OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **MICROSOFT CORPORATION AND SUBSIDIARIES**	OTA Case No. 21037336

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Michael S. Kelley, State Tax Counsel

For Respondent: Laurie J. McElhatton, Attorney

J. LAMBERT, Administrative Law Judge: On July 27, 2023, the Office of Tax Appeals (OTA) issued an Opinion which partially reversed respondent Franchise Tax Board's (FTB's) action denying Microsoft Corporation and Subsidiaries' (appellant's) claim for refund of $93,901,901 for the fiscal year ending June 30, 2018. The Opinion held that appellant's sales factor denominator should be recomputed by increasing it to include the gross receipts from qualifying dividends deducted from income pursuant to Revenue and Taxation Code (R&TC) section 24411 in the amount of $108,818,839,241. The Opinion otherwise sustained FTB's action. FTB filed a timely petition for rehearing (PFR), pursuant to R&TC section 19334.

A rehearing will be granted where one of the following grounds for a rehearing exists and materially affects the substantial rights of the party seeking a rehearing (here, FTB): (1) an irregularity in the appeal proceedings which occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise, occurring during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered evidence, material to the appeal, which the party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the OTA appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

FTB largely argues a rehearing should be granted because, in its view, the Opinion is contrary to law, but also asserts there were errors in law and irregularities in the appeal proceedings, and FTB appears to argue that there is newly discovered, material evidence.

Contrary to Law

The contrary to law standard of review shall involve a review of the Opinion for consistency with the law. (Cal. Code Regs., tit. 18, § 30604(b).) The question of whether the Opinion is contrary to law is not one which involves a weighing of the evidence, but instead, requires a finding that the Opinion is "unsupported by any substantial evidence"; that is, the record would justify a directed verdict against the prevailing party. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906-907; *Appeal of Le Beau*, 2018-OTA-061P.)[1] This requires a review of the Opinion in a manner most favorable to the prevailing party and indulging in all legitimate and reasonable inferences to uphold the Opinion if possible. (*Appeals of Swat-Fame Inc., et al.*, 2020-OTA-045P.) The question before OTA on a PFR does not involve examining the quality or nature of the reasoning behind OTA's Opinion, but whether that Opinion can or cannot be valid according to the law. (*Ibid.*)

Background

For the fiscal year ending June 30, 2018, appellant and certain unitary affiliated entities (water's-edge group) filed a water's-edge combined report (i.e., Form 100W, California Corporation Franchise or Income Tax Return – Water's-Edge Filers). (See R&TC, § 25110.)[2] During that tax year, appellant received repatriated dividends distributed from certain unitary controlled foreign corporations (CFCs), which were not part of the water's-edge group and were excluded from the water's-edge combined report.[3] Pursuant to R&TC section 24411(a), appellant deducted 75 percent of the qualifying repatriated dividend distributions received from

[1] As provided in *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654, it is appropriate for OTA to look to Code of Civil Procedure (CCP) section 657 and applicable caselaw as relevant guidance in determining whether a ground has been met to grant a new hearing.

[2] Affiliated entities are included in the water's-edge combined report to the extent provided under R&TC section 25110(a).

[3] Generally, repatriation is when foreign earnings of a CFC are distributed through dividends to domestic shareholders. (See, e.g., *Rodriguez v. Commissioner* (2013) 722 F.3d 306, 310.)

the CFCs (qualifying dividend deduction).

A water's-edge combined report applies the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC sections 25120 through 25139) to allocate and apportion income to California.[4] For the year at issue, appellant's business income was apportioned to California by multiplying business income by a single-sales apportionment formula (sales factor). (See R&TC, § 25128.7.) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax year, and the denominator of which is the total sales of the taxpayer everywhere during the tax year.[5] (R&TC, § 25134.)

On the water's-edge combined report, appellant included in its pre-apportioned business income the dividends remaining after applying the qualifying dividend deduction. Stated differently, appellant reported as gross income the entirety of the qualifying dividend income actually received from its CFCs and then deducted 75 percent of this total amount under R&TC section 24411, thereby including only 25 percent of the total amount in its pre-apportioned business income. On its original return, appellant only included in the sales factor denominator the dividends remaining after applying the qualifying dividend deduction (i.e., only 25 percent of the total dividend amount was included in the sales factor denominator). Appellant subsequently filed a claim for refund with FTB, asserting that the repatriated dividends should be included in the sales factor denominator without applying the qualifying dividend deduction (i.e., appellant argued 100 percent of the qualifying dividend income should be included in the sales factor denominator and not just 25 percent). FTB denied appellant's claim for refund, and appellant filed an appeal with OTA.

After an oral hearing, OTA issued an Opinion which held that: (1) qualifying dividends deducted from income pursuant to R&TC section 24411 are includable in appellant's sales factor; (2) gross receipts from the qualifying dividends should not be excluded from the sales factor as a substantial and occasional sale, pursuant to California Code of Regulations, title 18,

[4] R&TC, §§ 25101, 25110(a); Cal. Code Regs., tit. 18, § 25106.5(b)(3), (8), (9).

