IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

MICROSOFT CORPORATION,	)	
	)	
Plaintiff and Respondent,	)	**Case No. S133343**
	)	
vs.	)	
	)	
FRANCHISE TAX BOARD,	)	
	)	
Defendant and Appellant.	)	
	)	
	)	

BRIEF *AMICUS CURIAE* OF MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLANT, FRANCHISE TAX BOARD

Court of Appeal, First Appellate District, Division Three
Case No. A105312

San Francisco County Superior Court Case No. 400444
(Hon. Donald S. Mitchell, Judge)

Frank Katz, State Bar No. 42901
General Counsel
Shirley Sicilian,
Deputy General Counsel
Multistate Tax Commission
444 North Capitol Street, N.W.
Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
Attorneys for *Amicus Curiae*
Multistate Tax Commission

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INTEREST OF *AMICUS CURIAE* MULTISTATE TAX COMMISSION

Amicus Curiae Multistate Tax Commission (Commission) files this brief in support of Defendant-Appellant Franchise Tax Board (FTB). The Commission agrees with the FTB that returns of principal are not "gross receipts" and should not be included in the sales factor used for apportioning a taxpayer's business income under the Uniform Division of Income for Tax Purposes Act (UDITPA). The importance the Commission attaches to a correct and uniform construction of UDITPA on this point induced our promulgation of two uniformity recommendations, both of which are consistent with the FTB's position in this case and the current rule of law in the overwhelming majority of other states (FTB's Answer Brief [FTB's Br.] at pp. 17-19), and motivates our filing this brief today.

The Commission is the administrative agency for the Multistate Tax Compact, which became effective in 1967.[1] (See RIA State & Local Taxes:

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[1] The U.S. Supreme Court upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n* (1978) 434 U.S. 452.

All States Tax Guide ¶ 701 *et seq*. (2005).) Article IV of the Compact incorporates UDITPA almost word for word. Article VII charges the Commission with interpretation of UDITPA through promulgation of model regulations. (Compact, Art.VII.1.) Forty-six states are now members of the Commission, including California which enacted the Compact in 1974.[2] (See Cal. Stats. 1974, c. 93.) The substantive provisions of the Compact are found in California Revenue & Taxation Code[3] Section 38006. California also enacted UDITPA separately in 1966, prior to its adoption of the Compact. (See Cal. Stats. 1966, c. 2; Rev. & Tax. Code, § 25120 *et seq.*)

The Commission's statutory responsibility to recommend uniform interpretations of UDITPA addresses what is perhaps the most fundamental purpose of the Compact – to "promote uniformity or compatibility in significant components of tax systems" (Compact, Art. I; Rev. & Tax. Code, § 38006, Art. I). This purpose is central to the very existence of the Compact, which was the states' answer to an urgent need for reform in state taxation of interstate commerce, especially through the development of uniformity. (See e.g., H.R. Rep. No. 952, 89th Cong. 1st Sess., Pt. VI, at 1143 (1965) ["While each of the state laws contains its own inner logic, the aggregate of these laws – comprising the system confronting the interstate

[2] In addition to California, the full members are the states of Alabama, Alaska, Arkansas, Colorado, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington, and the District of Columbia. The five sovereignty members are the states of Florida, Kentucky, Louisiana, New Jersey and Wyoming. The associate members are the states of Arizona, Connecticut, Georgia, Illinois, Maryland, Massachusetts, Mississippi, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Vermont, West Virginia, and Wisconsin. The project members are the states of Iowa, Nebraska and Rhode Island.

[3] Unless otherwise indicated, all Section references are to sections of the Revenue & Taxation Code.

taxpayer – defies reason. Indeed, so varied are the provisions concerning jurisdiction, division of income, and tax base, that it is rare to find a statement which is true of all income tax states."].) Substantial lack of uniformity had resulted in burdensome complexity, uncertainty, compliance problems, serious administrative challenges, duplicate taxation and less than full apportionment of income. If the states failed to act, Congress stood ready to impose reform itself through federal legislation that would preempt and regulate state taxation.[4]

The promise of uniformity established by the states' adoption of the Compact and UDITPA was critical to preserving the recognized sovereignty the states enjoyed, and continue to enjoy, with respect to taxation of interstate and now foreign commerce. Today, the need for uniformity in state taxation has significantly intensified as our modern economy becomes less centered on local business and increasingly organized around interstate and international markets. Responding to the criticisms of Congress and the U.S. Supreme Court,[5] the states must be ever more vigilant to avoid significant deviations in taxing approaches.

