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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

9
10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **RAMBUS, INC.¹**) Case No. 512010
13)

14 Adjusted Carryover Amount

<u>Years</u>	<u>Amount</u>
March 31, 2003	Carryover Adjustment
December 31, 2003	Carryover Adjustment
December 31, 2004	Carryover Adjustment

18 Representing the Parties:

19
20 For Appellant: Eric M. Anderson, WTAS LLC
21 For Franchise Tax Board: Melissa Potter, Tax Counsel III
22

23 **QUESTIONS:** (1) Whether appellant has shown that respondent Franchise Tax Board erred in
24 determining that appellant's sales of intangible personal property should be
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26 ¹ Appellant Rambus, Inc.'s headquarters is located in Los Altos, Santa Clara County.

27 ² This appeal was originally scheduled for oral hearing at the August 2010 Board meeting but rescheduled to the September
28 2010 Board meeting on the Nonappearance Consent Matters calendar due to appellant's failure to respond to the hearing
notice. Appellant subsequently contacted the Board Proceedings Division to request that the appeal be heard before the
Board which resulted in the matter being rescheduled to this meeting.

1 sourced to California under the “greater cost of performance” rule of Revenue and
2 Taxation Code (R&TC) section 25136, subdivision (b).

3 (2) Whether appellant has met its burden of proof to show that the standard
4 apportionment formula fails to reflect its activities in this state fairly and, for that
5 reason, appellant is entitled to use an alternate apportionment formula pursuant to
6 R&TC section 25137 and, if so, whether appellant’s proffered alternative is
7 reasonable.

8 HEARING SUMMARY

9 Factual Background

10 Appellant Rambus, Inc. is the key corporate member of a unitary combined reporting
11 group that is in the business of creating broad range chip-to-chip interface technologies that enhance the
12 performance and cost-effectiveness of its customers’ semiconductor and system products. These
13 technologies fall into two major categories, memory interfaces and logic interfaces, which earn appellant
14 royalties and licensing fees based on five types of agreements with semiconductor and system
15 companies. Appellant’s principal sources of revenue are royalty and licensing fees from semiconductor
16 and system manufacturers operating outside the United States, which use appellant’s technologies in
17 their products. During the years in issue, appellant maintained two wholly-owned subsidiaries, Rambus
18 KK, a Japanese corporation which is located in Japan and provides administrative support, sales and
19 marketing and engineering services for appellant and Rambus Deutschland GmbH, a German
20 corporation treated as a disregarded entity for federal income tax purposes. (App. Open. Br., pp. 1-2;
21 Resp. Open. Br., pp.1-2.)

22 For tax year ended March 31, 2003, appellant did not assign its royalty and licensing
23 revenues to California. Appellant took the position that California Code of Regulations, title 18, section
24 (Regulation) 25137 allowed appellant to assign those sales to the location of those customers located
25 outside the United States. In August 2004, respondent issued FTB Notice No. 2004-5 (Aug. 6, 2004)
26 which states that it was necessary to obtain prior approval from respondent in order to take a position
27 under R&TC section 25137. Thereafter, appellant applied the sourcing rules under R&TC section
28 25136 and sourced revenue from royalties and licensing fees to California for tax year ended December

1 31, 2003, and subsequent years. (App. Open. Br., p.2.)

2 On audit, respondent reassigned appellant's sales derived from licensing intangible
3 property to California under R&TC section 25136 for the tax year ended March 31, 2003. The
4 reassignment was based on the audit's determination that appellant's activities that produced the gross
5 receipts in royalties and licensing fees occurred entirely within California and the costs of those
6 activities include appellant's headquarters, research and development team, and patent attorneys.
7 Respondent issued a Notice of Proposed Adjusted Carryover Amount (NPACA) for the income year
8 ending March 31, 2003 (IYE 3/03), a NPACA for income year ending December 31, 2003 (IYE 12/03),
9 and a NPACA for income year ending December 31, 2004 (IYE 12/04). Each of the NPACAs state that
10 the audit resulted in an additional tax liability of \$749,345 for IYE 3/03 and a reduction in the tax
11 amount prior to credits of \$(22,944) for IYE 12/03, a reduction in the research and development (R&D)
12 credit in the amounts of \$207,846, \$260,038, and \$1,437,501 for IYE 3/03, IYE 12/03, and IYE 12/04,
13 and a reduction of the carryovers of R&D credits from tax years prior to IYE 3/03 by \$900,377.
14 Appellant protested the NPACAs. Respondent affirmed the NPACAs in Notices of Action-Affirmation
15 dated September 14, 2009, and appellant filed this timely appeal. (Resp. Open. Br., pp. 2-3; App. Open.
16 Br., attachments.).

17 **Question (1): Whether respondent erred in determining that appellant's sales of intangible**
18 **personal property should be sourced to California under the "greater cost of performance" rule of**
19 **R&TC section 25136, subdivision (b).**

20 Contentions

21 Appellant's Contentions

22 Appellant states that for tax year ended March 31, 2003, it determined that it was
23 appropriate to source royalty and contract revenues for customer-licensees to Japan and Korea for
24 California tax purposes. Appellant takes the position the sales factor is intended to be market-based so
25 that only receipts derived from California customers should be sourced to California under R&TC
26 section 25136. Appellant provides a summary of the Uniform Division of Income for Tax Purposes Act
27 (UDITPA), adopted by California in 1966, which, appellant asserts, provided a statutory apportionment
28 scheme modeled on a three-factor formula using the average of the ratios of property, payroll, and sales

1 within and without the state. Appellant states that R&TC section 25136 provides that a taxpayer's sales,
2 other than sales of tangible personal property, shall be attributed to the state wherein the greater
3 proportion of the income-producing activity is performed, based on the costs of performance. Appellant
4 further asserts that using sales as a factor for apportioning income is grounded in the theory "that the
5 contribution of the consumer states toward the production of income should be recognized by attributing
6 the sales to those states." (*Quoting William J. Pierce, The Uniform Division of Income for State Tax*
7 *Purposes*, 35 Taxes No. 10, 748-49 (1957).) Appellant contends that the sales factor is intended to
8 provide the market state with an appropriate share (and to deny the manufacturing state an excessive
9 share) of the taxpayer's income base. (App. Open. Br., p. 3.)

10 Appellant argues that R&TC section 25136 provides that sales other than sales of
11 tangible personal property are in California if the "income-producing activity" takes place in California
12 or if the income-producing activity occurs in more than one state and the greater proportion of such
13 activity occurs in California than in any other state based on the costs of performance. Appellant points
14 to the phrase "income-producing activity" as including "the sale, licensing, or other use of intangible
15 personal property." (Cal. Code Regs., tit. 18, § 25136(b)(4).) Based on that specified activity, appellant
16 concludes that "the location of the income-producing activity for intangible property should be sourced
17 to the location of use". Under the facts presented here, appellant argues that "[t]he customer's site
18 where the technology is employed in developing semiconductors is the location where the patented and
19 copyrighted technologies are used." Appellant also notes that R&TC section 25127 applies this same
20 methodology to the sourcing of nonbusiness income from patent and copyright royalties. Based on the
21 language sourcing intangible property to the location of use under R&TC section 25136, appellant
22 contends that "the location where the intangible is licensed to the customer should control the sourcing
23 determination." (App. Open. Br., p.4.)

24 Appellant further contends that only the receipts from the licensing of intangible property
25 used by California customers should be included in the numerator of the sales factor. Appellant asserts
26 that the facts related to use of the intangibles in issue, as described by the Audit Issue Presentation Sheet
27 (AIPS) No. 1, are not in dispute and appellant provides integration services at the location of the
28 customer's manufacturing operation to successfully integrate the designs and technologies. Thus,

1 appellant argues that the “income-producing” activity occurs at the customer’s location and the sales
2 factor should be redetermined based upon sourcing it to the locations of use which is consistent with
3 other states’ laws. (App. Open. Br., p.5.)

