OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **BED BATH & BEYOND INC.**	OTA Case No. 18011340

OPINION

Representing the Parties:

For Appellant:	Eric S. Tresh, Esq. Eric J. Coffill, Esq. Tim Gustafson, Esq. Chris R. Lee, Esq.
For Respondent:	Thomas A. Lo Grossman, Tax Counsel IV Craig Swieso, Assistant Chief Counsel
For Office of Tax Appeals:	Michelle Huh, Tax Counsel

T. LEUNG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Bed Bath & Beyond Inc. (appellant or BBB) appeals actions by respondent Franchise Tax Board (FTB) partially denying[1] appellant's claims for refund of $363,301 for the taxable year ended (TYE) February 28, 2009 (2009 taxable year), $319,624 for the TYE February 27, 2010 (2010 taxable year), and $512,758 for the TYE February 26, 2011 (2011 taxable year), plus any applicable interest.

[1] Appellant submitted amended California corporation franchise tax returns (Forms 100X) claiming overpayments of $363,301 for the 2009 taxable year, $267,341 for the 2010 taxable year, and $343,756 for the 2011 taxable year. The Notice of Action (NOA) for the 2010 taxable year shows that appellant also claimed an additional refund of $52,283 for that taxable year so that its total claimed refund for the 2010 taxable year was $319,624 (i.e., $267,341+$52,283); similarly, the NOA for the 2011 taxable year shows that appellant claimed an additional refund of $169,002. FTB partially granted appellant's claims for refunds in its NOAs dated July 20, 2017, allowing overpayment amounts of $206,575.66 plus interest for the 2009 taxable year, $60,802.87 plus interest for the 2010 taxable year, and $142,942 plus interest for the 2011 taxable year. The remaining amounts in dispute are $156,725.34 (i.e., $363,301-$206,575.66) for the 2009 taxable year, $258,821.13 (i.e., $319,624-$60,802.87) for the 2010 taxable year, and $369,816 (i.e., $512,758-$142,942) for the 2011 taxable year, plus an as yet to be determined amount related to appellant's treasury function for each taxable year at issue.

Office of Tax Appeals Administrative Law Judges Cheryl L. Akin, Huy "Mike" Le, and Tommy Leung held an electronic hearing for this matter on October 26, 2021. At the conclusion of the hearing, the parties were requested to submit additional briefs by the close of business, November 29, 2021, after which the record was closed, and this matter was submitted for decision on December 8, 2021.

ISSUES

1. Whether appellant's receipts from its treasury function should be included in the sales factor of the apportionment formula for the taxable years at issue.
2. Whether appellant has shown that it is entitled to a refund on the ground that claimed vendor allowances should be included in its sales factor.

FACTUAL FINDINGS

1. Appellant operates a chain of home merchandise retail stores in the United States, Mexico, and Canada. It was founded in 1971, and is headquartered in New Jersey.
2. Appellant has a treasury department at its headquarters in New Jersey. Appellant's treasury department continually invested cash generated by its retail operations to maintain adequate working capital for its daily needs.
3. Liberty Procurement Co. Inc. (Liberty) is a member of appellant's combined reporting group and is the entity solely responsible for managing vendor relationships and negotiating vendor allowances. Liberty has hundreds of employees and an office located in New York.
4. During the 2009, 2010, and 2011 taxable years, appellant received allowances from vendors for various reasons such as cooperative advertising, purchase volume, supply distribution charges, vendor compliance, markdown reimbursements, and reimbursements for other expenses. Appellant recorded all vendor allowances, except direct cooperative advertising, as a reduction to cost of goods sold.
5. Appellant's tax returns for the 2009, 2010, and 2011 taxable years were examined by FTB. Several adjustments that are not relevant for purposes of this appeal were made by FTB. However, FTB denied appellant's claims for refund that were based on additions to its sales factor denominator for gross receipts from internal treasury function activities and vendor allowances. The denial of these two items are the subject of this appeal.

