

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF)	
)	
MICROSOFT CORPORATION)	OTA NO. 21037336
& SUBSIDIARIES,)	
)	
APPELLANT.)	
_____)	

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TRANSCRIPT OF PROCEEDINGS

SACRAMENTO, CALIFORNIA

TUESDAY, APRIL 18, 2023

REPORTED BY:

ANGEL LOVE
CSR NO. 13845

JOB NO.:
41354 OTA(B)

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TRANSCRIPT OF PROCEEDINGS, taken at
400 R Street, Sacramento, California,
commencing at 1:03 p.m. and concluding at
3:34 p.m. on Tuesday, April 18, 2023,
reported by ANGEL LOVE, CSR No. 13845, a
Certified Shorthand Reporter in and for
the State of California.

1 APPEARANCES:

2
3 Panel Lead: HON. JOSH LAMBERT

4 Panel Members: HON. SHERIENE RIDENOUR
5 HON. JOHN JOHNSON

6 For the Appellant: MICHAEL KELLEY
7 STEPHANIE PARKS

8
9 For the Respondent: LAURIE MCELHATTON
10 Tax Counsel

11 DELINDA TAMAGNI
12 Hearing Representative
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1 SACRAMENTO, CALIFORNIA; TUESDAY, APRIL 18, 2023

2 1:03 p.m.

3
4
5 JUDGE LAMBERT: We are now on the record in the
6 Office of Tax Appeals oral hearing for the Appeal of
7 Microsoft Corporation. Case Number 21037336. The date
8 is April 18, 2023, and the time is 1:04 p.m.

9 My name is Josh Lambert, and I'm the lead
10 Administrative Law Judge for this hearing. And my
11 copanelists today are Judge John Johnson and
12 Judge Sheriene Ridenour.

13 CDFT, can you please introduce yourselves for
14 the record.

15
16 MS. MCELHATTON: Laurie McElhatton, from the
17 California Franchise Tax Board.

18 MS. TAMAGNI: Delinda Tamagni, California
19 Franchise Tax Board.

20 JUDGE LAMBERT: Thank you.

21 And for Appellant, you may introduce yourselves
22 for the record.

23 MR. KELLEY: Michael Kelly, for Microsoft
24 Corporation.

25 MS. PARKS: Stephanie Parks, for Microsoft

1 Corporation.

2 JUDGE LAMBERT: Thank you.

3 As agreed to by the parties, the issues are
4 whether foreign dividend amounts should be excluded from
5 the sales factor and whether the use of an alternative
6 apportionment method is warranted.

7 And for Issue 1, I guess, depending on how we
8 rule, that will determine maybe the burden on Issue 2.
9 So, you know, any arguments on 2 of -- if the parties are
10 arguing alternative apportionment, then we'll just apply
11 it appropriately to our analysis.

12 Does that make sense?

13 MS. MCELHATTON: Uh-huh.

14 JUDGE LAMBERT: FTB provides Exhibits A through
15 E, and the appellant provides Exhibits 1 through 3.
16 There are no objections, and that evidence is now in the
17 record.

18 (Respondent's Exhibits A-E admitted.)

19 (Appellant's Exhibits 1-3 admitted.)

20 JUDGE LAMBERT: Mr. Kelley, this is your
21 opportunity to explain the appellant's position. If
22 you're ready to proceed, you have 60 minutes. Thanks.

23 MR. KELLEY: Thank you.

24 May it please the panel, we are here on Appeal
25 of the FTB's denial of Microsoft's claim for refund. The

1 work papers in the record establish the undisputed facts
2 in this case.

3 The central fact is that the Tax Cuts and Jobs
4 Act of 2017 gave rise to a dividend of \$109 billion in
5 our fiscal year ending 2018. The tax year is 2017. This
6 amount reflects accumulated foreign earnings and profits
7 of Microsoft's controlled foreign corporations or CFCs.
8 After applying California's 75 percent dividends received
9 deduction, the amount at issue is \$27 billion of taxable
10 income.

11 The question in this case presents is, how, if
12 at all, to apportion this influx of foreign source income
13 consistent with California law and the U.S. Constitution.

14 Two statutory provisions are key, as are two
15 constitutional provisions.

16 The first statutory provision is Section 25134,
17 which specifies how to determine the sales factor. That
18 statute says that the sales factor is a fraction, the
19 numerator of which is the total sales of the taxpayer
20 during the period and the -- in the state, rather, and
21 the denominator of which is the total sales of the
22 taxpayer everywhere during the tax period.

23 "Sales," we know from Section 25120, Subsection
24 (f)(1), means all gross receipts of the taxpayer if they
25 are not allocated. That is all apportionable or business

1 income.

2 Subsection (f)(2) defines "gross receipts" as,
3 quote, the gross amounts realized, the sum of money, the
4 fair market value of other property or services received
5 on the sale or exchange of property, the performance of
6 services or the use of property or capital. And that
7 includes rent, royalties, interest and dividends in a
8 transaction that produces business income in which income
9 gained or lost is recognized.

10 So truncating the statute as it applies here,
11 gross receipts means the gross amounts realized from
12 dividends in a transaction that produces business income.

13 The preamble to Section 25120 indicates that the
14 definitions in that statute apply to Sections 25120
15 through 25139, which are the UDITPA provisions, unless
16 the context requires otherwise.

17 That last clause, the contrary context clause,
18 is a major point of dispute between the parties. It
19 requires the panel to determine whether a contrary
20 context exists which makes the statutory definition of
21 gross receipts unworkable for foreign dividends.

22 The issue is then whether foreign dividends are
23 included in the sales factor measured by the actual
24 dividends distributed by the controlled foreign
25 corporations to a member of the water's-edge group or

1 whether that amount should be reduced by the 75 percent
2 dividends received deduction which applies to income.

3 The statutory definition here explicitly
4 provides that dividends are included in gross receipts
5 measured by, quote, the gross amounts realized, closed
6 quote.

7 The legislature also listed several items
8 excluded from the definition of gross receipts. None of
9 those items apply to foreign dividends. The legislature
10 was certainly aware of the dividends received deduction
11 and chose not to exclude it. Other UDITPA states
12 adopting this identical statute expressly remove the
13 dividends received deduction from the sales factor. For
14 example. Oregon revised Statute 314.665.

15 In this case, the dividends arose from a
16 transaction that produced business income. As such, a
17 contrary context cannot reasonably exist in this case
18 because the statutes specifically provides for dividends
19 and clarifies that dividends are included in the sales
20 factor measured by the gross amounts received. The
21 statute is plain and unambiguous, and the plain meaning
22 requires that the actual dividends of \$109 billion be
23 included as gross receipts in the sales factor.

24 Even if the statute is ambiguous, this panel is
25 compelled to adopt a construction favorable to Microsoft

1 because taxing statutes are strictly construed against
2 the government.

3 Here, the term "gross receipts" has previously
4 been construed by the California Supreme Court in a case
5 involving us, Microsoft, in 2007. The Supreme Court
6 found in that case that the actual amounts received from
7 the sale of treasury instruments were included as gross
8 receipts and not reduced by the basis deduction which
9 applies to income.

10 Like this case, the FTB argued that only taxable
11 amounts were included in the sales factor.

12 Now, the Supreme Court examined the legislative
13 history behind UDITPA and found that gross receipts meant
14 the whole amount received. That Court found, quote, to
15 only consider the net price difference as gross receipts
16 is an awkward fit with the statutory language at best.
17 To the extent the language is ambiguous, we generally
18 will prefer the interpretation favoring the taxpayer.

19 The Court's finding in Microsoft was adopted in
20 the General Mills case and by this panel in the Robert
21 Half decision.

22 The FTB sites its own nonbinding legal ruling,
23 2006-1, which conflicts with the current statute and was
24 published prior to the 2007 Microsoft California Supreme
25 Court case. Where an agency interpretation conflicts

1 with a statute and a supreme court decision construing
2 that statute, this panel is compelled to apply the
3 statute rather than the agency interpretation.

4 Moreover, there is no exempt income in this
5 case.

6 In Legal Ruling -- we cite this in the brief.

7 In Legal Ruling 376, the FTB clarified that,
8 while most dividends are deductible under Section 24411,
9 dividends between members of a unitary group are
10 eliminated under Section 25106.

11 In Letter Ruling 2006-1, the FTB conflates
12 deductions with eliminations and exemptions.

13 In addition, the Microsoft and General Mills
14 decisions adopted a broad definition of "gross receipts,"
15 and those decisions overrule to the extent it's not
16 already conflicting with the statute Legal Ruling 2006-1.

17 The statutory definition of "gross receipts"
18 includes transactions that produce business income,
19 whether those transactions involve income, gain or loss
20 recognition.

21 There is no legal authority for the FTB's
22 matching principle, nor does the legislative history of
23 the dividends received deduction in the final report of
24 the worldwide unitary taxation working group support the
25 FTB's theory that the dividends received deduction is

1 exempt income for water's edge filers.

2 We believe the plain language of the statute and
3 the 2007 Microsoft case are dispositive here.

4 However, if this panel does a deep dive into
5 whether a contrary context exists, the entire conceptual
6 framework of foreign dividends and the sales
7 apportionment must be considered. And one primary
8 consideration is that the statute must be construed in a
9 constitutional manner.

10 In the case of applying net dividends in the
11 sales factor, there are two sources of constitutional
12 violations. The due process clause and the foreign
13 commerce clause. In the interest of time, I will focus
14 here on the commerce clause. The briefs address due
15 process issues.

16 Moreover, in a case that involves foreign
17 commerce, such as this one, it's difficult to conceive of
18 a circumstance in which a Court would find a due process
19 violation without also finding a commerce clause
20 violation.

21 Conversely, if a Court finds one or more
22 commerce clause violations, that generally means there's
23 a due process problem, too.

24 The analytical framework for evaluating claims
25 under the foreign commerce clause starts with the four

1 factors in Complete Auto and then adds two factors from
2 Japan Lines.

3 In brief, one, California's tax must be applied
4 to an activity that has a substantial nexus with
5 California.

6 Two, the tax must be fairly apportioned.

7 Three, California's tax must not discriminate
8 against foreign commerce.

9 Four, the tax must be fairly related to the
10 services it provides.

11 Fifth, California's tax must not create a
12 substantial risk of multiple international taxation.

13 And, finally, six, California's tax must not
14 prevent the federal government from speaking with one
15 voice regarding commercial relations with foreign
16 governments.

17 Let's consider these factors in turn.

18 First, what is the activity? Does it have a
19 substantial nexus with California?

20 Here, the activity is the distribution of
21 earnings and profits from overseas companies that
22 themselves have no California connection. The FTB would
23 say none of this matters. So long as Microsoft, that is
24 the water's edge group, has nexus with California,
25 California can tax it on any activity or on no activity,

1 and this is not the law.

2 in Container, the Supreme Court held the due
3 process clauses -- the due process and commerce clauses
4 of the Constitution do not allow a state to tax income
5 arising out of interstate or overseas activities, even on
6 a proportional basis, unless there is a minimal
7 connection or nexus between the interstate or overseas
8 activities and the taxing state and a rational
9 relationship between the income attributed to the state
10 and the intrastate values of the enterprise.

11 Here, there is no nexus between the activities
12 of the CFCs and California. There's no connection
13 between California and the dividend. Nor is there a
14 rational relationship between the income that the FTB
15 attributes to California and the intrastate values of the
16 enterprise.

17 Two, is the tax fairly apportioned. The FTB
18 seeks to apply the same formula to apportion income that
19 is a result of many years of earnings and profits at
20 Microsoft's overseas operation as the formula the state
21 uses to apportion a percentage of domestic income to
22 California in a single year, even though that formula
23 does not take into account the overseas operation or the
24 relevant time period. This violates the maximum no
25 taxation without factor representation. The results are

1 both discriminatory and grossly distortive.

2 Courts test the fairness of state taxes by
3 asking about internal consistency and external
4 consistency. The department's formula, as applied here,
5 violates both internal consistency and external
6 consistency.