4 Appellant cites respondent’s reliance on *Appeal of Adobe Systems, Inc.*, an unpublished
5 summary decision, which focused on the activities of the taxpayer in determining where to assign the
6 taxpayer’s costs of performance for activities in multiple states that resulted in the sale of software.
7 Appellant distinguishes the facts in that case as involving the assignment of activity in more than one
8 location whereas in this appeal the income-producing activity, i.e., where the licensed technology is
9 delivered and used, takes place in only one location. For that reason, appellant argues that the cost of
10 performance rules have been misapplied and, moreover, the analysis of that decision is outdated and not
11 a reasonable interpretation of the statutory language. (App. Open. Br., p.5.)

12 Respondent’s Contentions

13 Respondent states that the general rule for assignment of sales in the sales factor is
14 governed by R&TC section 25134 which provides that the numerator is the total sales of the taxpayer in
15 California and the denominator is the total sales of the taxpayer everywhere during the taxable year.
16 The sales assignment rules for sales of other than tangible personal property are prescribed by R&TC
17 section 25136 which provides that such sales are properly sourced to California and included in the sales
18 factor if “(a) the income-producing activity is performed in this state; or (b) the income-producing
19 activity is performed both in and outside this state and a greater proportion of the income-producing
20 activity is performed in this state than in any other state, based on costs of performance.” Respondent
21 then cites the relevant portions of Regulation 25136 which describe the elements of the sales factor
22 formula, define “income-producing activity” and provide the general rule for the sourcing of receipts.
23 (Resp. Open. Br., pp. 4-5.)

24 Respondent asserts that receipts from royalty and licensing agreements account for a
25 majority of appellant’s income and are produced by appellant’s activities in the regular course of its
26 business for gain or profit. Respondent further asserts that the income-producing activities include
27 appellant’s R&D department, patent and intellectual property attorneys, and appellant’s headquarters, all
28 of which are located in California. Respondent contends that the items in issue are other than tangible

1 personal property so that receipts are assigned pursuant to R&TC section 25136 and applicable
2 regulations. Because the greater costs of performance relating to income-producing activity occurred in
3 California, respondent contends the receipts were properly assigned to the California sales factor
4 numerator. (Resp. Open. Br., pp. 5-6.)

5 Respondent argues that appellant ignores the plain language and meaning of R&TC
6 section 25136. In support of its position, respondent argues that principles of statutory construction
7 require the words of a statute to be given their usual and ordinary meaning and, in the absence of any
8 ambiguity, the plain meaning of the language controls. According to respondent, the language of R&TC
9 section 25136 and the applicable regulations is clear, concise and plainly written and states that sales are
10 to be assigned where the income-producing activity related to those sales occurred. If the activity
11 occurred in more than one state, then the sales are assigned to the location where the greater cost of
12 performing that activity occurred. In response to appellant's view that Regulation 25136 assigns sales of
13 intangible property to the location of the taxpayer's customer, respondent contends that Regulation
14 25136 specifically provides that R&TC section 25136 applies to the taxpayer's income-producing
15 activity and the taxpayer's trade or business. Finally, respondent contends that appellant cites no
16 authority for its implicit position that R&TC section 25136 and Regulation 25136 are contrary to the
17 intent of UDITPA and the Legislature. (Resp. Open. Br., pp. 6-7.)

18 With respect to appellant's interpretation of Regulation 25136, respondent argues that
19 appellant erroneously conflates the regulation's provisions for assigning sales of tangible personal
20 property and real property with the provisions for the assignment of sales of intangible personal
21 property. Furthermore, respondent contends there is no merit to appellant's reliance on the nonbusiness
22 income sourcing rules of R&TC section 25127 because the rules and underlying policies for sourcing
23 business and nonbusiness income are different. Moreover, respondent contends that UDITPA and the
24 Legislature frequently provide different rules for sourcing business and nonbusiness income and,
25 therefore, R&TC section 25136 may not be ignored on the ground the Legislature chose to adopt another
26 UDITPA provision for a different method of apportioning nonbusiness income. (Resp. Open. Br., pp. 7-
27 8.)

28 Respondent disputes appellant's position that New Mexico and Massachusetts have

1 statutory schemes similar to R&TC section 25136 and interpreted those provisions to mean that sales of
2 intangible property should be assigned to the location of where the customer uses the property. With
3 respect to the New Mexico case cited by appellant, respondent argues the decision is based on an
4 entirely different taxation scheme – the Gross Receipts and Compensating Tax Act – which is
5 completely different than UDITPA and California’s Franchise and Income Tax Act. (Resp. Open. Br.,
6 pp. 8-9.)

7 Respondent points out that there is an underlying published appellate opinion, *Kmart*
8 *Props., Inc. v. Taxation & Revenue Dep’t* (2001) 131 P.3d 27, in which Kmart transferred trade names
9 and trademarks to KPI, an intangible holding company, which licensed the trademarks back to Kmart in
10 return for royalty fees. All of KPI’s employees and tangible personal property were located in Michigan
11 and New Mexico assessed KPI with income and gross receipts taxes based on Kmart’s operations in
12 New Mexico. Although KPI did not have physical presence in New Mexico, the court held that the state
13 could assess both income and gross receipts tax³. Respondent contends that the court’s assignment of
14 sales to New Mexico was based on the state’s equitable authority pursuant to a statute similar to R&TC
15 section 25137, based on an analysis of the nature of trade names and trade marks, which is readily
16 distinguishable from the facts of this appeal. The court found that the royalties Kmart paid to KPI for
17 the use of Kmart trademarks and trade names should be assigned to New Mexico under that equitable
18 authority to modify an apportionment formula. The court also found that Kmart’s payroll and property
19 were determined not to be income-producing activities that resulted in the sales in question and were
20 excluded altogether from the apportionment formula as having little or no bearing on KPI’s business
21 activity. By contrast, respondent contends that appellant’s sales are derived from use of patent rights
22 and that the court held such rights are far different than trade marks and trade names and thereby implied
23 that such sales would be assigned differently. Based on the foregoing, respondent argues that the Kmart
24 decision does not support appellant’s position that appellant’s royalty and licensing fees should be
25 assigned to the customers’ locations. (Resp. Open. Br., pp. 9-11.)

26 Respondent contends that the Massachusetts statute and regulation are completely
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³ The New Mexico Supreme Court reversed the holding with respect to the assessment of the gross receipts tax.

1 different than R&TC section 25136 and Regulation 25136 in that Massachusetts law specifically
2 provides for the assignment of sales of intangible property which is defined as, *inter alia*, copyrights,
3 patents, trademarks and trade names, whereas California has only a general provision for assignment of
4 sales other than tangible personal property. Respondent also points out that under the Massachusetts law
5 the intangible sales will be assigned to Massachusetts to the extent the property is used in that state.
6 (Resp. Open. Br., pp. 12-13.)

7 Respondent also addresses appellant's discussion of respondent's citation of the *Appeal*
8 *of Adobe Systems, Inc.* in which appellant concludes that case is inapplicable here because it focused on
9 the assignment of activity in more than one location whereas in this case the income-producing activity
10 occurs in only one location, i.e., where the licensed technology is delivered and used. Respondent
11 contends that appellant again misinterprets R&TC section 25136 and Regulation 25136 and thereby
12 misconstrues *Appeal of Adobe Systems, Inc.* because the determination in that case is consistent with the
13 statutory scheme and with respondent's determination here. Specifically, respondent contends that
14 appellant's receipts from licensing its products are properly sourced to California because the greater
15 proportion of appellant's costs associated with licensing were incurred in California. (Resp. Open. Br.,
16 pp. 13-14.)