[5] "Sales" includible in the sales factor "means all gross receipts of the taxpayer not allocated under [R&TC] sections 25123 to 25127, inclusive [as nonbusiness income]." (R&TC, § 25120(f)(1).) For the year at issue, "[g]ross receipts" is defined under R&TC section 25120(f)(2), as explained further below. The issues in this appeal are essentially whether, as appellant argues, the qualifying dividends should be included in the sales factor at the gross amount under R&TC section 25120(f)(2) or, as FTB argues, included as the net amount under R&TC section 25120(f)(2), or completely excluded through application of an alternative apportionment method pursuant to R&TC section 25137.

(Regulation) section 25137(c)(1)(A); and (3) FTB has not shown that the use of an alternative apportionment method is warranted, pursuant to R&TC section 25137. FTB mainly asserts that the Opinion's holding for each of the three issues on appeal were contrary to law. Therefore, this Opinion on PFR will first primarily consider whether OTA's Opinion is contrary to law with respect to each of the holdings and will then address FTB's remaining grounds for rehearing.

Holding 1: Qualifying dividends deducted from income pursuant to R&TC section 24411 are includable in appellant's sales factor.

FTB contends that 75 percent of the dividends should be excluded from appellant's sales factor denominator based on FTB Legal Ruling 2006-01 (Legal Ruling 2006-01), which it asserts is consistent with "the basic principles of apportionment" (FTB referred to this concept as the "matching principle" in the original appeal). FTB asserts that the basic principles of apportionment provide that once the apportionable tax base has been determined, it is only apportioned by the activities that gave rise to the income or loss reflected in the apportionable tax base. FTB contends that activities that give rise to income or losses excluded from the apportionable tax base, due to exemption, exclusion, deduction, or otherwise, are required to be excluded from the apportionment formula. FTB also argues that the conclusion of the Opinion conflicts with the legislative intent of California's water's-edge provisions and R&TC section 24411.

However, FTB provides the same or similar arguments that were considered and rejected in the Opinion, and which OTA continues to find to be unpersuasive. (See *Appeal of Graham and Smith*, 2018-OTA-154P.) As discussed in the Opinion, the dividends qualify as gross receipts under R&TC section 25120(f)(2), and there is no applicable exclusion in the plain language of the statute. Specifically, "[s]ales" includible in the sales factor "means all gross receipts of the taxpayer not allocated under [R&TC] sections 25123 to 25127, inclusive [as nonbusiness income]." (R&TC, § 25120(f)(1).) For the year at issue, "[g]ross receipts" is defined in relevant part as: "*[T]he gross amounts realized* . . . on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and *dividends*) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the [U.S.]) under the Internal Revenue Code [IRC], as applicable for purposes of this part [i.e., California's Corporation Tax Law (CTL)]. Amounts realized on the sale or exchange of property *shall not be*

reduced by the cost of goods sold or the basis of property sold." (R&TC, § 25120(f)(2), italics added.) In addition, R&TC section 25120(f)(2) states that gross receipts, even if business income, shall not include items listed in subparagraphs (A) through (L), and the qualifying dividends deductible under R&TC section 24411 at issue here are not included in these subparagraphs.[6] Therefore, the dividends at issue qualify as gross receipts under the plain language of the statute.

The Opinion also observed that the legislative history does not support FTB's argument that a "matching principle" mandates treating the dividends as excluded from gross receipts or the sales factor. The Opinion noted that the bill analysis relating to the 2011 amendment adding R&TC section 25120(f)(2) does not indicate that the list of exclusions is non-exhaustive and only references the statutory exclusion of certain transactions that have been determined to be distortive when included in the sales factor. (See California Bill Analysis, A.B.X3 15 Sen., 2/14/2009.)[7]

Furthermore, the Opinion's holding in Issue 1 is consistent with the precedential OTA Opinion, *Appeal of Southern Minnesota Beet Sugar Cooperative and Subsidiary*, 2023-OTA-342P (*Minnesota Beet*), which examined a similar issue.[8] In *Minnesota Beet*, OTA held that appellant properly included in the combined reporting group's California apportionment percentage its property, payroll, and sales related to business activities that permitted it to deduct certain agricultural cooperative income under R&TC section 24404. As stated in *Minnesota*

[6] Items excluded from gross receipts under R&TC section 25120(f)(2) include, for instance, amounts received from transactions in intangible assets held in connection with a treasury function and from hedging transactions involving intangible assets. (See R&TC, § 25120(f)(2)(K), (L).) FTB did not argue in the underlying appeal that the dividends at issue met any of the specific exclusions in R&TC section 25120(f)(2)(A)-(L).

[7] The bill analysis states that "[gross receipts] will include all gross amounts . . . but will explicitly exclude purely financial corporate transactions (such as corporate [t]reasury function or hedging transactions . . .)." (California Bill Analysis, A.B.X3 15 Sen., 2/14/2009.)

