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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

PACIFIC BELL TELEPHONE COMPANY & AFFILIATES[1]

HEARING SUMMARY

CORPORATION FRANCHISE TAX APPEAL

Case No. 521312

Years	Proposed Assessments[2]
2001	$52,144,001
2002	$14,639,261

Representing the Parties:

For Appellant: Derick Brannan, PricewaterhouseCoopers
Bruce Daigh, PricewaterhouseCoopers

For Franchise Tax Board: Kathleen A. Andleman, Tax Counsel III

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[1] Appellant is headquartered in Texas.

[2] In its opening brief (Resp. Opening Br., p. 28, fn. 55), respondent states that it does not dispute appellant's claim that amounts which appellant received from the dispositions of auction rate securities and commercial paper should be included in the sales factor denominator, amounts totaling $330 million (for 2001) and $1.803 billion (for 2002). Respondent is requested to state, at least 14 days prior to the hearing, what effect this concession has on the proposed assessments.

QUESTIONS: (1) Whether income from appellant's foreign investments constitutes business income.

(2) Whether it is appropriate to exclude from appellant's gross receipts, and appellant's sales factor denominator, amounts received from transactions conducted by its treasury department, pursuant to Revenue and Taxation Code (R&TC) section 25137.

HEARING SUMMARY

Background

Appellant is a subsidiary of SBC Communications, Inc. During the taxable years at issue, SBC Communications, Inc. and its subsidiaries filed combined California returns which listed Pacific Bell Telephone Company as the key corporation and the returns were filed on a worldwide basis. (Resp. Opening Br., p. 1.)

Respondent conducted an audit and determined that the income from appellant's majority-owned subsidiaries was part of its unitary business income. This determination is not in dispute. Respondent also determined that the income received from minority interests which appellant held in seven foreign telecommunication-related companies also constituted business income. The dividend and capital gain income received from these companies is at issue in this appeal (Issue 1). (Resp. Opening Br., p. 5.) In addition, during the protest, appellant asserted that it should be able to add additional amounts (i.e., receipts from its sale of marketable securities from its treasury department investments) to its sales factor denominator (Issue 2).[3] (Resp. Opening Br., pp. 27-28.)

Based upon the results of the audit, respondent issued Notices of Proposed Assessment (NPA's) for additional tax dated October 12, 2006 (according to the Notices of Actions (NOA's) issued). Appellant protested the assessments. On December 16, 2009, respondent revised its proposed assessments and issued an NOA for the year ending December 31, 2001, in the amount of $52,144,001, and an NOA for the year ending December 31, 2002, in the amount of $14,639,261. Appellant filed this timely appeal.

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[3] Appellant states (App. Opening Br., p. 26) that it claimed a refund relating to the second issue in this matter. Respondent states (Resp. Opening Br., pp. 26-27) that this issue was raised during the protest. See the Staff Comments to Issue 2.

Overview of Appellant

SBC was initially formed as one of the seven regional Bell holding companies created to hold AT&T's local telephone companies and, in 1984, it was spun-off from AT&T pursuant to an anti-trust consent decree. In 1997, SBC merged with Pacific Telesis Group, in 1998, it merged with Southern New England Telecommunications Corporation and, in 1999, it merged with Ameritech Corporation (AIT). (Resp. Opening Br., p. 4; Exhibit A, p. 6.) Subsequent to the years at issue in this appeal, in 2005, appellant purchased "old" AT&T.

Issue 1: Whether income from appellant's foreign investments constitutes business income.

Contentions

Overview

At issue is the income which appellant earned during the relevant tax years from seven foreign investments. The income was earned from equity interests in Belgacom (Belgium), Tele Danmark (Denmark), diAx (Switzerland), TransAsia (Taiwan), Bell Canada (Canada), Telmex (Mexico), and Amdocs (Israel).

R&TC section 25120, subdivision (a), defines business income as:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

All income other than business income is deemed "nonbusiness income." (Rev. & Tax. Code, § 25120, subd. (d).) Non-business income is generally allocated directly to a taxpayer's domiciliary state. In contrast, business income is apportioned among the various states that the taxpayer does business, according to an apportionment formula.

R&TC section 25120, subdivision (a), provides for two tests to determine if income is business income: a transactional test and a functional test. (*Hoechst Celanese Corp. v. Franchise Tax Board* (*Hoechst Celanese*) (2001) 25 Cal.4th 508.) Under the transactional test, income is business income if it arises "from transactions and activity in the regular course of the taxpayer's trade or business." Under the functional test, income is business income "if the acquisition, management, and disposition of the [income-producing] property constitute integral parts of the taxpayer's regular trade or business operations." Income that meets either of these tests is treated as business income. (*Hoechst Celanese* at p. 526.) The parties in this matter, however, only discuss the application of the functional test to appellant's income from its foreign markets.

Appellant's Contentions

Appellant is headquartered in Texas and, during the tax years at issue, it asserts that it operated a regional domestic telecommunications company in thirteen states.[4] Appellant contends that its foreign investments could not be part of its domestic telecommunications business due to its limited ownership as well as regulatory, logistical, and technological roadblocks that made it virtually impossible for the company to integrate these investments into its regular business operations. Appellant asserts that, because California law makes it clear that income from investment activities which are not integral to a taxpayer's regular trade or business are not to be included in that taxpayer's California tax base, the capital gains and dividends from appellant's foreign investments are nonbusiness income and should not be included in appellant's California tax base. (App. Opening Br., p. 1.)

As a matter of background, appellant asserts that it evolved from one of the seven regional Bell operating companies out of the "old" AT&T and was essentially limited through the 1990's to providing local telephone services. During these appeal years, appellant alleges that wireline services represented 75 percent of its operating revenues, domestic wireless services represented 17 percent of its operating revenues, and its remaining revenues consisted primarily of its phone directory operations. Appellant states that, even with the passage of the federal Telecommunications Act of 1996 (Act), it was still subject to stringent requirements in order to provide long distance phone services but that the Act eliminated the need for court approval of new foreign investments. Appellant also states that, nevertheless, regulatory and legal restrictions still continued to control what appellant could do with its foreign investments. (App. Opening Br., pp. 2-3.)

Appellant asserts that it and other regional Bell operating companies began to invest in foreign telecommunication companies in the 1990's as foreign governments and foreign investment groups sought investment capital and the expertise offered by the telecommunications industry so that

[4] The thirteen states are: California, Texas, Illinois, Michigan, Ohio, Missouri, Connecticut, Indiana, Wisconsin, Oklahoma, Kansas, Arkansas, and Nevada.

foreign countries could develop and expand their telecommunication systems. Appellant alleges that it sent approximately 60 employees to work in the foreign companies that appellant invested in during these tax years. Appellant contends that these employees functioned in an advisory capacity to, among other activities, help these companies modernize, expand, plan networks, and plan financing. Appellant asserts that, through management agreements, the foreign companies reimbursed appellant for its costs on an arms'-length basis and that appellant had almost no further involvement in the operations of these foreign companies. (App. Opening Br., pp. 4-5.)

Appellant also asserts that, during the tax years at issue, the Federal Communication Commission's (FCC) International Settlements Policy (ISP) prevented favoritism and anti-competitive behavior in foreign markets by imposing operational and investment limitations. For example, appellant states that the ISP provided that: (1) all U.S. carriers had access to the same international rates from foreign carriers; (2) U.S. carriers were entitled to a share of U.S. inbound traffic based upon the carriers' proportionate share of U.S. outbound traffic; (3) the settlement rates for U.S. inbound and outbound traffic was symmetrical; and (4) carriers were prohibited from accepting special concessions from foreign carriers that had market power. Because of these provisions, appellant argues that it was impossible for appellant to obtain better rates, increased volumes, or other preferential arrangements for its domestic operations. In addition, appellant asserts that the combination of domestic and international regulations (including the World Trade Organization's Basic Telecommunications Agreement) prohibited anti-competitive behavior and prevented telecommunication companies from obtaining any benefit to their businesses by virtue of interests held in foreign telecommunication companies. (App. Opening Br., pp. 5-7.)

Appellant also alleges that it faced significant logistical hurdles in developing its international telecommunications business. Appellant contends that it could not integrate its network with a foreign carrier because wireline technology required that networks be physically connected in order to effectuate a call. Because of this, appellant asserts that it was not the carrier that directly connected with the foreign carrier, such that appellant could not influence the rates or terms of the foreign call. Additionally, appellant argues that roadblocks existed for the expansion of its wireless communications business with foreign companies, as the wireless technology which appellant used in the United States was different and incompatible with the wireless technologies used in Western Europe and Asia. Appellant contends that, because it only owned a minority interest in each of these foreign investments, appellant could not, and did not, control the decision-making process of these foreign companies. As a result of these limitations, appellant asserts that its core operations remained confined to being a regional domestic telephone company created out of the breakup of AT&T. (App. Opening Br., pp. 7-8.)

Appellant next asserts that during the late 1990's and the early 2000's, appellant made a decision to grow its domestic telecommunications business and needed capital to do so. Appellant contends that it began divesting itself of its foreign investments to accumulate capital and that this task was simple because appellant did not have joint networks, joint products, or any other joint activities with these foreign companies which needed to be unwound. (App. Opening Br., pp. 8-9.) With this in mind, appellant summarizes (below) the seven investments which are at issue:

- Belgacom. Appellant states that Belgacom was the national telecommunications operator in Belgium and that Ameritech Corporation (AIT) (which appellant purchased in 1999) acquired a 17.5 percent interest for $853 million, as part of a consortium, after the operator was privatized by the Belgian government in the 1990's. Appellant asserts that it assigned approximately 17 employees to this company during the tax years and it held three of the eighteen seats on the company's board of directors. The European Community's antitrust laws prevented appellant from leveraging its size so that appellant could sell equipment to Belgacom at better prices. Additionally, appellant was only one member of the consortium and so appellant's influence on Belgacom's operations was offset by the other members of the consortium. Additionally, because of the ISP (as mentioned above) and other regulations, appellant could not realize any benefits in traffic volume or pricing to gain any competitive advantages. Further, appellant asserts that its wireless technology was incompatible with the wireless technology used in Belgium. (App. Opening Br., pp. 9-10.)
- Tele Danmark. Appellant states that Tele Danmark was the incumbent telecommunications provider in Denmark and that, in 1998, AIT purchased a 41.6 percent interest in the company for $3 billion. After appellant's acquisition of AIT, appellant asserts that it sent 3 employees to the

company during these tax years, that it was able to appoint up to five members of the twelve member board of directors, and that Tele Danmark's chairman was always a Danish citizen. Appellant contends that, although AIT entered into a strategic cooperation agreement with Tele Danmark in 1997, appellant was unable to develop any synergies with the company due to the limited telecommunication traffic between Denmark and the United States. Further, appellant asserts that its wireless technology was incompatible with the wireless technology used in Denmark. (App. Opening Br., pp. 11-12.)

- diAx. Appellant states that, in 1998, it acquired a 40 percent interest in a wireless Swiss company, as part of a consortium. Appellant asserts that it sent 12 employees to the company during these tax years, held 3 of the 7 board of director positions, and supplied much of the initial leadership to the company. Appellant asserts that it was unable to use its purchasing power to help negotiate better prices for the procurement of equipment for diAx because of European restrictions on anti-competitive practices and due to appellant's lack of a business relationship with diAx's supplier of wireless network equipment. Additionally, appellant contends that its wireless technology was incompatible with the wireless technology in Switzerland. (App. Opening Br., p. 12.)
- TransAsia. Appellant states that, in 1997, it purchased a 19.4 percent interest in this Taiwanese regional mobile telephone company. Appellant asserts that it appointed some of the company's executives and sent approximately 2 employees to the company during these tax years. Appellant contends that it did not realize any synergies with this company and that it sold its interest in the company in 2001 after four years. (App. Opening Br., p. 13.)
- Telmex.[5] Appellant states that, in 1990, as part of a consortium with Grupo Carso and France Telecom, it purchased a 5 percent interest in the company. Appellant asserts that the Mexican government privatized Telmex and that Mexican law required that the control of the company remain with Mexican citizens. Appellant contends that it never controlled Telmex but that

[5] Relating to its investments in Telmex and Bell Canada, as Mexican and Canadian companies, appellant asserts that it explored the possibility of cross-border collaborations as part of these investments. However, appellant contends that, because of regulatory and technological roadblocks similar to those found with its other foreign investments, it was unable to achieve any meaningful synergies with these companies either. (App. Opening Br., p. 13.)

Grupo Carso, a different investor, had operating control of Telmex and had the right to appoint the majority of Telmex's board of directors. During the years at issue, appellant states that it provided Telmex with 4 of the 17 board of directors. Appellant states that it sent 16 of its employees to work for Telmex and that Telmex compensated appellant for these services pursuant to a management consulting contract. Appellant asserts that it was unable to achieve any meaningful results with its investment due to its lack of control of the company, regulatory and technical barriers, and differences with management. As an example, appellant alleges that it sought to become Telmex's partner in the long distance market, but Telmex picked Sprint as its long distance partner. (App. Opening Br., pp. 13-16.)