17 Appellant's Reply Brief

18 Appellant contends that respondent's application of R&TC section 25136 does not give
19 effect to the purpose and language of that section and its regulations. Appellant states that respondent,
20 without presenting any analysis or evidence, mischaracterizes the language of R&TC section 25136 as
21 clear and unambiguous and wrongly describes appellant's interpretation of that section as unreasonable.
22 Appellant contends that its interpretation of R&TC section 25136 is consistent with the plain language,
23 and the context and intent of that section. Specifically, appellant argues that the language provides that
24 receipts must be sourced to the location of the "income-producing activity", rather than, as respondent
25 argues, "assign[ing] intangible property based on the taxpayer's income-producing activity determined
26 by the taxpayer's greater costs of performance." For licensed intangible property, appellant argues that
27 the income-producing activity occurs only at a location where the property is licensed and delivered to
28 the licensee which is consistent with the treatment of other rented or licensed property. (App. Reply Br.,

1 pp. 2-3.)

2 Appellant also contends that the language of R&TC section 25136 is not clear, hence the
3 rules of statutory construction relied on by respondent have no application. Due to the ambiguity in the
4 language, appellant argues that the language must be construed in the manner that most closely comports
5 with the apparent intent of the Legislature to promote the general purpose of the statute and avoid an
6 interpretation that would lead to absurd consequences. Appellant further argues that respondent's
7 application of R&TC section 25136 must be examined to determine whether it leads to absurd results in
8 light of the fact numerous authorities stressed the market-based intent behind the UDITPA sales factor
9 and California courts and the Board recognize the sales factor was intended to reflect the contribution of
10 the marketplace. Appellant contends the property and payroll factors reflect the contribution of
11 manufacturing states where the bulk of planning, engineering and other service functions occur while
12 the sales factor gives weight to the marketplace for the taxpayer's goods and services, which are
13 elements not reflected in the property and payroll factors. Thus, appellant contends that respondent's
14 position (that costs of performance rules require assignment of nearly 100 percent of appellant's royalty
15 and licensing revenue to California) fails to account for the contribution of the marketplace and, thereby,
16 defeats the purpose and intent of R&TC section 25136. (App. Reply Br., pp. 3-5.)

17 Appellant asserts that as a fundamental rule of construction the provisions of a statute
18 must be construed together and considered as a whole. Consistent with those principles, appellant
19 contends that the emphasis on the term "use" in subdivisions (b)(2), (b)(3), and (b)(4) of Regulation
20 25136, in determining where the "income-producing activity" occurs indicates that Regulation 25136
21 focuses the sourcing inquiry on the location of use. Because the use of intangible property generally
22 occurs within the market state, appellant concludes that its interpretation comports with the purpose and
23 intent of R&TC section 25136. Appellant argues that respondent's argument in refutation of this
24 position construes the provisions of Regulation 25136 in isolation and is inconsistent with the intent of
25 the sales factor and elevates form over substance "by applying fundamentally different sourcing regimes
26 to the types of property listed under that regulation." (App. Reply Br., pp. 6-7.)

27 With respect to respondent's distinction between the sourcing rules for business and
28 nonbusiness income under R&TC sections 25136 and 25127, respectively, appellant argues that those

1 sections, which are parts of the same act, must be harmonized and construed together under the rules of
2 statutory construction. For that reason, appellant argues that even if the statutes are different they must
3 still be read in conjunction with each other and in view of the general purpose of the overall statutory
4 scheme, which is to properly reflect the revenue attributable to each market state. Appellant adds that,
5 even assuming respondent's interpretation is reasonable, that interpretation must give way to appellant's
6 equally reasonable interpretation because it has long been the policy of the California courts to favor the
7 taxpayer's interpretation to the extent the statutory language is ambiguous. (App. Reply Br., pp. 7-8.)

8 Appellant takes issue with respondent's assertion the *Kmart* court implied that sales of
9 trademark and trade name rights would be treated differently than sales of patent rights and appellant
10 contends that respondent misunderstands the court's distinction between patents and trademarks.
11 Appellant argues that the court's discussion of the distinction between patents and trademarks was in the
12 context of the court's discussion of the Commerce Clause nexus issue to underscore the fact that, unlike
13 a patent, a trademark is not a separate property right from its goodwill and both are bound to the
14 business that generates the goodwill. Thus, according to appellant, the court concluded that KPI, the
15 company that owned the trademarks and licensed them to Kmart, had requisite contacts with New
16 Mexico based on Kmart's activities in the state coupled with the tangible presence of KPI's trademarks.
17 Appellant contends that the foregoing explanation demonstrates that the *Kmart* court made the
18 distinction solely to "highlight" KPI's contacts with New Mexico and had no bearing on the assignment
19 of sales and equitable apportionment issue. In addition, appellant contends that respondent makes the
20 "simplistic" argument that the Massachusetts statute and regulation cited by appellant are irrelevant
21 because they are different than R&TC section 25136 and Regulation 25136. Appellant asserts that it
22 cites those provisions for the sole purpose of showing how other states construe statutory language that
23 mirrors California's sourcing language for "sales other than sales of tangible personal property." In that
24 respect, appellant contends that other states' experience provides useful guidance and indicates that
25 appellant's interpretation of the California provisions is not unreasonable. (App. Reply Br., pp. 8-11.)

26 Appellant argues that respondent's reliance on *Adobe Systems* is misplaced and that
27 appeal may not be cited as precedent under the Board's rules. Appellant points out that in *Adobe*
28 *Systems* the taxpayer's income-producing activities occurred in multiple locations so the Board

1 performed an “activity-by-activity costs of performance analysis” before concluding all the income was
2 properly sourced to California. By contrast, appellant argues this appeal presents no costs of
3 performance issue because appellant’s income-producing activity occurs in only one location, the
4 location of use. Moreover, appellant argues that the *Adobe Systems* decision is inconsistent with *The*
5 *Limited Stores, Inc. et al. v. Franchise Tax Bd.* (2007) 152 Cal.App.4th 1491, in which the court of
6 appeal rejected the taxpayer’s position that gross receipts from the sale of short term investments should
7 be included in the sales factor because, the court held, such a method “significantly understates
8 California’s contribution as a market” for the taxpayer’s retail sales. (App. Reply Br., pp. 11-12.)

9 Respondent’s Reply Brief

10 Respondent contends that appellant’s argument that licensing and delivery of the
11 intangible property is the only income-producing activity and that this activity occurred at the location
12 of use of the property is inconsistent with Regulation 25136. Specifically, respondent contends that
13 appellant’s position fails to include all of the activities, such as R&D, that are necessary to produce that
14 property. Respondent points to subdivision (b) of Regulation 25136 which provides that income-
15 producing activity includes all activities that the taxpayer engages in “for the ultimate purpose of
16 obtaining gains or profit”. Respondent further contends that there is no legal authority to support
17 appellant’s position that licensing and delivery of the end-product is the sole income-producing activity
18 that generates a sale of appellant’s intangible property. (Resp. Reply Br., pp. 3-4.)

19 Respondent contends that R&TC section 25136 and Regulation 25136 are not market-
20 based rules and even if one were to assume they are market-based rules it is not clear how one would
21 determine the location of use. Respondent further contends that appellant incorrectly reasons that the
22 rules for sourcing intangible property and tangible property must be consistent. Respondent points out
23 the general rule is intangible property is assigned based on the income-producing activity/greater costs
24 of performance rule as that activity is defined by the regulation. Respondent asserts that appellant seeks
25 to limit that general assignment rule by the special rules for real property and tangible personal property
26 set forth in subdivision (d)(2) of Regulation 25136. In reaching that conclusion, respondent argues,
27 appellant ignores the open-ended language of subdivision (b) which provides that there is no limitation
28 on the scope of income-producing activities under the general rules and the special rules do not apply to

1 intangible property. (Resp. Reply Br., pp. 4-5.)