Against this backdrop of desired uniformity, Microsoft (Taxpayer) advocates a distinctly minority interpretation of the term "gross receipts" used in UDITPA's definition of "sales." The definition of "sales" is a core provision of UDITPA's division of income rules, as "sales" are the basis for one of the three factors used to apportion multistate business income.

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[4] The Willis Committee performed a congressional study, sanctioned by Title II of Pub. L. 86-272, 73 Stat. 555, 556 (1959), of state taxation of interstate commerce, and made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. (H.R. REP. NO. 952, 89th Cong., 1st Sess., Pt. VI, at 1139*ff* (1965).)

[5] H.R. REP. NO. 1480, 88th Cong., 2nd Sess. (1964); *Allied-Signal Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 777-778 (severe multiple taxation has drastic consequences for national economy).

The interpretation of the term "gross receipts" in the definition of "sales" will therefore have a large impact on the apportionment formula and, in turn, important implications for uniformity. Where the sales factor is double or multiple-weighted, as it is now in California and the majority of other states, this impact is even larger. Deviation from a uniform understanding of this central term would significantly upset the goal of both UDITPA and the Compact to avoid duplicative taxation and ensure full apportionment. (See William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (1957). Duplicative taxation was also an objectionable characteristic of non-uniform state income taxation identified by Congress. (H.R. REP. NO. 1480, 88th Cong., 2nd Sess. (1964) at p. 389.))

Should California adopt Taxpayer's proposed non-uniform definition of "gross receipts," the result would be less than full apportionment for some California taxpayers and duplicative taxation for others. This is because improperly including returns of principal in the sales factor would cause a larger share of a California taxpayer's total multistate business income to be apportioned to its treasury function state. Such a formula, although incorrect, would not result in duplicate or less than full apportionment as long as both California and the treasury function state were to adopt it. But if California were to adopt a formula shifting income to a treasury function state, while the treasury function state has not adopted such a formula (and none have[6]), there would be less than full apportionment of the California taxpayers income. By the same token, should California adopt this position while other states have not, any multistate taxpayer whose treasury function is located in California would be subject to duplicate taxation. And, the amount of double taxation or less

[6]FTB's Br. at pp. 17-19.

than full apportionment could be significant.

The central, substantive problem with a rule that includes the return of principal in the denominator of the sales factor is its distortion of the apportionment of a taxpayer's income. A taxpayer, simply by engaging in short-term investment of its working capital, would increase many fold the denominator of the sales factor. This marked inflation of the sales factor denominator would reduce the apportionment to all states other than the state in which the treasury function is located.

That distortion is shown in the facts of this case. Microsoft invested on average approximately $480 million of working capital in marketable securities. Over 60 percent of these investments were held for seven days or less, and over 30 percent were held for just one day.[7] Including these repeated returns of principal in the sales factor would inflate the sales factor denominator by $5.7 billion. The consequence is a major reduction of the sales factor in California from 15.34% to 3.06%. There would also be an opportunity for further distortion of the apportionment factor through manipulation. That potential is graphically shown in this case by simply shortening the term of all these investments to the readily available overnights, thereby inflating the sales factor denominator by $175 billion ($480 million x 365 nights), virtually wiping out the California sales factor.

This distortion, and the potential for further distortion through manipulation of the length of term of the investments of working capital and though exploitation of non-uniformity by taxpayers who can easily place their treasury function (a mere six employees in this case) in the jurisdiction of choice has prompted jurisdiction after jurisdiction to exclude the return of principal from the sales factor by court decision and by legislation. The inevitability of this distortion both informs the reasonable

[7] Ct. of App. Slip Opn. at p. 2.

interpretation of "sales" in Section 25120(e) (Compact, Art. IV.1(g)) to exclude the return of principal and justifies application of Section 25137 (Compact, Art. IV.18) to eliminate distortion by such exclusion.

The two MTC regulations reflect this dual approach. One interprets "gross receipts" to exclude the return of principal. The other applies the equitable adjustment provision to remedy the distortion. Both regulations interpret the existing language of UDITPA to exclude returns of principal from the sales factor, consistent with the FTB's position, the decision of the appellate court below in this case and the current rule of law in the overwhelming majority of other states (FTB's Br. at pp. 17-19). Your *Amicus* respectfully urges this Court, an important and respected interpreter of UDITPA, to reach the same conclusion. As support, we set out the rationale which the Commission followed in reaching its conclusions in our Argument, below.

