Speaker 1 (00:00):

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Nikki Dobay (00:16):

Has the definition of gross receipts changed since the 2018 year that Microsoft was decided, or are we still operating under the same statutory definition? Wow, Frankie does not want California to change its definition. Hello, and welcome to GeTtin' SALTy, a state and local tax policy podcast hosted by Greenberg Traurig. My name is Nikki Dobay, shareholder in the Sacramento, California and Portland, Oregon offices. We are going to have a California catch up today with shareholder Shail Shah. I know that's a mouthful, we always say it, but it's kind of fun now. So Shail, thank you for joining us.

Shail Shah (00:57):

Thanks, Nikki. Thanks for having me on again.

Nikki Dobay (00:59):

So the now-worst kept secret in state and local tax is finally no longer a secret so let's just get right into it. Tell us about the biggest tax case that the OTA has decided, I think, to date. Correct me if I'm wrong on that.

Shail Shah (01:25):

I think you're right. So this is the appeal of Microsoft and we have, on the edges, discussed this case before. And it's officially published so now we can talk about it in the open, as opposed to whispering amongst the California tax practitioner circles. A little bit of background on Microsoft: Microsoft is a gross receipt sales factor case and it's for the tax year ending June 30, 2018. Microsoft filed on a water's-edge basis and for those who are unfamiliar with the water's-edge regime in California, that means they've elected to exclude their CFCs from their combined report in California. As many folks already know, under TCJA, there was this one-time deemed repatriation of earnings from foreign affiliates, and Microsoft went ahead and repatriated a significant amount of earnings into their water's-edge combined filing group.

Nikki Dobay (02:23):

Okay.

Shail Shah (02:25):

California allows for a 75% dividends-received deduction, which Microsoft took. They took the DRD and when they filed their return in their sales factor, they included 25% of the dividends in their sales factor nominator. None of those source to California because these are foreign earnings, so they wouldn't be California sourced. And then Microsoft realized, "Well, why are we only including the income amount in our sales factor?" because sales factor represents gross receipts and income is gross receipts after you take a certain amount of deductions and make certain adjustments.

Nikki Dobay (03:03):

Right.

Shail Shah (03:03):

And so they went back and they filed the refund claim and they said, "100% of the earnings, the dividend, should be included in our sales factor denominator." And not surprisingly, the FTB balked at it. It went through the administrator process, the refund was denied, so then it was in front of the Office of Tax Appeal. And in front of the OTA, Microsoft argued that, "We're entitled to the full amount of the gross receipts in our sales factor because gross receipts means gross receipts." I mean, the definition in California for gross receipts is pretty expansive. It's sort of adopted off UDIPTA and some modifications in the regulation by the Multistate Tax Commission, but it is a fairly broad definition. And the FTB argued two things, right? So they said, one, there's a legal ruling that FTB put out in 2006, 2006-01, that essentially there's this concept where they call it the matching principle and they say, "Well, there needs to be a correlation between what's included in the sales factor compared to what's included in your income."

Nikki Dobay (04:06):

Okay.

Shail Shah (04:08):

The second argument they made was an alternative apportionment argument. And the OTA disagreed with FTB on both of those issues and they said, "Look, gross receipts means gross receipts. If you guys want to change the definition, you have to do it through a legislative fix. But there's nothing in the statute that says that you only include income amounts in your sales factor. There's a difference between income and gross receipts." And the OTA rejected the FTB's alternative apportionment argument too and they said, "Look, you haven't showed us that this sort of repatriation is completely distorted," I think the exact phrase they used was, "Unique circumstance for Microsoft." Because Microsoft was consistently bringing in dividends from their foreign affiliates into the water's-edge group. So that's sort of the technical background on the case. And that decision came out July 27th, 2023.

Nikki Dobay (05:08):

Okay.

Shail Shah (05:09):

But to your point, Nikki, it was the worst kept secret in California because the decision came out. But because the Franchise Tax Board filed a petition for rehearing, the OTA could not release that decision, and so the opinion was floating around.

Nikki Dobay (05:28):

It was known about.

Shail Shah (05:30):

It was known about, it was in people's hands, and people knew what it was. But until the petition for rehearing was decided by the OTA, either granted or denied, they can issue the opinion.

Nikki Dobay (05:43):

Well, I just wanted to go back to the two arguments that the FTB put forward. And it seems like on the statutory language, the OTA has been pretty strong on, "California's statutes are pretty broad and gross

receipts means gross receipts." But how strongly did the FTB push the alternative apportionment argument?

