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May 1, 2024

Mr. Mark Ibele, Director
California Office of Tax Appeals
P.O. Box 989880
West Sacramento, CA 95798-9880

Via Email

Re: COST Recommends *Microsoft* Be Designated Precedential

Dear Director Ibele:

On behalf of the Council On State Taxation (COST), I strongly recommend a precedential designation for *In the Matter of the Appeal of Microsoft Corporation and Subsidiaries*, OTA Case No. 21037336, which addresses the treatment of dividends deductible under Revenue and Taxation Code (R&TC) § 24411 and whether those dividends should be included in the denominator of the sales factor for California corporate income tax apportionment purposes.¹

California Code Of Regulations Title 18, (Regulation) § 30502 clearly outlines a process and factors for the Office of Tax Appeals (OTA) to determine whether to designate an opinion as precedential. *Microsoft* is aligned with several of those precedential factors. Designating this case as nonprecedential is also inconsistent with precedential case law in California that has addressed issues similar to those addressed in *Microsoft*.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 500 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities.

COST members employ a substantial number of citizens in California, provide goods and services to a broad consumer base in the State, and conduct significant business operations within the State. COST has participated (as *amicus curiae*) in significant federal and state tax cases since its formation, including in California.

¹ *In the Matter of the Appeal of Microsoft Corporation and Subsidiaries*, OTA Case No. 21037336, 2024-OTA-130 (OTA July 27, 2023), *reh'g*, 2024-OTA-131 (OTA Feb. 14, 2024).

COST has a strong interest in equal and even-handed applications of the law. A consistent framework for and application of precedential designations by the OTA are essential for ensuring legal certainty, providing transparency, promoting fairness and equal treatment, and upholding and respecting the rule of law. They are also central to maintaining the integrity and credibility of California’s judicial system—a critical factor because the OTA was established in 2017 as an independent office to make impartial decisions on tax disputes.

Case Background

Microsoft filed a water’s-edge combined report in California for the 2018 fiscal year and received repatriated dividends from foreign subsidiaries outside its water’s-edge group. Microsoft included 25 percent of these dividends as apportionable income, after it applied California’s 75 percent dividends received deduction under R&TC § 24411. Although 25 percent of the dividends were treated as apportionable income, Microsoft included 100 percent of these dividends in the denominator of its sales factor in its claim for refund with the Franchise Tax Board (FTB). Microsoft asserted that these dividends should be included in the sales factor denominator without a reduction for dividends deductible under R&TC § 24411. The FTB disagreed and denied Microsoft’s refund claim.

On July 27, 2023, the OTA’s three-judge panel disagreed with the FTB and issued a unanimous opinion (Opinion) in favor of Microsoft regarding the inclusion of 100 percent of its deductible dividends under R&TC § 24411 in the sales factor denominator.² In rendering its decision, the panel addressed three issues as follows:

- **Microsoft’s qualifying dividends are “gross receipts” for sales factor purposes.** The panel held that California statutes and regulations did not preclude including the dividends that qualified for the R&TC § 24411 deduction as “gross receipts” as provided in R&TC § 25120(f)(2) in the sales factor denominator. It rejected the FTB’s argument that the “matching principle” should apply and only 25 percent of the dividends should be included in the sales factor denominator. The panel also rejected the FTB’s position that the qualifying dividend deduction should be treated like eliminated intercompany dividends under R&TC § 25106, noting that similar treatment is not applicable because R&TC § 25106 provides for the “elimination” of dividends qualifying under this statute, rather than the deduction of dividends qualifying under R&TC § 24411. In support of its position, the FTB relied on and requested deference to Legal Ruling 2006-01 (Ruling), which provides that a domestic corporation that received dividends from a unitary CFC excluded from the water’s-edge group should include the net dividends after applying the qualifying dividend deduction under R&TC § 24411 in the sales factor denominator.³ The panel found deference was inappropriate because the Ruling was an interpretation, not a formal regulation, that is inconsistent with well-established law.

² *Microsoft*, OTA Case No. 21037336, 2024-OTA-130 (OTA July 27, 2023).

³ FTB, Legal Ruling 2006-01 (Apr. 28, 2006) (see “Situation 2”).