[8] Appellant asserts that the Opinion is consistent with *Minnesota Beet*. *Minnesota Beet* was made precedential after the issuance of the underlying Opinion in this appeal, but before the issuance of this Opinion on PFR. Therefore, the underlying Opinion in this appeal is not yet final and *Minnesota Beet* is taken into consideration in determining whether the Opinion is contrary to law. (See Cal. Code Regs., tit. 18, § 30505; Gov. Code, § 11425.60(b).) For judicial decisions on interpreting the language of a statute and their retroactive effect on nonfinal cases, see *Vazquez v. Jan-Pro Franchising Internat., Inc*. (2021) 10 Cal.5th 944, 952, citing *Rivers v. Roadway Express, Inc*. (1994) 511 U.S. 298, 312-313 ["A judicial construction of a statute is an authoritative statement of what the statute meant before as well as after the decision of the case giving rise to that construction"].

Beet, "[t]here is no language in the UDITPA to support FTB's position that unitary business activities are excluded from the apportionment formula if they relate to deductible income." *Minnesota Beet* also stated that, while R&TC section 25120(f)(2)(A)-(L) "contains certain enumerated exclusions from the definition of 'gross receipts,' none of them relate to deductible member income under R&TC section 24404 or imply such an exclusion was contemplated by the Legislature." Similarly, none of the exclusions listed in R&TC section 25120(f)(2)(A)-(L) relate to deductible dividend income or imply that such an exclusion was intended or contemplated by the Legislature.[9]

OTA understands FTB's argument regarding the "basic principles of apportionment," including FTB's statement that "the factors that are employed to apportion income or loss should reflect the factors that produce the income or loss being apportioned." However, OTA continues to find the plain language of R&TC section 25120(f)(2) defining "gross receipts" as "the gross amount realized . . . in a transaction that produces business income," which explicitly includes dividends as a gross receipt, to be controlling. Because none of the exclusions listed in R&TC section 25120(f)(2)(A)-(L) relate to deductible dividend income or imply that such an exclusion was intended or contemplated by the Legislature, the Opinion is not contrary to law because it declined to apply the "basic principles of apportionment" advocated by FTB in favor of the plain language of the statute.

As explained in the Opinion, the plain language of R&TC section 25120(f)(2) provides that gross receipts includes "the gross amounts realized . . . in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the [U.S.]) under the [IRC], as applicable for purposes of [the CTL]. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold." Therefore, the gross amount realized in transactions

[9] FTB also argues that R&TC section 25120(f)(2) is a non-exhaustive list because the word "includes" does not ordinarily introduce an exhaustive list, citing *U. S. v. Herrera* (9th Cir. 2020) 974 F.3d. 1040, 1048 (*Herrara*). However, R&TC section 25120(f)(2) provides a definition followed by "shall not include . . . ." FTB does not offer support showing that its arguments as to interpreting "includes" extends to the language "shall not include." In addition, *Herrara* describes circumstances where "includes" precedes a definition and is followed by a list of examples. (*Herrara, supra*, 974 F.3d at p. 1048.) In this case, the list of exclusions has not been shown to represent examples. Furthermore, whether the term "includes" encompasses things not specified in the statute is a question of legislative intent. (*People v. Aguirre* (2021) 64 Cal.App.5th 652, 662.) As discussed in the Opinion, there is no evidence that the Legislature intended the list to be non-exhaustive.

producing business income that are recognized under the IRC are gross receipts according to the definition provided in R&TC section 25120(f)(2).

Additionally, the qualifying dividend deduction is not found in the R&TC provisions dealing with exempt entities (R&TC, section 23701 et seq.), gross income (Article 1 of Chapter 6 of the CTL), exclusions from gross income (Articles 2 and 3 of Chapter 6 of the CTL), or nonrecognition transactions (e.g., IRC sections 351, 721, and 1031). Rather, the qualifying dividend deduction is found in Article 2 of Chapter 7 of the CTL, as an item that is specifically deducted from gross income, which at that point has already been computed and includes the gross amount of dividends received from the CFCs. (See *Minnesota Beet*, *supra*.)

Furthermore, Regulation section 24411 describes R&TC section 24411 as a "deduction with respect to qualifying dividends" and the California Court of Appeal in *Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.* (2004) 120 Cal.App.4th 459, 481, describes R&TC section 24411(a) as a "75 percent dividends received *deduction* found in [R&TC] section 24411, subdivision (a)." (Italics added.) And as discussed in *Minnesota Beet*, an exclusion from gross income found in "Article 3 of Chapter 6 of the CTL . . . should not be considered the same as a deduction from gross income."[10]

FTB notes that R&TC section 24411 was enacted in 1986 and provides, for the first time in its PFR, legislative history materials for R&TC section 24411 which states: "Seventy-five percent of [CFC] dividends from subsidiaries owned more than 50 [percent] by the parent would be *exempt* from taxation . . . ." (Conference Committee Digest of Sen. Bill No. 85 (1985-1986 Session) as amended August 21, 1986, p. 2, italics added.)[11] Based on the new legislative history

[10] FTB nonetheless asserts that other states have required that activities that give rise to income or loss excluded from the apportionable tax base also must be excluded from the apportionment formula, citing *Ill. Dept. of Revenue v. Karloff Laboratories* (1999) IT 99-5, No. 94-IT-0000, and *Continental Ill. Nat. Bank & Trust Co. v. Lenckos* (1984) 102 Ill. 2d 210. These opinions, however, are not controlling on OTA, interpret different statutes, and OTA declines to follow their reasoning. FTB also cites to the same legal authorities in its original briefing, such as *Chase Brass & Copper Co. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457, which were already considered and deemed unpersuasive as support for the treatment of deductions in Legal Ruling 2006-01 in both the Opinion and in *Minnesota Beet*.

