

## Legal Updates & News

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#### California's Treatment of Treasury Function Gross Receipts Before January 1, 2011

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Given California's continuing budget woes, it comes as no surprise that certain tax provisions in California's recent budget agreements have come under fire as corporate handouts that will cost the state billions in lost revenue over the next ten years and beyond.<sup>[1]</sup> While the pros and cons of elective single-sales-factor apportionment<sup>[2]</sup> and the sharing of tax credits among members of a combined reporting group<sup>[3]</sup> are currently under debate, one provision has provoked little controversy thus far. The California Legislature in February 2009 adopted a new definition of "gross receipts" for California sales factor purposes.<sup>[4]</sup>

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Under California Revenue and Taxation Code section 25120,<sup>[5]</sup> for tax years beginning on or after January 1, 2011, California will define "gross receipts" for sales factor purposes to be the gross amounts realized on the sale or exchange of property, the performance of services, or the use of property or capital 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 United States) under the Internal Revenue Code. Specifically excluded from the definition are "amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets."

The new legislation provides that taxpayers principally engaged in purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function (e.g., a registered broker-dealer) are not performing a treasury function with respect to income so produced. The legislation also specifically excludes from gross receipts the following items: amounts received from hedging transactions involving intangible assets; repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument; the principal amount received under a repurchase agreement or other transaction properly characterized as a loan; proceeds from issuance of the taxpayer's own stock or from sale of treasury stock; damages and other amounts received as the result of litigation; property acquired by an agent on behalf of another; tax refunds and other tax benefit recoveries; pension reversions; contributions to capital (except for sales of securities by securities dealers); income from discharge of indebtedness; and amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.<sup>[6]</sup>

While the new legislation attempts to settle a host of gross receipts issues going forward from January 1, 2011, a future effective date nevertheless leaves certain questions unanswered and issues contested at present. One issue at the forefront of a number of appeals currently pending before the California State Board of Equalization (“SBE”) and protests presently before the California Franchise Tax Board (“FTB”) is the treatment of sales of marketable securities by a corporation’s treasury function for California corporate franchise and income tax purposes. The SBE had an opportunity to affirmatively address this issue in December 2008, in *Appeal of Home Depot U.S.A., Inc.*<sup>[7]</sup>

In *Appeal of Home Depot*, the taxpayer, a leading retailer in the home improvement industry, received business income arising from the redemption of marketable securities. Home Depot’s treasury department actively invested and managed the company’s cash from its retail operations and monitored the company’s investments in short-term financial instruments. While Home Depot had a presence in California through company stores as well as stores of its wholly-owned subsidiaries, the day-to-day management of the investments by its treasury department occurred at the company’s headquarters in Atlanta, Georgia. Home Depot’s treasury department engaged in these short-term investment activities to ensure the company had sufficient cash to cover its daily working capital needs and to ensure excess cash from the retail operations was appropriately invested. Home Depot filed a claim for refund with the FTB for the taxable year ended January 31, 1999, which requested the gross receipts from its redemption of marketable securities be included in its California sales factor. The FTB denied the claim on the grounds that the inclusion of treasury function gross receipts in the taxpayer’s California sales factor denominator would not fairly represent Home Depot’s activities in the state. The taxpayer appealed to the SBE.<sup>[8]</sup>

On appeal, Home Depot argued the FTB had not shown by clear and convincing evidence that including the gross receipts from the redemption of marketable securities in its sales factor resulted in the unfair representation of Home Depot’s business activities in California under section 25137.<sup>[9]</sup> Home Depot claimed that the use of the standard apportionment formula need result in only a “rough approximation” of its business activities in California. Home Depot also contended that inclusion of the gross receipts from its sale of marketable securities in its sales factor resulted in only a 3.27 percent reduction in the income attributable to California for the year under appeal; therefore, by comparison to prior SBE decisions regarding gross receipts, any distortion was too insignificant for any relief under section 25137.<sup>[10]</sup>

The FTB argued that including the gross receipts generated by Home Depot’s treasury activities in its sales factor was distortive under section 25137. The FTB also denied that there was any “margin of error” that would permit a relatively small amount of distortion. Therefore, the FTB proposed an alternative apportionment formula under *Microsoft* whereby only net receipts from the redemption of marketable securities would be included in Home Depot’s sales factor for California apportionment purposes.