7 The internal consistency test asks whether if
8 all jurisdictions applied to the same tax regime as
9 California's, the result would be to tax interstate or
10 foreign commerce more heavily than intrastate or domestic
11 commerce. That is whether California's tax structure
12 discriminates against foreign commerce.

13 The first step in this hypothetical
14 harmonization process is to figure out what all other
15 jurisdictions means. In an interstate commerce case, the
16 answer is all U.S. states. In a foreign commerce case,
17 the answer is -- also includes the subdivisions of other
18 countries. I owe this invite to articles by professors
19 Michael Knoll and Ruth Mason entitled, "The Dormant
20 Commerce Clause After Wynne."

21 The issue in this case, to paraphrase Knoll and
22 Mason, is how a globally universalized California tax
23 regime would apply to international income. Take a
24 fairly simple example. Assume a U.S. corporation has a
25 million dollars in sales and 200,000 in net income.

1 Split it 50/50 between Washington and California.
2 Apportioning this income to California, determining
3 California taxable income and calculating the California
4 tax is straightforward. The sales factor is 50 percent.
5 California's taxable income is 100 -- apportioned taxable
6 income, rather, is one \$100,000. And if the tax rate is
7 eight percent, the tax due is \$8,000.

8 Now, assume that, instead of 50 percent of the
9 sales and income in Washington, the corporation has 50
10 percent of its sales and income in British, Columbia.
11 Assume further that the B.C. sales are made by a
12 controlled foreign corporation and that CFC pays the U.S.
13 parent a dividend in the full amount of its 100,000 in
14 net earnings. How would California apply its standard
15 formula here?

16 First, using net dividends, the sales factor is
17 95 percent. That is its \$500,000 of California sales
18 divided by its \$500,000 of everywhere sales, plus \$25,000
19 of the net dividends in the denominator. So it would be
20 500,000 over 525,000. And that would be multiplied times
21 the pre-apportioned California net income of \$125,000.
22 That is the \$100,000 of domestic earnings and the 25,000
23 of the foreign dividends after --

24 JUDGE LAMBERT: Mr. Kelley, just making sure if
25 you could slow down, especially with all the numbers and

1 calculations, it would be helpful. You can go back just
2 a little bit.

3 MR. KELLEY: Sure.

4 JUDGE LAMBERT: Thanks.

5 MR. KELLEY: Applying California statutory
6 formula to a hypothetical where the British, Columbia
7 subsidiary exists.

8 First, using net dividends, the sales factor is
9 95 percent. That is \$500,000 of California sales, over
10 500,000 of everywhere sales and then the additional
11 25,000 of net dividends in the denominator. That sales
12 factor of 95 percent would be multiplied times net income
13 of \$125,000 resulting in California taxable income of
14 \$119,000. At an eight percent tax rate, the resulting
15 tax is \$9,523. That result would be higher than the
16 \$8,000 on domestic sales.

17 Using British Columbia as our stand-in for
18 subdivisions of all foreign countries and assuming
19 that as the internal consistency test deposits, that
20 British Columbia employees the same tax regime as
21 California, we can see the same discrimination against
22 foreign commerce. It is equivalent to a tariff on
23 foreign sales.

24 As this example further demonstrates, there is
25 no internal consistency here without gross dividends

1 included in the sales factor.

2 So now let's turn to external consistency.

3 External consistency asks whether the state has
4 only taxed a portion of the revenues from the interstate
5 or overseas activities which reasonably reflects the
6 in-state component of what's being taxed. And that is
7 from Container.

8 The answer here is clearly no. Given there is
9 no in-state component of the activity that California is
10 taxing here, the tax imposed using the standard formula
11 does not reasonably reflect the in-state component of the
12 activity being taxed.

13 The tax also violates the principle that the
14 factors used to apportion the taxpayer's income must
15 reflect a reasonable sense of how income has been
16 generated. Container Corp. says this is a constitutional
17 requirement, and it has plainly not been satisfied here.

18 The third question asked under the rubric of
19 internal consistency is whether multiple taxation occurs
20 with respect to the same revenue.

21 Here, there is Internet -- actual international
22 multiple taxation. The foreign earnings and profits were
23 taxed overseas by the foreign countries.

24 As a result, the tax imposed in this case fails
25 the second complete auto test.

1 Third, does the tax discriminate against foreign
2 commerce? Yes, as the example just given demonstrates.
3 But consider also the Kraft decision. The Supreme Court
4 said there, by its very nature, a unitary business is
5 characterized by a flow of value among its components.
6 The flow of value between Kraft and its foreign
7 subsidiaries clearly constitutes foreign commerce. This
8 includes the foreign subsidiary dividends which
9 themselves constitute foreign commerce.

10 The question Kraft poses is whether the
11 department standard formula discriminates against foreign
12 dividends, and the answer is yes. The standard formula
13 does this by not providing adequate factor
14 representation, unlike the state's treatment of domestic
15 commerce. That is exchanges within the water's edge
16 group.

17 In Kraft, the Court said the only subsidiary
18 dividend payment taxed by Iowa that are reflecting the
19 foreign business activities -- excuse me. I'll restate
20 that.

21 The only -- quote, the only subsidiary dividend
22 payments taxed by Iowa are those reflecting the foreign
23 business activity of the foreign subsidiaries.
24 Substitute California for Iowa and the same thing could
25 be said here.

1 Even if the standard formula includes 25 percent
2 of the dividend, there is discrimination against foreign
3 commerce. The net dividend inclusion counts only the net
4 income derived from sales overseas in the denominator,
5 whereas the numerator and the other half of the
6 denominator includes gross proceeds of sales. That's a
7 multiple of the net income number. This discrimination
8 against foreign commerce means that the tax imposed in
9 this case fails the third complete auto test.

10 Fourth, is the tax fairly related to the
11 services California provides? No, the state has provided
12 no services related to the foreign earnings it seeks to
13 tax. To be sure, the services that California provides
14 need not be limited to a particular activity to pass this
15 part of the test. That's from Goldberg.

16 But there are no California services remotely
17 connected to the CFC's sales. There are no cost of goods
18 sold that can be traced to California. One can also
19 compare the tax imposed in prior years to that imposed
20 here and readily conclude there was no increase in
21 services that would warrant a four to 12 times increase
22 to the tax burden for fiscal year of 2018. Applying the
23 standard formula to this foreign dividend violates the
24 fourth complete auto test.

25 Fifth, does this tax result in multiple

1 international -- taxation of multiple international
2 commerce? Yes, it does. The facts are clear. Microsoft
3 paid tax to foreign governments on these earnings.
4 California has no foreign tax credit. California cannot
5 claim the benefit of the federal foreign tax credit,
6 because among other things, that credit was restricted
7 for the deemed dividends under IRC 965. Knoll and
8 Manson -- excuse me.

9 Knoll and Mason dismantle that argument too.

10 Finally, six, does the tax interfere with the
11 federal government's need to speak with one voice on
12 matters of international tax policy? It does, but not to
13 such a degree that would be sufficient by itself to
14 result in a constitutional violation.

15 So let's review the results of applying the six
16 foreign commerce clause tests. Failing any one of them
17 is sufficient to create a constitutional violation. We
18 think there are problems under all six, but the ones that
19 present the clearest case for invalidation are numbers
20 two, three, four, and five. The tax is unfair. It
21 discriminates against foreign commerce. It is not fairly
22 related to the services that California provides, and it
23 results in multiple taxation. The evidence bearing on
24 these points is clear and undisputed.

25 If a contrary context exists under

1 Section 25120, another context that must be considered is
2 whether the FTB's method fairly apportions income to
3 California. We've already addressed the internal and
4 external consistency violations. We've also addressed
5 that net dividend inclusion counts only net income in the
6 sales -- in the sales factor and the denominator, whereas
7 the numerator and other half of the denominator related
8 to Microsoft's domestic sales both use gross proceeds of
9 sales. Net income and gross proceeds of sales are
10 different. And by substituting net income into the sales
11 factor, you can see the impact in our Exhibit Number 1.

12 I'm going to refer to the exhibit now.

13 In our exhibit, you can see that foreign
14 dividends are in the first column and our domestic sales
15 products is in the second column. We've deducted our
16 operating expenses and the 75 percent dividends received
17 deduction. The combined net income on the return for
18 this year was \$44 billion. A majority of which 27
19 billion, our 61 percent of the total, is from foreign
20 dividends.

21 However, using only the net dividends factor,
22 only 22 percent of the sales factor is related to those
23 foreign dividends. As such, the sales factor does not
24 represent the income it purports to apportion. Using the
25 statutory definition of gross receipts, \$109 billion, our

1 53 percent of the sales factor, relates to the foreign
2 dividends.

3 Accordingly, the statutory definition of gross
4 dividends is the only method that even approximates fair
5 apportionment in this case.

6 To review, no contrary context exists to ignore
7 the statutory definition of gross receipts. Gross means
8 gross. The FTB's position that net dividends should be
9 included in the sales factor would require this panel to
10 construe the statute in an unconstitutional manner and
11 creates malapportionment. As such, this panel must
12 follow the plain meaning of the statute.

13 Now, from what we can glean, the FTB has
14 abandoned any argument that the statutory definition of
15 gross receipts means net dividends, as they should. The
16 FTB -- we'll find out, but presumably has also abandoned
17 any argument that the net dividends result in fairly
18 apportioned income of the water's edge group because it
19 does not. Instead they make three broad contentions in
20 their brief.

21 First, under the doctrine of elections,
22 Microsoft elected into the water's edge treatment and
23 must live with the consequence of that election. This
24 argument is based on the false premise that taxpayers are
25 not entitled to fair apportionment if they could have

1 elected into a worldwide filing and that worldwide filing
2 resulted in fair apportionment.

3 The FTB's own water's edge manual makes it clear
4 that the water's edge rules do not override the
5 allocation and apportionment rules starting in
6 Section 25120.

7 Of course, there is nothing in the record to
8 suggest that, if Microsoft had filed a worldwide return
9 for the tax year, their income would be fairly
10 apportioned.

11 In fact, the accumulated foreign earnings and
12 profits distributed to the water's edge group would
13 likely create such a timing mismatch that that would not
14 be true.

15 In addition, there is no body of authority to
16 support the FTB's position that the state has a safe
17 harbor to any apportionment challenge if the taxpayer
18 would pay more under a worldwide filing. A safe harbor
19 does not exist in the law, and this panel should not
20 create one here by this decision.

21 Second, the FTB will also contend in its
22 Exhibit J that Microsoft's domestic sales factor has
23 remained relatively stable for the three years leading up
24 to the tax year at issue. What they won't say is that
25 Microsoft's tax returns, starting with the tax year at

1 issue and every year since, '19, '20, '21, '22, each of
2 those returns show more foreign dividends than operating
3 income. Primarily owing to a change in federal tax law.
4 As such, the subsequent returns look more like the tax
5 year at issue and misrepresents a permanent factual
6 change to Microsoft's filing rather than an isolated
7 transaction.

8 Finally, the FTB will contend that this gain
9 should be excluded from the sales factor by the casual or
10 isolated sales provision of Section 25137(c)(1). That
11 provision only applies to the sale of fixed assets, which
12 is not the case here, or the sale of other property, and
13 a dividend, of course, is neither under Internal Revenue
14 Code Section 301.

15 Moreover, the tax year at issue represents a
16 factual change, whereby similar dividends have been
17 declared each and every year since the tax year at issue.
18 As such, the dividends are neither casual or isolated.

19 I will reserve the rest of my time.

20 JUDGE LAMBERT: Thank you, Mr. Kelley. I will
21 turn to the panel and ask if they have any questions for
22 you at this time.

23 Judge Johnson, did you have any questions?

24 JUDGE JOHNSON: No questions at this time.

25 Thank you.

1 JUDGE LAMBERT: And thanks.

2 Judge Ridenour, did you have any questions?

3 JUDGE RIDENOUR: Not at this time. Thank you
4 very much.

5 JUDGE LAMBERT: Thank you.

6 I'll probably reserve questions until after I
7 hear FTB's arguments, as well. So I think we can proceed
8 with FTB.

9 If you're ready, Ms. McElhatton, you can
10 proceed. You have 60 minutes.

11 MS. MCELHATTON: Thank you.

12 Good afternoon. My name is Laurie McElhatton.
13 I'm Attorney V of the Franchise Tax Board. And my
14 co-counsel is Delinda Tamagni, and she is the Assistant
15 Chief Counsel of the Multi State Tax Bureau at the
16 Franchise Tax Board.