- **Microsoft’s qualifying dividends are not a substantial and occasional sale.** The panel found that the gross receipts from the qualifying dividends should not be excluded from the sales factor as a substantial and occasional sale pursuant to Regulation § 25137(c)(1)(A). If substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of a taxpayer’s trade or business, then such gross receipts are excluded from the sales factor under Regulation § 25137(c)(1)(A). The panel found that the substantial and occasional sale rules did not apply to these dividends because receiving a dividend is not a “sale” as used in Regulation § 25137(c)(1)(A). Reviewing the applicable statutes and regulatory history and case law related to Regulation § 25137(c)(1)(A), the panel found that the definition of a “sale” in Regulation § 25137(c)(1)(A) is more limited than the definition of “sales” in R&TC § 25120(f)(1) for sales factor purposes.
- **The FTB did not show that an alternative apportionment method is warranted.** The panel also found that the FTB did not meet its burden demonstrating a qualitative difference or quantitative distortion that would warrant use of an alternative apportionment methodology pursuant to R&TC § 25137.

On February 14, 2024, the OTA subsequently denied the FTB’s rehearing request and upheld its Opinion.⁴

***Microsoft* Should Be Precedential**

Microsoft should be designated precedential. The Opinion is clear and well-reasoned. It thoroughly analyzes the legal issues presented, considering relevant jurisprudence and legal authority. Such comprehensive and articulate legal reasoning should be relied upon as authoritative precedent.

Designating *Microsoft* as precedential is warranted especially because the Opinion meets several of the OTA’s precedential factors outlined in Regulation § 30502.

- **The Opinion establishes a new interpretation of law.** *Microsoft* addresses two significant legal issues that have not been definitively resolved in prior case law: (1) whether qualified deductible dividends received by water’s-edge filers are included in the sales factor denominator as “gross receipts;” and (2) whether dividends are treated as a “sale” for purposes of the substantial and occasional sale regulation. Both issues are issues of first impression. The Opinion provides clarity on the meaning of the term “gross receipts” for sales factor purposes. It also distinguishes use of the term “sale” for sales factor purposes from the term’s use for substantial and occasional sale purposes.
- **The Opinion resolves an apparent conflict in the law.** An apparent conflict in the law can arise when there are inconsistencies or contradictions between different legal authorities. Here, the FTB requested deference to its Ruling, and asserted that the Ruling is legal authority, contending that the Ruling was endorsed by the Legislature. The FTB has insisted

⁴ *Microsoft*, OTA Case No. 21037336, *reh’g*, 2024-OTA-131 (OTA Feb. 14, 2024).

the Ruling is dispositive, even though several precedential cases have broadly interpreted “gross receipts” for apportionment purposes.⁵ *Microsoft*, however, is the first case that squarely addresses one of the hypothetical situations in the Ruling.⁶ The Opinion clearly resolves this direct conflict and resolves the appropriate authoritative weight of the Ruling.

- **The Opinion involves a legal issue of continued public interest.** *Microsoft* provides much needed legal interpretation of fundamental statutory and regulatory terms and phrases (e.g., “gross receipts” and “sale”) that should be authoritative beyond application to the case at hand. There are other taxpayers who file on a water’s-edge basis and receive qualified deductible dividends from foreign subsidiaries that are subject to a deduction under R&TC § 24411. It is a common enough scenario that the FTB issued its Ruling to try to address this specific scenario almost 20 years ago.⁷ Even the FTB notes in its Petition for Rehearing that the Opinion will “materially affect the substantial rights of respondent [the FTB] in enforcing the law in this matter *as well as other matters with similar issues.*”⁸

Note, the first two issues opined by the OTA’s panel were heavily based on a statutory and regulatory analysis where the primary focus was on interpreting and applying relevant statutes, regulations, and legal precedents. The third issue, use of an alternative apportionment methodology, however, is a fact-intensive analysis, whereby the specifics may be complex, nuanced, and dependent on a multitude of factors specific to a particular taxpayer’s facts and circumstances. There are many factors that contribute to the fact-intensive nature of an alternative apportionment analysis, such as the variability of business operations, complexity of transactions, and documentation needed to establish support for an alternative apportionment method, resulting in a case-specific analysis, as demonstrated in *Microsoft*. The panel aptly notes this distinction in both its qualitative difference and quantitative distortion analysis.⁹ This, however, does not interfere with the OTA’s decision to render *Microsoft*’s holdings regarding the legal issues presented as authoritative and precedential.¹⁰