Shail Shah (06:09):

Yeah, it's a really good question because it was sort of a half-hearted argument and you saw it through the briefing. They didn't do a lot of analysis. The quantitative distortion piece of it wasn't very strong and I think where the FTB really struggled with the analysis is that the repatriation was somehow unconnected to Microsoft's core business. And I think they, and I sort of mentioned this before, really had a hard time convincing the OTA that despite the fact that Microsoft consistently, on an annual basis, had a significant amount of repatriation of earnings from their CFCs into the water's-edge group, that somehow this particular repatriation was different.

(07:02):

And they were trying on the edges, saying that, "Well, it's sort of unrelated to business. It's TCJA. It's not like their typical dividends that they've had in the past." But at the end of the day, the OTA said, "Look, we're looking at this history that Microsoft has brought in a significant amount of earnings from foreign affiliates into California. We're not going to treat this any different," or, "You have not met your burden of proof that this is different." And of course, in California, and I think in most states, the moving party for alternative apportionment is clear and convincing evidence.

Nikki Dobay (07:40):

Okay.

Shail Shah (07:40):

And in the OTA's perspective, the FTB did not meet that burden of proof.

Nikki Dobay (07:44):

And it's interesting because in this case, Microsoft did actually repatriate the earnings, as opposed to just having a deemed distribution under 965, and so to your point that their history of having done that was not unusual. And I guess what I'm teeing up a little bit is do you think there are facts that are distinguishable if other taxpayers are going to try to use this case, particularly in light of 965?

Shail Shah (08:19):

Yeah. I think it really helped Microsoft's argument that they actually repatriated the earnings because it sort of gave the OTA an out for not having to distinguish between deemed distributions versus actual distributions. But to your point, I think it is likely that, well, one, the FTB would likely latch onto that distinction. Where if there was just a deemed distribution, they would argue it does not have the same sort of economic effect, right? Because I think part of the OTA's analysis was that, "Well, look. These earnings actually came into California." There is a true economic impact of bringing the earnings in .and they may try to split hairs if they say, "Look. Well, if it's deemed, we understand it's recognized for income purposes, but it's not actually brought into water's-edge group." And that could be a distinction, which in my opinion, it's a distinction without a difference.

Nikki Dobay (09:19):

Yeah.

Shail Shah (09:20):

But it may be something that the OTA or the FTB would latch onto.

Nikki Dobay (09:25):

All right, now I'm going to give that question a different twist with the Beet Sugar case because in that case, this had to do with the co-op rules. Was that deemed income as well, or was that actual distributions? Do you know?

Shail Shah (09:44):

So that case did not deal with distributions, rather it dealt with co-op income. So this was income earned by the co-op.

Nikki Dobay (09:54):

Okay.

Shail Shah (09:54):

But because California provides a deduction for co-op income, that was the issue. But there's sort of a through line between Microsoft and Southern Minnesota Beet Sugar. It is that the OTA really focused on income comes in, it's recognized as income, and then by virtue of the mechanics of a state statute, there is a deduction. And from the OTA's view, it's, "Look. If the income's coming in, there has to be a corresponding apportionment representation in the sales factor."

Nikki Dobay (10:34):

Right.

Shail Shah (10:35):

Because you give a deduction, that does not negate the fact that there is income that's recognized in California.

Nikki Dobay (10:43):

Okay.

Shail Shah (10:44):

And so that was the sort of the common theme between Beet Sugar and Microsoft.

Nikki Dobay (10:49):

All right. Thank you for drawing that very straight line. And then I guess the final thing I note on this is the Moore case, which is pending before the US Supreme Court. If that court decides that 965 income is, in fact, income and is not going to follow the federal constitution, the 16th amendment, I think that would strengthen a taxpayer's argument that even deemed income, the receipts from that income should be recognized under California's definition of gross receipts.

Shail Shah (11:27):

Yeah, absolutely. I think it makes, potentially, the FTB's argument that there is a difference much more difficult because, again, to your point, if it's income and if the US Supreme Court has said it's income, I don't really see the distinction at that point.

Nikki Dobay (11:47):

All right. Now, one other twist on this. Has the definition of gross receipts changed since the 2018 year that Microsoft was decided, or are we still operating under the same statutory definition? Wow, Frankie does not want California to change its definition. So has California changed its definition? She's good. She knows what I'm talking. So Shail, has California's statutory definition of gross receipts changed since the tax year at issue in Microsoft?

Shail Shah (12:24):

It has not. And what's interesting is California changed the definition of gross receipts by statute for tax years beginning on or after January 1st, 2011. And that was in direct response to the first Microsoft case, which went through the Court of Appeal and had to do with Microsoft's treasury function. Also, there was a General Mills case that was around the same time that had to do with General Mills's hedging activities. And what they did was they narrowed the definition of gross receipts a bit by noting that the gross receipts have to be tied, or the gross receipts give rise to business income. So they wanted some sort of a tie if you had non-business income, which was somewhat obvious, but they wanted it somewhat explicitly in there. And then they had specific exclusions from the definition of gross receipts, hedging activity, like I said, treasury function, a few others.