[11] FTB for the first time in in its PFR also provides legislative history for a statutory amendment to R&TC section 24411 which states: "Water's-edge corporations are allowed *an exemption* for a certain amount of dividends received from foreign corporations in which they have a controlling interest, as specified. The amount *exempted* is either 100 percent or 75 percent, depending on whether the corporation decreases or increases, respectively, its foreign payroll. This bill clarifies the method used to determine the amount of foreign dividends which qualify for *the exclusion*." (Legislative Analyst, Sen. Bill No. 85 (1987-1988 Session) as amended Feb. 12, 1987, pp. 2-3, italics added; see also Legislative Analyst, Sen. Bill No. 85 (1987-1988 Session) as amended June 23, 1987, pp. 2-3.)

materials for R&TC section 24411, FTB contends that the Legislature intended for the deduction to be, in substance, an exclusion from gross income, which therefore cannot be a gross receipt for sales factor purposes.[12]

As held by the Board of Equalization (BOE) in *Appeal of NASSCO Holdings, Inc.* (2010-SBE-001) 2010 WL 5626976 (*NASSCO*), "[i]f a party attempts to submit evidence after a decision, they must show that the proffered evidence could not have been produced prior to the hearing in order for [OTA] to consider the evidence when deciding whether or not to grant the petition for rehearing."[13] (See Cal. Code Regs., tit. 18, § 30604(a)(3) [grounds for rehearing includes newly discovered evidence material to the appeal]; see also *Appeal of Do*, 2018-OTA-002P.) In *NASSCO*, BOE considered legislative history to be evidence for purposes of determining whether a rehearing should be granted under the ground of newly discovered evidence. In *NASSCO*, FTB did not provide certain legislative history materials until filing its PFR. As stated in *NASSCO*, "[FTB] had ample opportunity to address this issue, and discover and produce all relevant information. The fact that it now wishes it had more fully explored the issue does not provide a basis for a rehearing." Here, FTB was on notice of the issue and could have provided legislative history materials related to R&TC section 24411 during the underlying appeal.[14] Therefore, consistent with *NASSCO*, OTA declines to consider FTB's newly submitted legislative history materials and its related arguments.[15]

In conclusion, the Opinion's holding is consistent with *Minnesota Beet* in finding FTB's Legal Ruling 2006-01 unpersuasive to the extent it treats the qualifying dividend deduction at issue here as excluded from gross receipts. Accordingly, FTB has not shown that OTA's holding in Issue 1 is contrary to law.

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[12] In its PFR, FTB argues, based on this legislative history, that the Legislature originally intended for the qualifying dividend deduction to be an exclusion (rather than deduction) from gross income. This is somewhat different from the argument FTB presented in the original appeal, where FTB acknowledged that the qualifying dividend deduction should be treated as a deduction from income, but argued that it should, nevertheless, be excluded from the sales factor.

[13] A party seeking a rehearing under the ground of newly discovered, material evidence must show that, the evidence is newly discovered, the party exercised reasonable diligence in discovering and producing it, and the evidence is material to the appeal. (See Cal. Code Regs., tit. 18, § 30604(a)(3); *NASSCO*, *supra*.) FTB has not shown why it could not have provided the legislative history prior to the issuance of the Opinion.

[14] During the underlying appeal as support for its position as to Issue 1, FTB provided legislative history related to statutes other than R&TC section 24411.

Holding 2: Gross receipts from the qualifying dividends should not be excluded from the sales factor as a substantial and occasional sale, pursuant to Regulation section 25137(c)(1)(A).

Regulation section 25137(c)(1)(A) provides that, where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial and the sale is occasional. (*Ibid.*) The Opinion held that appellant's receipt of the dividends does not qualify as a "sale" of property under Regulation section 25137(c)(1)(A).

FTB argues that the Opinion incorrectly concluded that the qualifying dividends do not meet the requirements of Regulation section 25137(c)(1)(A). FTB argues that the qualifying dividends are a "sale" under Regulation section 25137(c)(1)(A) because they meet the definition of "sales" in R&TC section 25120(f)(1). However, as discussed in the Opinion, Regulation section 25137(c)(1)(A) applies to a "sale of a fixed asset or other property," such as "the sale of a factory, patent, or affiliate's stock." Under R&TC section 25120(f)(1) and (f)(2), "sales" is defined to include not only amounts from a sale of property, but also from the exchange of property, performance of services, and the use of property or capital (including rents, royalties, interest, and dividends). Therefore, as stated in the Opinion, while the dividends are "sales" for purposes of UDITPA under R&TC section 25120(f)(1), the plain language of Regulation section 25137(c)(1)(A) is more limited in scope and applies to a sale of property. FTB does not provide any legal authorities or evidence establishing that the plain language of the regulation should not be followed. Accordingly, FTB has not shown that OTA's holding in Issue 2 is contrary to law.