2 Respondent contends that appellant's position vitiates the statute and regulation such that
3 costs of performance would be irrelevant for all sales of intangible property because assignment of such
4 sales would be reduced to a determination of the location of customer use of the intangible property.
5 Respondent asserts that the focus of the statute and regulation always has been on the taxpayer's
6 income-producing activity that generated the sale. Respondent further asserts this principle was upheld
7 in the *Appeal of Mark IV Metal Products, Inc.* (82-SBE-181), decided August 17, 1982 (*Mark IV*), in
8 which this Board held that all the sales of a metal fabrication business were properly assigned to
9 California even though one of the appellant's principal customers was located in Texas. The Board
10 found the income-producing activity was the fabrication of metal seats which took place in California so
11 the sales were all California sales even though the fabricated seat parts were used by the customer in
12 Texas. Respondent argues the result in this appeal should be consistent with the *Mark IV* decision
13 because the income-producing activity is the R&D that occurred in California. (Resp. Reply Br., pp. 6-
14 7.)

15 Respondent also contends that, assuming appellant's position is correct, it is not
16 necessarily true that the "location of the use" is the place where the customers used the technology to
17 manufacture their products. Respondent notes that the states that employ a market-based rule do not
18 have a uniform definition of the location of the use. As examples, respondent states that use could be
19 deemed to occur at the headquarters or domicile of appellant's customers, rather than the location of the
20 manufacturing. Because California did not have a market-based rule for the years in issue, respondent
21 contends that it is not possible to know how the Legislature would intend to assign sales of intangible
22 property based on location of use. (Resp. Reply Br., pp. 7-8.)

23 Respondent contends that appellant wrongly relies on two Board formal decisions
24 (*Appeal of The Babcock & Wilcox Company*, 78-SBE-001, Jan. 11, 1978 and *Appeal of Finnigan*
25 *Corporation*, 88-SBE-022-A, Jan. 24, 1990) that decided issues related to the application of R&TC
26 section 25135, which is a market-based rule for assignment of sales of tangible personal property.
27 Respondent argues that R&TC section 25136 is "markedly different" than R&TC section 25135, so
28 those appeals are not applicable. As further evidence that R&TC section 25136 currently is not a

1 market-based rule, respondent points out a legislative change (SBX3 15) was necessary to enact the
2 market-based sourcing that goes into effect for tax years beginning on or after January 1, 2011. (Resp.
3 Reply Br., pp. 8-9.)

4 Respondent rejects the premise of appellant's argument that, as a fundamental rule of
5 statutory construction, all of the parts of the R&TC section 25136 and all of the parts of California's
6 UDITPA provisions must be harmonized. From that premise, appellant argues that sales of intangible
7 property must be assigned to the market state in order to harmonize all provisions of R&TC section
8 25136, and to harmonize R&TC section 25136 with R&TC section 25127. Respondent contends that in
9 many instances, the various parts of a statute or act may have different, and sometimes contrary,
10 purposes. As examples of those different or contrary purposes, respondent points out that under R&TC
11 section 25129, tangible personal property is included in the property factor but intangible property is
12 not, and under R&TC section 25132 payments to employees are included in the payroll factor but
13 payments to independent contractors are not. Respondent further argues that dissimilar treatment for
14 different items is not inconsistent with the purposes of UDITPA so the fact that there are two different
15 rules for sales of two different types of property does not mean one of the rules is inconsistent with
16 UDITPA. (Resp. Reply Br., pp. 9-10.)

17 With respect to appellant's discussion of *Adobe Systems*, respondent contends there is no
18 material basis for distinguishing the facts in that case from those presented here. First, respondent states
19 that appellant's income-producing activities occurred predominantly in California where appellant's
20 R&D of the technology took place. Secondly, respondent contends that it is immaterial that the income-
21 producing activities took place in one state, rather than in various states as in *Adobe Systems*, because
22 under R&TC section 25136 sales are assigned based on the location of the taxpayer's income-producing
23 activities rather than the location of use. In addition, respondent contends that *Adobe Systems* is not
24 inconsistent with *The Limited*, because the latter case involved the issue of whether the circumstances
25 warranted R&TC section 25137 relief, and "did not offer an opinion on the mechanics" of R&TC
26 section 25136 or Regulation 25136. (Resp. Reply Br., pp. 11-12.)

27 Applicable Law

28 Generally, the UDITPA requires that a taxpayer's unitary "business income" be

1 apportioned by means of a three-factor formula composed of property, payroll, and sales factors. (Rev.
2 & Tax. Code, § 25128.) The sales factor is defined as, “a fraction, the numerator of which is the total
3 sales of the taxpayer in this state during the income year, and the denominator of which is the total sales
4 of the taxpayer everywhere during the income year.” (Rev. & Tax. Code, § 25134.) The term “sales”
5 means “all gross receipts of the taxpayer,” and includes gross receipts from the licensing of intangible
6 personal property. (Cal. Code Regs., tit. 18, § 25134, subd. (a)(1)(E).)

7 Pursuant to R&TC section 25136, for taxable years prior to January 1, 2011, sales of
8 intangible personal property take place in California if:

9 (a) [t]he income-producing activity is performed in this state; or

10 (b) [t]he income-producing activity is performed both in and outside this state and a
11 greater proportion of the income-producing activity is performed in this state than in any
12 other state, based on costs of performance.”

13 Regulation 25136, subdivision (b) defines “income producing activity” as “the transactions and activity
14 directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose
15 of obtaining gains or profit” which “applies to each separate item of income”. Such activity includes
16 “[t]he sale, licensing or other use of intangible personal property.” (Cal. Code Regs., tit.18, § 25136,
17 subd.(b)(4).) Regulation 25136, subdivision (c) defines “costs of performance” as “direct costs
18 determined in a manner consistent with generally accepted accounting principles and in accordance with
19 accepted conditions or practices in the trade or business of the taxpayer.”

20 Senate Bill 15 (SB X3 15) repealed the current version of R&TC section 25136 for
21 taxable years beginning on and after January 1, 2011 and added a new R&TC section 25136 effective
22 for those taxable years. The new version of R&TC section 25136 provides, in relevant part, that “[f]or
23 taxable years beginning on or after January 1, 2011: (a) Sales, other than sales of tangible personal
24 property, are in this state as follows: . . . (2) Sales from intangible property are in this state to the extent
25 the property is used in this state.”

26 The fundamental purpose of statutory interpretation is to determine the Legislature’s
27 intent so as to effectuate the law’s purpose. First, the words of the statute are examined and given a
28 plain and commonsense meaning. If the language is clear and unambiguous there is no need for

1 construction or for an examination of extrinsic evidence of legislative intent. (*Lungren v. Deukmejian*
2 (1988) 45 Cal.3d 727, 735.) If there is ambiguity, then extrinsic sources may be consulted, including the
3 objective of the legislation and the legislative history. In that event, the language is to be construed in a
4 manner that “comports most closely with the apparent intent of the Legislature, with a view to
5 promoting rather than defeating the general purpose of the statute, and avoid an interpretation that would
6 lead to absurd consequences.” (*Estate of Griswold* (2001) 25 Cal.4th 904, 911.)