- Bell Canada. Appellant states that, in 1999, AIT purchased a 20 percent interest in Bell Canada for $3.4 billion. Appellant asserts that AIT appointed 2 of the 10 members of the board of directors and selected Bell Canada's chief financial officer. For the tax years at issue, appellant sent 7 employees to work for Bell Canada. Appellant contends that any hoped-for synergies failed to materialize and that, regarding long distance traffic, appellant could not realize any benefits in traffic volume or in pricing due to the ISP and other regulations which strictly prohibited any advantages. Additionally, appellant contends that its wireless technology was incompatible with the wireless technology used by Bell Canada. (App. Opening Br., pp. 16-17.)
- Amdocs. Appellant states that it acquired a 50 percent interest in this software products developer in 1985 when Amdocs was still a small start-up company. Appellant asserts that, despite its 50 percent ownership interest, it did not have a controlling interest in Amdocs and did not participate in the management of the company. Appellant further asserts that it provided no employees to Amdocs and that it only appointed 1 of the 11 members of the board of directors and that this individual did not serve on any management committees during the years at issue. Appellant contends that, although it purchased software products from Amdocs, the transactions were at arms'-length and were not significant to appellant (accounting for less than 1 percent of appellant's operating expenses and 3 percent of its capital expenditures during the tax years). Appellant states that, in the 2000 tax year, it reduced its interest in Amdocs to 10 percent and that

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it sold additional shares of the company in 2001 and 2002.[6] (App. Opening Br., pp. 17-19.)

Appellant argues that the California Supreme Court in *Hoechst Celanese* (*Hoechst Celanese* at pp. 529-530) concluded that the term "integral" provides the touchstone for determining whether income-producing property has a close enough relationship to a taxpayer to satisfy the functional test of R&TC section 25120, subdivision (a), and that the "mere control and use of the income-producing property" was not enough to satisfy the functional test. Appellant further asserts that the Court (*Hoechst Celanese* at p. 530) concludes that "integral" requires an organic unity between the taxpayer's property and the business activities such that the property contributes materially to the taxpayer's production of business income. Finally, appellant asserts that the Court (*Hoechst Celanese* at p. 532) holds that the property must be so interwoven into the fabric of the taxpayer's business operations that the property becomes "indivisible" or inseparable from the taxpayer's business activities with both "giving value" to each other. (App. Opening Br., pp. 20-21.)

In the *Appeal of Mark Controls Corporation*, 86-SBE-204, decided on December 3, 1986, appellant argues that the Board addressed the applicability of the functional test to a taxpayer's minority interest in a foreign investment that the taxpayer intended to integrate into its business. Appellant asserts that the Board found there was a potential to integrate the two businesses. However, appellant contends that the Board concluded that the owner's intentions and limited actions with the underlying investment did not cause the investment to become integral to the taxpayer's business such that the Board concluded the income from this investment was nonbusiness income. (App. Opening Br., p. 21.)

Appellant argues that respondent has ignored the facts of this case and applicable law in concluding that appellant's income from these foreign investments is business income under the functional test of R&TC section 25120, subdivision (a). Appellant instead asserts that it never had a plan to integrate these foreign investments into its regular business and was prevented from doing so, even if it wanted to, by various regulatory, logistical, and technological impediments. In each instance, appellant contends that it only held a minority interest in each of these foreign investments such that it

[6] Appellant asserts that Amdoc engaged in an initial public offering in 1998. (App. Opening Br., p. 18.)

could not exercise sufficient control over any of these investments to make their operations an integral part of appellant's domestic telephone operations. (App. Opening Br., p. 22.)

Citing *Hoechst Celanese* (*Hoechst Celanese* at p. 532), appellant asserts that income from foreign investments is nonbusiness income unless the investments are so interwoven into the fabric of its business operations that the foreign investments become "indivisible" or inseparable from appellant's domestic telecommunications business with both "giving value" to each other. Appellant argues that it was merely a regional domestic telecommunications provider during the years at issue such that these foreign investments did not contribute in any material way to appellant's business as such a provider. For example, appellant contends that these foreign investments did not increase its traffic or revenue or reduce its rates or expenses. (App. Opening B., pp. 22-23.)

Appellant disagrees with respondent's position that sending some employees to work for the foreign company and appointing members of the board of directors amounts to control of that company. Appellant instead contends that the Board in the *Appeal of Mark Controls* held differently and found that the mere representation of a minority shareholder on a board of directors and sending a limited number of employees was insufficient to establish that the taxpayer's investment income constituted business income. Appellant argues that in this instance even fewer factors existed than those present in the *Appeal of Mark Controls* as appellant had no material intercompany sales or licensing agreements with these foreign companies.[7] As such, appellant asserts that consistency requires a finding that its investment income from these foreign companies be treated as nonbusiness income. (App. Opening Br., pp. 23-24.)

Appellant next argues that the functional test under *Hoechst Celanese* is not met unless the flow of benefits contributes materially to a company's regular business operations. However, appellant asserts that here the foreign companies benefited from appellant's assistance but the foreign companies did not benefit appellant's regional domestic business operations. Appellant argues that there were a variety of factors that impeded these foreign companies from becoming integral to appellant's

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[7] Appellant argues that, in its investment in Tele Danmark, which was less than a 50 percent ownership interest, appellant arguably could have asserted control over the chairman of the board's seat but it did not do so. Appellant asserts that this fact weighs heavily against a business income determination. (App. Reply Br., p. 23.)

regional domestic telecommunications business, such as FCC and international regulations, technological limitations that prevented appellant from providing long distance services, technological limitations which made wireless systems incompatible, and geographic barriers. (App. Opening Br., pp. 24-26.)

Based upon the above, appellant asserts that its investment income from these foreign companies should be classified as nonbusiness income which is wholly allocable outside of the state.

Respondent's Contentions

Respondent asserts that, during the tax years at issue, appellant was a major telecommunications provider with a strong global presence, holding equity interests in telecommunication companies in approximately 25 foreign companies and having a carrying value of approximately $8.2 billion as of December 31, 2001. Respondent alleges that appellant committed a team of its employees (such as a "Global Markets Group") to the management and development of foreign telecommunication companies (which included dozens of majority-owned subsidiaries), assigning 262 employees to work full-time as "expatriate" employees for these foreign companies, with approximately one-half of these employees working for the seven foreign companies in which appellant held the equity interests at issue in this appeal. Further, respondent asserts that appellant entered into numerous agreements with these foreign companies, sharing technology and expertise and providing management and consulting services.

Respondent states that appellant touted itself as being "among the largest providers of telecommunications services in the United States and the world." In addition, respondent notes that, in its 2001 Annual Report, appellant stated that it had five reportable business segments, one of which is international, and that its international investments included local and long distance telephone services, wireless communications, voice messaging, data services, video services, Internet access, telecommunications equipment, and directory publishing. Finally, respondent states that one of appellant's press releases provides that appellant's "international investments have positioned the company to take full advantage of the increasing globalization of the telecommunications marketplace." (Resp. Opening Br., pp. 1-5; Exhibit A, p. 6, 7, & 9.)

Below are respondent's descriptions of the nature of appellant's interests in and income from each of the seven foreign companies:

- Belgacom. Respondent states that Belgacom was Belgium's primary full-service telecommunications operator and that, during the years at issue, the Belgian government owned just over a 50 percent interest in the company and appellant owned a 17.5 percent interest in the company (as the company's second largest shareholder). Respondent contends that appellant's interest in the company was further increased by virtue of the 16.5 percent interest in the company as held by Tele Danmark, as discussed below. Respondent states that appellant appointed 3 of the 18 members of the board of directors and sent 22 employees to work at Belgacom. Respondent asserts that a strategic cooperation agreement provided Belgacom with the opportunity to acquire products and services through AIT contracts. Respondent notes that appellant received dividend income from Belgacom of $3.6 million in 2001 and dividend income through a consortium of $32.4 million and $139.4 million for 2001 and 2002, respectively. (Resp. Opening Br., pp. 7-8.)
- Tele Danmark. Respondent states that Tele Danmark was Denmark's primary full-service telecommunications company. Respondent asserts that appellant was Tele Danmark's largest shareholder (with a 41.6 percent interest in the company), assigned 13 employees to work at the company, and controlled the company's board of directors by electing one-half of the members of the board of directors, including the chair who is entitled to cast the tie-breaking vote. Respondent points out that Tele Danmark held significant equity interests in other foreign telecommunication companies, including a 16.5 percent interest in Belgacom. Additionally, respondent notes that appellant and Tele Danmark entered into a strategic cooperation agreement (in 1997) and a cooperation and implementation agreement (in 1998) which allowed appellant and Tele Danmark to share know-how, technology, and expertise. Finally, respondent notes that appellant received dividend income of $26.3 million (2001) and $121.7 million (2002) from Tele Danmark. (Resp. Opening Br., pp. 5-6.)
- diAx. Respondent states that diAx was a wireless and long-distance provider in Switzerland which was formed by appellant and six Swiss electric utility companies. Respondent further states that appellant held a 40 percent interest in the company, appointed 3 members of the board

of directors, one of whom served as diAx's chief operating officer, and assigned 44 employees to work at the company. Respondent asserts that appellant realized a $563 million capital gain when it sold its interest in the company in 2001. (Resp. Opening Br., p. 8.)

- TransAsia. Respondent states that, during the years at issue, appellant was the largest shareholder in TransAsia, with a 43.6 percent interest in the company. Respondent asserts that appellant occupied 3 seats on the board of directors and supplied employees to the company. Additionally, respondent asserts that appellant noted in a business plan that TransAsia was appellant's first international investment in which it was building a telecommunications network from the "ground up." Respondent notes that appellant realized a capital gain of $103.9 million from TransAsia in 2001. (Resp. Opening Br., p. 8.)
- Telmex. Respondent states that, during the years at issue, appellant held an 8.1 percent interest, occupied 3 seats on the board of directors, and sent 29 employees to work for Telmex. Appellant entered into various joint investments with Telmex and partnered with Telmex and Bell Canada to expand into Latin America. Respondent notes that appellant received dividend income of $1.1 billion (2001) and $82.9 million (2002) and a capital gain of $82.6 million in 2002 from the sale of its interest in Telmex. (Resp. Opening Br., pp. 8-9.)
- Bell Canada. Respondent states that appellant, through AIT, acquired a 20 percent interest in the company in 1999. Respondent asserts that a partnership agreement provides for marketing cooperation, the exchange of know-how, and traffic exchange between the two companies. Respondent notes that a press release issued in 1999 provides that AIT, through its relationship with Bell Canada, would strengthen its international position and speed its global growth. Respondent states that an executive with appellant became Bell Canada's chief financial officer in 2000 and that 9 of appellant's employees worked at Bell Canada through the years at issue in this appeal. Respondent notes that appellant received dividend income of $144 million (2001) and $933 million (2002). (Resp. Opening Br., pp. 10-11; Exhibit C.)
- Amdocs. Respondent states that Amdocs is a major supplier of billing and customer service software used by telecommunication companies worldwide. Respondent further states that, in 1984, appellant (which was then Southwestern Bell) acquired a 50 percent interest in the

company and became Amdocs primary customer, and subsequently the two companies developed products together. Respondent asserts that appellant was Amdocs's largest customer in 2001 and its second largest customer in 2002. Additionally, respondent asserts that appellant provided office space and support services to Amdocs and appellant's employees who worked at Amdocs received Amdocs's stock as deferred compensation. Respondent notes that appellant received capital gains of $319.5 million (2001) and $140.3 million (2002) from Amdocs. (Resp. Opening Br., pp. 11-13.)

Respondent asserts (citing the *Appeal of Twentieth Century-Fox Film Corporation*, 89-SBE-007, decided on March 2, 1989) that the Board concluded that respondent's characterization of income as either business or nonbusiness income is presumed correct and that a taxpayer bears the burden of proving that respondent's characterization is erroneous. Respondent states that California Code of Regulations, title 18, section (Regulation) 25120, subdivisions (a) and (b), provides that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income" and that "[a] taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line." Respondent asserts that, because the investments at issue were all telecommunication-related companies which are part and parcel of appellant's global telecommunications business, there is a strong presumption that the income generated from these investments is business income. (Resp. Opening Br., p. 14.)

Respondent notes that Regulation 25120, subdivision (c)(4), states that

> . . . Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or **where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations**. [Emphasis added by respondent.]

Based upon this regulatory provision, respondent argues that appellant's investments were acquired in the course of, and related to, appellant's global telecommunications business such that the dividends and capital gains constitute business income. (Resp. Opening Br., p. 14.)

Respondent argues that, in *Hoechst Celanese*, the California Supreme Court reaffirmed the Board's long-standing interpretation of business income. Respondent states that, in *Hoechst Celanese* (*Hoechst Celanese* at pp. 527, 532), the Court found that the functional test for business income focuses on the income-producing property and its relationship to the taxpayer's business operations, such that the word "integral" refers to "an 'organic unity' between the income-producing property and the taxpayer's business activities" and that "[s]uch a relationship exists when the taxpayer controls and uses the property to contribute materially to the taxpayer's production of business income." (Resp. Opening Br., pp. 14-15.)