[15] Additionally, OTA also notes that it would only need to consult extrinsic aids such as the newly submitted legislative history materials where the language of statute is ambiguous or unclear. (See *Minnesota Beet*, *supra*.) As noted above, OTA continues to find R&TC section 25130(f)(2) defining "gross receipts" and R&TC section 24411 relating to "qualifying dividends" to be clear and unambiguous, and notes that on PFR, OTA reviews the Opinion in a manner most favorable to the prevailing party (here, appellant). (*Appeals of Swat-Fame Inc., et al.*, *supra*.) Furthermore, the Summary Digest for Senate Bill No. 85, chapter 660, which was not submitted by FTB in its PFR, is consistent with OTA's conclusion and the plain language reading of the statutory authority, stating "[t]his bill [AB 85] would permit a qualified taxpayer who elects to determine its income under a water's-edge election to *deduct* either 100% or 75% of specified portions of its qualifying dividends . . . ." (https://clerk.assembly.ca.gov/sites/clerk.assembly.ca.gov/files/archive/Statutes/1986/86Vol4_SummaryDigest.pdf, p. 221, Italics added.)

Holding 3: FTB has not shown that the use of an alternative apportionment method is warranted, pursuant to R&TC section 25137.

R&TC section 25137 provides that if the allocation and apportionment provisions under UDITPA do not fairly represent the extent of the taxpayer's business activity in this state (i.e., there is "distortion"), the taxpayer may petition for or FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (1) separate accounting; (2) the exclusion of any one or more of the factors; (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

As FTB was the party seeking a deviation from the standard apportionment formula, it had the burden of establishing, by clear and convincing evidence, that: (1) application of the standard apportionment formula does not fairly represent appellant's activities in California; and (2) its proposed alternative apportionment methodology is reasonable. (*Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 765 (*Microsoft*).) Courts have examined the following two factors in deciding whether there is distortion: (1) whether the activities generating the receipts were qualitatively different from the taxpayer's main line of business; and (2) whether the quantitative distortion that arose from the inclusion of the receipts was substantial. (*Microsoft, supra*, 39 Cal.4th at p. 766.)

The Opinion held that FTB did not show that the inclusion of 100 percent of the repatriated dividends in the sales factor resulted in distortion. Specifically, the Opinion rejected FTB's argument that the receipt of dividends was occasional and, therefore, held that FTB did not show a qualitative difference.[16] The Opinion also held that FTB did not show that inclusion of the dividends in the sales factor resulted in quantitative distortion.

Qualitative Analysis – Occasional Transaction

In its PFR, FTB argues that the Opinion's holding in Issue 3 is contrary to law because the dividends were a result of a one-time tax on earnings and profits accumulated from 1986 to 2017 and were occasional. As background, in 2017, Congress passed the federal Tax Cuts and

[16] FTB effectively argued that the receipt of dividends was qualitatively different from appellant's main line of business because such receipt was an occasional transaction, and analogous to an occasional sale under Regulation section 25137(c)(1)(A). A sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently. (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)2.)

Jobs Act (TCJA), which included adding a transition tax under IRC section 965. (P.L. 115-97, 131 Stat. 2054 (2017).) Under IRC section 965, previously untaxed foreign earnings of deferred foreign income corporations, such as CFCs, from post-1986 earnings and profits were deemed to be "repatriated" and subject to a one-time federal transition tax, regardless of whether the income was distributed. (See IRC, § 965; see also *Silver v. Internal Revenue Service* (2021) 531 F.Supp.3d 346, 531.) For the tax year at issue in this appeal, appellant was subject to the federal transition tax for deemed dividends attributable to accumulated foreign earnings and profits from its CFCs, pursuant to IRC section 965.[17]

As stated in the Opinion, the receipt of the dividends was not occasional because appellant regularly received dividends, including repatriated dividends, from its various subsidiaries and CFCs, and appellant did not receive only a single dividend distribution each year from a single subsidiary, but numerous dividends from its different subsidiaries and CFCs.[18] In addition, the Opinion stated that the repatriated dividends reflect the intent of the TCJA to transition to a new tax system and change business practices in not only the current year, but also going forward.[19] FTB's arguments are the same or similar to those considered and rejected in the Opinion, and which OTA still finds to be unpersuasive.[20] (See *Appeal of Graham and Smith*, *supra*.)

FTB also asserts that approximately nine weeks following the oral argument in this matter, the U.S. Supreme Court granted certiorari in *Moore v. U.S.* (*Moore*) (9th Cir. 2022) 36 F.4th 930, cert. granted (2023) 143 S.Ct. 2656. FTB asserts that the issue in *Moore* is

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[17] While California does not conform to IRC section 965, these same "deemed" dividends were then actually repatriated and distributed to appellant (i.e., actually paid to appellant by the CFCs), which resulted in the dividends being subject to California tax.

