BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

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

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TRANSCRIPT OF PROCEEDINGS

SACRAMENTO, CALIFORNIA

TUESDAY, APRIL 18, 2023

REPORTED BY:

ANGEL LOVE
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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.

APPEARANCES:

Panel Lead:	HON. JOSH LAMBERT
Panel Members:	HON. SHERIENE RIDENOUR HON. JOHN JOHNSON
For the Appellant:	MICHAEL KELLEY STEPHANIE PARKS
For the Respondent:	LAURIE MCELHATTON Tax Counsel
	DELINDA TAMAGNI Hearing Representative

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PRESENTATION

CLOSING STATEMENT

SACRAMENTO, CALIFORNIA; TUESDAY, APRIL 18, 2023

1:03 p.m.

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

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

CDFT, can you please introduce yourselves for the record.

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

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

JUDGE LAMBERT: Thank you.

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

MR. KELLEY: Michael Kelly, for Microsoft Corporation.

MS. PARKS: Stephanie Parks, for Microsoft

Corporation.

JUDGE LAMBERT: Thank you.

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

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

Does that make sense?

MS. MCELHATTON: Uh-huh.

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

(Respondent's Exhibits A-E admitted.)

(Appellant's Exhibits 1-3 admitted.)

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

MR. KELLEY: Thank you.

May it please the panel, we are here on Appeal of the FTB's denial of Microsoft's claim for refund. The work papers in the record establish the undisputed facts in this case.

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

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

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

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

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

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

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

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

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

The issue is then whether foreign dividends are included in the sales factor measured by the actual dividends distributed by the controlled foreign corporations to a member of the water's-edge group or whether that amount should be reduced by the 75 percent dividends received deduction which applies to income.

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

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

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

Even if the statute is ambiguous, this panel is compelled to adopt a construction favorable to Microsoft because taxing statutes are strictly construed against the government.

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

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

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

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

The FTB sites its own nonbinding legal ruling, 2006-1, which conflicts with the current statute and was published prior to the 2007 Microsoft California Supreme Court case. Where an agency interpretation conflicts with a statute and a supreme court decision construing that statute, this panel is compelled to apply the statute rather than the agency interpretation.

Moreover, there is no exempt income in this case.

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

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

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

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

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

There is no legal authority for the FTB's matching principle, nor does the legislative history of the dividends received deduction in the final report of the worldwide unitary taxation working group support the FTB's theory that the dividends received deduction is exempt income for water's edge filers.

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

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

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

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

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

The analytical framework for evaluating claims under the foreign commerce clause starts with the four factors in Complete Auto and then adds two factors from Japan Lines.

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

Two, the tax must be fairly apportioned.

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

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

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

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

Let's consider these factors in turn.

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

Here, the activity is the distribution of earnings and profits from overseas companies that themselves have no California connection. The FTB would say none of this matters. So long as Microsoft, that is the water's edge group, has nexus with California, California can tax it on any activity or on no activity, and this is not the law.

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

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

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

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

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

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

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

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

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

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

JUDGE LAMBERT: Mr. Kelley, just making sure if you could slow down, especially with all the numbers and calculations, it would be helpful. You can go back just a little bit.

MR. KELLEY: Sure.

JUDGE LAMBERT: Thanks.

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

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

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

As this example further demonstrates, there is no internal consistency here without gross dividends included in the sales factor.

So now let's turn to external consistency.

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

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

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

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

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

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

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

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

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

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

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

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

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

Fifth, does this tax result in multiple

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

Knoll and Mason dismantle that argument too.

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

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

If a contrary context exists under

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

I'm going to refer to the exhibit now.

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

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

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

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

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

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

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

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

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

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

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

Second, the FTB will also contend in its Exhibit J that Microsoft's domestic sales factor has remained relatively stable for the three years leading up to the tax year at issue. What they won't say is that Microsoft's tax returns, starting with the tax year at issue and every year since, '19, '20, '21, '22, each of those returns show more foreign dividends than operating income. Primarily owing to a change in federal tax law. As such, the subsequent returns look more like the tax year at issue and misrepresents a permanent factual change to Microsoft's filing rather than an isolated transaction.