Respondent next argues (citing the *Appeal of Standard Oil*, 83-SBE-068, decided on March 2, 1983) that holding a majority interest in a company is not necessary for a determination that dividends received from such an entity must nevertheless be included as part of the taxpayer's business income. Here, respondent states that appellant included in its unitary income the income from its majority-owned foreign subsidiaries, but not the income from its foreign investments in which it held minority interests. Respondent argues (citing the *Appeal of Standard Oil, supra*), however, that the law is clear in that income is business or nonbusiness income depending upon the relationship between the property generating the income and the taxpayer's activities and not based upon whether the taxpayer owned a majority or a minority interest in the company which generated the income. Respondent cites the *Appeal of Standard Oil Co. of California* which provides that the concepts of a "unitary business" and "business income" are distinguishable such that:

> [m]erely because the operations and management of a corporation in which the taxpayer is a stockholder are not so closely connected with the taxpayer's business activities as to be part of the taxpayer's 'unitary business' for combined reporting purposes should not mean that dividends received from the stock cannot be 'income arising from transactions and activities in the regular course of the taxpayer's trade or business' or that the 'acquisition, management, and disposition' of the stock do not 'constitute integral parts of the taxpayer's regular trade or business operations.' The criteria for combined reporting purposes and the definition of business income serve different purposes, ask different questions and apply different standards. The resolution of one does not compel the same resolution of the other.

(Resp. Opening Br., pp. 15-17.)

Respondent next argues that, unlike appellant's conclusion, the Board's decision in the *Appeal of Mark Controls, supra*, leads to a finding here that the income at issue is business income. Respondent contends that appellant's situation is distinguishable from the facts in the *Appeal of Mark Controls*. Respondent states that, in the *Appeal of Marks Controls*, the taxpayer purchased a minority interest in Weir, with an option to acquire the remainder of the shares, and with the intent to expand by acquiring complete ownership and control and integrating that company into its business operations. However, this never occurred. With respect to the other investment (i.e., Walthon) at issue in the *Appeal of Marks Controls,* respondent argues that the Board found that it was purchased as a passive investment, to attain regular dividends, and that Walthon was "hostile" towards sharing information with the taxpayer. Respondent asserts that there was nothing preparatory about appellant's actions regarding the foreign telecommunication companies that appellant invested in but that appellant accomplished its goal of forming relationships and synergies with these companies which allowed appellant to expand its global telecommunications business into new markets in foreign countries. Respondent asserts that appellant accomplished this through the employees, technology, marketing know-how, and expertise which it sent to those companies such that appellant was not merely a passive investor in these companies. Further, respondent states that the Board previously distinguished the *Appeal of Mark Controls* in the *Appeal of CTS Keene, Inc*., et al., 93-SBE-005, decided on February 10, 1993. Respondent provides a quotation from the decision indicating that, although the taxpayer in that appeal unsuccessfully sought to characterize its income as nonbusiness income, the Board found that there was nothing "preparatory" about CTS Keene, Inc.'s actions, which accomplished its goal of becoming a minority shareholder in a company that promoted its products. (Resp. Opening Br., pp. 17-19.)

In asserting that appellant's investment income should be classified as business income, respondent argues that (1) appellant's foreign holdings were acquired, maintained, and disposed of as integral parts of appellant's regular business operations, the investments were in the identical line of business as that in which appellant was engaged (i.e., the telecommunications industry), and appellant's international operations were one of its core business segments; (2) appellant's employees and management were actively involved in the daily operations, including the management, of these investments; (3) agreements were in place between appellant and the foreign companies for the exchange of technical and managerial expertise; (4) the sharing of such information and expertise allowed appellant to develop its operations, its products and services, and to become a global provider; and (5) appellant held significant equity interests in all of the foreign companies at issue here and likewise held positions of control in the management of these companies. (Resp. Opening Br., pp. 20-21.)

Respondent disagrees with appellant's characterization of itself as a regional domestic telecommunications company. Respondent instead contends that appellant operated an international business with global capabilities, based upon appellant's tax returns (1) in which appellant included the income from its majority-owned foreign interests as part of its unitary income and (2) because 48 of appellant's subsidiaries, included on appellant's Schedule R-7 (the election to file a unitary group return), were engaged in foreign operations (based upon the entity's names). (Resp. Opening Br., p. 21.)

Respondent disagrees with appellant's position that, unless the foreign investments contributed to appellant's regional telephone business, the investments could not have generated business income. Respondent argues that appellant filed worldwide combined returns which included its regional telephone business and its services business, its directory business, its software business, its equipment business, and its international operations. Respondent asserts that (citing the *Appeal of Monsanto Co.*, 70-SBE-038, decided on November 6, 1970), for an asset to be integrally-related to appellant's unitary business, the asset need only be integrated with some portion of the unitary business to be includable in the taxpayer's unitary business income. Respondent next argues that, with appellant's concession that it was unitary with foreign companies (i.e., subsidiaries located in Mexico, the United Kingdom, and other countries and United States' territories) which provided support services to its majority-owned companies, appellant acknowledges that its business was global in scope and that its global business was integrally related to the companies at issue here. (Resp. Opening Br., pp. 21-23.)

Respondent disagrees with appellant's argument regarding technological differences, FCC rules, and international law, and asserts that, not only did appellant provide assistance which benefited the foreign entities, appellant likewise gained business advantages through these relationships. Respondent points out that appellant acquired its stock in each of the foreign companies at issue here through private agreements such that appellant, in making such acquisitions, entered into cooperation agreements and agreements regarding the sharing of information technology and know-how, and that appellant looked at these investments as adding value and helping to grow its business. Additionally, respondent argues that, even if appellant was unable to gain any preferential treatment with the foreign companies due to regulatory restrictions, appellant nonetheless through an arm's-length relationship with these entities could still be integrally related (based upon a flow of value) to such entities to meet the test for business income. Also, respondent contends that the regulations referred to by appellant only represented a small part of appellant's business and the ISP referred to by appellant did not prohibit the transfer of technology, employees, or other flows of value between appellant and these foreign carriers. In addition, respondent argues that appellant was able to invest in these entities on terms that were unavailable to the public, as the entities were not publicly-traded at the time of appellant's investments, such investments were possible because of the existing benefits that appellant was able to provide to these companies, and, finally, appellant made such investments because of the benefits it anticipated receiving from the relationships. (Resp. Opening Br., pp. 23-26.)

Respondent also disagrees that appellant was unable to gain any benefit from its alliances with these foreign companies because of the roadblocks from different technologies used in the wireless communication companies in the United States versus Europe and elsewhere. Respondent contends that this issue only affected one part of appellant's business (i.e., wireless communications) and had "virtually nothing to do with other aspects of SBC's unitary business," such as appellant's wireline, marketing, directory publishing, internet services and software sales. Respondent also contends that appellant had, by 2000, decided to convert to this particular technology (i.e., GSM technology). As such, respondent argues that appellant gained by what it learned about this technology from these foreign investments to assist it in developing and rolling out its own GSM system. (Resp. Opening Br., p. 24.)

In concluding, respondent cites the United States Supreme Court decision in *Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159, 179 (italics in original), in which the Court stated that "[t]he prerequisite to a constitutionally acceptable finding of unitary business is a flow of *value*, not a flow of goods." Here, respondent asserts that there is an undisputable flow of value between appellant and these foreign companies with respect to its personnel working for these companies, the cooperative agreements which were entered into, the sharing of technology, know-how, marketing expertise, and best practices, and the intercompany product flow. Respondent concludes that appellant's relationship with these foreign companies was a unitary relationship, such that appellant was not a passive investor in the companies and that appellant, in reality, is one of the world's largest telecommunication companies. (Resp. Opening Br., p. 26.)

Supplemental Briefing

Appellant's Reply Brief

Appellant asserts that it was indeed a regional domestic telecommunications business during the years at issue and disputes respondent's characterization that appellant conducted a global telecommunications business. Appellant states that its operating revenue for 2001 was composed of the following: 75 percent from wireline services; 16 to 17 percent from wireless services; and 8 to 9 percent from directory services. For 2002, appellant states that its operating revenue was composed of the following: 74 percent from wireline services; 16 to 17 percent from wireless services; and 8 to 9 percent from directory services. In contrast, appellant states that less than 1 percent of its operating revenue in each of these years was attributable to its international segment. Similarly, appellant notes that, as of December 31, 2002, approximately 99 percent of its property, plant, and equipment was owned by its wireline subsidiaries located within the 13-state region. Additionally, appellant argues that very real federal and other regulatory restrictions limited appellant's ability to provide long distance services or to provide telecommunication services to multinational companies on a global scale. (App. Reply Br., pp. 2-3.)

Next, appellant disputes respondent's argument that it was able to accomplish its "goal" of forming global synergies and expanding its global telecommunications business through its investments in these businesses. Appellant asserts that its financial reporting of business "segments" (including a segment titled "international segment") is irrelevant to a determination of whether income is unitary income or business/nonbusiness income. (App. Reply Br., pp. 3-4.)

Additionally, appellant asserts that respondent has been unable to identify a single instance of how appellant benefitted, from a strategic perspective, from any of these foreign investments. Appellant argues that its primary business of originating and terminating domestic communications during the relevant tax years remained unchanged by these investments and that the investments did not allow appellant to expand or increase its customer base, service offerings, service volume, or operational revenues in any way. Appellant contends that it was not until 2005, when appellant purchased "old" AT&T, that appellant was able to achieve its goal of being a national, rather than a regional, telecommunications provider. At the same time, appellant states that the AT&T

acquisition also allowed it, through AT&T's network assets, to transition from a domestic to an international telecommunications service provider. (App. Reply Br., p. 5.)

Appellant also argues that respondent relied upon questionable and immaterial information in making its case. For example, regarding the 48 subsidiaries which appellant included on the Form R-7 to its return (to file a unitary group income tax return), the majority of these 48 companies were either inactive or were formed to hold appellant's nonbusiness investments, holding no other function.[8] Additionally, appellant asserts that most of the companies had no active business operations, no employees, and little or no business income or apportionment factors. In fact, appellant states that only 9 of the 48 subsidiaries had net income in 2001 and only 8 of these entities had net income in 2002. Appellant also states that, at protest, it disagreed with respondent's characterization of its foreign investment holding companies as part of appellant's unitary business. (App. Reply Br., pp. 5-7.)

Appellant next asserts the fact that it sent employees to work at these foreign companies did not make these investments integral to appellant's domestic telecommunications business.[9] For the investments under consideration here, appellant states that only about 60 employees were in place at these companies in 2001 and 2002, compared to appellant's 176,000 to 193,000 total employees during the same period of time. Appellant contends that these 60 employees are de minimis even when compared to the employees at the foreign companies themselves, accounting from 0.01 percent to 0.07 percent of its employees. Appellant asserts that its investments in these foreign companies was certainly one way only, as the foreign companies did not send any of their employees to the United States to work for appellant, or provide any flow of expertise and assistance to appellant, as these companies were behind appellant in technologies and business practices or had technology that was different and incompatible to that of appellant's regular domestic business. Additionally, appellant contends that its

[8] Appellant details the 48 entities as follows: 4 of the entities were United States companies with only domestic operations; 36 of the entities were formed to identify, hold, or otherwise perform functions related to nonbusiness foreign investments and were mostly passive holding companies or inactive; 1 entity was a leasing business holding a foreign lease; 3 entities were treated as nonunitary assets by respondent in 2000; and the last 4 entities were either holding companies for intangible property or former venture capital operations inactive in these tax years. (App. Reply Br., p. 6.)

[9] Appellant also notes that, due to Danish law and the company's articles of incorporation, it was unable to vote for 6 of the 12 members of the board of directors of Tele Danmark, and was able to elect 5 members with appellant's 41.6 percent interest in that entity. In addition, appellant, while admitting that it cast its vote for the chairman of the board, points out that this individual had been chairman prior to appellant's acquisition of AIT. (App. Reply Br., pp. 9-10.)

employees, who were sent to these foreign companies, were not asked to think of ways to connect the foreign investments to appellant's networks or to create synergies with appellant's domestic telecommunications business.[10] (App. Reply Br., pp. 7-9.)

Appellant also disagrees with respondent's assertion that there was an indisputable flow of value to appellant from these foreign companies. Appellant instead asserts that there was no transfer of technology to appellant by these companies as the cooperation agreements and other agreements entered into were forward-looking documents for projects that never materialized,[11] such that the synergies which respondent alleges were never achieved. Appellant argues that, but for the sales between appellant and Amdocs (the software developer), appellant did not have meaningful intercompany sales with any of these entities. (App. Reply Br., p. 11.)

Appellant asserts that, with the above reconciliation of the factual record in mind, it is again appropriate to review the legal authorities which are applicable to this appeal. First, appellant argues that the United States Supreme Court in *ASARCO Inc. v. Idaho State Tax Commission* (*ASARCO*) (1982) 458 U.S. 307 stated that, to determine whether investment income is earned inside or outside of a state, the courts must look principally at the underlying activity, not the form of the investment, to determine the propriety of apportionment. Consistent with this principle, appellant contends (in citing *Allied Signal, Inc. v. Director, Division of Taxation* (*Allied Signal*) (1992) 504 U.S. 768) that if the activity giving rise to income is unrelated to the activities carried out in the taxing state, that state must exclude the income in question from the apportionable tax base. (App. Reply Br., p. 12.)