17 The issue today involves the California tax
18 consequences that stem from the federally enacted Tax
19 Cuts and Jobs Act, which I will refer to as "the Act."

20 My discussion today will cover the following:

21 First, I'll explain the rules from the Act that
22 are relevant to this appeal and the impact of the Act on
23 Appellant's California return during the appeal year.
24 Then because Appellant files a California return on a
25 combined group basis with the water's edge election, I'll

1 explain how combined reporting works in the context of a
2 worldwide --

3 JUDGE LAMBERT: Ms. McElhatton, just remember to
4 speak slowly and if you're reading just so the
5 stenographer can get everything.

6 MS. MCELHATTON: Okay. I'll back up a little.

7 JUDGE LAMBERT: Okay.

8 MS. MCELHATTON: Then because Appellant filed a
9 California return on a combined group basis with the
10 water's edge election, I'll explain how combined
11 reporting works in the context of a worldwide and a
12 water's edge combined report.

13 After that, I will discuss the appeal issues
14 making four distinct points.

15 First, I'll discuss that there should be
16 100 percent exclusion of the repatriation dividends from
17 the sales factor as a substantial occasional sale under
18 Regulation 25137(c)(1)(a).

19 After that, I'll discuss that there should be
20 100 percent exclusion of the repatriation dividends from
21 the sales factor under Revenue and Taxation Code 25137.
22 As including the 108.8 billion in the sales factor at
23 100 percent is distortive.

24 Then I will discuss why there should be
25 75 percent exclusion of the repatriation dividends from

1 the sales factor under California law because the context
2 of having 75 percent of the repatriation dividends
3 statutorily removed from the apportionable base requires
4 exclusion from the sales factor as supported by the
5 presidential cases of Chase Brass and Container.

6 Finally, I will address Appellant's 25137
7 arguments. I will explain why some of these arguments
8 are barred by the doctrine of elections.

9 And then I will explain that Appellant has
10 failed to carry its burden for any of its arguments as it
11 is required to show with clear and convincing evidence
12 why inclusion of the repatriation dividends in the sales
13 factor at 25 percent gives rise to an apportionment
14 factor that unfairly represents the extent of its
15 California business activities.

16 So first let's talk about before the Tax Cuts
17 and Jobs Act. Under the law, before the Act,
18 multinational enterprises could and tended to defer U.S.
19 tax on foreign business income. This lead to a large
20 amount of accumulated foreign earnings.

21 Then along comes the Tax Cut and Jobs Act in
22 2017. The Act imposed a one-time tax on U.S.
23 shareholders with respect to the earnings, foreign
24 corporations retained and foreign jurisdictions post
25 1986. The Act specifically mandated that all U.S.

1 shareholders of such foreign corporations be taxed on
2 deemed repatriation dividends in the amount of all post
3 1986 retained earnings.

4 Under IRC 965, those deemed repatriation
5 dividends were taxed at a discount rate, and taxpayers
6 were allowed to pay the balance owed over eight years
7 without interest. Many U.S. shareholders of foreign
8 corporations that were required to affect and pay tax on
9 deemed repatriation dividends actually repatriated all or
10 some of these accumulated earnings.

11 At the same time, the Act created global
12 intangible low-taxed income known as "GILTI," which is
13 required -- which required U.S. shareholders to pay a tax
14 on their foreign earnings in the year the income is
15 earned without regard to actual distribution. So the
16 GILTI piece of the Act took care of the problem going
17 forward under the new federal regime once post 1986 --

18 MS. RIDENOUR: Can you please spell out the
19 acronym for the stenographer, please.

20 MS. MCELHATTON: Oh. The GILTI?

21 MS. RIDENOUR: Yes.

22 MS. MCELHATTON: G-I-L-T-I.

23 Basically the Act sought to remove the tax
24 incentives to accumulate income in foreign jurisdictions.
25 And that's how that worked out. So going forward, they

1 would be taxed every year, but there was this big
2 buildup, 1986 to 2017, and so that is what was subjected
3 to the deemed repatriation dividend.

4 Currently, California still does not conform --

5 JUDGE LAMBERT: Also, Ms. McElhatton, I'm sorry
6 to interrupt you again. I would just speak slower for
7 the stenographer's purpose. So when you're reading, it's
8 easy to talk fast, but just for our stenographer, let's,
9 maybe if you could, slow it down a little bit.

10 MS. MCELHATTON: Okay.

11 JUDGE LAMBERT: Thank you.

12 MS. MCELHATTON: Currently, California still
13 does not conform to these or other provisions of the Act.
14 As a result, California only taxes actual distributions
15 to California's shareholders of controlled foreign
16 corporations, or, for short, we'll call them CFCs.

17 California does not tax deemed dividends.
18 Appellant is a U.S. shareholder affected by the Act. It
19 was required to pay federal tax on its CFC's accumulated
20 post 1986 earnings that were deemed repatriated.

21 As required by the Act, Appellant's CFCs were
22 deemed to repatriate \$108.8 billion, and Appellant was
23 subject to federal tax on those earnings regardless of
24 whether the CFCs actually paid these dividends to
25 Appellant.

1 For California tax purposes, the actual payment
2 triggered the California rules that apply to CFC
3 dividends paid to California taxpayers with a portion of
4 the dividends included in the apportionable base.

5 So we must keep in mind that Appellant was not
6 the only company in this situation. All multinational
7 enterprises that met the description were required to do
8 the same during their 2017 fiscal year regardless of
9 whether the year ended in 2017 or 2018 for tax purposes.

10 Here, Appellant's 2017 tax year ends in June of
11 2018. So the Act required Appellant to pay federal tax
12 on the dividends deemed repatriated during its 2017
13 fiscal year that ended June 2018.

14 Importantly, many U.S. shareholders of CFCs,
15 just like Appellant, actually received during their 2017
16 fiscal year enormous amounts of repatriated dividends,
17 which their CFCs accumulated overseas post 1986.

18 As a result, many shareholders that are also
19 California taxpayers are mindful of this appeal and are
20 looking to see how it would affect their California tax
21 when it comes to their actual dividends received as a
22 result of this federal requirement to pay tax on deemed
23 repatriation dividends.

24 The impact of the Act on the California tax
25 reporting is twofold.

1 First, the year on appeal is an unusual year, as
2 the change in federal law prompted many CFCs to
3 repatriate and actually pay an enormous amount of
4 dividends to U.S. shareholders as a single payment with
5 the actual payment subject to California income tax rules
6 only to the extent the dividends are included in their
7 apportionable tax base.

8 Remember, this was for all earnings 1986 to
9 2017.

10 And then secondly, OTA's decision in this appeal
11 will affect the tax liability of every multinational
12 enterprise that actually repatriated post 1986 earnings
13 to U.S. shareholders, their California taxpayers.

14 It is FTB's position that California standard
15 rules require that dividends included in the
16 apportionable tax base are included in the sales factor
17 to the same extent they statutorily contribute to the
18 apportionable tax base. This is without regard to
19 whether items generate income or loss or have no impact
20 on taxable income. Thus any eliminated or deducted
21 portion of the dividends must not be included in the
22 sales factor, as this would result in a mismatch between
23 the components of the apportionment factor and components
24 of the apportionable base.

25 For Appellant specifically, at the time its CFCs

1 actually paid the 108.8 billion in repatriated dividends
2 to its U.S. shareholders, Appellant was well aware that
3 it would be taxed at the most on 25 percent of the
4 dividends paid to the water's edge combined reporting
5 group. Consistent with this understanding and California
6 rules on its original June 2018 tax return, Appellant did
7 not include in the apportionment factor any dividends
8 that were not included in its apportionable tax base.

9 Again, originally and as required by California
10 law, Appellant excluded from its apportionable tax base
11 and from its sales factor 75 percent of the 108.8 billion
12 in repatriation dividends that it received.

13 In fact, until it decided to amend its June 2018
14 return, Appellant consistently excluded from its sales
15 factors amounts of dividends that were excluded from its
16 apportionable tax base. Only when it comes to the year
17 on appeal, Appellant filed a claim for refund seeking to
18 include the 108.8 billion in its sales factor at
19 100 percent. Including -- at 100 percent would amount to
20 about a \$94 million refund.

21 Today, I will discuss the reasons why Appellant
22 is not entitled to the \$94 million refund, which FTB
23 denied.

24 First, I'll address the combined report
25 mechanics when a taxpayer files on a worldwide basis

1 versus when a taxpayer files with a water's edge
2 election.

3 An apportioning trade or business with sales in
4 and out of California is required to apportion its income
5 among the states where it does business. Under the
6 default rules, this apportioning trade or business would
7 file a worldwide combined report where it includes all
8 the income and factors from all unitary entities no
9 matter where they're located. So for worldwide combined
10 reporting, domestic and foreign entity income and factors
11 are fully included in the worldwide combined report.

12 Alternatively, a multinational enterprise has an
13 option to make a water's edge election. When a valid
14 water's edge election is made, the enterprise's combined
15 reporting group includes all domestic and some foreign
16 entities' income and factors. Thus, a water's edge
17 combined reporting group includes all of the income and
18 all of the factors of domestic entities.

19 However, when it comes to foreign entities,
20 their income and factors are only included to the extent
21 of their inclusion ratios.

22 For example. For fully excluded CFCs, none of
23 the income and factors are included in the water's edge
24 combined report. For partially included CFCs, the income
25 and factors of each CFC are included in the water's edge

1 combined report only to the extent of that CFC's
2 inclusion ratio, which is Subpart F income for each CFC,
3 divided by that CFC's earnings and profits.

4 Finally, to the extent foreign entities are
5 excluded from the water's edge combined report, they are
6 treated as unrelated third parties.

7 We next need to talk about the treatment of
8 transactions among affiliated entities. It is a well-
9 known rule set forth in Revenue and Taxation Code and
10 also in the regulations that intercompany transactions
11 between entities fully included in the combined report
12 are eliminated from the apportionable tax base and
13 removed from the factors. Rules to this effect can be
14 found under Revenue and Taxation Code 25106 and
15 Regulation 25106.5-1.

16 This means those amounts subject to elimination
17 would have been included in the apportionable base but
18 for expressed statutory removal from the base and the
19 factors.

20 For dividends paid by a foreign entity that
21 is part of a worldwide combined report, the intercompany
22 dividends are eliminated from the apportionable base to
23 the extent paid from unitary current and accumulated
24 earnings and profits, with the remainder of the dividend,
25 if any, subject to the dividends received deduction of

1 75 percent located at Revenue and Taxation Code 24411.

2 In this context, the 75 percent dividends
3 received deduction will apply if dividends are paid from
4 nonunitary earnings, which would be something like
5 earnings that were accumulated pre-acquisition. Thus for
6 excluded CFCs, those CFCs are not considered a source of
7 unitary business activity, and thus rather than a hundred
8 percent elimination, these dividends are 75 percent
9 removed from the apportionable tax base.

10 When it comes to a water's edge combined report,
11 however, how much of the dividends are considered paid
12 from nonunitary earnings in the context of a water's edge
13 election depends on the extent a CFC is excluded from the
14 water's edge combined report. This is determined by
15 looking at each CFC's inclusion ratio, which is
16 calculated as a ratio of each CFC's Subpart F income over
17 the CFC's earnings and profits.

18 The smaller the numerator part, that's the
19 Subpart F income part, then the smaller the inclusion
20 ratio. Just like any fraction. And the CFC's U.S.
21 shareholders deem dividends reduce the CFC's Subpart F
22 income included in the inclusion ratio. This means that
23 the larger is the deemed dividend paid by a CFC. The
24 smaller is the CFC's inclusion ratio. And the larger is
25 a --

1 MS. RIDENOUR: Excuse me. I think you might
2 need to slow down a little bit. I understand when I read
3 I read faster, too. Just slow it down. It's complicated
4 information. So thank you.