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

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

I will reserve the rest of my time.

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

Judge Johnson, did you have any questions?

JUDGE JOHNSON: No questions at this time. Thank you.

JUDGE LAMBERT: And thanks.

Judge Ridenour, did you have any questions?

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

JUDGE LAMBERT: Thank you.

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

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

MS. MCELHATTON: Thank you.

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

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

My discussion today will cover the following:

First, I'll explain the rules from the Act that are relevant to this appeal and the impact of the Act on Appellant's California return during the appeal year. Then because Appellant files a California return on a combined group basis with the water's edge election, I'll explain how combined reporting works in the context of a worldwide --

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

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

JUDGE LAMBERT: Okay.

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

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

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

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

Then I will discuss why there should be 75 percent exclusion of the repatriation dividends from the sales factor under California law because the context of having 75 percent of the repatriation dividends statutorily removed from the apportionable base requires exclusion from the sales factor as supported by the presidential cases of Chase Brass and Container.

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

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

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

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

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

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

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

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

MS. MCELHATTON: Oh. The GILTI?

MS. RIDENOUR: Yes.

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

Basically the Act sought to remove the tax incentives to accumulate income in foreign jurisdictions. And that's how that worked out. So going forward, they would be taxed every year, but there was this big buildup, 1986 to 2017, and so that is what was subjected to the deemed repatriation dividend.

Currently, California still does not conform --

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

MS. MCELHATTON: Okay.

JUDGE LAMBERT: Thank you.

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

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

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

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

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

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

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

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

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

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

Remember, this was for all earnings 1986 to 2017.

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

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

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

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

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

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

First, I'll address the combined report mechanics when a taxpayer files on a worldwide basis versus when a taxpayer files with a water's edge election.

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

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

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

For example. For fully excluded CFCs, none of the income and factors are included in the water's edge combined report. For partially included CFCs, the income and factors of each CFC are included in the water's edge combined report only to the extent of that CFC's inclusion ratio, which is Subpart F income for each CFC, divided by that CFC's earnings and profits.

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

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

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

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

75 percent located at Revenue and Taxation Code 24411.

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

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

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

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

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

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

So note, the smaller the CFC Subpart F income, the smaller is the CFC's inclusion ratio. This means the CFC's U.S. shareholders will have a larger portion of dividends subject to the 75 percent dividends received deduction where the inclusion ratio is small or zero, which is what we're dealing with here. This also means for small inclusion ratios, there is a larger amount of the dividend that is taxable in California.

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

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

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

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

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

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

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

The OTA set forth that the Court determined to focus on the actual rights and benefits acquired in the transaction from the perspective of the taxpayer. The end result in the 2006 Microsoft decision was that the full redemption price of the marketable securities that the taxpayer received at maturity were found to be gross receipts to be included in the sales factor. The same as marketable securities that were sold since the end result was the same.

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

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

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

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

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

Then we turn to whether the sale at issue is occasional. While FTB concedes that Appellant's CFCs pay dividends to the water's edge combined reporting group many times every year, we assert that this one-time repatriation dividend is different. This one-time repatriation dividend accounted for CFC deferred income from 1986 to 2017 and required a federal deemed dividend so that the deferred income was federally taxed to the U.S. shareholders.

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

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

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

This is the very fact pattern that the rule was meant to address, where a one-time large influx of gross receipts from an extraordinary event skews the sales factor. To prevent that skewing, the gross receipts from the one-time event are 100 percent excluded from the sales factor. That is the result that the FTB requests today.

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

If the repatriation dividends are included at --

JUDGE RIDENOUR: Stenographer, do you need a break?

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

(A break was taken.)

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

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

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

JUDGE LAMBERT: That happens.