(13:21):

So what was interesting was that Microsoft won its case based off of the more narrow definition of gross receipts after the 1/1/11 change. Beet Sugar was actually four years prior to 2011 so it was a more expansive definition, but it seems like OTA just didn't really care. It was an argument the FTB raised and OTA kind of dismissed it. They said, "Look, it even says in the statute that the amendment to the definition of gross receipts is merely a clarification," and their sort of view is, "Well, it's still the same as it was prior to 2011." So no, there has not been a change. Now, there is grumbling in California that the FTB is exploring legislative fixes to, in their view, remedy the Microsoft problem and see if there's a way for them to stop the slew of refund claims that have been filed on this issue. So unclear of where they are in the process, but I do understand they have been speaking to folks in the legislature about trying to see if they can amend the definition of gross receipts.

Nikki Dobay (14:41):

Well, Shail, that is all very interesting insights. My sense is in other states who have actually adopted the MTC's revised language, there's a big focus on they changed the definitions of business and non-business to apportionable and unapportionable income. But then when it comes to apportionment, we see states, in particular, Oregon and a few others, that are really focused on a taxpayer's receipts from the primary trader business. And it's putting a real twist on this so I hope the FTB doesn't start going down this road where we're seeing other states going, but I think this is going to be a big fight in the future.

Shail Shah (15:31):

Yeah, I agree. And what's sort of interesting is some of it is if they start making these distinctions, like to your point on primary trader business, I think on the other side of the coin, it impacts their argument that typically states the view they aggressively argue, that multiple business lines are unitary. And then if

you start making these distinctions between personal trader business and then maybe an ancillary trader business and you're saying, "Well, one's apportionable, one's not," on the other side, I think it weakens the state's argument to say, "Hey, we're going to combine all of these different divisions or entities," because you can't have it both ways. You can't say they're unitary, but then say they're so different that they're sort of unrelated.

Nikki Dobay (16:19):

Right. Or you're bringing in certain pieces of income into the tax base, yet you're saying you don't get factor representation for that. I think the states are really going down a pretty disturbing path at this point because they push so hard to get everything in to this apportionable income bucket, and then they are just trying to limit the factor relief, so big problem.

Shail Shah (16:48):

Yeah. So it's one of those things they need to be a little careful what they ask for because it could come back and bite them.

Nikki Dobay (16:56):

So it's going to be interesting to see where the states go and the fallout from this. I mean, we kind of have opposite sides of the coin with Vectron and Michigan, which was such a disturbing decision, where the court ruled against the taxpayer, and Microsoft will say, "Not a disturbing decision at all. Really great decision." And it's great to see the OTA, I would say, taking a reasonable reading of the statutory language.

Shail Shah (17:26):

Yeah, I completely agree. The wrinkle, obviously, with Microsoft, which I'll touch upon now, is that the OTA denied the FTB's petition for rehearing on Valentine's Day, on February 14th of this year, and the OTA then published the Microsoft decision the first week of April on its website. And what was shocking to everyone, and I realized sometimes I put things in writing when I speak to certain news outlets, but I guess I wasn't the only one that said this, everyone thought it was impressive actually. And I think I had said that standing on top of a mountain, screaming it out loud, and I was wrong and it was surprising to a lot of people. The way it works with the Office of Tax Appeals is that if a decision is marked either pending precedential or pending non-precedential, there are two dates we have to think about.

(18:26):

You have 30 days from the date that the decision was put on the website, so roughly around the first week of May to file a petition and really just an intention that you plan to provide additional arguments that you disagree with the designation. So if you disagree with Microsoft being non-precedential, you would file something within 30 days. And then you have an additional 30 days to provide your analysis and to supplement your petition. The Office of Tax Appeals has a committee. It's called the Precedential Committee, which also includes Kristen Kane, who's the chief counsel, Mark Ibele, who's the director of the OTA, a few other attorneys. And they sort of weigh whether they're going to effectively change the designation from non-precedential to precedential.

(19:23):

There's not a lot of history with this because one of the things that's interesting is that, and even the OTA said this many times, people just don't really petition them to either mark something as precedential or demote something from precedential to non-precedential. I forgot what the numbers

were, but they're really small, and I think they've changed their mind a couple of times. But it's such a small sample size, it's really hard to tell what the success rate is. But look, we know trade groups like CalTax, I believe, Kost, although I haven't seen anything officially from them yet, and other very prominent lobbying groups here in California like Silicon Valley Business Association, there's a few others, they're probably going to file petitions with the OTA and we'll see what happens. I mean, this, like I said, is somewhat novel. It hasn't really happened and there's not a huge sample size to know how they're going to decide. I do think they understand that this case is very important, but it's hard to tell why they didn't mark it precedential.