On December 18, 2008, after a nearly hour-and-a-half-long oral hearing, the SBE voted 3–2 in favor of the taxpayer and rejected the FTB’s use of an alternative apportionment formula under section 25137 to exclude gross receipts generated from the redemption of marketable securities from the sales factor. The SBE held that the FTB failed to carry its burden of proving by clear and convincing evidence that inclusion of these gross receipts resulted in distortion under prior SBE decisions and the California Supreme Court’s decision in *Microsoft*. Home Depot successfully argued that any distortion was too insignificant to permit relief under section 25137 as the gross receipts from the sale of its marketable securities was just 6.6 percent of the unitary business’ total gross receipts. Despite the fact the case was originally designated as a “test” case with 27 other SBE appeals involving the same issue held in abeyance, the SBE did not publish the decision. Accordingly, the decision is not precedential.<sup>[11]</sup>

What will become of other pending SBE appeals with the gross receipts issue? Subsequent to the SBE’s decision in *Appeal of Home Depot*, the FTB has invited a number of corporate taxpayers to participate in a “take it or leave it” streamlined resolution program to resolve pending SBE appeals<sup>[12]</sup> regarding inclusion of certain treasury receipts in the sales factor.<sup>[13]</sup> Under the terms of the program, the taxpayer and the FTB both agree to concede a specified portion of the tax in issue, and a closing agreement is then executed by the parties to confirm that agreement. That issue is then concluded (but other issues for that tax year may remain in dispute). The percentage that must be conceded by each party depends upon the percentage of the total sales factor denominator attributed to treasury function gross receipts, based on the table below.

Percentage of Treasury Function Gross Receipts in Sales Factor Denominator	Amount of Tax in Issue Conceded by Taxpayer in Closing Agreement	Amount of Tax in Issue Conceded by FTB in Closing Agreement
Up to 6.6%	25%	75%
More than 6.6%, up to 17.3%	40%	60%
More than 17.3%, up to 27.9%	70%	30%
More than 27.9%, up to 33.9%	85%	15%
More than 33.9%, up to 50%	90%	10%
More than 50%	95%	5%

To date, the FTB has not indicated whether it will continue its resolution program or expand the program to include corporate taxpayers currently at protest before the FTB who wish to settle their case (or at least the treasury function gross receipts issue) before the FTB's own Settlement Bureau.

In any event, absent challenges on constitutional or other grounds, the new legislation effectively ends all debate for tax years beginning on or after January 1, 2011, as gross receipts from the sale of marketable securities will be excluded from the sales factor in their entirety for California apportionment purposes once the legislation takes effect.

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#### Footnotes

[1] See, e.g., Jean Ross and Alissa Anderson, *To Have and Have Not: California Corporate Tax Breaks*, St. Tax Notes, July 13, 2009. But see Peter L. Faber, *California Legislation Is Solidly Grounded in Tax Policy*, St. Tax Notes, July 27, 2009.

[2] Cal. Rev. & Tax. Code §§ 25128, 25128.5.

[3] Cal. Rev. & Tax. Code § 23663.

[4] See SB 15, 3d Ex. Sess. (Cal. 2009).

[5] All section references herein are to the California Revenue and Taxation Code, unless otherwise noted.

[6] Cal. Rev. & Tax. Code § 25120.

[7] No. 298683 (Cal. State Bd. of Equalization Dec. 18, 2008), non-precedential letter decision.

[8] Home Depot requested (and was subsequently granted) deferral of its appeal pending the resolution of similar legal issues raised before the California Supreme Court in *General Motors Corp. v. Franchise Tax Bd.* ("General Motors"), 39 Cal. 4th 773 (2006). On August 17, 2006, the Court issued its opinion in *General Motors* and held that a repurchase agreement is analogous to a secured loan and, therefore, only the interest received with respect to that agreement should be treated as "gross receipts" for purposes of formula apportionment. On August 17, 2006, the Court also issued an opinion in *General Motors'* companion case, *Microsoft Corp. v. Franchise Tax Bd.* ("Microsoft"), 39 Cal. 4th 750 (2006), and ruled that, while redemption of marketable securities at maturity generates "gross receipts" that are includible in the apportionment formula, inclusion of such "gross receipts" was distortive for purposes of section 25137 under the particular facts of *Microsoft* and that an apportionment formula which included only "net receipts" was a reasonable alternative.

[9] Section 25137 provides in relevant part:

[I]f the allocation and apportionment provisions of this act do not fairly reflect the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require . . . if reasonable . . . [t]he employment of any . . . method to effectuate an equitable allocation and apportionment of the taxpayer's income.

[10] See, e.g., *Appeals of Pacific Telephone and Telegraph Company*, 1978 Cal. Tax LEXIS 91 (State Bd. of Equalization May 4, 1978).

[11] The SBE has declared that summary decisions are not citable authority and may not be relied upon or given any consideration as precedent. (*Appeal of Charles W. Fowlks*, No. 86R-0799-RO, 1989 Cal. Tax. LEXIS 32 (State Bd. of Equalization Oct. 31, 1989); see also SBE Rule for Tax Appeals No. 5451(d) (Cal. Code Regs. tit. 18, § 5451(d)).)

[12] The program aimed to resolve the backlog of cases which had been pending the California Supreme Court's decisions in *Microsoft* and *General Motors* and the SBE's decision in *Appeal of Home Depot*.

[13] Under the terms of the program, the FTB requires a taxpayer to remove principal amounts received from repurchase and reverse-repurchase agreements, bank savings accounts, and money market accounts from the sales factor denominator under *General Motors*.