5 MS. MCELHATTON: This means that the larger is
6 the deemed dividend paid by a CFC. The smaller is the
7 CFC's inclusion ratio. And the larger is the portion of
8 the paid dividend that the U.S. shareholder must include
9 in its California taxable base.

10 For example. If a CFC has a ten percent
11 inclusion ratio, then ten percent of the dividends it
12 pays to the water's edge combined reporting group -- that
13 is the domestic entities. Then ten percent of the
14 dividends that it pays will be considered intercompany,
15 and they will be eliminated from the water's edge
16 combined report apportionable tax base and the
17 apportionment factors under Revenue and Taxation
18 Code 25106, with the remainder of the dividends subject
19 to the 75 percent dividends received deduction under
20 Revenue and Taxation Code 24411.

21 So note, the smaller the CFC Subpart F income,
22 the smaller is the CFC's inclusion ratio. This means the
23 CFC's U.S. shareholders will have a larger portion of
24 dividends subject to the 75 percent dividends received
25 deduction where the inclusion ratio is small or zero,

1 which is what we're dealing with here. This also means
2 for small inclusion ratios, there is a larger amount of
3 the dividend that is taxable in California.

4 Okay. So we'll talk about the facts very
5 briefly here because they're pretty straightforward.

6 As appellant was subject to federal tax on 108.8
7 billion and deemed repatriation dividends under the Act,
8 it decided to actually repatriate. So they actually paid
9 a dividend of 108.8 billion, and that included its
10 earnings that have been held overseas from 1986 through
11 2017. Out of the paid dividend, about 81.6 billion was
12 deducted and thus removed from the apportionable base
13 used to calculate California tax owed, leaving roughly 27
14 billion in repatriated dividends in the apportionable
15 base subject to California tax.

16 Note that regardless of whether the dividends
17 produced income, loss or had no effect on apportionable
18 income, and regardless of the actual or projected amount
19 of dividends, Appellant always knew that California law
20 would provide it with relief and remove 75 percent of
21 those dividends actually paid by the CFCs from the
22 apportionable tax base.

23 So now moving on to the appeal issues. Now that
24 I've set out the general rules and the facts, I will
25 discuss each of the four issues.

1 So the first issue I will discuss is why this
2 repatriation dividend should be 100 percent excluded from
3 the sales factor as a substantial occasional sale
4 pursuant to standard apportionment rules at
5 Regulation 25137(c)(1)(A).

6 These one-time repatriation dividends, once
7 actually paid, are both substantial and occasional sales.
8 We know already that these dividends must be a sale, as
9 25 percent of them have historically been included in the
10 sales factor, as that is the amount remaining after the
11 75 percent dividends received deduction. There would be
12 nothing included in the sales factor if these dividends
13 were not a sale.

14 We also have the 2019 presidential OTA decision
15 in Appeal of Robert Half, holding that the definition of
16 sales is broad. In that case, value added taxes paid by
17 customers in foreign countries were found to be a sale.
18 The OTA in Robert Half referred to the California Supreme
19 Court case of Microsoft Corp. versus Franchise Tax Board
20 from 2006, which ultimately looked to the economic
21 reality of the taxed transaction based on substance, not
22 form.

23 The OTA set forth that the Court determined to
24 focus on the actual rights and benefits acquired in the
25 transaction from the perspective of the taxpayer. The

1 end result in the 2006 Microsoft decision was that the
2 full redemption price of the marketable securities that
3 the taxpayer received at maturity were found to be gross
4 receipts to be included in the sales factor. The same as
5 marketable securities that were sold since the end result
6 was the same.

7 In this case, the Appellant received nearly
8 108.8 billion in repatriation dividends, which under the
9 Microsoft and Appeal of Robert Half decisions would be
10 treated as a sale. And the economic reality is that
11 75 percent of the repatriation dividends were removed
12 from the apportionable base.

13 Appellant has raised an issue regarding whether
14 the substantial occasional sale rule applies to
15 intangibles. The regulation itself states that it
16 applies to a fixed asset and other property held or used
17 in the regular course of the taxpayer's trade or
18 business. The very language of Regulation 25137(c)(1)(A)
19 lays out that it does not apply only to fixed assets,
20 rather it says fixed assets and other property and has
21 been this way since 2001.

22 There is also an example in the regulation that
23 applies it to intangibles, such as patents and affiliate
24 stock. Thus looking only at the words of the regulation,
25 we can ascertain that the substantial occasional sale

1 rule applies to intangibles.

2 Now that we've determined that dividends are a
3 sale, we can look to whether the one-time repatriation
4 dividends are substantial. We know that the repatriated
5 dividends at 100 percent are \$108.8 billion. We also
6 know that, as originally filed, Appellant included
7 25 percent of the 108.8 billion in its sales factor
8 denominator for a total sales factor denominator of
9 122 billion. If we remove the 25 percent repatriation
10 dividends, roughly 27 billion, that leaves a total sales
11 factor denominator, without the repatriation dividends,
12 of 95 billion. You can see this at Exhibit D, table 1.

13 Since 108.8 billion is more than the total
14 amount of Appellant's sales factor denominator without
15 any repatriation dividends, remember it's only 95
16 billion, it clearly meets the five percent substantial
17 test at Regulation 25137(c)(1)(A) which requires that,
18 when the sales at issue are subtracted, the sales factor
19 denominator must decrease by five percent or more.

20 Then we turn to whether the sale at issue is
21 occasional. While FTB concedes that Appellant's CFCs pay
22 dividends to the water's edge combined reporting group
23 many times every year, we assert that this one-time
24 repatriation dividend is different. This one-time
25 repatriation dividend accounted for CFC deferred income

1 from 1986 to 2017 and required a federal deemed dividend
2 so that the deferred income was federally taxed to the
3 U.S. shareholders.

4 If you turn to Exhibit D, table 2, you can see a
5 summary table of dividends with the second row being the
6 dividends that were actually paid and thus subject to tax
7 by California.

8 This unique situation set in motion by the
9 enactment that Appellant, along with all other
10 multinational enterprises with untaxed income held
11 abroad, ended up paying an enormous repatriation
12 dividend, which is the subject of this appeal. FTB
13 asserts that this repatriation dividend was a one-time
14 event and should thus be considered occasional.

15 Under Appeal of Fluor, which is a 1995 State
16 Board of Equalization case, once a regulation is found to
17 apply, it becomes the standard apportionment method, and
18 there is no requirement to show distortion. FTB asserts
19 that this is just that situation, and accordingly, a
20 hundred percent of the nearly 108.8 billion in
21 repatriation dividends should be excluded from
22 Appellant's sales factor as a substantial occasional
23 sale.

24 This is the very fact pattern that the rule was
25 meant to address, where a one-time large influx of gross

1 receipts from an extraordinary event skews the sales
2 factor. To prevent that skewing, the gross receipts from
3 the one-time event are 100 percent excluded from the
4 sales factor. That is the result that the FTB requests
5 today.

6 Secondly, my second distinct point I will be
7 making is discussing Revenue and Taxation Code 25137,
8 which I'll refer to as 25137.

9 If the repatriation dividends are included at --

10 JUDGE RIDENOUR: Stenographer, do you need a
11 break?

12 JUDGE LAMBERT: Okay. We can take a ten-minute
13 break and go off the record for now and then come back on
14 in ten minutes. And you can take a break, and we can all
15 take a break, and that's it.

16 (A break was taken.)

17 JUDGE LAMBERT: Thank you. I will go back on
18 the record now.

19 And I guess maybe just slow down even more,
20 maybe take some pauses between sentences. That will
21 help. It looks like you have about 33 minutes remaining
22 of the allotted time.

23 MS. MCELHATTON: That's probably part of the
24 speed thing is to make sure I can get it all in in 60
25 minutes.

1 JUDGE LAMBERT: That happens.

2 MS. MCELHATTON: The more I slow down, the more
3 is going to get left off at the end.

4 JUDGE LAMBERT: Yeah. No. I understand. So
5 we'll see how it goes, and just we'll proceed and see how
6 it goes at the end. So you may proceed. Thanks.

7 MS. MCELHATTON: Okay. I'll back up a little
8 bit to the second distinct issues. So you probably have
9 some of this already. So now I'm going to discuss
10 Revenue and Taxation Code 25137.

11 If the repatriation dividends are included
12 100 percent in the sales factor under standard
13 apportionment, then the result is distortive.

14 If you turn to Exhibit E, table 1, you can see
15 the numbers as I discussed them.

16 First, we'll talk about profit margin. There
17 was a significant increase in Appellant's tax base from
18 the repatriation of income earned by foreign entities in
19 the form of a paid dividend, and this also created an
20 enormous \$108.8 billion bubble of gross receipts.

21 At the same time, Appellant's day-to-day
22 business generated gross receipts and net income but at a
23 much lower profit margin. The repatriation dividend
24 profit margin for the June 2018 fiscal year was
25 100 percent, while the regular operation profit margin

1 was 16 percent.

2 Also included as a point of reference on the
3 right side of the table is the corresponding numbers per
4 the June 2017 fiscal year.

5 The difference in profit margins supports a
6 finding of a qualitative difference between these two
7 revenue streams. After finding a qualitative difference,
8 one can explore whether there is a quantitative
9 distortion by including both revenue streams in the sales
10 factor.

11 First we'll look at the attribution test. For
12 quantitative distortion, the attribution test looks at
13 how much of Appellant's apportionable tax base will be
14 attributed to one jurisdiction if a large amount of gross
15 receipts are included in the sales factor denominator.
16 On these facts, we look to how much of the apportionable
17 tax base would be assigned to foreign jurisdictions.
18 This is a test that was first used in the 2006 Microsoft
19 decision. The results of the attribution test can be
20 seen at Exhibit E, table 2.

21 In this case, we have 108.8 billion in dividends
22 for the year at issue, as compared to 95 billion in
23 operational gross receipts, which is what the sales
24 factor denominator would be without the repatriation
25 dividends. If we add these two together, that would be a

1 sales factor denominator of \$204 billion. The 108.8
2 billion in repatriation dividends would be 53 percent of
3 the sales factor denominator, which means that 53 percent
4 of Microsoft's apportionable base would be attributed to
5 foreign jurisdictions where the CFCs that pay these
6 repatriation dividends were located.

7 We can also use the same numbers to do the
8 income to gross receipts test. If we compare what the
9 percentage of the repatriation dividends makeup of the
10 apportionable base as compared to the percentage of the
11 sales factor denominator, that would be, again,
12 53 percent that we've already discussed of the sales
13 factor denominator but 27 billion out of 122 billion of
14 the apportionable base or 22 percent. Thus the
15 representation in the sales factor is more than double
16 the representation in the apportionable tax base. This
17 also shows quantitative distortion if 100 percent of the
18 repatriation dividends are included in the sales factor.

19 Accordingly, if the OTA were to determine that
20 the 75 percent of dividends deducted from the
21 apportionable tax base should be actually included in
22 Appellant's sales factor denominator, this facts
23 situation would warrant a variance from standard
24 apportionment, as the apportionment factor including
25 100 percent of the 108.8 billion in repatriation

1 dividends would not fairly represent the extent of
2 Appellant's California business activities.

3 For a point of reference, including the 81.6
4 billion in receipts that were removed from the
5 apportionable tax base, would cause Appellant's sales
6 factor to go from 5.6 percent as correctly filed, down to
7 3.4 percent as claimed for this appeal. A relative
8 reduction of 40 percent. This can be seen at Exhibit E,
9 table 3.

10 For the three years prior to June 2018 fiscal
11 year, the apportionment factors for this Appellant were
12 5.3 percent, 5.7 percent and 6.7 percent. Thus one can
13 see that including the 75 percent of deducted dividends
14 in the sales factor excuse the factor in the same way as
15 a substantial occasional sale. You can see this at
16 Exhibit E, table 3.