7 “But the ‘plain meaning’ rule does not prohibit a court from determining whether the
8 literal meaning of a statute comports with its purpose or whether such a construction of one provision is
9 consistent with other provisions of the statute. The meaning of a statute may not be determined from a
10 single word or sentence; the words must be construed in context, and provisions relating to the same
11 subject matter must be harmonized to the extent possible.” (*Lungren v. Deukmejian, supra* at 735.)
12 Additionally, whenever possible, every word and clause of a statute must be given effect so that no part
13 or provision will be useless or meaningless, and none of its language rendered surplusage. (*Briggs v.*
14 *Eden Council for Hope & Opportunity* (1999) 19 Cal.4th 1106, 1118.)

15 It is assumed that statutory amendments have a purpose and “[g]enerally, a substantial
16 change in the language of a statute or constitutional provision by an amendment indicates an intention to
17 change its meaning.” (*Mosk v. Superior Court* (1979) 25 Cal.3d 474, 493.)

18 STAFF COMMENTS

19 It appears that the parties’ disagreement over the correct interpretation of the plain
20 language meaning of R&TC section 25136 and Regulation 25136 is focused on two points: (1) the
21 specific activities that constitute the income-producing activities relevant to determining where the sales
22 of intangible property are properly assigned; and (2) whether those income-producing activities are
23 consistent with the market-based intent behind the sales factor provisions of UDITPA.

24 Respondent argues that the relevant “income-producing activities” that generate the
25 receipts from the licensing and royalty agreements, i.e., the subject intangible property, are appellant’s
26 R&D activities necessary to develop the subject intangible property, the work of the patent and
27 intellectual property attorneys, and other activities conducted at appellant’s headquarters, all of which
28 are located in California. Appellant argues that subdivision (b)(4) of Regulation 25136, which lists “the

1 sale, licensing, or *other use* of intangible personal property” (italics added) as an example of “income-
2 producing activity” indicates that the location of the customer’s use of the subject intangible property
3 licensed by appellant is the location for purposes of sourcing appellant’s “income-producing activities”.
4 Consequently, appellant argues that none of the activities identified by respondent “are considered for
5 sourcing purposes because, consistent with the intent of UDITPA, the location of use controls.” (App.
6 Open. Br., p. 4.)

7 As stated above, for purposes of assigning gross receipts from “sales other than sales of
8 tangible personal property”, subdivision (a) of Regulation 25136 provides that:

9 gross receipts are attributed to this state if the income producing activity which gave rise
10 to the receipts is performed wholly within this state. Also, gross receipts are attributed to
11 this state if, with respect to a particular item of income, the income producing activity is
12 performed within and without this state but the greater proportion of the income
13 producing activity is performed in this state, based on costs of performance.

14 Subdivision (c) of Regulation 25136 defines “costs of performance” as “direct costs determined in a
15 manner consistent with generally accepted accounting principles and in accordance with accepted
16 conditions or practices in the trade or business of the taxpayer.”

17 Staff notes that the provision relied upon by appellant as support for its position that
18 gross receipts are properly sourced to the location of use, subparagraph (b)(4) of Regulation 25136, is
19 one of a non-exclusive list of four specified types of activities that constitute “income producing
20 activities”. However, the general attribution provisions of Regulation 25136, subdivision (a) indicate,
21 contrary to appellant’s position, that income producing activities with respect to intangible property (and
22 the other types of property) are not limited to the location of use. In addition, subparagraph (b)(4)
23 provides that an income producing activity includes the sale or licensing of intangible property which
24 may not occur at the location of the customer’s use. Thus, it appears to the Appeals Division that
25 appellant’s interpretation reads those terms out of the subparagraph and, thereby, makes them
26 inoperative. Finally, the costs of performance are defined as all direct costs of the taxpayer in the course
27 of the taxpayer’s business without specifying a particular location in which those costs are incurred.

28 At the hearing, appellant should be prepared to explain how its interpretation of
Regulation 25136 limiting income-producing activity to the location of the customer’s use can be
harmonized with the other provisions defining income-producing activity and costs of performance and

1 the specification of sales and licensing of intangible property as income-producing activity, which are
2 not limited by location of the customer's use. In addition, the parties should be prepared to explain
3 whether appellant's interpretation which focuses on the term "use" in subparagraph (b)(4) renders the
4 other terms "sale" and "licensing" useless.

5 With respect to the repeal of the current version of R&TC section 25136 and addition of
6 the R&TC section 25136 which is operative for tax years beginning January 1, 2011, the Appeals
7 Division notes that subdivision (a)(2) of new R&TC section 25136 specifically provides that sales from
8 intangible property are assigned to California "to the extent the property is used in this state." In the
9 view of the Appeals Division, that new provision appears to be consistent with appellant's position in
10 this appeal that, under the current version of R&TC section 25136, its receipts from the licensing and
11 royalty agreements should be assigned to the location of use. At the hearing, the parties should be
12 prepared to discuss whether the new provision, subdivision (a)(2) of new R&TC section 25136,
13 constitutes a substantial change in language which indicates an intention to change the meaning of the
14 R&TC section 25136.

15 **Question (2): Whether appellant has met its burden of proof to show that the standard**
16 **apportionment formula fails to reflect its activities in this state fairly and, for that reason,**
17 **appellant is entitled to use an alternate apportionment formula pursuant to R&TC section 25137**
18 **and, if so, whether appellant's proffered alternative is reasonable.**

19 Contentions

20 Appellant's Contentions

21 Appellant contends that R&TC section 25137, which is intended to remedy distortion of a
22 taxpayer's business activity, is applicable here because respondent's approach creates distortion "by
23 rotely misapplying RTC § 25136 and focusing on the administrative activities of [appellant's]
24 employees." Specifically, appellant asserts that respondent's sales factor apportionment is nearly 100
25 percent in California despite more than 50 percent of appellant's sales transactions occurring outside of
26 California. Appellant argues that "similar metrics" led the Supreme Court in *Microsoft Corp. v.*
27 *Franchise Tax Bd.* (2006) 39 Cal. 4th 750 (*Microsoft*), to "alter the application of the apportionment
28 formula . . . to more clearly represent the actual business activity in California." In this regard, appellant

1 argues that respondent may not use distortion to increase apportionment to California but “deny the
2 same application when the result would appropriately reduce the California income to reasonably reflect
3 the business activity in the state.” (App. Open. Br., p.6.)

4 Appellant further contends that respondent issued regulations providing for market
5 sourcing of certain items of income to cure the “anomaly” identified by appellant. Appellant cites two
6 regulatory provisions providing that (1) royalty fees for the use of a franchisor’s trademarks, trade name,
7 and service mark are attributed to the state in which the franchisee’s place of business is located and (2)
8 certain television broadcasting activities are sourced to the location of the audience. Appellant describes
9 the principle upon which these provisions are based as recognition that the location of the market is a
10 more reasonable reflection of the source of income derived therefrom. Appellant argues that the same
11 rule should apply here because it would not earn more than half its receipts if the marketplace outside of
12 California did not exist. (App. Open. Br., p.6.)

13 Appellant also cites *Appeal of Pacific Telephone and Telegraph Co.* (78-SBE-028),
14 decided on May 4, 1978 (*Pacific Telephone*), in which the Board held that, when analyzing the standard
15 for reasonable reflection of income, generally “the sales factor should reflect the markets for the
16 taxpayer’s goods or services since its purpose is to balance the property and payroll factors by giving
17 weight to elements of the business not reflected in those factors.” On that basis, the Board rejected the
18 position that “more than 11 percent of [the appellant’s] entire unitary business activities should be
19 attributed to any single state solely because it is the center of working capital investment activities”.
20 Appellant surmises that the AIPS’s and NPACA’s do not discuss the analysis because the proposed
21 adjustment unfairly represents the extent of appellant’s business activity in California which is precisely
22 the result *Pacific Telephone* was intended to avoid by proper application of UDITPA. (App. Open. Br.,
23 pp. 6-7.)