Our interest in providing this support is to maintain the extensive uniformity which currently exists regarding interpretation of the Compact and UDITPA on this fundamental point. We believe our concern for uniformity is shared by this Court, as it has explicitly recognized that "one of the primary objectives behind the UDITPA [is] to promote uniformity among the states" and that fulfilling this objective should be an important factor in interpreting UDITPA's terms. (*Hoechst Celanese Corp.* v. *Franchise Tax Board* (2001) 25 Cal.4th 508, 526.) We ask the Court to take into consideration the role of the Commission in promoting such uniformity through adoption of model regulations interpreting UDITPA and the Commission's reasoning in adopting these particular model regulations interpreting the term "gross receipts." (See *Jim Beam Brands Co.* v. *Franchise Tax Board* (2005) 133 Cal.App.4th 514, 530, wherein the Court recognized that consistency with Commission regulations supports the uniformity objective of UDITPA.) The Commission's reasoning on this

issue strengthens the conclusions of the FTB and the appellate court, and is far better suited to achieving the uniformity objective of UDITPA than is the Taxpayer's proposal.

Your *Amicus* makes this request well knowing that the current condition of state income tax uniformity is not perfect. Yet the concept of "sales" is a fundamental one for the uniform division of income, and is currently as near to a uniform concept as we could hope to come.[8] We respectfully submit that a decision in this case which conflicts with that prevailing view, particularly from a jurisdiction such as California that impacts an exceptionally large segment of total interstate commerce, would pose a significant obstacle to the achievement of the primary purposes of the Compact and UDITPA.

ARGUMENT

The Taxpayer in this case is engaged in the sale of software products. These sales produce large sums of excess cash on a short-term basis. Rather than let these sums lay idle, even for brief periods, Taxpayer has formed a treasury division to efficiently employ them in various types of short-term, liquid investments. The issue presented is whether the UDITPA sales factor should include, in addition to the income generated from these liquid investments, the repeated returns of the same principal.

Under UDITPA, "sales" are defined as "all gross receipts of the taxpayer…." (Rev. & Tax. Code, § 25120(e); Compact, Art. IV.1(g).) But the term "gross receipts" is not defined. Over the span of six years, from 1995 through 2001, the Commission analyzed the scope of the term "gross receipts" in the context of investments such as those at issue in this case. The Commission's analysis was performed through the formal rulemaking

[8] The FTB has identified 39 jurisdictions that have adopted the concept supported here. (FTB's Br. at pp. 17-19.)

procedures required for the development of model uniform interpretations of UDITPA. These procedures involved three public hearings, extensive written and oral public comment and formal polling of the Commission's member states, all in accordance with Article VII.2 of the Compact. The Commission's procedures ultimately resulted in the promulgation of two model regulations. Both clearly require the UDITPA term "gross receipts" to include interest income earned from such investments, but not the return of investment principal.

MTC Reg. IV.2(a)(5) defines the term "gross receipts" and expressly states that returns of principal on maturity or redemption of marketable instruments, including the type at issue in this case, are not gross receipts. MTC Reg. IV.18(c)(4) disallows returns of principal from such investments from inclusion in gross receipts as distortive of the sales factor. Under Reg. IV.18(c)(4), the returns of principal are treated the same whether they result from disposition on maturity or from disposition by third party sale prior to maturity – either way, they are excluded.

Most states have now adopted one or both of these interpretations, whether through judicial, legislative or regulatory means, if not specifically through adoption of the Commission's model regulations. Your *Amicus* sets out the rationale for its interpretations below, and respectfully urges this Court to consider the appropriateness of reaching a similar conclusion for like reasons.

I. Returns of Principal Are Not Gross Receipts.

There is no disagreement that, unless it would be distortive to do so, UDITPA requires inclusion in the sales factor of "all gross receipts" derived from transactions and activities in the regular course of a taxpayer's business. (Title 18, California Code of Regulations, Reg. 25134(a)(1) and MTC Reg.IV.15(a).) The controversy revolves around the proper interpretation of the term "gross receipts." Because UDITPA does not

define "gross receipts," the Commission adopted model regulation IV.2(a)(5) to provide a uniform interpretation of the term. The regulation includes interest realized on investment activity, but states explicitly that returns of principal from investments of the type at issue in this case are not included within the meaning of "gross receipts" for purposes of UDITPA:

> "Gross Receipts" are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property…or the use of the property or capital (including rents, royalties, *interest* and dividends) in a transaction which produces business income.... *Gross Receipts, even if business income, do not include such items as, for example*:
>
> 1) *repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument*;
>
> 2) *the principal amount received under a repurchase agreement or other transaction properly characterized as a loan*….