17 In that table, you can see the sales factor
18 results with 25 percent inclusion following California
19 law and 100 percent exclusion if the repatriation
20 dividends are found to be distortive under Revenue and
21 Taxation Code 25137.

22 Upon a finding of distortion on these facts, the
23 appropriate remedy under Revenue and Taxation Code 25137
24 would be to remove 100 percent of the gross receipts from
25 the repatriation dividends from the sales factor. Not

1 just the 75 percent of gross receipts associated with the
2 dividends received deduction. This result aligns with
3 how the substantial occasional sales are treated and
4 would allow Appellant's apportionable income to be
5 apportioned using the apportionment factor from regular
6 operations.

7 Looking at the very bottom of Exhibit E,
8 table 3, you can see the resulting sales factor would be
9 7.25 percent after 100 percent exclusion of the
10 repatriation dividends, which is in line with the three
11 prior year sales factors that were increasing each year
12 with the June 2017 fiscal year sales factor being
13 6.68 percent.

14 I'll next discuss an alternative position
15 looking at other California law regarding including the
16 deducted dividends in the sales factor. By way of
17 background, I'd like to quickly explain that I'm using
18 the term "apportionable tax base" or "apportionable base"
19 or just "base" because income and losses that are
20 included in the base are required to either be in that
21 base or removed from the base by statutes, regulations
22 and case law.

23 So we aren't talking about income and loss. We
24 are talking about items that are necessarily required to
25 be included or excluded from the apportionable base.

1 Losses continue to be reflected in the apportionable
2 base. Whereas income that is eliminated or deducted is
3 removed from the apportionable base.

4 In addition, as stated previously, FTB's
5 position is not that net income must be produced before
6 an item is included in the sales factor. Rather, if an
7 activity produces net income that is excluded from the
8 apportionable base, then it likewise is excluded from the
9 factors. If this is not so, then the apportionable tax
10 base would be apportioned using activities that did not
11 give rise to the tax base.

12 Both the as filed and claim positions are laid
13 out for you in Exhibit D, table 1. California law
14 dictates that Appellant's receipts from foreign dividends
15 are included in the sales factor net of deductions
16 because the deducted amounts are not reflected in the
17 apportionable base upon which the California tax is
18 calculated.

19 Theoretically transactions between foreign
20 entities and domestic entities would otherwise be
21 considered intercompany transactions if there was no
22 water's edge election. It is an artificial construct
23 that we consider these transactions as not intercompany
24 for a water's edge combined report. Unless the CFCs are
25 partially included in the water's edge combined report,

1 looking at the income and factors of the domestic
2 entities without the water's edge election, the
3 intercompany transactions are eliminated from both the
4 base and the factors under Revenue and Taxation
5 Code 25106.

6 While this is called an "elimination," it has
7 the exact same effect as a deduction. The intercompany
8 transaction amounts enter into the apportionable base and
9 then are removed. Since we already have this treatment
10 by statute and regulation for intercompany transactions,
11 we should have the same treatment for those transactions
12 in a water's edge combined report where 75 percent of the
13 dividend is removed by deduction from the apportionable
14 base. But for the water's edge election, 100 percent of
15 the repatriation dividends would have been removed from
16 both the tax base and the factors.

17 Under what rational should the treatment be
18 different after a water's edge election? In both
19 instances, the apportionable base and the sales factors
20 should match. In other words, whatever is statutorily
21 excluded from the calculation of the apportionable tax
22 base, should also not be considered in the calculation of
23 the sales factor.

24 A presidential California Appellate Court case
25 from 1977 that requires this result is Chase Brass and

1 Copper Company versus Franchise Tax Board. In that case,
2 the Court held that, because intercompany sales are not
3 included in the apportionable tax base, they are excluded
4 from the sales factor. In the same manner, the
5 75 percent of dividends that are deducted under Revenue
6 and Taxation Code 24411 are not reflected in the
7 apportionable tax base, and that should also be excluded
8 from the sales factor.

9 The holding in Chase Brass is supported by the
10 1983 U.S. Supreme Court case of Container Corporation
11 versus Franchise Tax Board, which held that the factor or
12 factors used in the apportionment formula must actually
13 reflect a reasonable sense of how income is generated.
14 Including \$81.6 billion in Appellant's sales factor that
15 is not included in the apportionable base would not give
16 rise to an apportionment formula that reflects a
17 reasonable sense of how the income is generated.

18 Now let's talk about Legal Ruling 2006-1. This
19 legal ruling directly applies on the facts at issue
20 today. The principles set forth in the Legal
21 Ruling 2006-1 were already in existence 29 years before
22 it was published because the 1977 Chase Brass case
23 occurred in 1977. This was nothing new in 2006.

24 Under California law, there is no requirement
25 that activities give rise to profit before being included

1 in the sales factor. And that is not what Legal
2 Ruling 2006-1 says. Rather, activities that give rise to
3 income excluded from the tax base, whether exempt,
4 eliminated or deducted, are also excluded from the sales
5 factor. Thus only receipts from activities that are
6 included in the apportionable base are included in the
7 sales factor.

8 Legal Ruling 2006-1 has been in the public
9 domain for more than 17 years, and the principles in the
10 legal ruling have been followed by both taxpayers and the
11 Franchise Tax Board for decades prior to the legal
12 ruling.

13 Appellant originally filed in a manner
14 consistent with Legal Ruling 2006-1, including only
15 27 billion in its sales factor denominator. This method
16 of reporting and the facts of this case are nearly
17 identical to Situation 2 in Legal Ruling 2006-1, which
18 reflects California law and the long-standing published
19 position of the Franchise Tax Board.

20 California law requires and FTB's long-standing
21 practice has been that dividends that are 75 percent
22 deducted under Revenue and Taxation Code 24411 are not
23 included in the sales factor. The California Supreme
24 Court held in 2006, in the case of Ordlock -- that's
25 O-R-D-L-O-C-K -- versus Franchise Tax Board, that

1 California courts accord significant weight and respect
2 to a long-standing statutory construction, whether in the
3 form of a policy or a rule, by the agency charged with
4 enforcement of the statute.

5 Ordlock is an Income and Franchise Tax case
6 where deference was given to FTB's statutory
7 interpretation.

8 Another case that gave deference to
9 administrative practice was Great Western Finance
10 Corporation versus Franchise Tax Board. In that case,
11 the plaintiff deducted amounts from income, and then it
12 sought to also deduct expenses associated with the
13 amounts that were deducted from income. The Court
14 disallowed this treatment, stating that expenses incurred
15 by a taxpayer in producing or receiving dividend income
16 are properly deductible only when that taxpayer's
17 dividend income is taxable.

18 In reaching its conclusion, the California
19 Supreme Court inquired about the administrative practice
20 of the FTB, and it learned that at least since 1962, that
21 is eight years prior to the year at issue, the FTB had
22 disallowed expenses incurred in receiving dividends which
23 had been deducted. The Court held expenses incurred to
24 produce deductible income may not be taken as a
25 deduction. The Court found that while administrative

1 determinations are not controlling, the existence of this
2 practice for at least the past eight years suggests
3 legislative acquiescence during that period in the
4 board's statutory construction.

5 On the present facts, this administrative
6 practice has been in existence long before 2006.
7 However, even if we start counting from 2006, that is 12
8 years of practice up to the year at issue in this appeal.
9 This is an administrative practice that was followed by
10 both taxpayers and the Franchise Tax Board.

11 In addition to the Chase Brass California
12 Appellate Court decision and Container U.S. Supreme Court
13 decision that support the conclusions in Legal
14 Ruling 2006-1, the California legislature endorsed Legal
15 Ruling 2006-1 nine years after the FTB issued it by
16 extending its application to the apportionment factors
17 attributable to the income of qualified health care
18 service plans excluded by Revenue and Taxation Code
19 Section 24330.

20 This legislative endorsement is not significant
21 because the law at issue was similar to Revenue and
22 Taxation Code 24411. Rather the reason why this
23 endorsement is significant is that it shows the
24 legislature was well aware of Legal Ruling 2006-1 and had
25 ample time to address any areas of disagreement that it

1 had with the holdings. Instead of that, the legislature
2 relied on Legal Ruling 2006-1, which includes a holding
3 regarding Revenue and Taxation Code 24411 deducted
4 income. The exact issue in this appeal.

5 In this case, the size of the apportionable tax
6 base has been determined, and it does not include
7 81.6 billion, which is the 75 percent deducted under
8 24411, which was removed from the tax base by the
9 statutory deduction. The amount removed from the
10 apportionable tax base should not be included in the
11 sales factor used to apportion the net income under
12 authority of Chase Brass and Container cases as set forth
13 in Legal Ruling 2006-1.

14 Now, one might ask about the impact in this one
15 year of this specific request by Appellant which goes
16 against California case law and clearly posted guidance
17 on filing requirements. Appellant is asserting this
18 position 12 years after Legal Ruling 2006-1 was published
19 and seven years after the amendments effective in 2011 to
20 Revenue and Taxation Code 25120(f)(2).

21 The total everywhere gross receipts for the
22 sales factor denominator with 25 percent of the
23 repatriation dividends is 122 billion. The repatriation
24 dividend at 100 percent is 108.8 billion.

25 If the 81.6 billion is added to the 122 billion

1 for the sales factor denominator, you can see why there
2 is such a large impact. If you turn to Exhibit D,
3 table 1, you can see how the large influx of repatriation
4 dividends would affect the sales factor if included at
5 100 percent and why Appellant is for the first time
6 seeking this unusual filing position.

7 Looking at the table, the first set of rows
8 shows the original filing position with 27 billion only
9 in the sales factor from the repatriation dividends as
10 required by California law. Then the second set of rows
11 shows what happens when you put in a hundred percent of
12 the 108.8 repatriation dividends and the sales factor
13 denominator per the claim for refund.

14 There are corollaries to this issue on appeal,
15 and I will just briefly go through those. The first one
16 is 25106. We've already talked about that. Under 25106,
17 where they're intercompany dividends, they are removed
18 from the apportionable base and also from the sales
19 factor. That's a corollary that we have here.

20 There's also nonbusiness income. Because that's
21 not associated with the business income that's being
22 apportioned, it's not included in the sales factor.
23 That's another corollary.

24 And then there's also Revenue and Taxation
25 Code 24425. And for that section, it states that amounts

1 that would otherwise be allowed as a deduction are
2 disallowed if the deduction is attributed to income that
3 is not included in the measure of tax. This means that
4 no deduction is allowed for expenses related to an
5 activity that's not included in the tax base. That's
6 also a little bit similar.

7 But now let's hone in on Revenue and Taxation
8 Code 25120(f)(2), which Appellant is heavily relying on
9 for its position. If the OTA finds that the repatriation
10 dividends are not a substantial occasional sale and that
11 their inclusion at 100 percent is not distortive, then
12 one must look at Revenue and Taxation Code 25120(f)(2)
13 more closely.

14 The preface to Revenue and Taxation Code 25120
15 states that the definitions apply unless the context
16 otherwise requires. If we insert this phrase after the
17 two definitions that are at issue in this appeal starting
18 at (f)(1), it would say sales means all gross receipts of
19 the taxpayer not allocated unless the context otherwise
20 requires. And (f)(2) would say in pertinent part gross
21 receipts means the gross amounts realized on the use of
22 property or capital, including dividends, in a
23 transaction that produces business income in which the
24 income gained or lost is recognized under the Internal
25 Revenue Code unless the context otherwise requires.

1 FTB asserts that the context requires a
2 different result on these facts. The context is that
3 81.6 billion in repatriation dividends are removed from
4 the apportionable base in a similar manner to when
5 intercompany dividends are removed under Revenue and
6 Taxation Code 25106. Thus, under Revenue and Taxation
7 Code 25120(f)(2), a transaction must give rise to
8 federally recognized income to be included in the sales
9 factor.

10 However, the end first is not true. Not all
11 activity that is recognized as income or loss under the
12 IRC is required to be included in the sales factor. Such
13 a conclusion would require Subpart F income to be
14 included in the sales factor, as it's recognized as
15 income or loss by the IRC, yet Subpart F income is not
16 included in either the apportionable base or the sales
17 factor for California purposes and is not listed at
18 (f)(2) either.