24 Respondent’s Contentions

25 Respondent contends that R&TC section 25137 is inapplicable because the
26 apportionment formula pursuant to R&TC section 25136 fairly represents appellant’s business in this
27 state and appellant’s proposed alternative formula is unreasonable. Respondent refers to appellant’s
28 reliance on *Microsoft* and summarizes appellant’s argument that, in that case, the court found that

1 Microsoft’s investment activity distorted the sales factor by focusing on “whether the rote application of
2 the apportionment formula reasonably reflects the income in the state.” Respondent states that appellant
3 correctly notes the receipts from Microsoft’s treasury function greatly exceeded the income generated
4 and had very different profit margins. However, respondent contends appellant does not understand that
5 the qualitative analysis of Microsoft’s ancillary treasury receipts compared with Microsoft’s primary
6 business receipts focused on the nature of the receipts and not on the function or operation of R&TC
7 section 25136 and Regulation 25136. Thus, respondent argues that appellant attempts to apply the
8 *Microsoft* analysis “without meeting its predicates, namely an ancillary function that, when included in
9 the sales factor, results in an unfair representation of the taxpayer’s business in the state.” (Resp. Open.
10 Br., pp. 14-16.)

11 Respondent distinguishes the facts in this case from *Microsoft* by pointing out that
12 appellant’s primary business is the development of technology and the royalties and licensing fees result
13 from sales made in the conduct of its primary business. Respondent concludes that no qualitative
14 distortion exists because appellant’s receipts are a result of appellant’s primary business as intended by
15 the operation of R&TC section 25136 and Regulation 25136. In addition, respondent contends that
16 appellant misreads *Microsoft* in the following ways:

- 17 • *Microsoft* did not involve the application of R&TC section 25136 which prescribes the method
18 for developing the sales factor numerator by determining the location to which the receipts are
19 assigned. Instead, *Microsoft* was concerned with developing the sales factor denominator by
20 determining the amount of the receipts in issue. Thus, the court made no finding regarding the
21 assignment of the receipts to a location because that was not an issue.
- 22 • R&TC section 25136 was not “rotely” applied here or in *Microsoft*. Respondent applied the law
23 to the facts, i.e., the income-producing activities and their costs of performance, to assign the
24 sales to the state with the greater costs of performance as UDITPA and the Legislature intended.
- 25 • R&D and legal activities are “income-producing activities”, and not ancillary “administrative
26 activities”, of appellant’s primary business that generate the bulk of appellant’s income.
- 27 • R&TC section 25136 and Regulation 25136 require that 100 percent of the sales be assigned to
28 California because the majority of the income-producing activities occurred in California and the

1 cost of performance rule is applied on an all or nothing basis.

- 2 • The facts here are completely distinguishable from the facts in *Microsoft* and, thus, do not
3 present “similar metrics”.

4 Finally, respondent contends that appellant has failed to meet its burden of proof by clear and
5 convincing evidence that the standard apportionment formula of R&TC section 25136 does not produce
6 incongruous results that require R&TC section 25137 relief. (Resp. Open. Br., pp. 16-17.)

7 Respondent also contends appellant misreads *Pacific Telephone* by stating that it stands
8 for the proposition that the sales factor should reflect the markets for the taxpayer’s goods or services
9 because its purpose is to balance property and payroll factors. Thus, appellant concludes that
10 respondent’s assignment of the sales to California where the R&D and legal activities occurred is
11 inconsistent with the Board’s decision in that case. However, respondent contends appellant misses the
12 following crucial points of that decision:

- 13 • The sales resulted from the taxpayer’s ancillary activities and not its main line of business.
14 • In that case, the Board made a qualitative and quantitative comparative analysis of all receipts.
15 • The Board’s focus was on the nature and amounts of the receipts and not on the operation of
16 R&TC section 25136 and Regulation 25136.
17 • The application of R&TC section 25136 and Regulation 25136 and whether such application was
18 contrary to the intent and purpose of UDITPA or the Legislature were not in issue.

19 (Resp. Open. Br., pp. 17-18.)

20 Respondent argues that the facts here are similar to those of the *Appeal of Merrill, Lynch,*
21 *Pierce, Fenner & Smith, Inc.* (89-SBE-017), decided on June 2, 1989 (*Merrill Lynch*), in which the
22 taxpayer bought and sold securities as its principal business both as an agent and as a principal. Most of
23 the taxpayer’s securities transactions as principal were conducted in New York, and were included in the
24 denominator of the sales factor but not the California numerator. The Board rejected respondent’s
25 justification for the application of R&TC section 25137 based on respondent’s position that its
26 alternative method was “better” than the standard formula. In order for respondent to prevail, the Board
27 held, respondent must show that appellant’s business activity in California was not fairly reflected by the
28 standard formula. The Board held that respondent failed to make such a showing. (Resp. Open. Br.,

1 pp. 18-19.)

2 Here, respondent contends, appellant makes the same argument that its proposed
3 alternative method is “better” because it reflects a market-based approach. In this regard, respondent
4 states that *Merrill Lynch* makes several important points relevant to this appeal:

- 5 • A large fluctuation in the sales factor percentages based on differences in the standard formula
6 and proposed alternative formula does not merit application of R&TC section 25137 absent a
7 showing of unusual circumstances.
- 8 • The argument that an alternative method is “better” than the standard formula is not a sufficient
9 basis by itself for application of R&TC section 25137.

10 Because appellant has not shown any unusual facts that produce incongruous results, respondent
11 contends that R&TC section 25137 is inapplicable. Furthermore, respondent contends, by seeking to
12 substitute its judgment for the drafters of the UDITPA and the Legislature, appellant’s proposed
13 alternative formula is unreasonable on its face. (Resp. Open. Br., p.19-20.)

14 With respect to appellant’s citation of the provisions under Regulation 25137 that include
15 market-sourcing provisions for specific industries, such as Regulation 25137-3(b)(2)(B), respondent
16 contends that none of them apply to the facts here. Respondent asserts that appellant is not seeking the
17 application of an industry-specific rule but rather the complete override of the statutory authority for the
18 sourcing of royalties and licensing fees regardless of industry. Finally, respondent contends appellant’s
19 argument that R&TC section 25137 relief is necessary to avoid double-taxation was rejected by the U.S.
20 Supreme Court in *Container Corp. of Am. v. Franchise Tax Bd.* (1983) 463 U.S. 159. There, the
21 Supreme Court held that a method of formula apportionment that “inevitably” led to double taxation
22 might be sufficient to render the method suspect, but the fact that a method sometimes results in double
23 taxation is not. (Resp. Open. Br., p. 20.)

24 Appellant’s Reply Brief

25 Appellant argues that respondent misreads *Microsoft, Pacific Telephone, Merrill Lynch*
26 and other sales factor distortion decisions that address the prerequisites for distortion under R&TC
27 section 25137. Appellant asserts that those cases do not stand for the proposition that only receipts
28 generated from ancillary or incidental business activities “can cause distortion or be excluded from the

1 sales factor”. Rather, appellant contends that they “merely hold that, where the inclusion of certain
2 receipts in the apportionment formula leads to an unfair reflection of business activity in the state, as
3 would be the case here if respondent’s application of section 25136 is accepted, an alternative formula
4 under R&TC section 25137 is justified.” (App. Reply Br., pp. 1-2.)

