more than $4 million of Illinois income tax and interest against Mead for its 1994 tax year.[62]

The Illinois Appellate Court held that the gain from Mead's sale of the stock of the Lexis/Nexis subsidiaries was subject to formulary apportionment under the "operational function test" of the United States Supreme Court's *Allied-Signal* decision.[63] The Illinois circuit court had found that Mead had spent considerable resources developing the Lexis/Nexis businesses since 1968.[64] Indeed, Mead had repeatedly converted the Lexis/Nexis' business from a corporate division to a corporate subsidiary and back, depending on which structure was more beneficial to Mead.[65] Mead had also retained tax benefits and control over the excess cash of the Lexis/Nexis businesses. Based on these findings, the Appellate Court upheld the circuit court's conclusion that Lexis/Nexis served an operational purpose within Mead's business operations, thereby allowing Illinois to apportion the gain from Mead's sale of Lexis/Nexis under Illinois' statutory definition of "business income," which incorporates the "operational function test" of *Allied-Signal*.[66]

> [T]he Illinois Appellate Court recently limited the taxpayer to including the net gains from its sales of investments in the denominator of its Illinois sales factor.

As for the sales factor issue, the Appellate Court held that although the Illinois Income Tax Act (the "IITA") defines "sales" to mean "gross receipts,"[67] this statutory definition had been modified by the Department's regulation providing that "[i]n the case of sales of business intangibles . . . gross receipts shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor."[68] The Appellate Court explained that this regulation had the "force and effect of law." Perhaps more significant to the outcome of the issue, however, was the Appellate Court's finding that:

> The inclusion of the gross receipts from the sale of financial instruments in Mead's sales factor denominator would not have resulted in a fair representation of its business activity; the gross receipts add approximately $4.8 billion to Mead's sales factor denominator when it actually earned only about $1.9 million on those investments. Accordingly, we believe summary judgment was properly granted in favor of the Department on this issue.[69]

Consequently, the Appellate Court held that, even if the Department's regulation did not limit Mead to including the net gains from its sales of business intangibles in the sales factor, the Department was still authorized to take this position under the "alternative relief" provision of Section 304(f) of the IITA.[70]

Conclusion

There are a number of important points in the California Supreme Court's *Microsoft* and *General Motors* opinions that should not be lost on taxpayers and state income tax auditors. First, the parties and the California Supreme Court agreed that if taxpayers sell marketable securities—as opposed to holding those securities to maturity—UDITPA allows the taxpayer to include the gross receipts from these sale transactions in the taxpayer's sales factor. When corporate treasury departments engage in long-term investments in securities, it is likely that the treasury department will sell securities from time to time. Under the holding of the *Microsoft* case, the gross receipts from such securities sale transactions would be includible in the corporation's California sales factor as long as the state cannot show that distortion of the apportionment computation will result.

Second, it is significant that even in situations where short-term securities investments are held to maturity, the California Supreme Court correctly determined that the UDITPA statutes provide for the inclusion of the gross receipts from those investment transactions in the denominator of the sales factor. Companies may be able to continue to include the gross receipts from their short-term securities transactions in the sales factor in California and other states if their short-term securities investment activity is not comparable to that

of Microsoft. After all, Microsoft derived 73 percent of its gross receipts, but only two percent of it net income from its treasury department function.

The state tax agency bears the burden to prove that distortion of the apportionment formula will result if a taxpayer is allowed to include gross receipts instead of net gains from short-term securities investments in the denominator of the sales factor. The California Supreme Court cautioned in *Microsoft* that the California FTB cannot reflexively limit taxpayers to including net gains from short-term securities transactions in the sales factor because that administrative position might distort the apportioned computation in favor of the state in certain cases. California FTB auditors undoubtedly will pressure taxpayers to agree to modify their California sales factors so that they only include net gains from short-term securities held to maturity, but taxpayers should carefully analyze their facts before conceding this issue.

The Illinois Appellate Court did not see any problems in the *Mead* case with how the Illinois Department of Revenue had issued a broad regulation providing that only net gains from sales of business intangibles are includible in the Illinois sales factor. This regulation is arguably contrary to the IITA's "sales" definition, which is identical to the UDITPA provision that the California Supreme Court interpreted in *Microsoft* and *General Motors.* Depending on the facts, companies may be able to argue that the application of this "one size fits all" approach to this apportionment issue in Illinois results in over-taxation of multistate taxpayers.

Taxpayers that do have short-term securities investment activity comparable to Microsoft and Mead are going to have to decide whether to amend the sales factor in their corporate income tax returns for open tax years in California, Illinois and any other states that follow the *Microsoft* and *Mead* decisions. This will not be an easy decision in California and Illinois because both of these states may impose significant amounts of penalties and interest if the open tax years were eligible for the California and Illinois tax amnesty programs.

Endnotes

1 *See, e.g., American Tel. & Tel. Co. v. Tax Appeal Board,* Mt. SCt, 241 Mont. 440, 787 P2d 754, 757-59 (1990); *Sherwin-Williams Co. v. Department of Revenue,* Ore. SCt, 329 Ore. 599, 996 P2d 500, 501 (2000); *Sherwin-Williams Co. v. Johnson,* Tenn. CtApp, 989 S.W.2d 710, 712-15 (1998); *United States Steel Corp. v. Wisconsin Department of Revenue,* Wis. Tax App., 1985 Wis. Tax LEXIS 89.