19 One might ask about the treatment of cost of
20 goods sold. What about those? Those are included in the
21 sales factor. And what implication does that have for
22 dividends that are deducted from the tax base? The
23 answer is that cost of goods sold and deducted dividends
24 are not similar and cannot be equated to each other.
25 Cost of goods sold are included in the apportionable tax

1 base as an expense item. They're in there. And thus,
2 they are also reflected in the sales factor. They match.

3 Deducted dividends are removed from the
4 apportionable tax base. And therefore, they are properly
5 removed from the sales factor. The issue here is whether
6 amounts removed from the apportionable base should still
7 be reflected in the sales factor as proposed by
8 Appellant.

9 Appellant argues that FTB is not following the
10 statute and that the statute is not discretionary.
11 However, there is an outlet built directly into the
12 statute for when the context otherwise requires. In
13 addition, there are concrete examples where items that
14 would otherwise be considered gross receipts under
15 Revenue and Taxation Code 25120(f) are not included in
16 the sales factor. Gross receipts can be excluded from
17 the sales factor pursuant to Revenue and Taxation
18 Code 25137 upon a showing of distortion.

19 Also, when a transaction is not considered to be
20 a sale or by regulation, such as Regulation
21 25137(c)(1)(D), treasury receipts, or 25137(c)(1)(A),
22 substantial occasional sales, those are all items that
23 are not included in the sales factor, but they're not
24 listed at (f)(2) either.

25 Gross receipts have also been excluded from the

1 sales factor where the income was not included in the
2 apportionable base upon which the California tax is
3 calculated. This is Chase Brass.

4 In Chase Brass, gross receipts were excluded
5 from the sales factor as they were associated with
6 intercompany items that were not in the tax base. Chase
7 Brass relates to the appeal at hand because 81.6 billion
8 in dividends from foreign entities were removed from the
9 tax base by deduction and thus should not be included in
10 the sales factor.

11 The holding in Chase Brass is also supported by
12 Container Corp. versus Franchise Tax Board, which held
13 that the factor or factors used in the apportionment
14 formula must actually reflect a reasonable sense of how
15 the income is generated. It is not a controlling
16 distinction that Chase Brass involved intercompany sales
17 because the holding in that case can appropriately be
18 applied in other fact patterns where income is not
19 included in the apportionable base such as here, nor is
20 it particularly relevant that in later years there was a
21 statute, Revenue and Taxation Code 25106, and a
22 Regulation, 25106.5-1, that address the treatment of
23 intercompany transactions, the subject matter in Chase
24 Brass.

25 At the time of Chase Brass, there was no

1 definitive guidance on what to do with gross receipts
2 from intercompany transactions that don't change the
3 apportionable tax base, and the Court did the right thing
4 to exclude the intercompany gross receipts as should be
5 done here.

6 In Chase Brass, the apportionable tax base was
7 not changed from the intercompany transactions as revenue
8 merely moved from one unitary entity to another unitary
9 entity. In the present case with the water's edge
10 combined report, CFCs, remember, are treated as third
11 parties. To the extent that the water's edge combined
12 reporting group apportionable tax base changed for the
13 25 percent that is included in the tax base, there's
14 sales factor representation. For the 75 percent not
15 included in the apportionable base, there is no sales
16 factor representation. This totally lines up with Chase
17 Brass.

18 The water's edge combined reporting group
19 apportionable base did not change, as that income was
20 removed similar to removing the intercompany transaction
21 income. That is the economic reality that we are
22 addressing here, as under the 2006 Microsoft decision
23 suggested that we look at the economic reality of the
24 transaction and that we look at the substance, not the
25 form of a transaction.

1 JUDGE LAMBERT: Ms. McElhatton, I'm just giving
2 you a warning. You have five minutes left in our time.

3 MS. MCELHATTON: Yep. Okay. Thank you.

4 Chase Brass was looking at a unitary business
5 and the shifting of income between members. In the
6 present case, the unitary group is larger than the
7 water's edge combining reporting group, which is a subset
8 of all of the entities that are unitary.

9 While it may be that FTB had more discretion in
10 pre-UDITPA years regarding how to apportion income and
11 loss, in the present case, when the context otherwise
12 requires, a similar result should be reached as supported
13 by the Container U.S. Supreme Court decision.

14 Thus adding 81.6 billion dollars to the sales
15 factor that is not associated with the apportionable tax
16 base that is being apportioned does not reflect a
17 reasonable sense of how the income is -- that is being
18 apportioned was generated. And accordingly, under the
19 Chase Brass and Container cases, these billions of
20 dollars deducted under Revenue and Taxation Code 24411
21 should not be included in the sales factor.

22 While there is no general provision that calls
23 for deducted income to be removed from the sales factor,
24 there was no provision at the time of the Chase Brass
25 decision that intercompany items should be eliminated

1 from the factors, and yet the Court was able to come to
2 the correct conclusion that intercompany transaction
3 income that is removed from the apportionable base is not
4 included in the sales factor. It does not matter that we
5 now have regulations that give guidance on intercompany
6 items. For the year at issue in this case, sales and
7 gross receipts for purposes of the sales factor are
8 defined at 25120(f). And those definitions apply unless
9 the context otherwise requires as occurs for this
10 Appellant.

11 There is no reason to look to outside sources
12 for definitions of gross receipts, as we have an outlet
13 in the statement "unless the context otherwise required"
14 at Revenue and Taxation Code 25120. Thus there is no
15 reason to look beyond the statute when defining sales or
16 gross receipts.

17 Okay. So I am going to skip to Appellant's
18 25137 request. They are requesting in one portion
19 something that is barred by the doctrine of elections but
20 only part of it. So CFC income and receipts are what we
21 are going to talk about first.

22 Appellant asserts that FTB's denial of
23 Microsoft's refund claim creates gross distortion that
24 vastly overstates income. If Appellant were to stop
25 here, that would be an appropriate ground for a variance

1 action request. But --

2 JUDGE LAMBERT: Ms. McElhatton, I was wondering
3 if you want to take time from your closing, the
4 15 minutes now, if you want to finish but reduce your
5 closing time.

6 MS. MCELHATTON: That's a great idea.

7 JUDGE LAMBERT: I'll let you know when it's been
8 ten minutes.

9 MS. MCELHATTON: That would be great. Five
10 minutes on rebuttal would probably be plenty.

11 JUDGE LAMBERT: Okay.

12 MS. MCELHATTON: Okay. So I'll back up so you
13 remember what I said.

14 Appellant asserts that FTB's denial of
15 Microsoft's refund claim creates gross distortion that
16 vastly overstates income. If Appellant were to stop
17 there, that would be an appropriate ground for a variance
18 action request.

19 So we're not saying whenever there's water's
20 edge election you can never have a variance action
21 request as they're asserting. That is not what we're
22 asserting, but Appellant must show with clear and
23 convincing evidence that standard apportionment that
24 removes the 75 percent of the repatriation dividend from
25 the sales factor gives rise to apportionment that does

1 not fairly represent the extent of Appellant's California
2 business activities.

3 No such showing has been made for the roughly
4 five percent sales factor for the year at issue.
5 Appellant has not shown that this five percent sales
6 factor unfairly represents the extent of its California
7 business activities. Since that burden has not been met,
8 no variance should be granted. We really don't even need
9 to talk further about it. However, I will go further and
10 explain.

11 Appellant also goes so far as to suggest that
12 all of Microsoft's foreign operation underlying sales
13 receipts generating the profit represented by the
14 dividends over that time frame should be included in its
15 sales factor denominator.

16 In other words, Appellant seeks to include all
17 of the receipts of its controlled foreign corporations
18 that had operations that contributed to the dividend that
19 was paid to its U.S. shareholders.

20 First, we only look to reasonable alternatives
21 when the primary burden that I just recounted has been
22 met.

23 Here, Appellate is demanding an alternative
24 without meeting its primary burden. Appellant has not
25 shown that a roughly five percent apportionment factor

1 for this one year unfairly represents the extent of its
2 California business activities. Without that showing, we
3 don't even talk about a remedy because you don't get
4 there. That's the next step, but I'll go beyond the
5 basics.

6 Trying to include operational receipts from
7 excluded CFCs in the water's edge combined report sales
8 factor, that is the part that is barred by the doctrine
9 of elections and thus is not even a proper ground for a
10 variance action request.

11 If we were to talk about remedy, Appellant
12 elected water's edge, which largely excludes the income
13 and the factors from controlled foreign corporations from
14 the water's edge combined report. We aren't talking
15 about dividends here. We're talking about operational
16 receipts of these controlled foreign corporations. The
17 ones that we treat as third parties when you make a
18 water's edge election.

19 This is a profound request by Appellant seeking
20 a method that is not allowed by standard water's edge
21 combined reporting rules. Including the receipts from
22 foreign operations, an Appellant's sales factor would
23 essentially be a worldwide combined report, except that
24 the income earned by the foreign operations would largely
25 not be in the apportionable tax base due to the water's

1 edge election. Appellant has not provided an analysis
2 upon which any relief can be granted.

3 I'll rely on my brief for the doctrine of
4 elections where it's explained there. There's the
5 Grynberg case, G-R-Y-N-B-E-R-G, versus Commissioner.
6 It's a 1984 case, and it sets out that there are two
7 elements to the doctrine of election. The first is that
8 there be a free choice, and the second is that there be
9 an overact communicating that choice to the Commissioner.
10 Clearly it applies here, and it appears that Appellant
11 has dropped that argument anyway.

12 So in conclusion, if standard apportionment
13 includes 100 percent of the repatriated dividends in the
14 sales factor, then 100 percent of the repatriated
15 dividends should be excluded from the sales factor either
16 because they are a substantial occasional sale or because
17 inclusion at a hundred percent is distortive under
18 Revenue and Taxation Code 25137.

19 In the alternative, presidential case law and
20 long-term administrative practice, as explained in Legal
21 Ruling 2006-1, support a finding that the 75 percent of
22 dividends deducted from the apportionable tax base for
23 the water's edge combined reporting group should be
24 excluded from Appellant's sales factor.

25 Finally, for Appellant's request for a variance

1 under 25137, Appellant has not carried its burden of
2 proving by clear and convincing evidence that a roughly
3 five percent apportionment factor unfairly represents the
4 extent of its California business activities.
5 Accordingly, there is no need to analyze possible
6 alternatives.

7 In addition, Appellant's extraordinary request
8 to include CFC operational results is barred by the
9 doctrine of elections.

10 Thank you.

11 JUDGE LAMBERT: Thank you, Ms. McElhatton. And
12 I think at this time we can -- I can see if the panel has
13 any questions to ask. And also, you have seven minutes
14 left of the 12 that we gave you after adding the 10. So
15 that means you should have -- seven-plus five is 12.
16 Okay?

17 MS. MCELHATTON: Okay.

18 JUDGE LAMBERT: Judge Johnson, did you have any
19 questions?

20 JUDGE JOHNSON: Yes. Thank you.

21 On that last point with doctrine of elections in
22 reference to inclusion of the dividends and the sales
23 factor being contrary to the water's edge election, is
24 not the inclusion of the dividends required by the Tax
25 Cut and Jobs Act, though?

1 MS. MCELHATTON: Okay. So what we have to
2 remember is the point I was making here is what Appellant
3 is trying to do is to include the operational receipts.
4 So you have CFCs here in foreign jurisdiction and here's
5 your domestic. So we have the CFCs here and they're
6 doing operations; right? They're taking in receipts
7 because they have all their operations in foreign
8 jurisdictions. They're taking in those receipts. But
9 remember, under a water's edge election, we treat the
10 CFCs as a third party. So those amounts, those
11 operational receipts that are coming in, those are not
12 allowed to be included in the water's edge combined
13 reporting group over here. The domestic -- mostly
14 domestic entities. Those receipts that they earned, as a
15 third party, remember, are not allowed to be included in
16 the sales factor for the water's edge combined reporting
17 group because they're third parties, and you don't
18 include receipts earned by third parties.