5 If the Board concludes that R&TC section 25136 assigns 100 percent of the royalty and
6 licensing fee income to the California numerator of the sales factor, appellant contends that R&TC
7 section 25137 relief is appropriate because the formula would not fairly represent the extent of
8 appellant’s business activity in California. Appellant contends that respondent’s argument against the
9 application of R&TC section 25136 does not address the unfairness of 100 percent sourcing to
10 California when a significant portion of that income was generated elsewhere. In addition, appellant
11 argues that, contrary to respondent’s position, the *Microsoft* court made clear that R&TC section 25137
12 applied not only to unique, nonrecurring situations. Appellant also asserts that it presented clear and
13 convincing evidence of distortion by offering a quantitative analysis of the unfair representation cause
14 by R&TC section 25136. (App. Reply Br., pp. 12-14.)

15 Appellant argues that the distinction drawn by the *Microsoft* court between “core
16 business” receipts and “ancillary” receipts does not render that case inapplicable to the facts in this
17 appeal. Appellant explains the court performed a “qualitative” and a “quantitative” review of
18 Microsoft’s business activities. Appellant asserts the qualitative review concerned distinguishing the
19 ancillary treasury department functions from the core business functions which resulted in the court
20 excluding the ancillary receipts as distorting the sales factor because there was no correlation between
21 the amount of receipts and the amount of income from intangible investments. Appellant concludes that
22 the existence of ancillary business receipts was merely a circumstance warranting relief of R&TC
23 section 25137. Appellant argues that respondent’s narrow reading of the *Microsoft* decision leads
24 respondent to conclude erroneously that appellant has failed to demonstrate qualitative distortion
25 because the receipts in issue are from appellant’s primary business. Appellant contends that
26 respondent’s conclusion limits distortion claims to situations in which “ancillary” receipts exist which is
27 contrary to the Board’s decision in *Appeal of Crisa Corporation* (2002-SBE-004), decided June 20,
28 2002 (*Crisa*). (App. Reply Br., pp. 14-16.)

1 Finally, appellant takes issue with respondent’s argument that *Microsoft* is
2 distinguishable from this appeal because in *Microsoft* only the amount of the receipts was in issue and
3 not the assignment of receipts pursuant to R&TC section 25136. Appellant argues the *Microsoft* simply
4 holds “where the inclusion of certain receipts in the apportionment formula leads to an unfair reflection
5 of business activity in the state, such inclusion is inappropriate.” Thus, appellant contends the holding
6 applies to both the composition of gross receipts for purposes of R&TC section 25120 and to “sales
7 other than sales of tangible personal property” for purposes of R&TC section 25136. (App. Reply Br.,
8 pp. 16-17.)

9 Respondent’s Reply Brief

10 Respondent takes issue with appellant’s argument that respondent improperly limits the
11 scope of *Microsoft* and *Crisa* and, by extension, R&TC section 25137. Respondent argues that in
12 *Microsoft* the finding that the treasury function activities were qualitatively different from Microsoft’s
13 main business activities and the distinction the court drew between those facts and the facts in *Merrill*
14 *Lynch* indicate “the unusual facts and circumstances that warranted R&TC section 25137 relief were the
15 existence of an ancillary business function which gave rise to substantial gross receipts.” By contrast,
16 respondent argues, the receipts in issue here are not qualitatively different from receipts of appellant’s
17 principal business. Furthermore, contrary to appellant’s position, respondent argues the *Microsoft* court
18 did not hold that unusual facts and circumstances are no longer required for R&TC section 25137 relief.
19 Rather, the court only stated the section “ordinarily applies to nonrecurring situations” but said nothing
20 that would alter the requirement that unusual facts or circumstances that make the standard
21 apportionment formula distortive are present. (Resp. Reply Br., pp. 12-14.)

22 Respondent also quotes language from *Crisa* stating that section 25137 is applicable
23 when the standard UDITPA apportionment provisions “produce inequitable results when applied to
24 unusual fact situations.” Respondent asserts the only facts and circumstances claimed by appellant to be
25 unfair and unusual is the general application of R&TC section 25136 to appellant’s main business
26 activity receipts as intended by UDITPA and the Legislature. However, respondent contends those facts
27 and circumstances are not unusual, do not create unfairness under the standard apportionment formula,
28 and do not create distortion within the meaning of R&TC section 25137. (Resp. Reply Br., pp. 14-15.)

1 Finally, respondent contends that appellant's citation of other states' statutes and
2 regulations is irrelevant to an interpretation of R&TC section 25136 for one or some combination of the
3 following reasons:

- 4 • The other states' laws do not provide for an income-producing activity/greater costs of
5 performance rule as does R&TC section 25136 and Regulation 25136.
- 6 • The other states' rules specifically apply to patent and/or royalty or similar agreements unlike
7 R&TC section 25136 and Regulation 25136.
- 8 • The other states' rules are market-based for all intangibles unlike R&TC section 25136 and
9 Regulation 25136. (Resp. Reply Br., pp. 15-16.)

10 Applicable Law

11 R&TC section 25137 provides that, if the standard UDITPA allocation and
12 apportionment provisions "do not fairly represent the extent of the taxpayer's business activity" in
13 California, then respondent may require, or the taxpayer may request, modification of the standard
14 provisions so as to "effectuate an equitable allocation and apportionment of the taxpayer's income."
15 R&TC section 25137 provides what might be thought of as a "safety valve" that potentially applies if
16 special circumstances make it unfair to apply the standard apportionment and allocation provisions.
17 Thus, when R&TC section 25137 applies, a taxpayer's apportionment percentage may be determined
18 using allocation and apportionment rules that differ from the standard allocation and apportionment
19 rules. Under the authority of R&TC section 25137, respondent has promulgated Regulation 25137
20 which provides, in part, that Section 25137 "permits a departure from the allocation and apportionment
21 provisions of the [UDITPA] only in limited and specific cases" and "may be invoked only in specific
22 cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce
23 incongruous results under the apportionment and allocation provisions contained in these regulations."

24 Taxpayers are entitled to rely upon respondent's UDITPA regulations and respondent is

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1 bound to apply those regulations. (*Appeal of Union Carbide Corporation*, 84-SBE-057, April 5, 1984.)⁴
2 Thus, if a party wishes to depart from a UDITPA regulation, where the regulation applies by its terms,
3 that party must prove the existence of distortion. (*Appeal of Fluor Corporation*, 95-SBE-016, Dec. 12,
4 1995.) Proving distortion requires a qualitative analysis of the relationship between the apportionment
5 formula and the taxpayer’s business activities. (*Appeal of Crisa Corporation, supra.*) Deviation from
6 the apportionment formula is not authorized merely because a party has presented a “better” or more
7 “reasonable” approach – the party wishing to deviate from the formula must demonstrate distortion.
8 (*Appeal of New York Football Giants, Inc.*, 77-SBE-015, June 28, 1979.) The California Supreme Court
9 has stated that the party invoking that section has the burden of proving by clear and convincing
10 evidence that: (1) the approximation provided by the standard formula is not a fair representation of the
11 taxpayer’s business activity in California; and (2) its proposed alternative is reasonable. (*Microsoft*
12 *Corporation v. Franchise Tax Board, supra*, 39 Cal.4th at p. 765.)

13 In the *Appeal of Fluor Corporation, supra*, the Board held the standard apportionment
14 formula to be generally applicable, unless the party seeking to depart from the standard formula could
15 prove that such formula did not fairly represent the taxpayer’s business activities in the state. However,
16 if the regulations specifically provide a relevant special formula and the conditions and circumstances
17 delineated in the regulations are satisfied, the special apportionment method must be applied. On the
18 other hand, any party wishing to deviate from the method prescribed in the regulations must first
19 establish by clear and convincing evidence that the special formula does not fairly represent the extent of
20 the taxpayer’s activities in this state.