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

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

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

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

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

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

At the same time, Appellant's day-to-day business generated gross receipts and net income but at a much lower profit margin. The repatriation dividend profit margin for the June 2018 fiscal year was 100 percent, while the regular operation profit margin was 16 percent.

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

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

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

In this case, we have 108.8 billion in dividends for the year at issue, as compared to 95 billion in operational gross receipts, which is what the sales factor denominator would be without the repatriation dividends. If we add these two together, that would be a sales factor denominator of $204 billion. The 108.8 billion in repatriation dividends would be 53 percent of the sales factor denominator, which means that 53 percent of Microsoft's apportionable base would be attributed to foreign jurisdictions where the CFCs that pay these repatriation dividends were located.

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

Accordingly, if the OTA were to determine that the 75 percent of dividends deducted from the apportionable tax base should be actually included in Appellant's sales factor denominator, this facts situation would warrant a variance from standard apportionment, as the apportionment factor including 100 percent of the 108.8 billion in repatriation dividends would not fairly represent the extent of Appellant's California business activities.

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

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

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

Upon a finding of distortion on these facts, the appropriate remedy under Revenue and Taxation Code 25137 would be to remove 100 percent of the gross receipts from the repatriation dividends from the sales factor. Not just the 75 percent of gross receipts associated with the dividends received deduction. This result aligns with how the substantial occasional sales are treated and would allow Appellant's apportionable income to be apportioned using the apportionment factor from regular operations.

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

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

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

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

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

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

Theoretically transactions between foreign entities and domestic entities would otherwise be considered intercompany transactions if there was no water's edge election. It is an artificial construct that we consider these transactions as not intercompany for a water's edge combined report. Unless the CFCs are partially included in the water's edge combined report, looking at the income and factors of the domestic entities without the water's edge election, the intercompany transactions are eliminated from both the base and the factors under Revenue and Taxation Code 25106.

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

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

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

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

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

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

Under California law, there is no requirement that activities give rise to profit before being included in the sales factor. And that is not what Legal Ruling 2006-1 says. Rather, activities that give rise to income excluded from the tax base, whether exempt, eliminated or deducted, are also excluded from the sales factor. Thus only receipts from activities that are included in the apportionable base are included in the sales factor.

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

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

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

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

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

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

In reaching its conclusion, the California Supreme Court inquired about the administrative practice of the FTB, and it learned that at least since 1962, that is eight years prior to the year at issue, the FTB had disallowed expenses incurred in receiving dividends which had been deducted. The Court held expenses incurred to produce deductible income may not be taken as a deduction. The Court found that while administrative determinations are not controlling, the existence of this practice for at least the past eight years suggests legislative acquiescence during that period in the board's statutory construction.

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

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

This legislative endorsement is not significant because the law at issue was similar to Revenue and Taxation Code 24411. Rather the reason why this endorsement is significant is that it shows the legislature was well aware of Legal Ruling 2006-1 and had ample time to address any areas of disagreement that it had with the holdings. Instead of that, the legislature relied on Legal Ruling 2006-1, which includes a holding regarding Revenue and Taxation Code 24411 deducted income. The exact issue in this appeal.

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

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

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

If the 81.6 billion is added to the 122 billion for the sales factor denominator, you can see why there is such a large impact. If you turn to Exhibit D, table 1, you can see how the large influx of repatriation dividends would affect the sales factor if included at 100 percent and why Appellant is for the first time seeking this unusual filing position.

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

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

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

And then there's also Revenue and Taxation Code 24425. And for that section, it states that amounts that would otherwise be allowed as a deduction are disallowed if the deduction is attributed to income that is not included in the measure of tax. This means that no deduction is allowed for expenses related to an activity that's not included in the tax base. That's also a little bit similar.

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

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

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

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

One might ask about the treatment of cost of goods sold. What about those? Those are included in the sales factor. And what implication does that have for dividends that are deducted from the tax base? The answer is that cost of goods sold and deducted dividends are not similar and cannot be equated to each other. Cost of goods sold are included in the apportionable tax base as an expense item. They're in there. And thus, they are also reflected in the sales factor. They match.