19 So then they do pay the dividends over, but the
20 doctrine of elections, I wasn't applying the doctrine of
21 elections to the dividend payment. I was applying it to
22 their argument that we should be including the receipts
23 earned by those CFCs. Not the dividends paid, but the
24 receipts that they earn when they do their activities in
25 foreign jurisdictions.

1 Does that explain?

2 JUDGE JOHNSON: I think so. Yeah. And maybe
3 Appellant wants to address that as well when they get to
4 the rebuttal portion, the additional information about
5 that.

6 As to the 25137 distortion argument -- I'll just
7 go to my notes real quick here.

8 I know you had mentioned that the 7.25 factor
9 that you get when you remove all the dividends was more
10 representative based on prior years' activity.

11 MS. MCELHATTON: Well, I would not use the term
12 "more representative" because that's not the test. The
13 test is whether something unfairly -- in a particular
14 year -- apportionment factor unfairly represents the
15 extent of the appellant's California business activities.
16 That's the test.

17 Now, I did include the other years. As you
18 could see, the apportionment factor was gradually
19 increasing. I think the year before it was about
20 6.8 percent, and then it went up to 7.25 if you do the
21 hundred percent exclusion. And so that is just a way of
22 looking at the progression because then you can see if
23 there's a big difference. You know, is it all of a
24 sudden a 25 percent factor or something. But it's not
25 out of line with the other years with a hundred percent

1 exclusion.

2 JUDGE JOHNSON: Okay. I guess that's my
3 question with it being out of line from the prior years.
4 Rather than continuing to increase, maybe that's a trend
5 that you see, would it also be fair to look at the
6 previous years, average them and see about a 5.8 percent,
7 which is closer to the 5.6, which is when you include the
8 25 percent dividends in the apportionment factor?

9 MS. MCELHATTON: That's another way of looking
10 at it. I probably wouldn't do it that way just because
11 you're seeing a progression. And so with the average,
12 you wipe out the progression. So you're not really
13 seeing the progression anymore. That is another way of
14 looking at it, if you wanted to.

15 JUDGE JOHNSON: Okay. And having the benefit of
16 hindsight seeing the year we're in now versus the year
17 then, would you also look at the years that were
18 following to see if progression continues or the
19 progression reverses?

20 MS. MCELHATTON: I have not done that, and this
21 year has largely not been fully audited. So we don't
22 even have a lot of information for this year. So, no, I
23 have not looked at the later years.

24 JUDGE JOHNSON: Then the last question I'd like
25 to ask is -- perhaps more clarification. You mentioned

1 sort of the impact or the effect of deductions being
2 similar to those of elimination. And you raised the
3 comparison of cost of goods sold and other deductible
4 items and perhaps, you know, you can say legal fees
5 for -- incurred in negotiating sales contracts. Can you
6 explain a little bit further as to why these deducted
7 amounts are special compared to other deducted amounts
8 that are included in the apportionable factor?

9 MS. MCELHATTON: Well, each one has to be looked
10 at separately. So are you talking about the ones that I
11 list out that aren't included? You're wanting me to
12 explain why they're not included?

13 JUDGE JOHNSON: I'm talking specifically about
14 cost of goods sold you mentioned being included but these
15 dividends being different, and, therefore, they're not
16 included.

17 MS. MCELHATTON: Okay. So the cost of goods
18 sold. The part that's confusing about cost of goods sold
19 is it's a negative number, and I think that's a little
20 bit confusing for folks. So that's why we tried to shift
21 the wording to apportionable tax base, because the
22 apportionable tax base includes income, and it also
23 includes expense items. So then once you include the
24 expense items, then the income becomes smaller. And
25 that's what cost of goods sold does, and that's what I

1 was trying to explain. Maybe I didn't do a very good job
2 of explaining it, but losses and cost of goods sold,
3 those are all in the apportionable tax base.

4 You know, if you have \$10 in income and you have
5 \$2 in cost of goods sold, then what you're going to end
6 up with is \$8. So the negative \$2 is in there is what --
7 that's the point I was trying to make.

8 Did I answer or?

9 JUDGE JOHNSON: Yeah.

10 MS. TAMAGNI: I just want to add that I think
11 the point that Laurie is making is that cost of goods
12 sold is part of the apportionable tax base, and here
13 we're looking at dividends that are not in the
14 apportionable tax base because they've been removed. So
15 even though cost of goods sold is an expense and it would
16 be -- if you looked at it on paper, it would be a
17 negative number; right? It's still in that base, whereas
18 here we have dividends that have been removed, so ...

19 Thank you.

20 JUDGE JOHNSON: The only last question I have --
21 and maybe it's actually for Appellant to answer on
22 rebuttal if they choose to -- is just a brief explanation
23 of why they originally filed one way and then now have
24 changed their mind.

25 But you can answer that on your rebuttal if you

1 want to.

2 MR. KELLEY: How about we just answer it now
3 because I'm the person who had to make that decision. So
4 welcome to my life; right?

5 So we file our California tax return, and if we
6 get it wrong, let's say we understate the amounts on the
7 return, there's a 20 percent substantial understatement
8 penalty that could apply, and so -- so when faced with a
9 choice between filing a return that we believe is the
10 right return, that is gross dividends, versus filing the
11 return using the net dividends amount and then following
12 it up with a refund claim gets us out of the possible
13 application of penalties, and there's no other reason
14 than that.

15 JUDGE JOHNSON: Okay. No other questions.
16 Thank you.

17 JUDGE LAMBERT: Thanks.

18 Judge Ridenour, did you have any questions?

19 MS. RIDENOUR: No questions. Thank you very
20 much.

21 JUDGE LAMBERT: Thanks.

22 I had a couple of questions.

23 Ms. McElhatton, I'm just confirming on the
24 schedules that you provided, I believe, on Exhibit E,
25 page 1, for instance --

1 MS. MCELHATTON: Table 1?

2 JUDGE LAMBERT: Yeah, table 1. On the left,
3 there's a line called CFC's income. And it's, like,
4 three billion, I guess. Is that the income related to
5 the inclusion ratio? I was wondering.

6 MS. MCELHATTON: Do you mean other income?

7 JUDGE LAMBERT: Under the other income it says
8 "CFC's income."

9 MS. MCELHATTON: Oh, CFC income. Oh. Okay.
10 That goes into the 94 billion. They can probably answer
11 this better, but that would probably be from their
12 inclusion ratio. So if they have, like, a one percent
13 inclusion ratio, there will still be a little bit of
14 income that is CFC income that is included in the water's
15 edge combined report. I was trying not to get too deep
16 in the weeds, but I think that's what that is.

17 MR. KELLEY: Yeah. That's correct.

18 JUDGE LAMBERT: Okay. Thanks. I was just
19 confirming that.

20 And also on the same table on the middle column
21 says additional dividends of 109 billion and earlier was
22 108, I think, after certain things were moved. Should
23 that be 108 or is that 109?

24 MS. MCELHATTON: No. It's correct. We were
25 trying to be super accurate here. And the reason why

1 it's 109 is it's still reflecting the 25106 dividends.
2 They're going to be eliminated.

3 So as I said before, they're paid in. All of
4 these are paid in and then some are removed. So it's,
5 like, \$200,000. I think it's on a different one of these
6 schedules. Maybe one of the earlier ones. Let's see. I
7 think it's maybe in D. There's, like, 200,000 in the
8 25106 dividends, and we wanted to make sure -- here it
9 is. 219.

10 Okay. It's on Exhibit D, table 1. You skip
11 those first two rows and you go down to the notes. It's
12 in the notes 1 section, and then it says "total PTI."
13 And then if you go one, two, three, four, four down, it
14 says "less intercompany dividends 25106." We just wanted
15 to make sure that you knew that.

16 So, for example, if you decided that a hundred
17 percent of these dividends should be included under
18 standard apportionment, the 25106 dividends, those are
19 eliminated. So those would come out. And that was why
20 we decided to get in the weeds a little bit there. And
21 so the actual number is 108.8 billion.

22 JUDGE LAMBERT: Okay. So it's 108. It just
23 includes the intercompany that's excluded.

24 MS. MCELHATTON: The 109 includes the
25 intercompany that will be eliminated. Yes. And we

1 realized that, and we thought maybe we better lay it out
2 for you so that you see the difference.

3 JUDGE LAMBERT: Okay. Thanks. That is helpful.

4 And in terms of the Legal Ruling 2006-1 -- well,
5 maybe you covered this, but the statute changed after,
6 and does that change how we likely interpret the legal
7 ruling after 25120 was amended in 2011?

8 MS. MCELHATTON: No, it doesn't change the legal
9 ruling, 2006-1, because it addresses items that are
10 exempt or deducted or eliminated from income. And so we
11 still have those issues. And if they're deducted, exempt
12 or eliminated, then they're also not included in the
13 sales factor, and that's still the case after 2011 when
14 25120 was amended and (f) was added. Subdivision (f).

15 JUDGE LAMBERT: Okay. Thanks.

16 MS. MCELHATTON: Uh-huh.

17 JUDGE LAMBERT: And in terms of, like, possible
18 alternative of apportionment, you're arguing that it
19 should be a hundred percent excluded or 25 or either
20 depending on your argument?

21 MS. MCELHATTON: Under 25137, it's a hundred
22 percent exclusion, and this mirrors the substantial
23 occasional sale rules. For that, you have a hundred
24 percent exclusion as well. And so if you find for some
25 reason that this is not a substantial occasional sale and

1 that it should be a hundred percent excluded, then it's
2 distortive and under 25137 should be 100 percent
3 excluded, even the 25 percent. So all 108.8 billion.

4 JUDGE LAMBERT: Okay. Thanks. I'm just
5 clarifying.

6 MS. MCELHATTON: Yes.

7 JUDGE LAMBERT: I have no further questions at
8 this time.

9 Did we want to take a break?

10 Stenographer, did you need a break, or should we
11 continue?

12 We can take a break and come back in ten
13 minutes. And I'll go off the record.

14 (Off the record.)

15 JUDGE LAMBERT: We're back on the record if
16 everyone is ready.

17 I think we added it up.

18 And, Mr. Kelley, I think you have 43 minutes.
19 You don't have to use the whole time, but that's what you
20 have. So you can continue.

21 MR. KELLEY: Thank you.

22 One of the things I heard during the arguments
23 was about this was an enormous amount of income. And for
24 clarity, the federal tax law change is -- resulted in
25 more than 109 billion of income, and it resulted in

1 157 billion of federal income; right? So under federal
2 tax law, Microsoft and companies like us needed to
3 recognize deferred foreign earnings and profits as of the
4 measurement date that had been accumulated and not yet
5 distributed back into the U.S. So for Microsoft, during
6 the tax year on the federal return, it was 157.

7 And to the FTB's point, because California did
8 not conform to those law changes, it was only after there
9 was an actual dividend, a legal dividend, rather than
10 this fictional federal deemed dividend; right? So
11 federal law, there's a fictional dividend equal to these
12 earnings and profits that hypothetically are a dividend
13 paid from the foreign subs, but we declared a legal
14 dividend, so we actually moved the cash balances from
15 these entities into the U.S., but it wasn't a one-for-one
16 distribution, rather it was \$109 billion. That's a
17 rounded number. All right. So the rest of it is -- you
18 know, these are grounded numbers.

19 One of the consequences of the federal tax law
20 change is it created a circumstance where the company has
21 now a regular policy of returning earnings and profits
22 from outside the U.S. into the U.S., which I think is
23 probably the intent of the law; right? So you see
24 companies like us making these annual large distributions
25 on the books; right? And we've smoothed it out for book

1 dividends as compared to these federal taxable income,
2 and it's only these actual book dividends that were
3 taxable.

4 And so for example. The subsequent year there
5 was a \$45 billion tax book dividend; right? So the year
6 after this there was a \$45 billion, and the year just
7 filed there was a \$71 billion book distribution of
8 earnings and profits from the foreign entities.