6. During audit and protest, FTB sent several Information Document Requests (IDRs) and correspondence to appellant requesting more information about the vendor allowances and treasury gross receipts. In response, appellant submitted the following to FTB:
   - An explanation of four specific vendor allowances -- markdown reimbursements, vendor rebates, supply distribution charge, and vendor compliance.
   - Signed vendor contracts dated December 16, 2014, with redacted vendors for the term January 1, 2015, to December 31, 2015.
   - A signed vendor contract dated January 27, 2014, with a redacted vendor for the term May 1, 2013, to December 31, 2013.
   - A copy of Appendix B, signed in 2015, to a contract, which outlines the certificate of insurance requirements for the vendor.
   - Three sample unexecuted vendor contracts for the 2016 taxable year and a copy of BBB's vendor compliance guide.
   - A statement indicating that the treasury function gross receipts totaled $107,550,000 for the 2009 taxable year, $68,570 for the 2010 taxable year, and $1,354,070,000 for the 2011 taxable year. Appellant also showed the treasury function gross receipts, as a percentage of the sales factor denominator, equaled: 1.4956 percent for the 2009 taxable year, 0.8746 percent for the 2010 taxable year, and 15.4601 percent for the 2011 taxable year.[2]

DISCUSSION

Background

California uses the unitary business method to determine the California-source of income of a business which derives income from both within and without this state. (*See Barclays Bank PLC v. Franchise Tax Bd. of California* (1994) 512 U.S. 298 (*Barclays*).) A unitary business is an enterprise comprised of a number of commonly owned and controlled businesses, each of which is dependent on, or contributes to, the operation of the entire business enterprise of the group. (*Edison Cal. Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481.) Fundamental to the unitary business principle is the concept that the profitability of a unitary business arises from its

[2] Appellant stated that the amounts reflected the addition of three categories: (1) redemptions of held-to-maturity investment securities; (2) redemption of available-for-sale investment securities; and (3) redemption of trading investment securities.

operation as a whole, and that it would be misleading to characterize its income as deriving from a single identifiable source. (*Container Corp. of America v. Franchise Tax Bd.* (1983) 463 U.S. 159, 181 (*Container*).) "As explained in *Container Corp.*, unitary taxation 'rejects geographical or transactional accounting,' which is 'subject to manipulation' and does not fully capture 'the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.' " (*Barclays*, 512 U.S. at p. 303 (quoting from *Container*, 463 U.S. at pp. 164-165).)

"If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary." (*Edison Cal. Stores, Inc. v. McColgan*, *supra*, 30 Cal.2d 472, 481.) In contrast, "separate accounting treats each corporate entity discretely for the purpose of determining income tax liability. Separate accounting poses the risk that a conglomerate will manipulate transfers of value among its components to minimize its total tax liability." (*Barclays*, 512 U.S. at p. 305.)

Under the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC sections 25120 through 25139), which was adopted by California and certain other states to establish uniform rules for the attribution of corporate income, a unitary enterprise's "business income" is apportioned among the taxing jurisdictions according to a formula. (See *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755-756 (*Microsoft*).) For the taxable years at issue, California generally required a taxpayer's business income to be apportioned by a three-factor formula comprised of a property factor, a payroll factor, and a double-weighted sales factor. (R&TC, § 25128(a).)

"The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." (R&TC, § 25134.) The term "sales" is defined as "all gross receipts of the taxpayer not allocated [as nonbusiness income] under [s]ections 25123 through 25127, inclusive [of the R&TC]." (R&TC, § 25120(e); see *Microsoft*, 39 Cal.4th at p. 758.) Accordingly, a taxpayer's total gross receipts are included in the sales factor denominator. (*Appeal of Robert Half International Inc. and Subsidiaries*, 2019-OTA-330P (*Robert Half International*).) "In the case of a taxpayer engaged in . . . purchasing and reselling goods or products, 'sales' includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the income year) held [by] the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales, less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales." (Cal. Code Regs., tit. 18, (Regulation) § 25134(a)(1)(A).) "In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency, or the performance of equipment service contracts, research and development contracts, 'sales' includes the gross receipts from the performance of such services including fees, commissions, and similar items." (Cal. Code Regs., tit. 18, § 25134(a)(1)(C).)

The term "all gross receipts" under R&TC section 25120(e) is not defined by the statute or regulation. "Gross" suggests the entire amount received, not just the amount received in excess of the purchase price. (*Microsoft*, 39 Cal.4th at pp. 758-759.) The *Microsoft* court ultimately looked to the "economic reality" of the taxed transaction based upon the substance, not the form, of that transaction. (*Id.* at pp. 760-761; see also *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 783-784 (*General Motors*).) In general, "gross receipts" means the whole amount received, without deduction. (*General Motors,* 39 Cal.4th at p. 783.) Treating the full redemption price of securities as gross receipts was consistent "with the application of 'gross receipts' to a wide range of other transactions." (*The Limited Stores, Inc. v. Franchise Tax Bd.* (2007) 152 Cal.App.4th 1491, 1497.) "Gross" means the full amount received, not the net gain or gross income from the transaction. (*General Mills v. Franchise Tax Bd.* (2009) 172 Cal.App.4th 1535, 1548 (*General Mills*).) Lastly, to underscore the broad nature of the type of receipts included in the sales factor, the *General Mills* court noted that "many transactions that do not generate profit are nevertheless included as 'sales' for UDITPA purposes . . . ." (*Id*. at p. 1547.)[3]