Appellant next argues that the California Supreme Court in *Hoechst Celanese* described in great detail the integral relationship that must exist between in-state and out-of-state activities before a state may include income from the out-of-state activities in the apportionable tax base. Appellant continues by asserting that the relationship, or lack thereof, between appellant's activities and its foreign

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[10] Appellant submitted declarations from several company executives in support of these contentions. (App. Reply Br., p. 9.)

[11] Appellant submitted declarations from several company executives in support of this contention. (App. Reply Br., p. 11.)

investments must be evaluated against the standards set forth in *Hoechst Celanese*.[12] (App. Reply Br., p. 13.)

Appellant asserts that the income from its foreign investments does not qualify as apportionable business income because there is no "integral" relationship between appellant's foreign investments and its business activities in California. Appellant argues that its foreign investments are not interwoven into the fabric of its business operations (due to regulatory, logistical, technological, and geographical limitations) such that the investments are divisible and separable from appellant's core business activities. Appellant asserts that it deliberately negotiated provisions into its investment agreements with these foreign companies to allow appellant to readily dispose of its investments so it could obtain optimal financial returns. (App. Reply Br., pp. 13-14.)

In addition, appellant contends that its core operations and its foreign investments do not provide value to each other, as required by the functional test of *Hoechst Celanese*. Here, appellant asserts that it could not gain any expertise or other strategic value from its foreign investments. Under *ASARCO* (citing *ASARCO* at p. 322), appellant argues that the test adopted is the materiality of the investment to the operation of the investor, not the other way around. Further, appellant argues that the Supreme Court in *ASARCO* (citing *ASARCO* at pp. 328-329) held that, to be considered an operational investment and thus business income, a stock investment must be made to further a material operation of the investor, such as the procurement of materials or the expansion of an investor's distribution system. However, appellant contends (citing *ASARCO* at pp. 321, 323) that even if an investment contributes to a flow of materials to the investor, unless there is a benefit which is better than what would result from

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[12] Appellant cites *Hoechst Celanese* as follows:
"In the context of the business income definition, the word 'integral' . . . refers to an 'organic unity' between the income-producing property and the taxpayer's business activities. **The property must be so interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable from the taxpayer's business activities with both 'giving value' to each other. Such a relationship exists when the taxpayer controls and uses the property to contribute materially to the taxpayer's production of business income.** In this way, we capture the true meaning of 'integral' . . .

"Forming these interpretations of the statutory language into a cohesive whole, we conclude the income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. **In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations.** Such an interpretation of the functional test flows from the ordinary meaning of the statutory language and the California decisions that formed the basis for the UDITPA definition of 'business income.'" (*Hoechst Celanese, supra*, at p. 532 (citations omitted by appellant, emphasis added by appellant).)

the normal marketplace, the investment yields non-business income. (App. Reply Br., pp. 14-15.)

With this, appellant argues that the contributions its foreign investments made (to appellant) are tenuous at best and are in no way material to appellant's operations as required by the functional test of R&TC section 25120, subdivision (a), and by the Court in *Hoechst Celanese*. Appellant claims that the foreign investments did not give any value or contribute in any material way to appellant's normal domestic telecommunications business and, as such, were not integral and could not give rise to apportionable business income. (App. Reply Br., p. 15.)

Appellant contends that the facts in *ASARCO* are similar to appellant's facts and bear careful consideration in this matter. Appellant asserts that the Supreme Court concluded that, even though a parent company (a mining company) shared a similar line of business with subsidiaries and even owned a majority of voting stock in the subsidiaries, the subsidiaries represented discrete business enterprises that had nothing to do with the taxpayer's business in Idaho such that the income from these investments could not be included in the taxpayer's apportionable tax base. Appellant notes, for example, that even though ASARCO owned a 51.5 percent interest in Southern Peru Copper Corporation (Southern Peru), Southern Peru was in the same line of business as ASARCO, and ASARCO provided Southern Peru with purchasing, traffic, and preparation services and ASARCO relied upon Southern Peru for raw materials (with Southern Peru selling 35 percent of its output to ASARCO), the dividends ARASCO received were considered nonbusiness income. Similarly, appellant notes that the income which ARASCO received from ASARCO Mexicana, S.A. (Mexicana) was also found be to nonbusiness income even though appellant owned a 48 percent interest in the company and Mexicana was in the same line of business as ASARCO, but Mexicana operated independently of ASARCO and did not sell any of its inventory to ASARCO. (App. Reply Br., pp. 17-18.)

Appellant asserts that its appeal is factually stronger than any of the investments considered by the Supreme Court in *ASARCO*. Here, appellant points out that it did not have a majority interest in any of its foreign investments, did not (with the exception of Amdocs) have any intercompany sales with these companies, such that its domestic communications business was unaffected by these stand-alone investments. Appellant further points out, in comparison, that appellant's purchases only accounted for 10 to 13 percent of Amdoc's sales, such sales were on an arms-length basis, and appellant did not hold a controlling interest in Amdocs. (App. Reply Br., p. 19.)

Appellant distinguishes itself from the taxpayers in the *Appeal of Standard Oil*, *supra*, a formal opinion that respondent relies upon, in which Standard Oil acquired 52 percent of its oil supply from two foreign companies, one in which it held a 30 percent interest and the other in which it held a 50 percent interest. Appellant asserts that there are almost no similarities between itself and the facts of the *Appeal of Standard Oil* as appellant is not using the output from its foreign investments in its regular trade or business, but that it only made these investments to gain a superior rate-of-return with the excess capital which it had due to the limited growth opportunities in its domestic telecommunications business. (App. Reply Br., p. 20.)

Regarding the Board's decision in the *Appeal of Occidental Petroleum*, 83-SBE-119, decided on June 21, 1983, appellant asserts that the Board reached different conclusions based upon that taxpayer's investments. For example, appellant contends that, for companies which were fully integrated and functioning parts of the taxpayer's existing unitary business, the Board found that the income from those investments was apportionable business income. However, appellant asserts that, for companies in which the taxpayer did not possess more than the potential to integrate those entities into its ongoing business, the Board found that such investments were nonbusiness income. Here, appellant argues that the Board should focus on the status of appellant's investments at the time appellant received income or decided to sell the stock, as appellant did not acquire, maintain, or dispose of any of these investments as part of its unitary business. Additionally, appellant contends that, unlike the situation in the *Appeal of CTS Keene, Inc.*, *supra*, it did not expand its "manufacturing and marketing" in the foreign countries as a result of its investments. (App. Reply Br., pp. 21-22.)

<u>Respondent's Reply Brief</u>

Respondent asserts that the declarations which appellant submitted by company executives contained qualified assertions, were devoid of supporting documentation, and included statements in which the declarants admitted that they had no basis for the statements. Additionally, respondent points out that several of the declarants did not work for AIT (which appellant merged with in 1999), such that these individuals could only speculate as to the reasons why AIT made investments in Tele Danmark, Bell Canada, and Belgacom. (Resp. Reply Br., p. 1.)

Respondent asserts that appellant's after-the-fact declarations do not impugn appellant's contemporaneous documentation showing that appellant was generating business income from its foreign investments. Respondent argues that the contemporaneous documentation, such as news reports, appellant's annual reports, and agreements between appellant's domestic and foreign entities, reveal that AIT and appellant purchased the foreign investments to expand their global business and to share employees, technology, and best business practices. (Resp. Reply Br., pp. 1-2.)

Respondent disagrees with the statements made in the declarations that the flow of value between appellant and its foreign investments was only one way. Respondent argues that there was an exchange of technical information and information specific to the management and best practices of a telecommunications business, such that the income received was business income under Regulation 25120, subdivision (b)(1), as appellant was in the same line of business as these foreign companies. Additionally, respondent contends that appellant was able to retain and utilize its "surplus human capital" by placing these employees with these foreign companies so that appellant could both benefit from the growth of these foreign companies and, at the same time, avoid losing these employees to its competitors. (Resp. Reply Br., p. 2.) Consistent with these activities, respondent asserts that appellant's SEC filing and its profile on its website describe appellant as having foreign investments as one of its business segments and as being a global communications provider. Respondent argues that news articles describe appellant as having investments in up to 23 countries and as being a company of global reach, after its 1997 acquisition of Pacific Telesis Group. (Resp. Reply Br., pp. 2-3.)

Respondent next disagrees with appellant's characterization of its revenue from its foreign investments as representing less than 1 percent of its operating revenue, as appellant reports the revenue from the "international segment" separately from the operating revenue on its financial statements. Respondent asserts that, when viewed as a percentage of operating income, the foreign segment of appellant's business would represent 7 percent of its income or almost $1 billion of revenue in 2002. Respondent asserts that, in this context, the foreign segment of appellant's business in not "inconsequential." (Resp. Reply Br., p. 4.)

Respondent next disputes the table submitted by appellant (Appellant's Exhibit 22) which appellant uses as evidence that it is not engaged in global business operations. Respondent argues that, despite appellant's assertions, appellant nevertheless included companies in its combined return which had, as their primary purpose, the holding and serving of interests in foreign companies. (Resp. Reply Br., pp. 4-5.)

Appellant's Supplemental Brief

Appellant asserts that its foreign investments did not impact its California operations in anyway. Moreover, because the operations of these foreign investments were never interwoven with, or indivisible from, appellant's domestic business operations and had no impact on appellant's California or domestic operations, appellant contends that the income from these foreign investments is nonbusiness income allocable to appellant's commercial domicile in Texas. (App. Supp. Br., pp. 1-3.)

Appellant argues that it and respondent both agree that the foreign investments must be "integral" to appellant's California telecommunications business in order for such income to be treated as business income. Appellant argues that the United States Supreme Court in *Allied Signal* (*Allied Signal* at p. 787) found that income that is "unrelated to [the activities] carried out in [California]," must be treated as nonbusiness income. Appellant contends that the Supreme Court focused on the relationship between the in-state activities and the activities which gave rise to the disputed income, because it is this second activity which determines a state's jurisdiction to tax. Appellant argues that, absent some meaningful relationship between appellant's California activities and its foreign telecommunication investments, California may not tax the foreign income. Here, appellant contends that its acquisition, management, or disposition of the foreign investments had no impact on its operations carried out in California or in the United States. Appellant concludes, based on this, that California may not tax income from these foreign investments. (App. Supp. Br., p. 3.)

Appellant next asserts that both federal and California rulings hold that foreign investments in similar lines of business give rise to nonbusiness income absent significant intercompany transactions or some other meaningful interrelationship between the domestic and foreign operations. For example, appellant notes that, in *ASARCO*, the United States Supreme Court determined that income from foreign mining investments gave rise to nonbusiness income even though the taxpayer had the potential to control the operations of those investments. Appellant next states that, in the *Appeal of Occidental Petroleum* and in the *Appeal of Mark Controls*, the Board found that foreign investments in similar lines of business did not give rise to business income and that the mere ability to control foreign investments without actual control did not give rise to business income. (App. Supp. Br., p. 4.)

As to the declarations submitted by company officials, appellant argues that these declarations were made under penalty of perjury from five individuals with first-hand knowledge of appellant's motives in acquiring and holding the foreign investments. Further, appellant asserts that four of these individuals served on one or more of the boards of directors of the companies at issue here and that all of these individuals witnessed and/or participated in appellant's decision-making relating to these investments. Overall, appellant argues that each of these individuals confirmed that appellant conducted a domestic telecommunications business and that these foreign investments did not form an integral part of, or make a material contribution to, appellant's domestic business. (App. Supp. Br., pp. 5-6.)

As to respondent's criticism of the declarations being limited to the declarants' own personal knowledge, appellant argues that the declarations were worded carefully out of respect to the process and to the Board and that such limitations actually added to the credibility of the declarations. As to respondent's criticism that none of the declarants had personal knowledge of AIT's motivations for acquiring the foreign investments (i.e., Tele Danmark, Bell Canada, and Belgacom), appellant contends that (1) AIT's motives in years prior to the relevant tax years is irrelevant; (2) since none of the declarants participated in AIT's decision-making, none of the declarants provided a statement for which they lacked first-hand knowledge of the facts; and (3) upon appellant's acquisition of AIT (and its foreign investments), appellant treated these foreign investments as investments, not as strategic opportunities. (App. Supp. Br., pp. 5-6.)

Next, appellant argues that respondent's reliance on third-party sources in support of its position is unreliable as these outsiders focus on financial rather than tax considerations. Additionally, appellant argues that respondent's emphasis on appellant's Form 10-K filings and annual reports is also unmerited as financial accounting does not have tax considerations as its primary goal. Appellant also asserts that the contemporaneous information which respondent looks to (such as the investment agreements which appellant signed) is unreliable and that respondent should have instead focused on the regulatory restraints placed on appellant and the integration which failed to take place. Finally, appellant contends that respondent misconstrued statements made in the declarations provided as "concrete examples" that appellant was a global concern. (App. Supp. Br., pp. 7-9.)