⁵ See *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal.4th 750 (Cal. 2006) (holding that the redemption of marketable securities at maturity generates “gross receipts” that are includible in the taxpayer’s sales factor, but the FTB met its burden of establishing an alternative apportionment methodology); *In the Matter of the Appeal of Robert Half International Inc. & Subs.*, OTA Case No. 18011756, 2019-OTA-330P (OTA 2019) (holding that value-added tax imposed on the provision of services generates “gross receipts” that are includible in the taxpayer’s sales factor); *In the Matter of the Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*, OTA Case No. 19034447, 2023-OTA-342P (OTA Mar. 17, 2023), *reh’g*, 2023-OTA-343 (OTA June 26, 2023) (holding that payroll, property, and sales that generated deductible agricultural cooperative income under R&TC § 24404 are “gross receipts” that are includible in the taxpayer’s corresponding apportionment factors). Note, these cases are all precedential, except for the FTB’s petition for rehearing in *Southern Minnesota Beet Sugar*, which was denied by the OTA.

⁶ FTB, Legal Ruling 2006-01 (Apr. 28, 2006) (see “Situation 2”).

⁷ *Id.*

⁸ Respondent’s Petition for Rehearing, *Microsoft*, p. 5 (filed Aug. 28, 2023) (*emphasis added*).

⁹ See *Microsoft*, 2024-OTA-130, n. 42, n. 50 (“A determination under R&TC section 25137 is a fact-specific inquiry and depends on the circumstances of the case...Therefore, while FTB has not shown distortion here, that does not mean distortion could not be found in other circumstances involving repatriated dividends[.]”).

¹⁰ See *Microsoft*, 39 Cal.4th 750 (Cal. 2006) (a precedential California Supreme Court decision opining on the meaning of “gross receipts” for sales factor purposes, while also opining on whether the FTB met its burden of establishing an alternative apportionment methodology under R&TC § 25137—a fact-intensive finding).

Microsoft's current designation as nonprecedential also is not aligned with California's case law on similarly related issues, which are precedential.¹¹ For example, *In the Matter of the Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*—decided only 4 months earlier than *Microsoft*—examined an issue similar to *Microsoft*'s first issue related to the inclusion of deductible dividends in the sales factor denominator.¹² In *Southern Minnesota Beet Sugar*, the OTA panel ruled that payroll, property, and sales that generated deductible agricultural cooperative income under R&TC § 24404 are included in the taxpayer's corresponding apportionment factors, and are not excluded from the numerators or denominators of the taxpayer's apportionment factors. Like *Microsoft*, the OTA panel in *Southern Minnesota Beet Sugar* found that the plain language of R&TC § 25120(f)(2) defining "gross receipts" means "gross"—"the amount realized...in a transaction that produces business income." Even the OTA panel in its opinion on *Microsoft*'s petition for rehearing found that "the [*Microsoft*] Opinion's holding in Issue 1 [related to the inclusion of deductible dividends in the sales factor denominator as 'gross receipts'] is consistent with the precedential OTA Opinion, *Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*, 2023-OTA342P (*Minnesota Beet*), which examined a similar issue." There are two decisions examining similar issues, but one designated as precedential, while the other is currently designated as nonprecedential. This raises unusual discrepancies that can only be addressed by changing *Microsoft*'s designation to precedential.

Conclusion

On behalf of COST, I urge the OTA to change *Microsoft*'s designation to precedential. *Microsoft* falls squarely within the scope of OTA opinions that should be precedential. Designating *Microsoft* as precedential helps promote consistency and fairness. It ensures predictable and even-handed application of the law so that similar cases are decided in a similar manner. The OTA, serving as an independent tax office, needs to contribute to the stability of California's legal system for taxpayers and the State, and provide an efficient and streamlined judicial process that is respected as transparent legal authority.

Thank you for the opportunity to provide insights on this matter.

Respectfully,



Stephanie T. Do

cc: COST Board of Directors
Patrick J. Reynolds, COST President & Executive Director

¹¹ See *supra* note 6.

¹² *Southern Minnesota Beet Sugar*, OTA Case No. 19034447, 2023-OTA-342P (OTA Mar. 17, 2023), *reh'g*, 2023-OTA-343 (OTA June 26, 2023).