

Calif. Budget Will Prevent Another Microsoft-Style Tax Win

By Maria Koklanaris

Law360 (June 27, 2024, 7:45 PM EDT) -- A measure in California's new budget tax law, enacted Thursday, will potentially save the state more than \$1 billion by preventing more wins like the one Microsoft secured when the state Office of Tax Appeals ruled it could include 100% of the dividends from foreign affiliates in its California sales factor denominator.

Among the measures agreed to Saturday by Democratic Gov. Gavin Newsom and the California Legislature is turning into law a regulation, 2006-1, from the state Franchise Tax Board that disallows including receipts in the sales factor if the related income is not also taxed. The new tax law, S.B. 167, signed by acting Gov. Eleni Kounalakis, means an end to opinions such as the one in Microsoft. There, the OTA ruled that qualifying dividends can be included in the sales factor even if deducted and the relevant gross receipts can also be in the sales factor, contrary to arguments from the FTB.

The OTA's ruling greatly reduced Microsoft's income apportionable to California, triggering a \$94 million refund.

Because so many other businesses are in situations like Microsoft's, tax professionals have estimated the state would have to pay out \$1.3 billion in the first year and hundreds of millions in subsequent years if all of them won using the same argument, according to Shail Shah, a veteran California practitioner and a tax partner at Greenberg Traurig LLP.

California finalized its budget after dealing with a \$50 billion shortfall, and Shah noted before it was enacted that the new budget legislation would prevent results like that in Microsoft by constricting the definition of the gross receipts allowed into the sales factor. It would exclude from the sales factor all items of income, such as deductions and exemptions, that are not part of net income.

"It's pretty broad," Shah said. "Effectively what the language says is that gross receipts actually equal net income, which is really sort of mind-boggling. That's the concept of gross receipts thrown out the window."

Extensive case law in California seems to support the conclusion that the OTA made in Microsoft, Shah and others said. Most recently, there is the OTA's opinion In the Matter of Southern Minnesota Beet Sugar Cooperative. There, the office said, in an August pending precedential opinion, that Southern Minnesota Beet Sugar Cooperative could factor in property, payroll and sales attributed to income that it took an agricultural cooperative deduction for. The cooperative was calculating the California income tax liabilities for its combined group, which included a California-based business. The office declined to

adopt the FTB's stance that the factors that led to deductible income should have been disregarded for apportionment purposes. The language in the budget would also negate that opinion for other businesses in a similar situation.

California courts have come to similar conclusions on behalf of Pacific Telephone & Telegraph in 1971, General Mills in 2012 and Robert Half International in 2019. Nor is this Microsoft's first litigation in this arena — a 2006 California Supreme Court decision held that the FTB could use an alternative apportionment method to determine the company's taxable income. But there the court also determined that the company, which had redeemed marketable securities in gross receipts, could include the full redemption amount in its sales factor.

The language in the budget also seems to contradict California statute, according to Josh Grossman of Moss Adams LLP. Section 25120 of the state revenue and taxation code defines gross receipts to include dividends.

The budget language "very much takes a net-income-based approach to what is included in the apportionment formula, which I see an inherent tension between this and our definition of gross receipts in 25120," Grossman said.

He noted that the state already has an avenue if it wants to impose an alternative apportionment — it can seek to determine if there is distortion of the company's activity in the state.

"When you think about the history of gross receipts cases, whether it's General Mills or Microsoft or Robert Half, they all start with 'gross [receipts] means the full amount received' and then they proceed to analyze whether distortion existed," Grossman said. "And if this is the new status of the law, you don't really have a distortion analysis anymore."

In the current Microsoft matter, the OTA found that there was no distortion and thus no need for an alternative apportionment formula. It was a sound, reasoned ruling and trying to negate it seems to fly in the face of the OTA's purpose, said Carley Roberts, leader of the state and local tax group at Pillsbury Winthrop Shaw Pittman LLP. Roberts said most of the OTA's decisions have been for the tax agency involved, often the FTB. Microsoft has stood out as a case that went the other way, Roberts said, and the business community perceives the new budget tax law as an end-run.

"I think about the OTA when it was created, and it has always touted its ability for transparency and to be independent," Roberts said. "If I were administration at OTA I'd be so frustrated that it's just undermining both their authority and the whole purpose of being created."

The budget language also says the FTB can implement the law changes without first going through formalities called for in the state administrative procedure act, said Will Gorrod, tax partner at Morgan Lewis & Bockius LLP.

"The FTB doesn't have to adhere to those," Gorrod said. "This is trying to free the FTB from requirements that are in place for a good reason."

The OTA and the FTB declined to comment.

However, Darien Shanske, a law professor at University of California, Davis School of Law, told Law360 that the OTA did not correctly apply the law and that he also disagrees with a policy stating that the FTB

cannot challenge the Microsoft opinion.

The correct result would be a reversal of the decision, according to Shanske.

"I don't think, strictly speaking, the Legislature and the governor need to do anything," he said. "This decision should just be overturned."

Because that possibility seems remote, Shanske said he agrees with the Legislature's language in the budget that the change is a "clarification" of existing law rather than a repudiation of current law.

While he believes the decision was wrong, he said, "Certainly having the Legislature and governor formally agree through this bill should be helpful."

--Editing by Tim Ruel and Abbie Sarfo.