Finally, appellant disputes respondent's suggestion that appellant's financial statements were misleading in that its financial statements did not include the income from appellant's international segment as part of appellant's operating revenue. Appellant responds that "the financial statements reflect the foreign investments using the equity method [because] the foreign activities are not even considered an operating segment of [appellant's] business." (App. Supp. Br., pp. 9-10.)

Applicable Law

As an equitable and constitutional method for taxing corporations that do business in multiple states and countries, California, like many other states, has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA).[13] (See Rev. & Tax. Code, §§ 25120 – 25141.) Under this scheme of taxation, a taxpayer's income is divided into business or nonbusiness income. Business income is apportionable to each state by use of a three-factor formula. Nonbusiness income, however, is allocable only to the taxpayer's commercial domicile. (*Hoechst Celanese, supra*, at pp. 508, 513.)

R&TC section 25120, subdivision (a), states that "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. R&TC section 25120, subdivision (d), states that "nonbusiness income" means all income other than business income.

R&TC section 25120, subdivision (a), provides two alternative tests, the "transactional" test and the "functional" test, to determine whether income constitutes business income. (*Hoechst Celanese, supra*, at pp. 508, 520-526.) Under the "transactional" test, the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer's trade or

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[13] The UDITPA has been adopted by over 20 states and attempts to address the fair assessment of corporate taxes by the various states based upon a taxpayer's economic activity. The UDITPA seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme—equitable to each jurisdiction which is seeking its own fair share and equitable to the taxpayer so that the taxpayer does not have the same income taxed multiple times.

business. (*Id*. at p. 526.) Under the "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (*Id*. at p. 527.) If either of those two tests is met, the income will constitute business income. Respondent's determination regarding the character of the income under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (*Appeal of Twentieth Century-Fox Film Corporation, supra*.)

The functional test focuses on the income-producing property and the "critical inquiry" is the "relationship between this property and the taxpayer's business operations." A taxpayer's control and use of the income-producing property must be part of the taxpayer's normal or typical business activities. In providing meaning to the term "integral" in the statute, a determination must then be made as to whether the property has a close enough relationship to the taxpayer to satisfy the functional test. Thus, "'integral' requires an organic unity between the taxpayer's property and business activities whereby the property contributes materially to the taxpayer's production of business income." (*Hoechst Celanese, supra*, at pp. 528-530.)

The Court in *Hoechst Celanese* further explained that:

> In the context of the business income definition, the word "integral" therefore refers to an "organic unity" between the income-producing property and the taxpayer's business activities. (*Holly Sugar, supra*, 18 Cal.2d at p. 224.) The property must be so interwoven into the fabric of the taxpayer's business operations that it becomes "indivisible" or inseparable from the taxpayer's business activities with both "giving value" to each other. (*Ibid*.) Such a relationship exists when the taxpayer controls and uses the property to contribute materially to the taxpayer's production of business income. [Citations omitted.] . . .
>
> Forming these interpretations of the statutory language into a cohesive whole, we conclude that income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations. Such an interpretation of the functional test flows from the ordinary meaning of the statutory language and the California decisions that formed the basis for the UDITPA definition of "business income."

(*Hoechst Celanese* at p. 532.)

The Court noted (*Hoechst Celanese*, at pp. 533-534) that its interpretation of the functional test was consistent with the Board's prior decisions:

> . . . . On the one hand, the SBE has consistently found business income under the functional test where the taxpayer's control and use of the property contributed materially to the production of business income and became an indivisible part of the taxpayer's business. For example, . . . the SBE found that dividends from a joint venture were business income because these ventures "contributed materially to the production of operating income . . . and clearly served to further the operation of" the taxpayer's business. (*Standard Oil*, *supra*, [citations omitted].) Finally, the SBE held that income from stock sales constituted business income because "the assets and activities represented by the stock were fully integrated and functioning parts of [the taxpayer's] existing unitary business." (*Occidental Petroleum, supra*, [citations omitted].)
>
> On the other hand, the SBE has consistently refused to find business income under the functional test where the taxpayer's control and use of the property did not contribute materially to the production of business income and were separate from the taxpayer's business. . . . Similarly, the SBE held that income from the sale of stock in a company constituted nonbusiness income where the taxpayer exercised no control over and received no special benefits from that company. (*Mark Controls, supra*, [citations omitted].) . . .

In the *Appeal of Standard Oil*, *supra*, the Board found that the dividends the taxpayer and its subsidiaries received from affiliated joint venture corporations (Aramco and CPI), in which the taxpayer did not hold controlling interests, constituted business income. The taxpayer, a Delaware corporation which had its principal office in this state, was the parent company of an affiliated group of domestic and foreign subsidiary corporations engaged in all aspects of a worldwide unitary petroleum business. The taxpayer owned 30 percent of the stock of Aramco and was entitled to a share of Aramco's oil and gas production. The taxpayer owned 50 percent of the stock of CPI and was likewise entitled to a share of CPI's oil and gas production.

The Board found that the taxpayer's fundamental purpose in creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to ensure an available supply of crude oil and natural gas liquids for its worldwide petroleum operations. The Board also found that the taxpayer's participating equity interest in Aramco and CPI contributed materially to the production of operating income for the rest of the taxpayer's unitary business and served to further the operation of the taxpayer's integrated petroleum enterprise conducted in and outside of California. As a result, the Board concluded that these stockholdings were integrally related to the taxpayer's unitary business such that the dividends received constituted business income.

In the *Appeal of Occidental Petroleum*, *supra*, the Board found that the gains that the taxpayer and its affiliates realized from the sales of stock in various corporations constituted business income. The taxpayer, a California corporation which also had its commercial domicile in this state, was an explorer and developer of oil and gas properties. The Board first concluded that each of the stock sales in question was related in some fashion to the taxpayer's concerted effort to expand and consolidate its basic unitary business involving natural resources and energy sources.

With respect to the taxpayer's sales of stock in Cofesa, Waiawa Realty, and Oxytrol, the Board found that the transactions involving these unitary subsidiaries gave rise to business income under the functional test, as the stock of each of these entities had been acquired (or created) and managed in furtherance of the actual operation of the taxpayer's unitary business. The Board concluded that, at the time the various decisions to sell the stock of these entities was made, the assets and activities of these entities were fully integrated and functioning parts of the taxpayer's existing unitary business.[14]

In the *Appeal of Mark Controls, supra*, the Board found that the capital gain realized from a taxpayer's sale of stock constituted nonbusiness income.[15] The taxpayer, a Delaware corporation with its commercial domicile in Illinois, was a manufacturer of flow control products, environmental control products, and lavatory fixtures and conducted some of these manufacturing activities in California. In 1971, the taxpayer purchased a 49.5 percent interest in Weir (a corporation from the United Kingdom and a manufacturer of ball and butterfly valves) and held an option to purchase the balance of Weir's outstanding shares. The taxpayer intended to expand its marketing and manufacturing operations to the United Kingdom and it executed a licensing agreement with Weir. There was approximately $200,000 in annual intercompany sales between the parties during the appeal years and the taxpayer placed one of its directors on Weir's board of directors. That individual also became an officer of Weir. The taxpayer believed that Weir was mismanaged and, in 1974, in an attempt to

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[14] The Board, however, reached a different conclusion regarding the taxpayer's sale of stock in Tenneco and Island Creek. Although the taxpayer's purpose in acquiring the stock of each was to expand its unitary business, the Board concluded that neither of these stockholdings, nor their assets and activities, constituted integral parts of the taxpayer's existing unitary operations at the time that the taxpayer decided to sell the stock that it held in these entities. Moreover, the Board found that at no time did these entities possess more than the potential for actual integration into the taxpayer's ongoing business. As such, the Board concluded that the sale of stock in these entities constituted nonbusiness income because such mere potential was insufficient to support a finding that the gains from these sales was business income under the functional test.

[15] There was a second transaction at issue in the *Appeal of Mark Controls*—the taxpayer's sale of stock in Walthon, a corporation in which the taxpayer held 20 percent of that company's outstanding shares. The Board found that the sale of this stock was also properly classified as nonbusiness income.

improve Weir's performance, the taxpayer sent two of its executives to work at Weir. In 1976, after its efforts to improve Weir's operations and profitability failed, the taxpayer sold its interest in the company, realizing a gain on the stock sale.

The Board found that the taxpayer's actions were, at most, preparatory to integrating Weir into the taxpayer's unitary business and that the taxpayer's actions and intent did not result in Weir's stock, assets, or activities becoming an integral part of the taxpayer's business. The Board further found that at no time did Weir possess more than a potential for actual integration into the taxpayer's ongoing unitary business operations. As a result, the Board concluded that mere potential was insufficient to support a finding that a gain from such a stock sale was business income under the functional test.

In the *Appeal of CTS Keene, Inc., supra*, the Board found that the gain realized from a taxpayer's sale of stock in a British corporation constituted business income. In 1965, the taxpayer's parent company entered into a licensing agreement with AB Electronic Components, Ltd. (AB Electronic), an unrelated British corporation, to manufacture and market the parent company's products in Great Britain and Europe. In 1970, the parent company later purchased 10 percent of AB Electronic's stock and extended its licensing agreements with AB Electronic. In 1979, the parent company purchased additional shares of AB Electronic, increasing its ownership interest to 20.5 percent of AB Electronic's common stock, with the goal of extending the relationship between the companies. Finally, in 1982, the parent company sold all of its AB Electronic stock for a gain and reported the gain as nonbusiness income to its commercial domicile outside of California.

The Board concluded that the gain realized was business income under the functional test. The Board found that: (1) the parent company's stockholding in AB Electronic was integrally related to the group's unitary business and was an asset that served an operational function in that business (rather than merely an investment function); and (2) the parent company's two purchases of stock in AB Electronic, and the licensing agreements between the two companies, expanded AB Electronic's manufacturing and marketing of the parent company's products in Europe and generated royalties to the parent company which constituted business income. The Board also concluded that the facts present here were distinguishable from those present in the *Appeal of Mark Controls*, as there was nothing "preparatory" about the taxpayer's actions, as the taxpayer's apparent business goal was fully accomplished by becoming a minority shareholder in AB Electronic (i.e., by supplying AB Electronic with new capital and assisting AB Electronic's efforts of becoming a more effective promoter of the parent company's products in Europe).

In addition to the UDITPA and case law, Regulation 25120 provides in part:

> (a) Business and Nonbusiness Income Defined. . . .
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> . . .
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> The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. . . .
>
> (b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.
> . . .
>
> (1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.
> . . .
>
> (c) Business and Nonbusiness Income; Application of Definitions. . . .
> . . .
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> (2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. . . .
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> . . .

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(4) Dividends. Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations. . . .

The United States Supreme Court has spoken on a State's ability to tax nondomiciliary corporations and the impact of the Due Process and Commerce Clauses of the United States Constitution on such taxation. The Supreme Court has held that a gain from the sale of stock can constitutionally be apportioned even if the previously-affiliated company was not part of the same unitary business, as long as the stockholding served an operational function rather than an investment function.

In *Allied Signal, supra*, 504 U.S. 768, 772, the Supreme Court stated that States can only tax nondomiciliary corporations if there is a "minimal connection" between a corporation's interstate activities and the State and there is a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. The Court further stated that a State need not attempt to isolate a corporation's intrastate income-producing activities from the rest of the corporation's business, but instead could tax an apportioned sum of the corporation's multistate business if the business was unitary. However, the Court pointed out a State could not tax a nondomiciliary corporation's income if the income was derived from an unrelated business activity which constituted a discrete business enterprise.

The Supreme Court in *Allied Signal* (*Allied Signal, supra*, at p. 780) further noted that, where the business activities of a dividend payor have nothing to do with the activities of the recipient corporation in the taxing State, Due Process concerns may preclude apportionability because there is no underlying business. Accordingly, the Court noted that in *ASARCO* and *F.W. Woolworth Co. v. Taxation and Revenue Dep. of N.M.*, (1982) 458 U.S. 354, it struck down States' attempts to include unrelated business activities, not derived from unitary businesses, in taxpayers' apportionable tax base.

The Court (*Allied Signal, supra*, at pp. 780-781) then summarized the *ASARCO* decision as follows:

The principal question in *ASARCO* concerned Idaho's attempt to include in the apportionable tax base of ASARCO certain dividends received from, among other companies, the Southern Peru Copper Corp. [Citations omitted.] The analysis is of direct relevance for us because we have held that for constitutional purposes capital gains should be treated as no different from dividends. [Citations omitted.] . . . [ASARCO] was one of four of Southern Peru's shareholders, owning 51.5% of its stock. Under an agreement with the other shareholders, ASARCO was prevented from dominating Southern Peru's board of directors. ASARCO had the right to appoint 6 of Southern Peru's 13 directors, while 8 votes were required for the passage of any resolution. Southern Peru was in the business of producing unrefined copper (a nonferrous ore), some of which it sold to its shareholders. ASARCO purchased approximately 35% of Southern Peru's output, at average representative trade prices quoted in a trade publication and over which neither Southern Peru nor ASARCO had any control. [Citations omitted.] We concluded that "ASARCO's Idaho silver mining and Southern Peru's autonomous business [were] insufficiently connected to permit the two companies to be classified as a unitary business." [Citations omitted.]