In general, if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activities in California, the taxpayer may petition for, if reasonable, the use of an alternative method "to effectuate an equitable allocation and apportionment" of its income. (R&TC, § 25137.) The taxpayer can invoke R&TC section 25137 if it proves that application of the general provisions of UDITPA would lead to an

[3] R&TC section 25120 was amended, operative for taxable years beginning on or after January 1, 2011, to provide a more robust definition of "gross receipts." (See R&TC, § 25120(f)(2).)

unfair representation of the extent of its activities in California. (*Appeal of Fluor Corporation* (95-SBE-016) 1995 WL 799363 (*Fluor*).) *Fluor* holds that where there is no special formula or method provided in the regulations, the standard UDITPA formula applies unless the party that seeks to depart from it proves distortion. However, if regulations under R&TC section 25137 apply, the regulations will control, unless the party objecting to the application of the regulation shows by "clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in the state." (*Fluor*, *supra* [citing additional authorities].)

Pursuant to R&TC sections 19503 and 25137, FTB promulgated several special apportionment regulations to address situations where application of UDITPA would result in an unfair representation of the extent of a taxpayer's business activities in California. (See *Fluor, supra.*) As relevant here and discussed further below, FTB adopted a rule that altered the standard apportionment formula where a corporation received gross receipts from its treasury functions. (See Cal. Code Regs., tit. 18, § 25137(c)(1)(D).)

<u>Issue 1: Whether appellant's receipts from its treasury function should be included in the sales factor of the apportionment formula for the taxable years at issue</u>.

Procedurally, appellant argues that Regulation section 25137(c)(1)(D) contradicts *Microsoft* and questions whether this rule is valid and applicable to it. However, Office of Tax Appeals (OTA) lacks the authority to invalidate FTB's regulations. (See Gov. Code, § 11350; *Appeal of Talavera*, 2020-OTA-022P.) Furthermore, the regulation is consistent with *Microsoft* in that it recognized that gross receipts from a taxpayer's treasury function is a "sale" for R&TC section 25120(e) purposes and that their inclusion in the sales factor is distortive.[4] In light of *Microsoft* and other cases that found the inclusion of income from treasury functions to be distortive, FTB promulgated Regulation section 25137(c)(1)(D) under the auspices of R&TC section 25137[5] to provide rules relating to the sales factor treatment of gross receipts generated

[4] Put another way, if receipts from a taxpayer's treasury function did not satisfy the definition of "sale" under R&TC section 25120(e), any debate regarding their inclusion in the sales factor would be unnecessary.

[5] FTB may require the use of an alternative method of apportionment if the methodology provided by UDITPA results in distortion. (R&TC, § 25137; *Appeal of Fluor Corporation*, *supra*.)

by a taxpayer's treasury function.[6] FTB saw the proposed regulation as a necessity because: (1) FTB did not have a regulation addressing the sales factor of a treasury function; (2) the regulation would eliminate the need for endless litigation and provide taxpayers with guidance and certainty on this issue; and (3) FTB had an obligation to regulate when it sought to prescribe rules of general application.[7] FTB held several interested parties meetings to discuss *Microsoft* and *General Motors*, published a public notice required by Government Code section 11346.4 on June 29, 2007, and held a hearing on August 17, 2007, to consider the adoption of the proposed regulation.[8] Finally, after extensive public input and consideration, FTB approved the regulation for submission to the Office of Administrative Law (OAL). The regulation was approved by OAL, and it became operative on May 29, 2008, and applicable for the taxable years at issue.

As in effect for the taxable years at issue,[9] Regulation section 25137(c)(1)(D) excludes from the numerator and denominator of the sales factor gross receipts from the taxpayer's treasury function. The regulation provides a definition for "treasury function" and prescribes the types of gross receipts that are excluded. Moreover, Regulation 25137(c)(1)(D) is part of a series of rules adopted by FTB under R&TC section 25137 which provides alternative apportionment methods for situations where, if the standard apportionment method under UDITPA were used, it would result in distortion. (See Cal. Code Regs., tit. 18, § 25137(a).) Under *Fluor*, these alternative apportionment methods become the applicable "standard," and any party wishing to deviate therefrom can do so only after showing by clear and convincing evidence that the alternative method does not fairly represent the taxpayer's business activities in California (i.e., is distortive) and that the proposed method is reasonable. (See also *Microsoft,* at p. 765; *Appeal of Crisa Corporation* (2002-SBE-004) 2002 WL 1400003.)