9 So big, yes. Infrequent, no. They're frequent
10 now. And it's a fundamental shift in the federal tax
11 code where companies no longer are -- our company is no
12 longer, you know, keeping earnings and profits outside of
13 the U.S. We're returning it back into the U.S. And so
14 this casual isolated sale discussion, it's not isolated.

15 And the idea that a company like us has earnings
16 and profits that are greater than the domestic earnings
17 and profits isn't unusual. In fact, in our 10-K for this
18 tax year, 50 percent of our sales were from outside of
19 the U.S. We're a local business. We have sales
20 operations. We sell software outside of the U.S. and
21 quite a bit. And so these are not -- this is part of our
22 business starting in this tax year and moving forward.
23 So there's nothing casual or isolated about it.

24 One curious application of the California tax
25 law is that for the three years prior to this tax year,

1 you know, before credits, our taxable amounts were in the
2 30s, 40s millions of dollars. They started with a three
3 or four. In 2018, it was \$204 million; right? So it
4 went from 30s and 40s to 200. The next year -- these are
5 rounded again -- 190. Next year, 190. Next year, 240.
6 Next year, 380.

7 I mean, these are all because of the foreign
8 earnings and profits brought in. You see a huge
9 multiplier of the tax law, and it all comes to this
10 algebraic formula where foreign dividends are represented
11 using net income numbers even though the domestic profits
12 are apportioned using gross sales numbers. And so that
13 algebraic short shifting of dividends, foreign dividends,
14 is always going to create this problem, and it always has
15 created this problem for the last 12 years or for however
16 long, but historically companies haven't distributed very
17 large dividends back from foreign companies. So it just
18 hasn't -- it's always been there. It just hasn't been
19 enough. It's been a rough cut justice to this point.

20 So shifting back. At the end of our case in
21 chief, we said what we don't see the Department, FTB,
22 rather, arguing is that gross amounts received from
23 dividends means net dividends are no dividends. I mean,
24 that entry point in the statute is critical, of course,
25 because there is a threshold issue here.

1 And, Judge Lambert, you mentioned it as we sat
2 down. The OTA must decide as a threshold issue whether
3 the receipts are included in the sales factor before you
4 address any distortion issues.

5 So you have to decide, well, what's the
6 statutory method? Is it what the statute says? Gross
7 amount dividends are included in the sales factor
8 measured by gross amounts received. Are you following
9 the Microsoft case? Gross means gross.

10 Deductions for income aren't deductions for the
11 sales factor. And only when you reach that kind of
12 threshold issue then can you go down -- down and address
13 these other issues about, well, who then -- we believe
14 it's not distortive to have gross dividends in there. We
15 showed you why in our Exhibit 1. It is -- it
16 proportionally represents the gross dividends amounts in
17 the sales factor by including the gross dividends as
18 opposed to the net dividends.

19 But once you decide that's true, which we
20 believe it's true -- the statute says gross dividends.
21 Other states, as I mentioned, with the same statute, the
22 same UDITPA statute, call out no, dividends aren't --
23 dividends received deduction aren't included in our
24 statute. And Oregon is the example that we give. There
25 are other examples. So when the legislature in this

1 uniform act wants the dividends received deduction to be
2 removed from the sales factor, it says it in the statute.
3 It's not implied.

4 Now, if you agree with us that gross means
5 gross, then the Franchise Tax Board hasn't carried its
6 burden. It really, really hasn't even briefed this
7 issue. It's had a single exhibit that alleges qualitative
8 distortion figures, but that's not enough to carry
9 the burden of the clear and convincing burden under
10 Section 25137.

11 Now, to address the Chase Brass -- Chase Brass,
12 Container are both prewater's edge cases; right? They
13 are both worldwide years. And in that case, yeah, it
14 makes sense that intercompany receipts are eliminated,
15 but that's not the fact pattern we have here. These are
16 water's edge years.

17 So every dollar that comes in the door goes into
18 the sales factor for apportionment purposes. 25106,
19 intercompany elimination just doesn't my here. The only
20 way the FTB can exclude these receipts is to allege
21 distortion, and it hasn't and cannot carry that burden.

22 And then finally to talk about rules of
23 statutory construction. We have opposing rules here.

24 Now, the FTB alleges there's deference to the
25 agency here. They're the administrative body that is

1 charged with implementing these statutes. But in the
2 Microsoft case, the Supreme Court -- and almost identical
3 facts -- sales factor, whether it included a deduction
4 that applies to income, said we believe that this is a
5 circumstance where any ambiguity must be construed in the
6 favor of Microsoft. And that was with the full knowledge
7 that the FTB was on the other side of that and they were
8 the administrative agency that now they're seeking
9 deference for.

10 And then finally, this matching of receipts
11 argument that we hear, I think, is just dispensed with a
12 2007 Microsoft California Supreme Court case. The FTB is
13 talking about deductions to the income tax base. We're
14 talking about inclusion in the sales factor for
15 apportionment purposes. Income tax base and
16 apportionment are very different applications and
17 California law is clear on the latter. These receipts,
18 gross amounts received from dividends, come in the door
19 absent any distortion.

20 That's all I have.

21 JUDGE LAMBERT: Okay. Thank you, Mr. Kelley.

22 Now, I'll turn to Ms. McElhatton, if you want to
23 give closing remarks. I think we calculated you have,
24 you know, 12 minutes left.

25 MS. MCELHATTON: Okay. That's fine.

1 I'll start out just with saying that Appellant
2 says that the Microsoft California Supreme Court case is
3 identical facts to this case and that ambiguity should be
4 in favor of Microsoft, but that case is not identical to
5 this case. In that case, they were looking at sales.
6 They were looking at marketable securities. It was very
7 different than what we're looking at here.

8 There was also no published guidance. So when
9 we're talking about deference, there really was not a
10 deference issue in the Microsoft case. So that is
11 entirely separate.

12 And then as far as the constitutional arguments,
13 those are outside the scope of this appeal. As you know,
14 it's an administrative tribunal with jurisdiction that's
15 limited by its enabling legislation. So OTA has
16 jurisdiction to hear and decide disputes over proposed
17 assessments, refunds of tax, interest and penalties. The
18 OTA has limited jurisdiction over constitutional issues.
19 And that's at regulation 30104, which states the OTA does
20 not -- this first part is me talking.

21 The OTA does not have jurisdiction to decide --
22 and this is a quote -- "whether a California statute is
23 invalid or unenforceable under the United States or
24 California Constitution unless a federal or California
25 Appellate Court has already made such a determination.

1 That's Regulation 30104(a).

2 Appellant is arguing that certain California
3 statutes cannot be enforced as written because they
4 violate the U.S. Constitution, which is contrary to OTA's
5 own rules for it to even consider those arguments. As a
6 result, Appellant's constitutional claims may not be
7 raised in this forum.

8 And Appellant argues that it does not waive
9 constitutional claims through its water's edge election,
10 but then it refuses to reply further since the
11 Constitution cannot be decided at the OTA level. They
12 did flesh out their constitutional arguments here, but
13 they are not properly before this tribunal.

14 So if this panel finds that the substantial
15 occasional rule does not apply, then the repatriation
16 dividends of 108.8 billion should still be a hundred
17 percent excluded from the sales factor because to include
18 them in the sales factor is distortive. We've included
19 all sorts of schedules to show both qualitative
20 distortion by comparing the profit margins and
21 quantitative distortion by looking at the attribution
22 test and also comparing the receipts with the income.
23 We've done all of these things, and these are all tests
24 that's came right out of the 2006 Microsoft case.

25 So we have carried our burden, and all of those

1 exhibits are in Exhibit E. So including the repatriation
2 dividends at a hundred percent would cause 53 percent of
3 Appellant's apportionable tax base --

4 JUDGE LAMBERT: Ms. McElhatton, just slow down a
5 little bit.

6 MS. MCELHATTON: Including the repatriation
7 dividends at 100 percent would cause the 53 percent of
8 Appellant's apportionable tax base to be attributed to
9 foreign jurisdictions. Excluding a hundred percent of
10 the repatriation dividends is a reasonable alternative,
11 as the end result is that the apportionable base is
12 apportioned using the sales factor from the regular
13 business operations of Appellant, which is about a
14 five percent apportionment factor.

15 So just to summarize, if standard apportionment
16 includes a hundred percent of repatriation dividends in
17 the sales factor, then a hundred percent should be
18 excluded be -- either because they are a substantial
19 occasional sale or because including them in a hundred
20 percent is distortive under 25137.

21 In the alternative, presidential case law and
22 long-term administrative practice, as explained in Legal
23 Ruling 2006-1, support a finding that the 75 percent of
24 dividends deducted from the apportionable base for the
25 water's edge combined reporting group should be excluded

1 from Appellant's sales factor.

2 Finally, for Appellant's request for a variance
3 under 25137, Appellant has not carried its burden of
4 proving by clear and convincing evidence that a roughly
5 five percent apportionment factor unfairly represents the
6 extent of its California business activities.

7 Accordingly, there's no reason to even look at possible
8 alternatives.

9 In addition, Appellant's extraordinary request
10 to include CFC operational receipts is barred by the
11 doctrine of elections.

12 Okay. Thank you.

13 JUDGE LAMBERT: Okay. Thank you,
14 Ms. McElhatton.

15 Mr. Kelley, did you have any final remarks or
16 comments on anything?

17 MR. KELLEY: Just two quick things, Judge.
18 Judge Johnson asked a question that I didn't respond to.
19 The question was, well, are we making the CFC factor
20 inclusion argument and how does that work. I mean, I
21 think -- that's only when you're down in equitable
22 apportionment and you're looking at remedial methods;
23 right? A method that would result in a fair amount of
24 apportionment. And there's really no limit about which
25 method could do that or would do that, but the idea that

1 CFC -- related CFC sales should be included is from the
2 Hellerstein, H-E-L-L-E-R-S-T-E-I-N, treatise state tax.

3 The FTB can't have it both ways. They can't use
4 the unitary business principle as the hook to grab the
5 foreign dividends when it comes to the income side but
6 then block any of the related foreign sales in -- so you
7 have to take both if you're going to look at a larger
8 context of what those look like. So that's our view. If
9 we're looking at remedial methods under 25137, that's
10 certainly a remedial method that does, in our view, more
11 fairly reflect income.

12 And one last argument. We make the
13 constitutional arguments because our view is that the
14 gross receipts method is the statutory method, that gross
15 income means gross dividends. And our view is that, if
16 you want to deviate from that because there's a contrary
17 context, then you must look at the whole context. And
18 one thing that you must evaluate is whether this method
19 of net dividends or zero dividends would, in fact, be
20 unconstitutional as applied to our case. So we're not
21 asking you to strike down the statute that's
22 unconstitutional, but we are asking you to interpret the
23 existing statutes in a way that doesn't conflict with the
24 Constitution.

25 JUDGE LAMBERT: Thank you, Mr. Kelley.

1 And I'm going to ask the panel if they have any
2 final questions of either party.

3 Judge John Johnson, did you have any questions?

4 JUDGE JOHNSON: No questions. Thank you, both.

5 JUDGE LAMBERT: Thanks.

6 And Judge Ridenour, did you have any questions?

7 MS. RIDENOUR: Also no questions. Thank you
8 very much.

9 JUDGE LAMBERT: And this is Judge Lambert. I
10 have no questions. So if there's nothing further, I'm
11 going to conclude the hearing, and I want to thank both
12 parties for appearing today, and we will issue a written
13 opinion within a hundred days. So thank you. The record
14 is now closed.

15 If everyone can stick around just for a little
16 while, I'm going to check with the stenographer to see if
17 she needs anything that was missed during the
18 presentations. So thanks again.

19 (Proceedings concluded.)
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2
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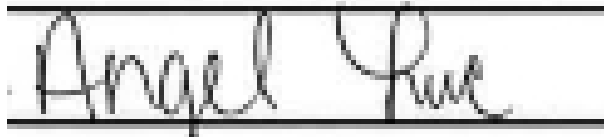
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15 I further certify that I am not of counsel or
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17 any way interested in the outcome of the said hearing.
18

19 IN WITNESS WHEREOF, I have subscribed this
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21 May 2023.

22 
23

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