[18] As noted in the Opinion, because OTA did not find the dividends to be "occasional," this Opinion did not reach the question of whether distortion would be established in this case if, under FTB's analogy, the dividends were found to be both substantial and occasional. The statutory touchstone remains whether the formula fairly represents a unitary business's activities. (*Microsoft, supra*, 39 Cal.4th at p. 770.)

[19] As noted in the Opinion, the rules enacted by the TCJA "encourage repatriation of foreign income . . . ." (*Silver v. Internal Revenue Service*, *supra*, 531 F.Supp.3d at p. 351.)

[20] OTA notes that its conclusion is consistent with FTB's Chief Counsel Ruling (CCR) 2014-02, which determined that, while the aggregate of gross receipts from post-bankruptcy asset sales of a taxpayer were substantial, the transactions were not occasional sales. In reaching this conclusion, CCR 2014-02 states that the taxpayer at issue consummated multiple asset sale transactions within a two-year period at short intervals on a regular basis. CCR 2014-02 also states that the taxpayer's implementation of asset sale transactions was consistent with the policy of the Bankruptcy Code and became part of its normal course of business. While a CCR is not binding authority, OTA's conclusion is consistent with the reasoning of CCR 2014-02.

whether the transition tax under IRC section 965 is unconstitutional. FTB contends that, if the U.S. Supreme Court holds that the statute is unconstitutional, such a result will demonstrate error in OTA's examination of IRC section 965 in concluding the receipt of dividends was not occasional because "the entire regime that gave rise to the one-time repatriation dividend will cease to exist." However, California does not conform to IRC section 965, and the dividends at issue were actually distributed to appellant instead of being "deemed" distributed. Therefore, it does not appear that such a ruling in *Moore* would impact the issue here. Accordingly, FTB has not shown that the Opinion was contrary to law in holding that the transaction was not occasional and that a qualitative difference was not established on that basis.

Qualitative Analysis – Main Line of Business

FTB provides a new legal theory in its PFR that the dividends are qualitatively different because the one-time dividends received in the year at issue reflect accumulated foreign earnings and profits that are not part of appellant's main line of business. FTB asserts that appellant's main line of business is the sale of products, and that appellant is not in the day-to-day business of receiving the type of dividends at issue in the appeal.

New theories that could have been raised, but were not, is not one of the causes that permits a new hearing. (See *Insurance Co. of the State of Pa. v. American Safety Indemnity Co.* (2019) 32 Cal.App.5th 898, 922; see also Civ. Proc., § 657.) "It is the general rule that a party to an action may not, for the first time on appeal, change the theory of the cause of action."[21] (*Panopulos v. Maderis* (1956) 47 Cal.2d 337, 340.) (*Id*. at p. 341.) OTA adopts the same rule here for a PFR requesting a new hearing based on a new legal theory that was not raised by the party in the original appeal.[22]

Additionally, in determining whether the taxpayers' hedging activities were qualitatively different from its main line of business, the court in *General Mills* examined numerous facts relating to both activities, such as: ownership and physical procession/delivery of the commodities; the number of employees engaged in the activities; plant and equipment needed for

[21] This is "especially true when the theory newly presented involves controverted questions of fact or mixed questions of law and fact." A determination under R&TC section 25137 presents a mixed question of fact and law. (*General Mills v. Franchise Tax Bd.* (2012) 208 Cal.App.4th 1290, 1302.)

[22] See *Hoffman-Haag v. Transamerica Ins. Co.* (1991) 1 Cal.App.4th 10, 15 [applying law on changing legal theories on appeal to motions for new trial under CCP section 657]

the activities; storage space needed; transportation needed; production costs; scalability of the activities; time required to complete the activities; time between the purchase and sale in the activities; capital requirements; net payments received by the taxpayer from the activities; necessity of consumer demand for the activities; contribution of the activities to the company's profit and loss; the rate at which the activities' transactions are cancelled, etc. (See *General Mills v. Franchise Tax Bd.* (2012) 208 Cal.App.4th 1290, 1304-1305 (*General Mills*).) Based on this detailed examination, the *General Mills* court concluded that there was "sufficient" qualitative difference between the taxpayer's hedging activities and main line of business because the hedging activities "play[ed] only a supportive function and would be economically meaningless if separated from ultimate sales of . . . products for profit" and that the activities were "not conducted for [their] own profit . . . ." (*Id.* at pp. 1303, 1305-1306.)