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[6] FTB "Initial Statement of Reasons for Adoption of California Code of Regulations, Title 18, Section 25137(c)(1)(D)" (Initial Statement of Reasons), p. 1. The Initial Statement of Reasons was obtained from the website Wayback Machine. (Available at web.archive.org/web/20100211160555/http://www.ftb.ca.gov/law/regs/25137c1d_isr.pdf.)

[7] Initial Statement of Reasons*, supra*, at p. 1.

[8] FTB "Final Statement of Reasons for Adoption of California Code of Regulations, Title 18, Section 25137(c)(1)(D)" (Final Statement of Reasons), p. 1. The Final Statement of Reasons was obtained from the website Wayback Machine. (Available at web.archive.org/web/20100211160555/http://www.ftb.ca.gov/law/regs/25137c1d_fsr.pdf.)

[9] The R&TC was subsequently amended, operative for taxable years beginning on or after January 1, 2011, to address the treasury function receipts issue. (See R&TC, § 25120(f).)

Appellant contends that Regulation section 25137(c)(1)(D) is not valid or applicable to the taxable years at issue and that pursuant to *Microsoft* its treasury receipts are gross receipts that must be included in its sales factor. Appellant argues that FTB may only exclude the treasury receipts if it shows that their inclusion in the sales factor is distortive under R&TC section 25137. Appellant further contends that the inclusion of receipts from its treasury function in its gross receipts for the years at issue is not distortive to the point that FTB may impose an alternative apportionment method under R&TC section 25137 and the use of net receipts as a reasonable alternative. Appellant further argues that the quantitative impact from receipts generated by its treasury function is substantially less than the ones seen in *Microsoft*, *The Limited*, and *General Mills*, and thus the receipts are not distortive and, therefore, the imposition of net receipts or any other alternative apportionment method is not appropriate.

However, we find that FTB properly excluded the treasury gross receipts under Regulation section 25137(c)(1)(D), which was validly adopted and within FTB's well established broad rule-making authority. (See *Appeal of Talavera*, *supra*.) We also find that FTB reasonably determined that the inclusion of treasury receipts was distortive and therefore issued a regulation providing that treasury receipts must be excluded. Moreover, the 2009 amendments to R&TC section 25120 regarding the definition of "sales" provide as follows: "(4) The changes to this section by the act adding this sentence pertaining to taxable years beginning before January 1, 2011, *constitute clarifying, nonsubstantive changes*." (R&TC, § 25120(f)(4) (emphasis added).) Thus, given the opportunity to reject Regulation section 25137(c)(1)(D) the Legislature declined to so do.[10]

Under *Fluor*, *supra*, the regulation controls, unless appellant can show, by clear and convincing evidence, that application of the regulation (i.e., excluding appellant's treasury function receipts) would not fairly represent the extent of its activities in this state. " 'Clear and convincing' has been defined as 'explicit and unequivocal,' leaving 'no substantial doubt,' and 'sufficiently strong to command the unhesitating assent of every reasonable mind.' " (*Appeal of Adickes* (90-SBE-012) 1990 WL 259706.) Here, appellant has not made such a showing. Appellant contends that the quantitative impact of including its treasury function receipts in its sales factor is substantially less than the impact shown in *General Mills* and *Microsoft*.

[10] "In adopting legislation, the legislature is presumed to have had knowledge of existing laws and existing domestic judicial decisions and to have enacted an amended statute in light of such laws and decisions." (*Andrepont v. Meeker* (1984) 158 Cal.App.3d 878, citing *Bailey v. Superior Court* (1977) 19 Cal.3d 970, fn. 10.)

Specifically, appellant argues that its treasury function receipts only account for about 5 percent of its total receipts and decrease its apportionable California business income by only about 2.5 percent. On this basis, appellant contends that inclusion of the gross receipts is not distortive.

But, appellant's argument reverses the applicable legal standard. Per *Fluor*, *supra*, Regulation 25137(c)(1)(D)'s exclusion of the treasury function receipts is the standard apportionment method. If appellant wishes to deviate from Regulation section 25137(c)(1)(D), it needs to prove by clear and convincing evidence that *excluding* the treasury function receipts would be distortive, and that its alternative of including the treasury function receipts in the sales factor is reasonable. Ironically, by arguing that the quantitative impact of including its treasury function receipts in the sales factor does not amount to distortion, then axiomatically the exclusion of those very same treasury function receipts cannot be distortive. As appellant has failed to show that application of Regulation section 25137(c)(1)(D) to exclude its treasury function receipts would not fairly represent its activities in California, we must apply the regulation.[11]

<u>Issue 2: Whether appellant has shown that it is entitled to a refund on the ground that claimed vendor allowances should be included in its sales factor</u>.