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

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

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

Gross receipts have also been excluded from the sales factor where the income was not included in the apportionable base upon which the California tax is calculated. This is Chase Brass.

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

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

At the time of Chase Brass, there was no definitive guidance on what to do with gross receipts from intercompany transactions that don't change the apportionable tax base, and the Court did the right thing to exclude the intercompany gross receipts as should be done here.

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

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

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

MS. MCELHATTON: Yep. Okay. Thank you.

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

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

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

While there is no general provision that calls for deducted income to be removed from the sales factor, there was no provision at the time of the Chase Brass decision that intercompany items should be eliminated from the factors, and yet the Court was able to come to the correct conclusion that intercompany transaction income that is removed from the apportionable base is not included in the sales factor. It does not matter that we now have regulations that give guidance on intercompany items. For the year at issue in this case, sales and gross receipts for purposes of the sales factor are defined at 25120(f). And those definitions apply unless the context otherwise requires as occurs for this Appellant.

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

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

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

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

MS. MCELHATTON: That's a great idea.

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

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

JUDGE LAMBERT: Okay.

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

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

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

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

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

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

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

Here, Appellate is demanding an alternative without meeting its primary burden. Appellant has not shown that a roughly five percent apportionment factor for this one year unfairly represents the extent of its California business activities. Without that showing, we don't even talk about a remedy because you don't get there. That's the next step, but I'll go beyond the basics.

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

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

This is a profound request by Appellant seeking a method that is not allowed by standard water's edge combined reporting rules. Including the receipts from foreign operations, an Appellant's sales factor would essentially be a worldwide combined report, except that the income earned by the foreign operations would largely not be in the apportionable tax base due to the water's edge election. Appellant has not provided an analysis upon which any relief can be granted.

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

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

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

Finally, for Appellant's request for a variance under 25137, Appellant has not carried its burden of proving by clear and convincing evidence that a roughly five percent apportionment factor unfairly represents the extent of its California business activities. Accordingly, there is no need to analyze possible alternatives.

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

Thank you.

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

MS. MCELHATTON: Okay.

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

JUDGE JOHNSON: Yes. Thank you.

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

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

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

Does that explain?

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

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

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

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

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

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

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

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

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

JUDGE JOHNSON: Then the last question I'd like to ask is -- perhaps more clarification. You mentioned sort of the impact or the effect of deductions being similar to those of elimination. And you raised the comparison of cost of goods sold and other deductible items and perhaps, you know, you can say legal fees for -- incurred in negotiating sales contracts. Can you explain a little bit further as to why these deducted amounts are special compared to other deducted amounts that are included in the apportionable factor?

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

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

MS. MCELHATTON: Okay. So the cost of goods sold. The part that's confusing about cost of goods sold is it's a negative number, and I think that's a little bit confusing for folks. So that's why we tried to shift the wording to apportionable tax base, because the apportionable tax base includes income, and it also includes expense items. So then once you include the expense items, then the income becomes smaller. And that's what cost of goods sold does, and that's what I was trying to explain. Maybe I didn't do a very good job of explaining it, but losses and cost of goods sold, those are all in the apportionable tax base.

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

Did I answer or?

JUDGE JOHNSON: Yeah.

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

Thank you.

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

But you can answer that on your rebuttal if you want to.

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

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

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

JUDGE LAMBERT: Thanks.

Judge Ridenour, did you have any questions?

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

JUDGE LAMBERT: Thanks.

I had a couple of questions.

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

MS. MCELHATTON: Table 1?

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

MS. MCELHATTON: Do you mean other income?

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

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

MR. KELLEY: Yeah. That's correct.

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

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

MS. MCELHATTON: No. It's correct. We were trying to be super accurate here. And the reason why it's 109 is it's still reflecting the 25106 dividends. They're going to be eliminated.