FTB's new legal theory raises material issues which were not previously presented or considered, and which appellant was not provided the opportunity to address. (See *Panopulos v. Maderis, supra*, 47 Cal.2d at p. 341.) In addition, the record does not include sufficient evidence regarding the activities which gave rise to the dividends in comparison to the activities which FTB contends make up appellant's main line of business; therefore, OTA is unable to perform an analysis similar to that performed by the court in *General Mills*. For these reasons, OTA declines to address FTB's new legal theory.[23]

Quantitative Distortion

As to the quantitative analysis, FTB contends that there is a large amount of business activities attributed to foreign jurisdictions due to the inclusion of the repatriated dividend receipts in the sales factor. FTB asserts that 53 percent of appellant's business income will be attributed to foreign jurisdictions, meaning the apportionable income for every state where appellant does business will be decreased to make up for that amount. FTB asserts that this is a larger amount than the 11 percent attribution rate that was found distortive in *Pacific Telephone*

[23] Even if FTB's theory had been raised in the underlying appeal, it would be unpersuasive because, as explained above, FTB has not presented sufficient evidence regarding the activities which gave rise to the dividends in comparison to the activities which FTB contends makes up appellant's main line of business. (See *General Mills, supra*, 208 Cal.App.4th at pp. 1304-1305.) Furthermore, even if FTB established a qualitative difference on this basis, FTB has not established quantitative distortion or that the formula unfairly represents appellant's business activities in this state. (See R&TC, § 25137; *Microsoft, supra*, 39 Cal.4th at p. 770.) See the discussion of quantitative distortion which follows next.

and Telegraph Company (78-SBE-028) 1978 WL 3941 (*Pacific*) and the 24 percent attribution rate found to be distortive in *Microsoft*.

However, FTB's focus on the percentage assigned to foreign jurisdictions in isolation is misplaced. "[C]ase law does not indicate that this quantitative metric, or any one metric, alone is dispositive." (*General Mills*, *supra*, 208 Cal.App.4th at p. 1313.) As noted in the Opinion, while inclusion of the gross dividends in the sales factor causes 53 percent of appellant's business activities to be attributed to foreign jurisdictions, the dividends account for 61 percent of the net income subject to apportionment and, therefore, comprise a significant amount of the income to be apportioned, which are circumstances that are not comparable to cases such as *Pacific* or *Microsoft*. (*Microsoft*, *supra*, 39 Cal.4th at pp. 765-766.) In *Microsoft*, the treasury department investments accounted for less than 2 percent of the net income subject to apportionment, but caused 24 percent of the unitary business income to be attributed to the location of the treasury department.[24] (*Microsoft*, *supra*, 39 Cal.4th at pp. 766-767, 769, fn. 17.) In *Pacific*, the Board of Equalization found that the investment activities accounted for less than 2 percent of net income, but caused 11 percent of net income to be assigned to the investment activity location.[25] The same is not true here as the dividends comprise a larger percentage of the net income subject to apportionment (61 percent here as compared to less than 2 percent in both *Microsoft* and *Pacific*), which makes it reasonable for 53 percent of that net income to be apportioned to the foreign jurisdictions that generated the dividend income at issue.

FTB does not otherwise dispute the quantitative analysis, which examined the profit margins provided by FTB, the effect of the dividends on net income compared to gross receipts, and the change in the apportionment formula resulting from including the qualifying dividends in the sales factor. The Opinion found that the quantitative effects were not comparable to those examined in cases such as *Microsoft* and did not show distortion. Accordingly, FTB has not shown that the Opinion is contrary to law as to its conclusion that FTB has not shown distortion.

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[24] When considering the sales factor alone, the treasury function produced less than 2 percent of the net income subject to apportionment, but approximately 73 percent of the gross receipts. (*Microsoft, supra* 39 Cal.4th at p. 765, fn. 17.)

[25] Again, considering the sales factor alone, the treasury function produced less than 2 percent of the net income subject to apportionment, but approximately 36 percent of the gross receipts. (*Pacific*, *supra*; see also *Microsoft*, *supra*, 39 Cal.4th at p.765 discussing *Pacific*, *supra*.)

Irregularities in the Proceedings/Error in Law

A procedural "error in law" means an error in the OTA appeals hearing or proceeding, other than a legal error in the Opinion. (Cal. Code Regs., tit. 18, § 30604(b).) For example, the erroneous admission of evidence subject to attorney-client privilege, over the objection of the party petitioning for a rehearing, might be a basis for a rehearing due to an error in law if the error was material. (*Ibid*.) An irregularity in the proceedings has been defined as "[a]ny departure by the court from the due and orderly method of disposition of an action by which the substantial rights of a party have been materially affected." (See *Appeal of Graham and Smith*, *supra*, citing *Gay v. Torrance* (1904) 145 Cal. 144, 149.)

Additional Briefing

FTB asserts that at the prehearing conference, the parties requested additional briefing on new arguments, which OTA denied. FTB asserts that this resulted in the panel hearing new arguments for the first time at the oral hearing, which was an irregularity in the proceedings that prevented fair consideration of the appeal and amounted to an error in law. Appellant asserts that FTB had ample opportunity to develop and present its arguments during briefing and chose to do so in an abbreviated form, as demonstrated by its nine-page opening brief.