Vendor Allowances - Generally

"A sales-based vendor allowance is an allowance, discount, or price rebate a taxpayer earns as a result of selling a vendor's merchandise, typically at a temporarily reduced price."[12] In this appeal, appellant claims five main categories of vendor allowances: markdown reimbursements, vendor rebates, supply distribution charges, vendor compliance, and cooperative advertising.

Markdown Reimbursements

According to appellant, a markdown reimbursement is an allowance that it receives from the vendor when the product is not selling at the price that appellant initially marked the product

[11] Appellant's argument mainly focuses on quantitative measures of distortion. However, it is well-established that qualitative considerations of how activities generating the income at issue differ from the taxpayer's principal business activities are an important part of the distortion analysis. (See, e.g., *Microsoft*, at pp. 768-771.)

[12] Office of the Federal Register, Notice of Proposed Rulemaking Sales-Based Royalties and Vendor Allowances (published December 17, 2010). See also Sales-Based Royalties and Vendor Allowances, 79 Fed. Reg. 20904 (January 13, 2014).

at during the course of its business. Appellant argues that markdown reimbursements should be included in its gross receipts because it reports the whole amount received from the sale of the product, whether the whole amount received came from the customer or the whole amount received was a combination of the customer's sale and vendor reimbursement of the difference between the retailer's marked price and the markdown price. FTB contends that markdown reimbursements reduce the product price and cost of goods sold (COGS) and do not give rise to gross receipts because the vendors do not have a recognizable benefit, either in the form of goods or services, in exchange for the markdown reimbursement that is separable from the purchase by appellant.

Vendor Rebates

According to appellant, a vendor rebate is an allowance that it receives from the vendor when appellant and the vendor agree on how much merchandise appellant will purchase, and that if appellant purchases a certain volume of merchandise, the vendor will pay appellant or credit appellant's account. Appellant argues that vendor rebates should be included in its gross receipts as a sale of an intangible because vendor rebates are an incentive to purchase a certain volume of merchandise from the vendor, and payments for vendor rebates should be treated as New York sales since the greater cost of performance (i.e., the negotiation between appellant and vendors for the vendor rebates and the management of vendor relationships) occurred at appellant's buying office (Liberty) in New York. FTB contends that vendor rebates are volume discounts that reduce COGS and do not constitute gross receipts for sales factor purposes because appellant can only obtain volume discounts through the purchase of the underlying products from the vendor, and thus there is no additional sale of products or services from appellant back to the vendor that would give rise to a gross receipt for sales factor purposes.

Supply Distribution Charge

According to appellant, a supply distribution charge is an allowance that is negotiated between appellant and the vendor for freight charges to ship the merchandise to various stores in different states. Once appellant and the vendor agree to a certain benchmark for freight charges and appellant exceeds that benchmark, the vendor will thereafter rebate a portion of freight charges to appellant. FTB argues that the supply distribution charge is ancillary to COGS and should be a contra expense, or reimbursement of an expense, because there is no asset or service delivered to the vendor that is separate from appellant's purchase of products.

Vendor Compliance

According to appellant, a vendor compliance charge is an allowance that it and its vendor negotiate regarding terms of compliance with respect to shipping and delivery. If the vendor fails to comply with the agreed upon standards of shipping and delivery, then additional charges are assessed against the vendor, such as a charge for late delivery of merchandise. FTB contends that vendor compliance charges do not constitute gross receipts because there is no asset or service delivered to the vendor that is separate from appellant's purchase of products from which appellant can reasonably estimate the fair value of the benefit provided to the vendor.

Cooperative Advertising Allowance

According to appellant, a cooperative advertising allowance is an allowance that it receives if appellant and its vendor agree to share certain costs of advertising or appellant agrees to advertise or promote the vendor's merchandise in various ways, such as print or digital advertising. If appellant meets the specific criteria for advertising the vendor's merchandise, then the vendor pays a specified amount to appellant, such as a percentage of products purchased. FTB argues that this allowance may be included as gross receipts if the payment from the vendor to appellant is separate from the underlying purchase of products or services by appellant, and if the value of the advertising can be readily determined. FTB also argues that appellant has not provided copies of the contracts supporting the cooperative advertisement allowance payments as a payment for an identified service, and thus appellant has not substantiated such allowance.