2 *See, e.g., American Tel. & Tel. Co. v. Tax Appeal Board,* Mt. SCt, 241 Mont. 440, 787 P2d 754, 757-59 (1990); *Sherwin-Williams Co. v. Department of Revenue,* Ore. SCt, 329 Ore. 599, 996 P2d 500, 501 (2000); *Sherwin-Williams Co. v. Johnson,* Tenn. CtApp, 989 S.W.2d 710, 712-15 (1998); *United States Steel Corp. v. Wisconsin Department of Revenue,* Wis. Tax App., 1985 Wis. Tax LEXIS 89.

3 *Microsoft Corp. v. Franchise Tax Board,* Cal. SCt, 39 Cal. 4th 750, 139 P3d 1169 (Aug. 17, 2006).

4 *General Motors Corp. v. Franchise Tax Board,* Cal. SCt, 39 Cal. 4th 773, 139 P3d 1183 (Aug. 17, 2006).

5 *Mead Corp. v. Illinois Department of Revenue,* No. 1-03-1160 (Ill. App. Ct., 1st Dist., Nov. 3, 2006).

6 *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750, 757, 139 P3d 1169 (Aug. 17, 2006).

7 *Id.* at 757 fn. 6.

8 *Id.* at 757.

9 *Id.* at 767.

10 *Id.*

11 *Id.* at 765 fn. 17.

12 *Id.* at 757.

13 *Id.*

14 *Id.*

15 *Id.* at 757-58.

16 Cal. Rev. & Tax Code §25137.

17 *Microsoft,* 39 Cal. 4th at 758.

18 Cal. Rev. & Tax Code §25134.

19 Cal. Rev. & Tax Code §25120(e).

20 UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT, 7A part 1 (U.L.A. 2002) p. 141.

21 *Microsoft,* 39 Cal. 4th at 759. As support for its interpretation of the plain meaning of the California and UDITPA statutes, the California Supreme Court cited the following dictionary definitions of "gross receipts": BLACK'S LAW DICTIONARY 722-23 (8th ed. 2004) ("gross receipts" are "[t]he total amount of money or other consideration received by a business taxpayer for goods or services performed in a year, before deductions," *citing* 26 USC §448); AMERICAN HERITAGE DICTIONARY 578 (2d college ed. 1982) ("gross" means "exclusive of deductions; total").

22 *Microsoft,* 39 Cal. 4th at 759.

23 *Id.* at 760 (emphasis added) (*comparing* Proceedings of Com. of Whole for UDITPA, transcript of Aug. 22, 1956, p. 5 ("income" definition) with Proceedings of Com. of Whole for UDITPA, transcript of July 9, 1957, p. 28 ("gross receipts" definition).

24 *Id.*

25 *Appeal of Pacific Telephone & Telegraph Co.,* Cal. SBE, [Cal.] St. Tax Rep. (CCH) ¶ 205-858, (May 4, 1978).

26 *Microsoft,* 39 Cal. 4th at 760 (*quoting from Pacific Telephone & Telegraph,* [Cal.] St. Tax Rep. (CCH) ¶ 205-858 at p. 14,907-42).

27 *See, e.g., American Tel. & Tel. Co. v. Tax Appeal Board,* Mt. SCt, 241 Mont. 440, 787 P2d 754, 757-59 (1990); *Sherwin-Williams Co. v. Department of Revenue,* Ore. SCt, 329 Ore. 599, 996 P2d 500, 501 (2000); *Sherwin-Williams Co. v. Johnson,* Tenn. CtApp, 989 S.W.2d 710, 712-15 (1998); *United States Steel Corp. v. Wisconsin Department of Revenue,* Wis. Tax App., 1985 Wis. Tax LEXIS 89.

28 *See, e.g.,* AT&T Telephone & Telegraph Co. v. Taxation Division Director, NJ Super., 194 N.J. Super. 168, 476 A.2d 800, 802-803 (1984); Walgreen Arizona Drug Co. v. Arizona Department of Revenue, Ariz CtApp, 209 Ariz 71, 97 P3d 896, 899-902 (Ariz. 2004); Sherwin-Williams Co. v. Department of Revenue, Ind. Tax Ct., 673 NE2d 849, 851-53 (1996).

29 *Microsoft,* 39 Cal. 4th at 763.

30 *Id.* at 764.

31 Cal. Rev. & Tax Code §25137.

32 *Microsoft,* 39 Cal. 4th at 765.

33 *Container Corporation v. Franchise Tax Board,* SCt, 463 US 159, 170, 103 SCt 2933 (1983).

34 *Microsoft,* 39 Cal. 4th at 765 n. 16.

35 *Appeal of Pacific Telephone & Telegraph Co.,* Cal. SBE, [Cal.] St. Tax Rep. (CCH) ¶ 205-858, (May 4, 1978).