Finally, the Supreme Court also held that "the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. . . . What is required instead is that the capital transaction [must] serve an operational rather than an investment function." (*Allied Signal* at p. 787.)

STAFF COMMENTS[16]

At the hearing, the parties should be prepared to discuss the following: (1) whether the foreign investments and appellant's business should be considered to be in the same general line of business, as appellant is a telecommunications company; (2) the relationship between appellant's foreign investments and its business activities in California; (3) how, and to what extent, the foreign investments were indivisible and inseparable from appellant's business activities; (4) the intercompany transactions or other interrelationships between a taxpayer and its investment which are necessary for a finding that the relationship gives rise to business income; and (5) if appellant controlled and used the foreign investments such that these investments materially contributed (i.e., a flow of value) to appellant's production of business income, including the business advantages that appellant gained through its relationships with the foreign investments.

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[16] Staff notes that in the *Appeal of Pacific Telephone and Telegraph Company* (*Appeal of Pacific Telephone*), 78-SBE-208, May 4, 1978, the Board issued a formal opinion for a consolidated appeal of appellant's predecessor, Pacific Telephone and Telegraph Company, for two sets of tax years (proposed assessments for 1961 and 1963 and claims for refund for 1967 through 1970). The first issue addressed in that formal opinion was whether the taxpayer's sales of stock in 1961 and 1963, relating to the reorganization of the company, were business income or nonbusiness income. As California did not adopt the UDITPA until 1966, the discussion in that portion of the formal opinion is not germane to the appeal at hand. However, this formal opinion is relevant to the second issue in this appeal, as later income tax years were at issue and were addressed in the opinion.

Issue 2: Whether it is appropriate to exclude from appellant's gross receipts, and appellant's sales factor denominator, amounts received from transactions conducted by its treasury department, pursuant to R&TC section 25137?

Contentions

Overview

At issue here are the amounts to be included in the denominator of the fraction representing appellant's sales factor of the apportionment formula. R&TC section 25134 provides that the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in California during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year. R&TC section 25120, subdivision (e), defines the term "sales" as "all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive."

For purposes of the sales factor, for each of a taxpayer's trades or businesses, the term "sales" means all gross receipts derived by the taxpayer from transactions and activity in the regular course of those trades or businesses. (Cal. Code Regs., tit. 18, § 25134, subd. (a)(1).) Increases in a taxpayer's California in-state gross receipts results in a larger California numerator, and a larger California sales factor. Conversely, increases in a taxpayer's out-of-state gross receipts results in a larger denominator and a smaller California sales factor.

As mentioned above, during the protest, appellant sought to add additional amounts[17] (i.e., receipts from its sales of marketable securities from its treasury department investments) to its sales factor denominator. Appellant sought to add $8,059,322,382 in receipts to the sales factor denominator for 2001 and $15,205,194,427 in receipts to the sales factor denominator for 2002. Appellant earned interest income of $9,202,720 and $10,930,568 in 2001 and 2002, respectively, relating to the receipts mentioned above. Specifically, the following table illustrates the amounts at issue here (Resp. Opening Br., pp. 26-27):

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[17] See the final paragraph of this Overview section which addresses the terms to be used in this discussion.

	2001		2002	
	Interest	Total Receipts	Interest	Total Receipts
Auction Rate Securities	$6,752,914	$234,033,076	$3,308,578	$805,910,244
Certificates of Deposit	$46,959	$900,000	$0	$0
Commercial Paper	$59,110	$96,440,890	$520,155	$996,591,845
Euro Time Deposits	$205,043	$1,270,000,000	$2,083	$50,000,000
Money Market Funds	$2,138,694	$6,457,948,416	$7,099,752	$13,352,692,338
Totals	$9,202,720	$8,059,322,382	$10,930,568	$15,205,194,427

R&TC section 25137 provides that, if the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of a taxpayer's business activity in California, the taxpayer may petition for, or the Franchise Tax Board may require, relating to all or to a part of the taxpayer's business activity, the following: a separate accounting, the exclusion of one or more of the apportionment factors, the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in California, or the employment of any other method to effect an equitable allocation and apportionment of the taxpayer's income.

Appellant's Contentions

Appellant asserts that its treasury department (located in San Antonio, Texas) bought and sold marketable securities, such as money market shares, tax-exempt municipal bonds, certificates of deposit, commercial paper, Euro time deposits, and Treasury notes, and that it was appropriate for appellant to include these receipts in its apportionment factor. Appellant contends that respondent denied the inclusion of these gross receipts as part of appellant's sales factor because of respondent's contention that the inclusion of these amounts would distort the portion of appellant's income which was assigned to California, such that appellant's business activity in California would not be fairly reflected. Appellant disagrees and argues that the inclusion of its treasury receipts in its sales factor do not give rise to distortion. (App. Opening Br., pp. 26-27.)

Appellant first cites Regulation 25134, subdivision (a)(1), which defines the term "sales" for purposes of the sales factor:

> Section 25120(e) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under Sections 25124 to 25127 inclusive. Thus, 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. . . .

Appellant asserts that the term "gross receipts" is not defined in the Revenue and Taxation Code for purposes of the sales factor but that the California Supreme Court in *Microsoft Corporation v. Franchise Tax Board* (*Microsoft*) (2006) 39 Cal. 4th 750, 759, stated that "gross receipts" as used in R&TC section 25120, subdivision (e), "naturally includes the entire redemption price of marketable securities." Appellant further asserts that the Court stated that the term "gross" implies the whole amount received and not just the amount received in excess of the purchase price. Further, appellant argues that the Court disagreed with respondent's interpretation that the portion of the gross proceeds from Microsoft's securities transactions, which represented the return of Microsoft's principal, should not be considered a "receipt." Accordingly, appellant asserts that the full amount received upon the redemption of marketable securities constitutes "gross receipts" for purposes of computing a taxpayer's sales factor for California apportionment purposes and that such receipts must be assigned to the state where the income-producing activity was performed which, in appellant's case, is Texas. (App. Opening Br., p. 27.)

Appellant asserts that the Court in *Microsoft* discussed the parameters for which a distortion of the sales factor could occur, citing the *Appeal of Pacific Telephone*, *supra*. Appellant contends that the Board found in favor of respondent (i.e., that only the net receipts from the taxpayer's treasury activities should be included in the taxpayer's sales factor) in part because Pacific Telephone's gross receipts from its treasury operations represented 34 percent of its overall business receipts for apportionment purposes but only 2 percent of its overall income. In *Microsoft*, appellant contends that Microsoft's gross receipts from its treasury operations represented 73 percent of its overall business receipts but only 2 percent of its overall income. In comparison, appellant points out that its treasury receipts represented only 11.6 percent and 20 percent of its total gross receipts for 2001 and 2002, respectively. (App. Opening Br., p. 28.)

Appellant further points out that Microsoft's treasury receipts caused its standard apportionment formula to assign 24 percent of its business activities to its company headquarters and Pacific Telephone's treasury receipts caused its standard apportionment formula to assign 11 percent of its business activities to its company headquarters. In comparison, appellant asserts that its treasury receipts caused its standard apportionment formula to assign only 5.64 percent and 10 percent of its business activities to its company headquarters (in Texas) for 2001 and 2002, respectively.[18] Appellant also points out that in the *Appeal of Home Depot*, a nonprecedential Board decision in 2008, Home Depot's treasury receipts represented 6.6 percent of the company's total gross receipts and would have caused the apportionment formula to assign only 3.3 percent of its business activities to that company's headquarters. Appellant asserts that the Board concluded that respondent failed to prove, by clear and convincing evidence, that the inclusion of Home Depot's treasury receipts in its sales factor resulted in a distortion of its standard apportionment formula. With this, appellant argues that the inclusion of the gross receipts from its marketable securities does not give rise to distortion, such that it should be allowed to include these gross receipts in its sales factor for purposes of apportioning its income. (App. Opening Br., pp. 28-29.)

Respondent's Contentions

Respondent asserts that appellant appropriately included interest from its treasury department investments as gross receipts in its sales factor for apportionment purposes. However, during the protest, respondent contends that appellant claimed it should be able to add an additional $23 billion[19] of purported gross receipts for the two-year period to its sales factor denominator for returns of principal relating to its treasury department investments. Respondent contends that the vast majority of appellant's treasury department investments were, in substance, merely loans and that only the interest from these investments, and not the returned principal, is properly includable in appellant's sales factor formula. Respondent argues that if the returned principal amounts were included in appellant's sales factor denominator, as sought by appellant, the apportionment formula would fail to properly represent appellant's business activity in California. As a consequence, respondent states that it invoked its

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[18] Appellant asserts that, in 2002, its treasury investments actually generated more net income than the company's core telephone business, which reported a net business loss for that year. (App. Opening Br., p. 28.)

[19] See the amounts mentioned (and also detailed in the table) in the Overview section above.

authority under R&TC section 25137 to utilize an alternate apportionment formula which only includes the gains, and not the returned principal from these investments, in appellant's gross receipts. Respondent argues that this method of apportionment is consistent with relevant authorities and with appellant's treatment of these transactions on its originally-filed returns. (Resp. Opening Br., pp. 26-27.)

Respondent asserts that most of the purported receipts which appellant seeks to add to its sales factor denominator consist of returned principal from certificates of deposit, money market funds, and Euro time deposits, which are similar to loans to a bank and the repayment of the amounts loaned plus an agreed amount of interest. Consistent with this, respondent contends that the California Supreme Court in *General Motors Corporation et al. v. Franchise Tax Board* (*General Motors*) (2006) 39 Cal. 4th 773, held that the returned principal from transactions that are, in essence, loans do not constitute receipts for sales factor purposes. Consequently, respondent argues that appellant cannot include the returned principal it receives when disposing of these investments in its sales factor denominator. (Resp. Opening Br., pp. 27-28.)

Respondent next asserts that, if appellant is allowed to add the returned principal from its treasury department investments to its sales factor denominator, appellant's apportionment formula would fail to fairly represent the extent of the taxpayer's business activity in the state as required by R&TC section 25137, the *Microsoft* decision, and other case law. In such a situation, respondent contends that, under R&TC section 25137, it would apply an alternate apportionment formula to exclude appellant's returned principal from the sales factor denominator. (Resp. Opening Br., pp. 28-29.)

Respondent contends that, in various Board formal opinions (such as the *Appeal of Crisa Corp.*, 2002-SBE-004, June 20, 2002, and the *Appeal of Pacific Telephone*, *supra*), the Board has concluded that respondent could utilize R&TC section 25137 to exclude the returns of principal from a taxpayer's ancillary treasury department functions from the taxpayer's sales factor because, without doing so, the sales factor would fail to fairly represent the extent of the taxpayer's business activity in California. For example, in the *Appeal of Pacific Telephone*, the additional treasury gross receipts, if included in the taxpayer's sales factor, would have constituted 36 percent of the taxpayer's total business gross receipts, yet such receipts would have generated less than 2 percent of the company's income.

Respondent argues that the Board's decision was affirmed in *Microsoft*, as that company's investments produced less than 2 percent of the company's income but, if those investments were included in the sales factor, would have represented 73 percent of the company's gross receipts. Respondent asserts that the California Supreme Court in *Microsoft* (*Microsoft* at p. 767) noted that the mixing of receipts from low-margin treasury investments with high-margin sales from the taxpayer's main line of business presents a problem with the UDITPA because the UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state. (Resp. Opening Br., pp. 29-31.)

Respondent states that, on its originally-filed returns, appellant reported total gross receipts of $60,987,174,315 for 2001 and $60,590,561,298 for 2002 and unitary business income of $7,920,367,595 for 2001 and $4,143,454,938 for 2002. Respondent further states that, for 2001, appellant's 13.1 percent profit margin, which it earned from its main line of business, was approximately 119 times greater than the 0.11 percent profit margin that appellant earned from its treasury investments. For 2002, respondent states that appellant's 6.9 percent profit margin, which it earned from its main line of business, was approximately 98 times greater than the 0.07 percent margin that appellant earned from its treasury investments. Respondent contends that it was these types of substantial discrepancies in profit margins which provided the basis for the Court in *Microsoft* to allow respondent to utilize an alternate apportionment formula to exclude the returns of principal from that company's treasury investments. (Resp. Opening Br., pp. 31-32.)

Respondent concludes by pointing out that, over the two-year period at issue here, appellant's treasury department activity generated 0.16 percent of the company's income yet accounted for 16 percent of its gross receipts (if these receipts are included in appellant's sales factor). Further, respondent contends that including these amounts in the sales factor will assign 8 percent of appellant's income to the location of the company's treasury department (in Texas) and that the treasury receipts would assign approximately 100 times (16 percent divided by 0.16 percent) more income to appellant's Texas domicile through the apportionment formula than was actually earned by the transactions which generated those receipts. With this in mind, respondent asserts that treating appellant's returns of principal from its treasury activity as receipts would overload appellant's sales factor and cause the company's apportionment formula to fail to fairly represent the extent of appellant's business activity in California. For that reason, respondent contends that it acted properly in utilizing an alternate apportionment formula under R&TC section 25137 which includes the interest earned from these investments,[20] but not the returns of principal from those transactions, in the formula. (Resp. Opening Br., pp. 33-34.)

