



This Week in State Tax (TWIST)

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California: OTA Rejects FTB's Rehearing Petition; Dividends Fully Included in Sales Factor

The California Office of Tax Appeals (OTA) recently denied the FTB's petition for rehearing in *Matter of Appeal of Microsoft Corporation*. The primary substantive issue in *Microsoft* was what portion of a qualifying dividend paid by a qualified foreign subsidiary and received by a California water's-edge group member was reflected in the sales factor. Specifically, is the entire dividend amount included in the sales factor or just the amount remaining after applying the 75 percent dividends received deduction allowed under R&TC section 24411? On its original return, Microsoft included in its sales factor denominator only the 25 percent of the dividend amount that was included in the California income base. Subsequently, Microsoft filed an amended return including all the dividends in the sales factor; this resulted in an approximate \$94 million refund. The dividends at issue were distributed following the taxpayer's payment of the one-time transition tax under IRC section 965. After the FTB denied the refund, the taxpayer appealed to the OTA. After an oral hearing, the OTA issued an Opinion holding that: (1) qualifying dividends deducted from income under R&TC section 24411 are includable in the sales factor; (2) gross receipts from the qualifying dividends are not excludable from the sales factor as a substantial and occasional sale, and (3) the FTB had not shown that the use of an alternative apportionment method was warranted. The FTB subsequently filed a petition for rehearing (PFR) on the basis that the holdings in the Opinion were contrary to California law.

In its Opinion on the PFR, the OTA first addressed its holding that the deducted dividends were included in the sales factor. The FTB relied on Legal Ruling 2006-01 as support for its position that activities that gave rise to income or losses excluded from the apportionable tax base, due to exemption, exclusion, deduction, or otherwise, were required to be excluded from the apportionment formula. The OTA noted that the plain language of the law provides that the sales factor includes all gross receipts unless excluded. There was no exclusion applicable here, and the OTA declined to apply the "basic principles of apportionment" advocated by FTB in favor of the plain language of the statute. The OTA observed further that its conclusion was consistent with *Minnesota Beet*, a recent precedential OTA opinion holding that deductible cooperative income was nevertheless included in the sales factor. In its PFR, the FTB presented for the first-time legislative history for the dividends received deduction that suggested it was viewed by the legislature as an exemption or exclusion. The OTA, however, declined to consider this newly submitted evidence and concluded that the FTB had not established that the Opinion was contrary to law with respect to its first holding.

The OTA next rejected the FTB's contention that the Opinion was contrary to law

because it concluded that the dividends were not excluded from the sales factor under a regulatory exclusion for receipts from a substantial, occasional sale of a fixed asset or other property held in the regular course of the taxpayer's trade or business. While dividends are "sales," the exclusion at issue was limited in scope and applied to a sale of property. Next, in a lengthy discussion as to whether inclusion of the dividends created distortion under both a quantitative and qualitative analysis, the OTA concluded that it did not err when it ruled in the Opinion that the FTB did not meet its burden of proving by clear and convincing evidence that the standard apportionment formula did not fairly represent the extent of Microsoft's activities in California. Finally, the OTA concluded the Opinion was not contrary to law with respect to its conclusion that there were not irregularities in the appeal proceedings that prevented fair consideration of the appeal, including the denial of a request for additional briefings and interruptions during the opening arguments. Please contact [Oksana Jaffe](#) with questions.

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