21 In *Pacific Telephone, supra*, the Board considered whether the sales factor should include
22 the gross receipts from the sale or redemption of certain interest-bearing and discount securities. Pacific
23 Telephone and Telegraph (PT&T) was a member of an integrated nationwide group of telephone
24 companies known as the Bell System, all of which were engaged in a unitary communications business.

26 ⁴ Shortly after *Union Carbide Corporation*, the Board reached an apparently inconsistent conclusion in the *Appeal of*
27 *Triangle Publications* (84-SBE-096), decided on June 27, 1984 (*Triangle Publications*). In *Triangle Publications*, the Board
28 held that, to the extent a UDITPA regulation conflicts with the standard apportionment formula, the regulation is applicable
only upon a showing of distortion in the standard formula. However, in *Fluor Corporation*, the Board expressly overruled
that portion of *Triangle Publications*.

1 A number of the unitary companies maintained pools of working capital, which pending their use in the
2 unitary business were invested in short-term, interest-bearing and discount securities, such as U.S.
3 Treasury bills, other obligations of federal, state and local governments, bank certificates of deposit, and
4 various commercial paper. The largest pool of these funds was maintained and managed by a treasury
5 department of American Telephone and Telegraph (AT&T) in New York.

6 Respondent took the position that including the receipts in the denominator of the sales
7 factor would not fairly represent the extent of PT&T's communications business activity in California.
8 Respondent argued that the inclusion in the sales factor of the "gross receipts" from the investment
9 activities would result in the investment activities of AT&T, which were incidental to the Bell System's
10 communications business, causing an unreasonable apportionment of the Bell System's income to New
11 York. Specifically, respondent conceded that the interest or yield generated by the investments should
12 be included in the sales factor and to exclude only the capital element of the investment. Respondent
13 backed up its distortion claim by showing that inclusion of both capital investment and yield, when
14 added to the Bell System's other business income, constituted on average 36 percent of the business
15 income, which treated approximately one-third of the Bell System's total sales as occurring in New
16 York. Further, the effect of the sales factor on the apportionment formula resulted in assigning to New
17 York approximately 11 percent of the Bell System's entire business income.

18 The Board concluded that respondent satisfied its burden of proof by demonstrating the
19 standard apportionment formula yielded an unreasonable result. In its analysis, the Board observed that
20 the sales factor should reflect the markets for the taxpayer's goods or services, since the purpose of the
21 sales factor is to balance the property and payroll factors by giving weight to elements of the business
22 not reflected by those factors. The Board thus held that inclusion of the "enormous volume of
23 investment receipts substantially overloads the sales factor in favor of New York, and thereby
24 inadequately reflects the contributions made by all the other states, including California, which supply
25 the markets for the communications services provided by Pacific and its affiliates." Further, the Board
26 rejected the "notion that more than 11 percent of the Bell System's entire unitary business activities
27 should be attributed to any single state solely because it is the center of working capital investment
28 activities that are clearly only an incidental part of one of America's largest, and most widespread,

1 businesses.” (Emphasis in original.)

2 In its holding, the Board rejected PT&T’s argument that the pools of working capital
3 played a central role in the financial operations of the unitary business, and thus should be given weight.
4 In doing so, the Board expressed “serious doubts . . . whether the turnover of assets in those pools has
5 any value to the unitary business beyond the income that it generates directly.” Finally, the Board
6 recognized that the contribution made by the pools was reflected in the payroll factor, which included
7 the payroll attributable to the treasury department employees, and in the sales factor, which respondent
8 conceded should include the income element of the investment receipts.

9 In *Merrill Lynch, supra* the Board considered two issues: 1) Whether respondent met its
10 burden of proving that the statutory apportionment formula did not fairly reflect Merrill Lynch’s
11 business activity in state; and 2) whether interest income arising from margin account contracts made by
12 California customers with Merrill Lynch’s New York office was includible in the California numerator
13 of the sales factor. Merrill Lynch, with its affiliates, conducted a single worldwide unitary financial
14 services business. In some of its securities transactions, Merrill Lynch acted as a broker, buying and
15 selling securities in the open market for customers, and earning a commission on the sales. In other
16 transactions, Merrill Lynch traded securities as a principal or underwriter, purchasing securities for its
17 own account and remarketing them. Most of Merrill Lynch’s California sales were brokerage sales and
18 the company included only the commission income in gross receipts for purposes of the numerator of
19 the sales factor. With respect to Merrill Lynch’s principal transactions, most of those occurred in New
20 York and the company included the gross receipts, including the capital element, from these transactions
21 in the denominator of the sales factor. Respondent argued this method of accounting for gross receipts
22 underweighted the brokerage sales in California and overweighted the principal sales in New York. For
23 that reason, respondent sought to apply R&TC section 25137 to adjust the sales factor by using only
24 gross profits from both sales in the factor.

25 In its decision, the Board observed the three factors of the apportionment formula balance
26 each other, each reflecting a different contribution to the business activity and income of the unitary
27 business as a whole. The Board concluded that distortion of a single factor may not necessarily result in
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1 an unfair reflection of the business activity in the state.⁵ From that premise, the Board formulated the
2 relevant rule as “whether distortion must be shown in all or just one of the factors will depend upon the
3 ultimate distortive effect that occurs when all three factors are considered in combination.” In applying
4 this rule, the Board found that the sales factor was not sufficiently distortive to cause the entire formula
5 to unfairly represent Merrill Lynch’s activities in the state. Specifically, the Board disagreed with
6 respondent’s conclusion that Merrill Lynch’s brokerage transactions were virtually identical to its
7 principal or underwriting transactions, but merely treated differently by Merrill Lynch. The Board also
8 rejected respondent’s calculations in support of its argument of distortion, finding that respondent’s
9 main support was that its results differed from the statutory formula results and respondent’s
10 calculations resulted in a lower denominator and higher numerator.

11 The Board adopted the standards articulated by the United States Supreme Court in
12 decision upholding the standard apportionment formula against constitutional challenges such that the
13 standard formula merely needed to provide a “rough approximation” of the income attributable to the
14 taxing state and that a substantial margin of error is inherent in any method of apportionment. Thus, the
15 Board held the more precise method proposed by respondent did not justify deviation from the statutory
16 apportionment formula if the statutory apportionment formula fairly reflects the taxpayer’s business
17 activity in the state. In reaching its conclusions, the Board specifically distinguished *Pacific Telephone*
18 as involving an incidental part of appellant’s unitary business, while *Merrill Lynch* concerned a
19 fundamental segment of the financial services provided by the taxpayer. The Board also held that
20 respondent did not make a showing of distortion in *Merrill Lynch* as it had in *Pacific Telephone*.

21 STAFF COMMENTS

22 Appellant argues that the standard sales factor formula of R&TC section 25136 and
23 Regulation 25136 does not fairly represent the extent of its business activity in California because most
24 of its licensed technology is used by customers located outside of California. Appellant contends that
25 R&TC section 25136 is unfair because nearly 100 percent of appellant’s sales are assigned to California
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27 ⁵ In support of this conclusion, the Board cited *Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159,
28 183, in which the United States Supreme Court upheld imposition of California’s apportionment formula against Commerce
Clause challenges.

1 “despite the sales being transacted more than 50% outside of California.” (Resp. Open. Br., p.6.)
2 However, appellant has not shown specifically how the sales factor formula as applied by respondent
3 results in a distortion of appellant’s business activity in California, which presumably includes the R&D
4 activities and legal work that takes place in the state. At the hearing, appellant should be prepared to
5 present clear and convincing evidence that shows that the apportionment determined by the standard
6 formula is not a fair representation of appellant’s business activity in California and to demonstrate that
7 its proposed alternative is reasonable.

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