Supplemental Briefing

Appellant's Reply Brief

Appellant asserts that the primary issue here is the treatment of its sales of money market funds.[21] Appellant claims that, because the sales price of shares in these funds fluctuates with the market and is not dependent on the amount originally paid to acquire the shares, proceeds from the sales of shares in money market funds qualify as gross receipts for sales factor purposes and should be included in full in the sales factor. Appellant contends that respondent mistakenly contends that the proceeds from the sales of shares in money market funds constitute a return of capital and are therefore not receipts for sales factor purposes. More specifically, appellant contends that respondent's position ignores the guidance of the Court in *General Motors* in which the Court held that, when the sales price is determined based upon the value of the investment, and is not dependent upon the amount originally paid to acquire the investment, the proceeds will constitute receipts for sales factor purposes. (App. Reply Br., pp. 24-25.)

Appellant argues that shares in money market funds have the characteristics of a commodity and are subject to market fluctuations. Appellant points out that money market funds are merely a conduit which holds securities that, if held directly by the owner, would generate gross proceeds that would be includable in the sales factor. Further, appellant notes that the majority of the underlying investments in appellant's money market fund were in commercial paper and other securities which respondent considers to be marketable securities. Appellant contends that it should not matter

[20] See the table in the Overview section above.

[21] $6.4 billion of the approximately $8 billion in receipts at issue for 2001 are money market funds. For 2002, $13.3 billion of the approximately $15.2 billion in receipts at issue are money market funds. See the table in the Overview section above. (Resp. Opening Br., p. 27.)

whether it holds these securities directly or by way of a money market fund for the proceeds from these investments to be treated as gross receipts for sales factor purposes. (App. Reply Br., pp. 25-26.)

Appellant next argues that the inclusion of the proceeds does not result in a distortion of appellant's sales factor as respondent relies upon faulty calculations in making this assertion. For example, appellant notes that it suffered a net business loss from its unitary business activity for 2002. Also, appellant notes that, in the ratio of treasury receipts to total gross receipts, respondent did not include treasury receipts as part of appellant's total gross receipts. Appellant contends that, even with these errors, the inclusion of appellant's gross proceeds from its treasury investments in its sales factor is not distorted compared to the percentages which were found to be distortive in the *Appeal of Pacific Telephone*, *Microsoft*, and *The Limited Stores, Inc. v. Franchise Tax Board* (2007) 152 Cal.App.4th 1491 (*The Limited Stores*). Appellant asserts that, if only the underlying investments (held by the money market funds) which generated the gross proceeds were reviewed, as if held directly (for purposes of calculating the gross receipts from appellant's money market fund sales), the distortion alleged by respondent would be even less. Specifically, appellant alleges that the ratio of treasury receipts to total gross receipts (including treasury receipts) would be 7.92 percent for 2001 and 15.15 percent for 2002. (App. Reply Br., pp. 26-28.)

Appellant concludes by offering that, if the Board found that the inclusion of all of appellant's treasury receipts in the sales factor was distortive, the next step would be to craft an appropriate remedy under R&TC section 25137. Appellant notes that, in a June 15, 2010 letter, respondent offered to include 60 percent of appellant's gross treasury receipts in the sales factor for 2001 and 2002. (App. Reply Br., p. 28.)

<u>Respondent's Reply Brief</u>

Respondent asserts that appellant has failed to establish that its money market funds were not the economic equivalent of loans. Respondent states that the Securities and Exchange Commission describes money market funds as low-risk securities which attempt to keep their net asset values at a constant $1.00 per share value by investing in government securities, certificates of deposit, commercial paper, and other highly-liquid and low-risk securities. Respondent therefore asserts that such funds are protected to a large extent from fluctuations in value, are highly liquid, and are treated by their holders as the virtual equivalent of a savings account. Respondent argues that, in *Microsoft*, the California Supreme Court (*Microsoft* at p. 760) stated that, in applying R&TC section 25120, the economic reality of the transaction must be looked at and, in that matter, the economic reality of money market funds was that such funds are similar to other money accounts. (Resp. Reply Br., pp. 5-6.)

Respondent asserts that there is no basis for appellant's position that one must look at the underlying securities held by a particular form of investment and that the issue here is not the character of the interest received from the various investments but the apportionment treatment of the activity. As such, respondent argues that the holder of an interest in a money market fund should not be treated differently for apportionment purposes from an investor in any other type of money account, as such an idea was rejected by the Court in *Microsoft*. Respondent asserts that, because the underlying activities of money market funds do not involve an income-producing activity of the taxpayer, a fund's sales activities cannot be included in the taxpayer's sales factor. Respondent states that Regulation 25137, subdivision (c)(1)(C), provides, with respect to the sales factor for the apportionment formula, that "[w]here business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor." (Resp. Reply Br., pp. 6-7.)

Respondent acknowledges that it made errors in its calculations in its opening brief. However, respondent contends that, even after correcting those errors, it is still clear that the inclusion of appellant's returned principal from its treasury function in the sales factor formula would result in distortion. (Resp. Reply Br., p. 7.)

Respondent lays out appellant's California sales, total "everywhere" sales, unitary business income, and treasury income (i.e., interest income) and gross receipts as follows (Resp. Reply Br., pp. 7-8):

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	2001	2002
California Sales (per appellant's original returns)	$15,495,351,820	$14,772,679,810
Total Sales (per appellant's original returns)	$60,976,868,504	$60,589,429,115
Total Sales (underlying FTB's NOA determination)	$60,987,174,315	$60,590,561,298
Unitary Business Income (per appellant's original returns)	$3,344,472,825	($1,208,272,846)
Unitary Business Income (underlying FTB's NOA determination)	$4,885,696,026	$731,708,768
Treasury function – interest	$9,202,720	$10,930,568
Treasury function – gross receipts	$8,059,322,382	$15,205,194,427

With this, respondent states that, if appellant's returns of principal are treated as gross receipts and included in appellant's "everywhere" receipts, its total gross receipts would be $69,046,496,697 (i.e., $60,987,174,315 + $8,059,322,382) for 2001 and $75,795,755,725 (i.e., $60,590,561,298 + $15,205,194,427) for 2002. (Resp. Reply Br., p. 8.)

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With the above information, respondent makes comparisons of appellant's receipts to those at issue in the *Appeal of Pacific Telephone*, the *Microsoft* case, and *The Limited* case (Resp. Reply Br., p. 9):

	Appellant	Pacific Telephone	Microsoft	The Limited
Treasury receipts/ total gross receipts	2001: 11.7% 2002: 20.1%[22]	36%	73%	28%
Treasury income/ unitary business income	2001: Less than 0.2% 2002: Less than 1.5%[23]	Less than 2%	Less than 0.2%	Less than 0.1%
Non-treasury profit margin/treasury profit margin	2001: 70 times larger 2002: 17 times larger[24]	Unknown	170 times larger	460 times larger

Respondent argues, based upon the charts above, that appellant's treasury department functions are only a very small part of appellant's operations and are not a part of its main line of business, as the profit margin from appellant's treasury department was only 0.114 percent for 2001 and

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[22] The calculation of appellant's treasury receipts to its total gross receipts (including treasury receipts) is as follows (Resp. Reply Br., p. 9):
2001: $8,059,322,382 / $69,046,496,697 = 11.7%
2002: $15,205,194,427 / $75,795,755,725 = 20.1%

[23] The calculation of the comparison of appellant's treasury income to its unitary business income is as follows (Resp. Reply Br., p. 9):
2001: $9,202,720 / $4,885,696,026 = 0.188%
2002: $10,930,568 / $731,708,768 = 1.49%

[24] The calculation of the comparison of appellant's non-treasury profit margin to its treasury profit margin is as follows (Resp. Reply Br., pp. 9-10):
Appellant's non-treasury profit margin is calculated by dividing appellant's unitary business income by the sales factor denominator, resulting in the following:
2001: $4,885,696,026 / $60,987,174,315 = 8.01%
2002: $731,708,768 / $60,590,561,298 = 1.21%
Next, appellant's treasury profit margin is calculated by dividing appellant's treasury (investment) income by its treasury (investment) gross receipts, resulting in the following:
2001: $9,202,720 / $8,059,322,382 = 0.114%
2002: $10,930,568 / $15,205,194,427 = 0.072%
With these percentages, the calculation of appellant's non-treasury profit margin to its treasury profit margin is as follows:
2001: 8.01 / 0.114 = 70
2002: 1.21 / 0.072 = 16.81

0.072 percent for 2002. Respondent contends that appellant's treasury department activity is simply different than its main line of business and that the inclusion of appellant's treasury function amounts in its sales factor as gross receipts would be in error. Respondent cites *Microsoft* in which the Court stated (*Microsoft* at p. 767) that "modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem." (Resp. Reply Br., p. 10.)

Respondent asserts that if treasury receipts are included in the sales factor here, the amount of income that would be assigned through apportionment to the treasury function would be 30 times more than what was earned by the treasury department in 2001 and, as a result, would vastly overstate the importance of appellant's treasury activity. In addition, respondent points out that, for 2002, appellant's treasury department produced a greater amount of gross receipts ($15,205,194,427) than the amount generated from appellant's operations (i.e., appellant's sales) ($14,772,679,810) in California. (Resp. Reply Br., pp. 8, 11.)

Furthermore, respondent asserts that distortion is present here, even though the ratio of treasury receipts to total gross receipts is not as great as in the cited cases. Respondent cites the *Appeal of Crisa Corporation, supra*, which states: "[t]he central question under section 25137 is not whether some quantitative comparison has produced a large-enough 'distortive' figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. . . . If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then section 25137 may apply." Here, respondent contends that, to suggest an alternative method of apportionment is not warranted under R&TC section 25137, would fail to fairly reflect appellant's business activities. (Resp. Reply Br., p. 11.)

Respondent next asserts that the Board should ignore the settlement offer made by respondent relating to the inclusion of returned principal from treasury investments in appellant's sales factor, because evidence of an offer to resolve a dispute is inadmissible (pursuant to Evidence Code

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section 1154 and 1152).[25] Respondent contends that its proposal was based upon the acceptance of certain criteria and that the proposal was rejected by appellant. Respondent argues that it is inappropriate for appellant to reference respondent's prior settlement offer as appellant has now offered entirely new terms to go along with respondent's prior offer. (Resp. Reply Br., p. 12.)

Finally, respondent argues that appellant's alternative which would allow for a partial recognition of its returned principal as gross receipts in the sales factor (see the summary of Appellant's Supplemental Brief below) implies that appellant has not received the recognition of an appropriate portion of its treasury department activity in the apportionment formula. Instead, respondent contends that the income from appellant's treasury department investments was included in the sales factor and that the payroll and property involved in that activity were included in appellant's payroll and property factors. As such, under *Microsoft*, respondent asserts that nothing more is required. (Resp. Reply Br., pp. 12-13.)

<u>Appellant's Supplemental Brief</u>

Appellant states that, in *Microsoft*, the Court held that "gross receipts" included the entire redemption price of securities. Further, appellant states that, in *General Motors*, the Court held that, when the sales price is determined based upon the value of the investment and is not dependent upon the amount originally paid to acquire the investment, the proceeds will constitute receipts for purposes of the sales factor. Appellant asserts that it is respondent's position that *Microsoft* does not apply to money market funds. Appellant argues, to the contrary, that money market funds are neither loans nor money market depository accounts. (App. Supp. Br., p. 10.)

Appellant asserts that receipts from loans or deposits are not included in the sales factor because the principal amount belongs to the lender/depositor and that party is entitled to the return of the principal amount. In contrast, however, appellant asserts that investors in money market funds have no recourse against the fund manager of a money market fund for the loss of principal. Appellant contends that the relative safety of an investment (i.e., the amount of risk) is not the deciding factor of whether

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[25] Evidence Code section 1154 provides: "Evidence that a person has accepted or offered or promised to accept a sum of money or any other thing, act, or service in satisfaction of a claim, as well as any conduct or statements made in negotiation thereof, is inadmissible to prove the invalidity of the claim or any part of it."

proceeds should be included in the sales factor. Moreover, unlike respondent's characterization, appellant alleges that money market funds do carry a risk of loss. Appellant notes that respondent includes the gross proceeds from United States Treasury bills in the sales factor even though Treasury bills are a relatively-safe investment and investors rarely lose principal on such investments. (App. Supp. Br., p. 11.)

Appellant contends that a share in a money market fund is a marketable security, not a loan, and, as such, there is no agreement that amounts paid by investors will be returned. Appellant asserts that, in *General Motors* (*General Motors* at pp. 788), the Court recognized the difference between marketable securities and loans such that, in a sale or redemption of marketable securities, the price that is paid to the seller is dependent upon the value of the securities held and not a function of the initial cost. However, when a loan is repaid, the price paid to the seller is tied to the original amount of the loan and is not affected by the fluctuations in the value of the securities being held. (App. Supp. Br., pp. 11-12.)