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

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

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

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

MS. MCELHATTON: The 109 includes the intercompany that will be eliminated. Yes. And we realized that, and we thought maybe we better lay it out for you so that you see the difference.

JUDGE LAMBERT: Okay. Thanks. That is helpful.

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

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

JUDGE LAMBERT: Okay. Thanks.

MS. MCELHATTON: Uh-huh.

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

MS. MCELHATTON: Under 25137, it's a hundred percent exclusion, and this mirrors the substantial occasional sale rules. For that, you have a hundred percent exclusion as well. And so if you find for some reason that this is not a substantial occasional sale and that it should be a hundred percent excluded, then it's distortive and under 25137 should be 100 percent excluded, even the 25 percent. So all 108.8 billion.

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

MS. MCELHATTON: Yes.

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

Did we want to take a break?

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

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

(Off the record.)

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

I think we added it up.

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

MR. KELLEY: Thank you.

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

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

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

One of the consequences of the federal tax law change is it created a circumstance where the company has now a regular policy of returning earnings and profits from outside the U.S. into the U.S., which I think is probably the intent of the law; right? So you see companies like us making these annual large distributions on the books; right? And we've smoothed it out for book dividends as compared to these federal taxable income, and it's only these actual book dividends that were taxable.

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

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

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

One curious application of the California tax law is that for the three years prior to this tax year, you know, before credits, our taxable amounts were in the 30s, 40s millions of dollars. They started with a three or four. In 2018, it was $204 million; right? So it went from 30s and 40s to 200. The next year -- these are rounded again -- 190. Next year, 190. Next year, 240. Next year, 380.

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

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

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

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

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

But once you decide that's true, which we believe it's true -- the statute says gross dividends. Other states, as I mentioned, with the same statute, the same UDITPA statute, call out no, dividends aren't -- dividends received deduction aren't included in our statute. And Oregon is the example that we give. There are other examples. So when the legislature in this uniform act wants the dividends received deduction to be removed from the sales factor, it says it in the statute. It's not implied.

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

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

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

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

Now, the FTB alleges there's deference to the agency here. They're the administrative body that is charged with implementing these statutes. But in the Microsoft case, the Supreme Court -- and almost identical facts -- sales factor, whether it included a deduction that applies to income, said we believe that this is a circumstance where any ambiguity must be construed in the favor of Microsoft. And that was with the full knowledge that the FTB was on the other side of that and they were the administrative agency that now they're seeking deference for.

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

That's all I have.

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

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

MS. MCELHATTON: Okay. That's fine.

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

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

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

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

That's Regulation 30104(a).

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

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

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

So we have carried our burden, and all of those exhibits are in Exhibit E. So including the repatriation dividends at a hundred percent would cause 53 percent of Appellant's apportionable tax base --

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

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

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

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

Finally, for Appellant's request for a variance under 25137, Appellant has not carried its burden of proving by clear and convincing evidence that a roughly five percent apportionment factor unfairly represents the extent of its California business activities. Accordingly, there's no reason to even look at possible alternatives.

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

Okay. Thank you.

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

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

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

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

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

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

JUDGE LAMBERT: Thank you, Mr. Kelley.

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

Judge John Johnson, did you have any questions?

JUDGE JOHNSON: No questions. Thank you, both.

JUDGE LAMBERT: Thanks.

And Judge Ridenour, did you have any questions?

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

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

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

(Proceedings concluded.)

REPORTER'S CERTIFICATE

STATE OF CALIFORNIA)
) ss.
COUNTY OF ALAMEDA   )

I, Angel Love, a Certified Shorthand Reporter of The State of California, do hereby certify that I am a disinterested person herein; that I reported the foregoing hearing to the best of my ability in shorthand writing; that I thereafter caused my shorthand writing to be transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said hearing, or in any way interested in the outcome of the said hearing.

IN WITNESS WHEREOF, I have subscribed this certificate at Sacramento, California, on this 1st day of May 2023.

Angel Love

Angel Love, CSR NO. 13845

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