Nikki Dobay (20:32):

Is there something that the taxpayer community should have done beforehand? I mean, should there have been outreach beforehand? It is a little bit of a head-scratcher as to why they marked it that, but it's hard to know what could have been done differently since this case was getting so much attention.

Shail Shah (20:53):

Yeah, it's interesting because going back to what we said at the beginning, it was the worst kept secret in California. So I think a lot of people felt like, "Well, was it ripe enough, because it was not published yet, for folks to go out and actually say, 'Hey, we think this should be precedential'?" Because the reality is nobody should really have known what the decision was until it was actually put on the website. So there was a sort of chicken-and-egg thing where you're like, "Yeah, we should have pushed the OTA. But then technically, it's not official yet so is it a little bit premature for us to go and push the OTA?" I think this is one of those things where there may be a teaching moment for the OTA that they may want to consider publishing decisions, and then having some sort of a designation that there's a petition for rehearing or something out there. So that way, you don't sort of run into this issue where everybody knows what the opinion is, but they actually can't take any sort of official action on it because it hasn't gone on their website.

Nikki Dobay (22:01):

Because normally, courts, when there is a petition for rehearing, the decision is out there. So it is a bit odd that that's their process because, again, it's pretty typical in other states where a decision has been released in whatever form that is. So meaning it's publicly available if you want to find it, and then whichever side can move for a rehearing. So I think to your point, a good, maybe, lesson for the OTA.

Shail Shah (22:38):

Yeah. Look, the OTA is a fairly young agency when you sort of think about taxing agencies. The other thing, and I'll give a lot of credit to the OTA, is they are very, very transparent and very open to ideas. They recognize they're a young agency. When they first started, it was kind like a startup company. They were just trying to figure everything out. I'm fortunate enough to be on the advisory committee for the Office of Tax Appeals so at our next meeting, this is something I would likely bring up. I'm sure other folks will bring it up and try to brainstorm, to your point, to have some sort of a process where decisions are still published so folks know what's sort of out there and be transparent and say, "Look, this is this a pending decision, given the petition for rehearing, so you can't rely on it. And then when it becomes final, we'll sort of designate it as final."

Nikki Dobay (23:26):

Yeah. And I mean, if there's this fear that if they grant the motion for rehearing and the decision changes, that has some implications. I guess I would say, again, this is a pretty typical process in other states and other courts and similar types of deciding bodies have done just that and the sky has not fallen. But yeah, it was definitely a twist for this case. So we were going to talk about a few San Francisco cases, but Frankie, she's not very happy with the FTPI think so we're not going to push her too far today. So we'll regroup on those cases, but we have to do a surprise non-tax question. And so I'm going to go with this today. So it is springtime, does your drink of choice change in the spring? So I usually move from brown liquors to clear, so I'm getting into my gin and tonic phase, which [inaudible 00:24:28] would tell you gin and tonic is not a cocktail. It is medicine. So that's a whole different podcast. But in your household, do you have any shifts in your winter to summer drink of choice?

Shail Shah (24:43):

Yeah, definitely the clear spirits come out in the spring, a lot more margaritas. I start drinking more pilsners, a little bit lighter beers, and definitely the white wines, slightly chilled red wines start coming out. We're not a rosé family, so we ...

Nikki Dobay (25:02):

Wow. Okay.

Shail Shah (25:03):

Not a lot of rosés, but definitely whites.

Nikki Dobay (25:03):

Don't do the pink wine.

Shail Shah (25:09):

I know. I know. Yes, definitely the lighter, chiller alcohols has come out and margaritas are big.

Nikki Dobay (25:17):

Right.

Shail Shah (25:17):

We love making margaritas.

Nikki Dobay (25:18):

All right. We don't make margaritas, but when we do ... We don't make them much, but they are great. And we are big fans of rosé. I mean, we have a dog named Rosé of Pinot Noir. But I recently tasted a rosé of Cabernet Franc, which is what Frankie's name is based on so we have both rosés in our house.

Shail Shah (25:43):

Nice. Nice.

Nikki Dobay (25:45):

All right. Well, Shail, thank you for joining me. I think this was a great conversation. Thank you for getting us caught up. My apologies to the listeners for Frankie being in a little bit of an irritated state this morning. But we are going to wrap it up very quickly. So thank you for listening and stay tuned. I'll be back with you again on GeTtin' SALTy.