Appellant's Vendor Contracts

In support of its vendor allowances, appellant enclosed various sample contracts and executed contracts for different years during protest and on appeal. During protest, appellant provided its general vendor contracts, both executed and samples, that show the type of vendor allowances, such as advertising, markdown support, and supply chain, and other terms of the agreement, such as the agreement tier structure. Appellant also provided a copy of the vendor compliance guide, which requires the vendors to sign an acknowledgement agreeing to comply with the terms and conditions set forth in the compliance guide. On appeal, appellant provided three vendor agreements that it signed with different vendors for taxable years 2011 and 2019. Each agreement outlined the terms and conditions of the individual vendor's "benefits program" in which appellant was eligible to participate.

Although the agreements might show the potential of how much appellant could earn from each vendor during the contract term, appellant did not provide substantiation on how much it actually earned from each vendor's benefits program or a breakdown of the vendors and allowance amounts that appellant received during the taxable years at issue. Appellant also did not provide any vendor contracts for the 2009 and 2010 taxable years in which it filed claims (based on vendor allowances) for $249,500 and $267,341, respectively.

Vendor Allowances Analysis

The *Microsoft* court has concluded that " '[g]ross' implies the whole amount received, not just the amount received in excess of the purchase price," referencing the Black's Law Dictionary definition of "gross receipts," which is "[t]he total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions, . . ." (*Microsoft*, *supra*, 39 Cal.4th at p. 759, fn. 7; *General Motors*, *supra*, 39 Cal.4th at p. 786.) As discussed above, the California courts have found amounts reported from the redemption of marketable securities (*Microsoft* and *The Limited*) and commodity hedging contracts (*General Mills*) to constitute "gross receipts" that are included in the sales factor, despite not being specifically listed in R&TC section 25120 or Regulation section 25134. Similarly, in *Robert Half International*, *supra*, OTA found that value added tax (VAT) on sales of services comes within the court's interpretation of "all gross receipts" under R&TC section 25120(e). In light of *Microsoft* and its progeny, with some exceptions not relevant here, the applicable precedents suggest a broad interpretation of gross receipts. Therefore, we believe vendor allowances are "gross receipts" for sales factor purposes.

Although FTB argues that vendor allowances, for the most part, are offsets to COGS and are not "gross receipts," we are not convinced that such a strict interpretation of what constitutes a "gross receipt" is consistent with the holdings in *Microsoft* and *General Motors*.[13] Moreover, many transactions that do not generate profit are nevertheless included in "sales" for UDITPA purposes. (See *General Mills*, 172 Cal.App.4th at p. 1547, citing *John Deere Plow Co. of Moline v. Franchise Tax Bd*. (1951) 38 Cal. 2d 214; *Appeal of Royal Crown Cola Co.* (74-SBE-047) 1974 WL 2863 [sales attributable to unprofitable unitary members must be included in sales factor]; *Appeal of Hammond Organ Co.* (62-SBE-025) 1962 WL 1432 [promotional activity properly considered for computation of sales factor].) In addition, FTB's own manual, with reference to the "vendor perspective," speaks in terms of the vendor paying such allowances, either as a credit or a rebate, to the retailer.[14]

However, we disagree with appellant's assertion that its vendor allowances are the result of the performance of services so as to constitute the sale of an intangible. Because Liberty is included in appellant's combined report, it is by definition functionally integrated with the other segments of appellant's unitary business (see *Container*, at pp. 178, 179); thus, we believe the vendor allowances are so critically intertwined with the inventory purchased from vendors that they cannot be segregated therefrom. (See *Container*, at p. 181.) The vendor allowances are not separately stated as an activity discreet from its sale of inventory for financial reporting purposes, as evidenced by appellant's annual 10-K for the 2011 fiscal year filed with the Securities and Exchange Commission, as well as for generally accepted accounting principles. Furthermore, to allow such functional cleaving could lead to heretofore integrated acts (such as purchasing inventory from appellant's vendors) being treated as a separately stated service, transmuting sales of tangible property into sales of intangible property. We believe that separating out vendor allowances from COGS and treating them as sales of intangibles is tantamount to sanctioning separate accounting along transactional lines, which is susceptible to

[13] We looked at Regulation section 1671.1 to see if the Sales and Use Tax rules could offer some guidance. After conducting more research and considering the parties' post-hearing briefs, we decided not to rely on Regulation section 1671.1 because some of its provisions are incompatible with *Microsoft's* and *General Motors*' interpretation of the term "gross receipts." For instance, one example has a manufacturer issuing a check to a retailer for the retailer selling the manufacturer's product at a discount, exceeding a set volume amount, and setting aside preferential shelf space; the regulation concluded that the rebate check was not subject to tax. (See Cal. Code Regs., tit. 18, § 1671.1(d)(4)(D).) Under *Microsoft* and *General Motors*, the rebate check would qualify as a "gross receipt" for sales factor purposes.