It is within OTA's discretion whether or not to grant additional briefing. (See Cal. Code Regs., tit. 18, § 30304(c).)[26] In addition, the record does not include any written request by FTB for additional briefing. (See Cal. Code Regs., tit. 18, § 30304(c) [requests for additional briefing "must be made in writing"].) Furthermore, FTB did not request additional briefing during or after the hearing, and OTA did not determine that additional briefing was necessary at, or after, the hearing. Additionally, in reaching its determination, OTA considered the parties' oral arguments, which are part of the oral hearing record. (See Cal. Code Regs., tit. 18, § 30102(w)(7).) Accordingly, FTB has not shown there was an irregularity in the proceedings that materially affected its substantial rights or an error in law based on any denial of additional briefing.

[26] See also Cal. Code Regs., tit. 18, §§ 30213(a)(7), (8) [authority of panel to issue rulings on motions and order the closure of the record], 30421(c) [authority of lead panel member to decide prehearing motions].

Hearing Interruptions

FTB asserts that, during its presentation at the oral hearing, the stenographer for OTA repeatedly interrupted FTB and at one point requested a 10-minute break in the middle of FTB's presentation. As a result, FTB contends that it was unable to present all its arguments, which was an irregularity in the proceedings. FTB was provided with the time that it requested for its presentation, which was 60 minutes and, before the hearing, it was agreed that FTB would receive an additional 15 minutes for closing remarks. During the hearing, both appellant and FTB were briefly reminded to speak slower to allow the stenographer to properly transcribe what was being stated. OTA was within its authority to control the proceedings to ensure there is an accurate record, which includes the oral hearing transcript. (Cal. Code Regs., tit. 18, §§ 30102(w)(7), 30213(a)(1).) Accordingly, FTB has not shown that interruptions at the hearing were an irregularity in the proceedings that materially affected its substantial rights.[27]

Repatriated Dividends in Subsequent Years

At the hearing, as to whether the receipt of dividends was occasional, appellant stated that, due to the TCJA, it now has a regular policy of repatriating dividends. Appellant stated that "similar dividends have been declared each and every year since the tax year at issue" so "the dividends are neither casual [n]or isolated." FTB asserts that the repatriated dividends in subsequent years were not, in fact, similar in amount to the current year.[28] FTB contends that it "appears" the Opinion relied on appellant's incorrect statements in reaching its conclusion that the repatriated dividends were not occasional. However, the Opinion did not rely upon, or make any statements as to, the amount of repatriated dividends received in subsequent years. The

[27] FTB also asserts that the stenographer requested a 10-minute break in the middle of its presentation. A 10-minute break was necessary for the stenographer, given the length of the hearing. Before the break, OTA stated it was going off the record, and after the break concluded, OTA went back on the record. Therefore, FTB did not lose any time in its presentation due to the break.

[28] At the hearing, appellant stated that during the "subsequent year there was a $45 billion tax book dividend . . . 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." According to FTB's schedules provided with its PFR, there were gross dividends subject to R&TC section 24411 of approximately $45 billion for the fiscal year ending June 30, 2019, $22 billion for the fiscal year ending June 30, 2020, and $29 billion for the fiscal year ending June 30, 2021. The appeal record relied upon by the Opinion does not include any evidence as to the amount of repatriated dividends received in subsequent years because appellant's statements at the hearing were not testimony that could be relied upon as evidence.

Opinion stated that "the examination of whether the dividends would qualify as occasional under Regulation section 25137(c)(1)(A)2. does not take into consideration the size or amount of the gross receipts."[29] Therefore, FTB has not shown that there was an irregularity in the proceedings that materially affected its substantial rights on the basis that OTA relied upon appellant's incorrect statements as to the amount of repatriated dividends received in subsequent years.

Newly Discovered, Material Evidence

A party seeking a rehearing under the ground of newly discovered, material evidence must show that: (1) the evidence is newly discovered; (2) the party exercised reasonable diligence in discovering and producing it; and (3) the evidence is material to the appeal. (See Cal. Code Regs., tit. 18, § 30604(a)(3); *NASSCO*, *supra*.) Newly discovered evidence must be material in the sense that it is likely to produce a different result. (*Hill v. San Jose Family Housing Partners, LLC* (2011) 198 Cal.App.4th 764, 779.)

FTB provides new evidence with its PFR, which are schedules of repatriated dividends reported on appellant's tax returns on Form 100W, Schedule H, for years after the year at issue. FTB asserts that the amount of repatriated dividends in subsequent years as asserted by appellant at the hearing were not similar to the actual reported amounts. However, the evidence is not material to FTB's case because it is not likely to produce a different result. The Opinion did not rely on the amount of subsequent dividends in concluding that the dividends were not occasional. In addition, FTB's schedules support the Opinion's conclusion that the dividends were not occasional because the schedules demonstrate that appellant received repatriated dividends in subsequent years. Accordingly, FTB's schedules do not establish that a rehearing should be granted based on newly discovered, material evidence.

[29] The Opinion also did not make any conclusion based on whether appellant received repatriated dividends in subsequent years. Rather, the Opinion states that the repatriation of dividends in the year at issue reflects the "intent of the TCJA to transition to a new tax system and change business practices in not only the current year, but also going forward."

Conclusion

FTB has not shown that any grounds exist to grant a rehearing. Consequently, the PFR is denied.

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

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Cheryl L. Akin
Administrative Law Judge

Date Issued: 2/14/2024