Appellant asserts that a money market fund is a security that is subject to market fluctuations, carrying no promises of a return of capital, as an investor relinquishes its right to the capital it has invested, with no promise of repayment, and any proceeds that the investor receives from the sale of its shares is not the return of the investor's own funds (unlike a loan or deposit). Appellant reiterates that a money market fund is a conduit for the underlying investments and should be treated the same as if it held the underlying investments directly (e.g., if appellant had invested in commercial paper directly, appellant would be able to include the gross proceeds from the sale or redemption of the commercial paper in the sales factor formula). (App. Supp. Br., pp. 12-13.)

Next, appellant contends that, even with respondent's corrected computations of appellant's treasury receipts, the inclusion of the proceeds from its treasury department does not establish distortion in appellant's sales factor. Appellant argues that the relative quantitative impact on appellant's sales factor is far less than the impact in the other matters mentioned by respondent. Appellant contends that respondent's approach (and contention of distortion) is flawed because in 2002, for example, appellant's treasury department generated net income but its business operations generated a net loss. (App. Supp. Br., pp. 13-14.)

Finally, appellant argues that it offered the information in respondent's June 15, 2010 letter, relating to a settlement of this issue, as an example of a way to remedy this part of the appeal. Appellant asserts that, if the Board concludes that it is distortive to include the proceeds from the money market funds in the sales factor formula, the Board should consider employing the percentage which had been proposed in respondent's letter (i.e., that 40 percent of the receipts would be treated as taxable). (App. Supp. Br., pp. 14-15.)

<u>Applicable Law</u>

Appellant is engaged in a unitary business together with other commonly-controlled corporations. As a result, appellant's business income must be apportioned according to the UDITPA as set forth in R&TC sections 25120 through 25141. California's version of UDITPA generally requires that a taxpayer's business income be apportioned by a formula composed of a property factor, a payroll factor and a double-weighted sales factor. (Rev. & Tax. Code, § 25128.) The numerators of these respective factors represent the taxpayer's property, payroll and sales in California, while the denominators represent the taxpayer's property, payroll and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, & 25134.)

R&TC section 25137 provides that, if the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of a taxpayer's business activity in California, the taxpayer may petition for, or the Franchise Tax Board may require the following, if reasonable, with respect to all or any part of the taxpayer's business activity:

> (a) a separate accounting;
>
> (b) the exclusion of one or more of the apportionment factors;
>
> (c) the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in California; or
>
> (d) the employment of any other method to effect an equitable allocation and apportionment of the taxpayer's income.

It is well settled that the party invoking R&TC section 25137 bears the burden of proof. (*Appeal of Crisa Corporation*, *supra*.) The California Supreme Court has stated that the party invoking that section has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation of the taxpayer's business activity in California and (2) its proposed alternative is reasonable. (*Microsoft* at p. 765.)

In 2006, the California Supreme Court issued opinions in the companion cases of *Microsoft* and *General Motors*. In *Microsoft*, the Court held that redemption of marketable securities at maturity generates "gross receipts" that are includible in the apportionment formula under R&TC section 25128. (*Microsoft* at p. 755.) However, the Court further held that the inclusion of such "gross receipts" was distortive for purposes of R&TC section 25137, under the particular facts of *Microsoft*, and that an apportionment formula that included only "net receipts" was a reasonable alternative there. (*Microsoft* at pp. 755, 764-772.) In *General Motors*, the Court held that a repurchase agreement (commonly known as "repos") was analogous to a secured loan such that only the interest received with respect to that agreement should be treated as "gross receipts" for purposes of formula apportionment. (*General Motors* at pp. 235-236.)

In *Microsoft*, the taxpayer reported the income from its treasury department as business income and the entire amount that it received from sales and redemptions of marketable securities as gross receipts. The Franchise Tax Board accepted the taxpayer's treatment of its treasury department income as business income and allowed the inclusion of securities sales as gross receipts, but disallowed the return of capital in security redemption transactions. In other words, the Franchise Tax Board only counted as gross receipts, for security redemptions held to maturity, the price differential between the redemption price and the purchase price.

The Court in *Microsoft* concluded that the meaning of the term "gross receipts" under the UDITPA more naturally includes the entire redemption price of marketable securities—that the term "gross" implies the whole amount received, not just the amount received in excess of the purchase price of the security. (*Microsoft* at p. 759.) The Court noted that, under Regulation 25134, subdivision (a)(1), gross receipts include payments arising not just from sales but from "transactions and activity in the regular course of" a taxpayer's business as well, such that there was no reason to place great significance on the label "sale." (*Microsoft* at p. 761.)

As to the distortion issue, the Court initially noted that the party invoking R&TC section

25137 has the burden of proving by clear and convincing evidence (1) that the approximation provided by the standard formula is not a fair representation and (2) that the party's proposed alternative is reasonable. (*Microsoft* at p. 765.) The Court then went on to explain that the issue relating to short-term security investments was one of scale and not the inclusion of the full sales or redemption price of the security in gross receipts. The Court noted that short-term securities involve margins (i.e., the difference between the cost and the sales price of the security) that are quite small in absolute terms and, as a result, make these securities quite different than the sale of other types of commodities. To illustrate this, the Court noted that Microsoft's 1991 redemptions totaled $5.7 billion, while the income from these investments totaled only $10.7 million, a margin of less than 0.2 percent. In contrast, Microsoft's nontreasury activities produced gross receipts of $2.1 billion and income of $659 million, a margin of more than 31 percent (170 times greater than the margin from its securities). (*Microsoft* at p. 767.)

The Court stated that this situation, a mix of low-margin sales with a mix of higher margin sales, presented a problem for the UDITPA because the "UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state." (Microsoft at p. 768.) The Court explained that (*Microsoft* at pp. 768-769):

> . . . modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem. Under the UDITPA, the operations and gross receipts of a treasury department are properly attributed to the state where the department operates—here, Washington. (See § 25136.) The nature of these operations means that Microsoft's true margin for its Washington operations will be much, much lower than the worldwide average, and its margin for every other state will be much higher than the worldwide average. Thus, rotely applying the worldwide average margin (Total Income/Total Sales) to each state's gross receipts would result in severely underestimating the amount of income attributable to every state *except* the state hosting the treasury department, for which state the income would be correspondingly severely overestimated. In such circumstances, rote application of the standard formula does not fairly represent the extent of a taxpayer's activity in each state, except in the rare instance when corresponding imprecision in the payroll and property factors may happen to balance out this distortion. [Footnotes omitted.]

The Court then went on to state that R&TC section 25137 ordinarily applies to nonrecurring situations, but does not apply only to such situations and that the inquiry under the statute remains: does the formula fairly represent a unitary business's activities in a given state and, when it does not, the relief provision may apply. (*Microsoft* at p. 770.)

The Court concluded that the Franchise Tax Board's alternative (i.e., to include in the denominator of the sales factor only the net receipts from Microsoft's redemptions) was reasonable and that the application of R&TC section 25137 in that matter was appropriate. The Court found that (*Microsoft* at pp. 770-771):

> 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. These transactions generated minimal income (just under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of gross receipts for 1991). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on property and payroll factors. The distortion the [Franchise Tax] Board has shown here is of both a type and size properly addressed through invocation of section 25137; application of the standard formula does not fairly represent the extent of Microsoft's business in California. . . .

In *General Motors*, the California Supreme Court compared amounts received from the sale and redemption of securities, such as what is at issue in this appeal, to amounts received from secured loans. In reaching its holding, the Court found that (*General Motors* at pp. 787-788):

> [f]or tax purposes, we care why money is being received. If it is received in exchange for a commodity, we treat the full price as gross receipts. If it is received in exchange for the use of money, only the interest, not the principal, is a gross receipt. In a *securities sale* or *redemption*, the price paid the seller is a function of the securities held and is independent of the initial cost. In a *secured loan*, the price paid is tied to the initial cost (the amount loaned) and is independent of fluctuations in the value of the securities held. In a *repo*, the price paid is also tied to the initial cost and is independent of fluctuations in the type or value of the securities held. Thus, a repo has the characteristics of a loan, and only the interest received is a gross receipt for purposes of the UDITPA. (Italics in original.)

In *The Limited Stores*, *supra*, the Court of Appeals, consistent with the *Microsoft* decision, held that the entire amount received in the redemption of securities should be treated as gross receipts. The Court of Appeals, again consistent with *Microsoft*, determined that the taxpayer's treasury department functions were qualitatively different from the taxpayer's principal business (i.e., a retailer of men's and women's clothing and bath products) and that the quantitative distortion from the inclusion of its investment receipts in the sales factor was substantial, such that it was appropriate for the Franchise Tax Board to correct these distortions by way of R&TC section 25137. The Court of Appeals then concluded that the Franchise Tax Board's alternative of only including the net receipts from the taxpayer's redemptions in the sales factor denominator was appropriate.

In *The Limited Stores*, the Court of Appeals found that the distortion in that matter was even greater than the distortion present in *Microsoft* and in the *Appeal of Pacific Telephone*. In *The Limited Stores*, for 1993, the taxpayer's short-term investments produced less than 1 percent of the company's business income, but over 62 percent of the company's gross receipts. For 1994, the taxpayer's short-term investments again produced less than 1 percent of the company's business income, but over 52 percent of the company's gross receipts. Looking at distortion on the basis of the taxpayer's margins, for 1993 and 1994, the company's redemptions totaled approximately $20 billion while its income from these transactions was approximately $16 million, a margin of less than 0.1 percent. From the sale of tangible property in 1993 and 1994, the company had $14.5 billion in gross receipts and income from these transactions of $6.7 billion, a margin of over 46 percent—roughly 460 times greater than its margin from the redemptions from the company's treasury department. (*The Limited Stores*, at p. 1500.)

In the *Appeal of Pacific Telephone, supra*, the Board was faced with deciding whether to exclude the return of capital element of a taxpayer's investment receipts.[26] The Board found that distortion existed due to the inclusion of such receipts in the sales factor and that it was appropriate to utilize an alternative formula, pursuant to R&TC section 25137, as proposed by the Franchise Tax Board. In *Microsoft*, however, the Court noted that, because the inclusion of sales and redemptions in gross receipts was not a major point of contention or analysis in this appeal, the Court did not put great weight on this particular decision. (*Microsoft* at p. 760.)

Nevertheless, we note that the Board in the *Appeal of Pacific Telephone* found that distortion existed as the income from these investments constituted less than 2 percent of the company's business income, but when the receipts from these investments were combined with the gross receipts from the taxpayer's other business activities, such receipts would constitute approximately 36 percent of the company's total receipts in each appeal year. In other words, this one activity alone would treat approximately one-third of the Bell System's total "sales" as having taken place in New York and the apportionment formula would assign about 11 percent of the Bell System's entire business activities to New York.

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[26] This portion of the Board's opinion addressed the taxpayer's 1967, 1968, 1969, and 1970 income tax years. Earlier tax years, not relevant to this issue, were also in dispute in that appeal.

STATE BOARD OF EQUALIZATION
CORPORATION FRANCHISE TAX APPEAL

<u>STAFF COMMENTS</u>

As noted above, in its opening brief, respondent states that it does not dispute appellant's claim that amounts which appellant received from the dispositions of auction rate securities and commercial paper should be included in the sales factor denominator, amounts totaling $330 million (for 2001) and $1.803 billion (for 2002). (Resp. Opening Br., p. 28, fn. 55.) Respondent asserts that the amounts which appellant received from certificates of deposit, Euro time deposits, and money market funds remain in dispute. (Resp. Opening Br., p. 28, fn. 56.) However, in its final brief, appellant states that it "agrees with the treatment of the other security types, and only takes exception with the FTB's conclusion that money market funds are not distinguishable from money market deposit accounts." (App. Supp. Br., p. 15.) Based upon the above, it is the understanding of the Appeals Division that: (1) respondent agrees that receipts from auction rate securities and commercial paper should be included in the sales factor formula; (2) appellant no longer seeks to include receipts from certificates of deposit and from Euro time deposits in the sales factor formula; and (3) only the gross receipts (i.e., returned principal) from the money market fund transactions remain in dispute. At least 14 days prior to the hearing, the parties should confirm that only the money market fund transactions remain in dispute.

With respect to the refund amounts relating to this issue, the Appeals Division notes that neither party submitted the claims for refund or respondent's denial of those claims. In addition, neither party referenced the claimed refund amounts or the manner in which those amounts were calculated. Staff requests that, at the hearing, the parties clarify the record with regard to the status of the refund claims and whether the Board's determination of this issue will resolve appellant's refund claims.

In addition, at least 14 days prior to the hearing, appellant is requested to provide (1) a schedule showing appellant's calculation of the sales factor based on the amounts that it believes should be included as gross receipts and (2) the amount of taxable income for each year based on the revised sales factor. Consistent with this and with the concessions mentioned above, staff also requests, at least 14 days prior to the hearing, that each party provide schedules showing its calculation of the amount of tax at issue for each year.

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