[14] See FTB Multistate Audit Technique Manual (July 15, 2020) Chapter 7512.8 Vendor Allowances – Vendor Perspective.

the type of "manipulation" pronounced by the *Barclays* and *Container* Courts. (See *Barclays,* at p. 303.)

A review of many of the agreements submitted by appellant into the record make it apparent that the vendor allowances are related to appellant's handling of the respective vendor's products that are sold by appellant; for example, some of the allowances are based on the volume of products sold, the condition of the products delivered to appellant, and how quickly appellant can sell the product(s). Indeed, this informs us that, but for appellant's sale of the vendor's products, there would be no vendor allowance. Thus, we conclude that vendor allowances are additional compensation paid to appellant for its unitary business of selling its vendors' tangible personal property (inventory/products) to its retail customers which happen to be paid to appellant by its vendors rather than its retail customers. Nevertheless, we do recognize that there may be some vendor allowances, such as for advertising, that might merit treatment as a sale of an intangible. Unfortunately, as mentioned below, the record is not sufficiently developed for us to make that determination here.

Burden of Proof

Appellant has the burden of showing that it is entitled to its claimed refunds. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235 (*Dicon*).) It cannot simply assert error by FTB and attempt to shift the burden of proof to the state. (*Ibid.*)

Here, appellant has not substantiated the total amount of its claimed vendor allowances.[15] Appellant also has not substantiated the amount attributable to each type of allowance. In addition, appellant has not provided documentation to show that, where appropriate, it included allowances in the numerator of the sales factor.[16] Thus, while we find that all or some types of

[15] Appellant provided FTB with a spreadsheet showing various aggregate amounts, such as, for the 2010 taxable year, $162,908,948 of "markdown reimbursements," and $185,673,863 of "vendor rebates." However, we have no evidence to substantiate that the listed amounts are correct or determine the terms of the underlying contracts. To the extent that the amounts shown are drawn from appellant's financial statements, we cannot determine if those figures would be the same as the relevant amounts for income tax purposes.

[16] Appellant asserts that, because vendor allowances result from the sale of an intangible, all of such sales should be attributed to New York (the place of performance) so that none of the allowances should be included in the numerator of appellant's sales factor. Since we find today that vendor allowances are integrated with the purchase of inventory (tangible personal property) from the respective vendor and the subsequent sale of that inventory to appellant's retail customers, and is therefore a sale of tangible personal property, appellant would need to associate its vendor allowances with the inventory it sold in California, and include those vendor allowances in the numerator of its sales factor.

vendor allowances should be included in "sales" as gross receipts, appellant has not shown that it is entitled to a refund, or, if it is entitled to a refund, what the amount of that refund would be.

During protest, FTB requested that appellant provide explanations of each vendor allowance it claimed on its amended returns and its calculation of the vendor allowances in its books and records; a list of all its vendors; unredacted versions of the vendor allowance agreements; and its contractual agreements between appellant and the vendors. Appellant argues that FTB's requests for information were not "relevant and reasonable" under Regulation section 19032(a)(3) and (4). However, R&TC section 19032 "confers broad authority on . . . FTB to 'examine' a tax return and to 'determine the correct amount of the tax.' " (*Dicon*, 53 Cal.4th at p. 1234.) The information requested by FTB was reasonable and relevant to determine whether appellant was entitled to its claimed refunds.

More importantly, appellant has the burden of proof. (*Dicon*, 53 Cal.4th at p. 1235.) In the absence of documentation substantiating the amount and types of allowances for each taxable year, we have no basis to find that appellant is entitled to a refund.

HOLDINGS

1. Appellant's receipts from its treasury function are not includible in the sales factor of its apportionment formula for the taxable years at issue.
2. Vendor allowances are sales of tangible property and are includable in the sales factor. However, appellant has not substantiated that it is entitled to a refund.

DISPOSITION

FTB's actions are sustained.

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Tommy Leung
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Tommy Leung
Administrative Law Judge

I concur:

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Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

H. LE, Dissenting and Concurring, in part:

I respectfully dissent from the majority's Opinion on Issue 1 and concur on Issue 2.

Issue 1: Treasury function receipts.

When a regulation is inconsistent with controlling law (existing statutes, court decisions, or other law provisions), I believe OTA must follow controlling law. (Gov. Code, §§ 11342.2, 11349(d); *Appeal of Save Mart Supermarkets and Subsidiary* (2002-SBE-002) 2002 WL 245682; contra, *Appeal of Talavera*, 2020-OTA-022P.)