36 *Microsoft,* 39 Cal. 4th at 765-66 (*quoting from Pacific Telephone & Telegraph,* [Cal.]

St. Tax Rep. (CCH) ¶ 205-858 at p. 14,907-43).

[37] *Microsoft,* 39 Cal. 4th at 765 n. 17.

[38] *Id.* at 767.

[39] *Id.* at 770-71.

[40] *Id.* at 771. The California Supreme Court also noted that unacceptable levels of distortion are less likely to arise in situations where investment activity is the taxpayer's principal business activity. The Supreme Court cited with approval the California SBE's rejection, in *Appeal of Merrill Lynch, Pierce, Fenner & Smith, Inc.,* Cal. SBE, [Cal.] St. Tax Rep. (CCH) ¶ 401-740, (June 2, 1989), of the FTB's argument that Merrill Lynch should include only net gains from its securities investments in its California sales factor.

[41] *General Motors Corp. v. Franchise Tax Board,* Cal. SCt, 39 Cal. 4th 773, 139 P3d 1183 (Aug. 17, 2006).

[42] *Id.* at 777-78 and 779.

[43] *Id.* at 779.

[44] *Id.* at 779 and 780.

[45] *Id.*

[46] *Id.* 781; the California Supreme Court addressed repos in greater detail in *Bewley v. Franchise Tax Board,* Cal. SCt, 9 Cal. 4th 526, 529, 886 P2d 1292 (1995).

[47] *General Motors,* 39 Cal. 4th at 782.

[48] *Id.* at 784.

[49] *Nebraska Department of Revenue v. Loewenstein,* 513 US 123, 115 SCt 557 (1994).

[50] *Microsoft,* 39 Cal. 4th at 784 (*quoting from Loewenstein,* 513 US at 134).

[51] *Bewley v. Franchise Tax Board,* 9 Cal. 4th 526, 531-32 (1995).

[52] *Microsoft,* 39 Cal.4th at 785 n.6 (*citing In re County of Orange,* DC Cal., 31 FSupp2d 768, 778 (1998) (repos are not secured loans for purposes of debt-limit provisions of California Constitution); *Granite Partners L.P. v. Bear, Stearns & Co.,* DC N.Y., 17 F. Supp. 2d 275, 302, 1998-2 Trade Cas. (CCH) ¶72,301 (repos are purchase and sale agreements and thus not subject to Uniform Commercial Code (UCC) article 9 secured loan obligations); *In re Comark,* CA-BR-9, 145 B.R. 47, 53-54, Bankr. L. Rep. (CCH) ¶74,956 (1992) (repos are securities transactions, not secured loans, under particular bankruptcy law provisions); *In re Residential Resources Mortgage Investments,* DC BR Ariz., 98 B.R. 2, 23, Bankr. L. Rep. (CCH) ¶72,723 (1989) (repos involve sale and repurchase of security); 44 Ops. Cal. Atty. Gen. 140, 143 (1964) (State Treasurer is authorized to enter repos because they involve sale, not loan).

[53] *Id.* at 785.

[54] *Id.* at 787.

[55] *Id.* at 788.

[56] *Id.* at 789. The California Supreme Court dealt with a second issue in *General Motors, i.e.,* whether other members of the General Motors unitary group were entitled to utilize California research tax credits that the Delco subsidiary had earned as a result of its $2.8 million of research expenditures. In 1976, the California legislature had adopted a solar energy tax credit statute that expressly allowed unitary group corporations that did not own the premises where the solar energy system was installed to share in the tax credit. Two years later, the California legislature amended the solar energy tax credit statute so that only the owner of the premises could utilize the tax credit. Finding that the California research tax credit statute, Cal. Rev. & Tax Code §23609, lacked any language allowing other members of a unitary group to share in the tax credit, the California Supreme Court held that only the Delco subsidiary was entitled to utilize the research tax credit that it had earned as a result of its own research expenditures. *General Motors,* 39 Cal. 4th at 792-793.

[57] *Mead Corp. v. Illinois Department of Revenue,* No. 1-03-1160 (Ill. Ct. App., 1st Dist., Nov. 3, 2006).

[58] *Mead,* slip op. at 2.

[59] *Id.*

[60] *Id.*

[61] 86 Ill. Admin. Code §100.3380(b)(6).

[62] *Mead,* slip op. at 2.

[63] *Allied-Signal, Inc. v. Director, Division of Taxation,* SCt, 504 US 768, 112 SCt 2251 (1992).

[64] *Mead,* slip op. at 11.

[65] *Mead,* slip op. at 12.

[66] *Mead,* slip op. at 11. The Appellate Court also rejected Mead's argument that the gain from the sale of Lexis/Nexis was nonbusiness income under the *Blessing/White* "cessation of business" principle, because Mead had reinvested the $1 billion gain in its ongoing business operations. *Blessing/White, Inc. v. Zehnder,* Ill. App., 329 Ill. App. 3d 714, 768 2d 332 (2002).

[67] 35 ILCS 5/1501(a)(21).

[68] 86 Ill. Admin. Code §100.3380(b)(6).

[69] *Mead,* slip op. at 20.

[70] 35 ILCS 5/304(f).