California Code of Regulations, title 18, (Regulation) section 25137(c)(1)(D) is inconsistent with decades of case law that has interpreted Revenue and Taxation Code (R&TC) section 25120(e), which simply states "[f]or taxable years beginning before January 1, 2011, 'sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive." In *Appeal of Pacific Telephone & Telegraph Company* (78-SBE-028) 1978 WL 3941, the State Board of Equalization found that income generated by treasury function activities come within the literal definition of sales that are includible in the sales factor and that Franchise Tax Board (FTB) had the burden of clearly showing distortion under R&TC section 25137. More recently, in *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750,[1] the California Supreme Court found that proceeds from treasury activities constituted gross receipts for sales factor purposes and that FTB had "the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable." Despite this history, and over public objections of being "inconsistent with prior case law" and being "possibly unconstitutional,"[2] FTB amended Regulation section 25137 to exclude treasury function receipts from the sales factor under its alternative apportionment provision and, thus, shifted the burden to taxpayers to prove by clear and convincing evidence that the exclusion of treasury function receipts does not fairly represent taxpayers' activities in California. Consequently, Regulation section 25137(c)(1)(D) is inconsistent with prior case law.

[1] See also *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, a companion case to *Microsoft*, involving repurchase agreements.

[2] FTB "Final Statement of Reasons for Adoption of California Code of Regulations, Title 18, Section 25137(c)(1)(D)" (Final Statement of Reasons), p. 3. The Final Statement of Reasons was obtained from the website Wayback Machine. (Available at web.archive.org/web/20100211160555/http://www.ftb.ca.gov/law/regs/25137c1d_fsr.pdf.)

Regulation section 25137(c)(1)(D) is also inconsistent with R&TC section 25120(f), which the California Legislature amended to provide a statutory definition of "gross receipts" for sales factor purposes, as well as certain enumerated exclusions from that definition. Specifically, R&TC section 25120(f)(2)(K) prospectively excludes treasury function activities from the definition of gross receipts for tax years beginning on or after January 1, 2011. Indeed, the California Legislature specifically left intact R&TC section 25120(e) for tax years beginning before January 1, 2011, which *Microsoft* interpreted to include treasury function activities in gross receipts. However, Regulation section 25137(c)(1)(D) explicitly excludes treasury function receipts from the sales factor under the alternative apportionment provision beginning on or after January 1, 2007. Thus, Regulation section 25137(c)(1)(D) is inconsistent with R&TC section 25120(f) by excluding treasury function receipts four years earlier than what the statute requires.

The majority cites to following language in R&TC section 25120(f)(4) to argue that the Legislature was given the opportunity to reject Regulation section 25137(c)(1)(D) but the Legislature declined to so do: "The changes to this section by the act adding this sentence pertaining to taxable years beginning before January 1, 2011, constitute clarifying, nonsubstantive changes." However, R&TC section 25120(f)(4) refers to the addition in R&TC section 25120(e) that states "*For taxable years beginning before January 1, 2011*, 'sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive." (Italics added.) Thus, the language in R&TC section 25120(f)(4) can be interpreted as for taxable years beginning before January 1, 2011, the Legislature intended not to change prior case law which found treasury receipts are gross receipts for sales factor purposes. In fact, as previously noted, the Legislature added R&TC section 25120(f), which then explicitly excludes treasury receipts from gross receipts prospectively starting on January 1, 2011, and thus rejected Regulation section 25137(c)(1)(D)'s exclusion of treasury receipts before January 1, 2011. If the Legislature wanted to acquiesce to Regulation section 25137(c)(1)(D), it could easily have done that in R&TC section 25120(e) by excluding treasury receipts in that same subdivision or by not putting a prospective date in R&TC section 25120(f). Instead, the Legislature left R&TC section 25120(e) intact, along with the well-settled case law that treasury function receipts are gross receipts for sales factor purposes. To the extent there is ambiguity, I must prefer the interpretation favoring the taxpayer. (*Microsoft Corp. v. Franchise Tax Bd.*, *supra*, 39 Cal.4th at p. 759.)

Accordingly, I would follow *Microsoft* and R&TC section 25120 and find that treasury function receipts are properly included in the sales factor for the years at issue and grant appellant's refund claims on this basis.

Issue 2: Vendor allowances.

I agree with the majority that vendor allowances are "gross receipts" for sales factor purposes and agree that appellant did not meet its burden of proof in substantiating that it is entitled to a refund based on the disputed vendor allowances. However, based on the evidence and arguments provided by the parties, I disagree with the finding that vendor allowances are sales of tangible personal property.

DocuSigned by:
Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

Date Issued: 3/17/2022