(MTC Reg. IV.2(a)(5) (Emphasis added).)

The Commission's rationale for this policy is that a return of principal from such investment is not a "receipt" at all. It is simply the return, by the borrower to the lender, of the lender's own principal. When these marketable instruments mature, the borrower returns the taxpayer's principal, along with an interest amount. The taxpayer is not "selling" its excess cash when it makes these investments.[9] It is lending its excess cash and earning interest income as consideration for the investment. The transactions at issue in this case are essentially loans of excess cash.

Because the return of principal from these investment transactions is, in conceptual economic and legal terms, simply the return of loaned *intangible* property; for tax purposes it should be treated in a manner

[9] See *United States* v. *Investors Diversified Services* (D.Minn. 1951) 102 F.Supp. 645, 647. See also FTB's Br. at pp. 12-14.

perfectly comparable to the return of loaned *tangible* property. The value of loaned tangible property is not considered "income" includable in gross receipts upon its return, nor should the value of loaned intangible property (cash) be included as gross receipts upon its return. In both cases the transaction at issue is, in economic substance, [10] a loan and not a sale. Thus, in both cases, only the interest income, i.e., the "*amounts realized … on … the use of the property or capital*" should be included in gross receipts. (MTC Reg. IV.2(a)(5) [emphasis added].) The mere fact that the returned intangible property may be in the form of cash should not cause it to be confused with a gross receipt.

Your *Amicus* respectfully submits that the rationale stated above amply supports an interpretation of the term "gross receipts" to include only interest income, and not return of principal, for purposes of calculating the sales factor under UDITPA. This interpretation should be given significant weight in light of the statutory directive requiring that UDITPA "*shall* be interpreted to effectuate its general purpose to make uniform the law of those states that enact it." (Rev. & Tax. Code, § 25138 [emphasis added]; see also, Compact, Art. I and Rev. & Tax Code, § 38006, Art. I ["The purposes of this compact are to: … Promote uniformity or compatibility in significant components of tax systems."]; see also, Compact, Art. XII and Rev. & Tax Code § 38006, Art. XII ["This compact shall be liberally construed so as to effectuate the purposes thereof"].) An interpretation by this Court consistent with the model regulation would be uniform with the current rule in the overwhelming majority of states. (See FTB's Br. at pp. 17-19.) By contrast, adoption of the interpretation proposed by Taxpayer would establish California as the only jurisdiction

[10] For tax purposes, "'the incidence of taxation depends upon the substance, not the form, of the transaction.'" (*Federal Employees Dist. Co.* v. *Franchise Tax Board* (1968) 260 Cal.App.2d 937, 944 [citation omitted].)

that follows such a rule, and would clearly contravene the directives and frustrate the goals of UDITPA.

This Court has explicitly recognized that fulfilling UDITPA's uniformity objective is an important factor in the interpretation of UDITPA's terms regardless of whether that uniformity has been achieved through regulatory interpretations, judicial determinations or legislative amendment:

> Although courts in other jurisdictions that have adopted the UDITPA have disagreed [with regard to the functional test for business income]…, the state legislatures in these jurisdictions have not. In four of the five states where the state court rejected the [functional test], the state legislature amended the [UDITPA statute] to include such a test. Thus, virtually all states adopting the UDITPA now construe the [UDITPA statute to include such a test]. In the interests of promoting uniformity, we do the same." [citations omitted].)

(*Hoechst Celanese Corp.* v. *Franchise Tax Board*, *supra*, 25 Cal.4th at p. 526.)

In *Jim Beam*, the California Court of Appeal recently reached a similar conclusion:

> Although [taxpayer] acknowledges that most of the out-of-state cases it cites have been superseded by statute, [taxpayer] argues that our interpretation of [UDITPA] should reflect the holdings of these cases rather than the policies adopted by the legislatures of our sister UDITPA states. … We reject this argument because … the objective of UDITPA is 'to promote uniformity in allocation *practices*.'" [Citing to *Hoechst Celanese*, *supra*, at p. 518]).)

(133 Cal.App.4th at pp. 529-530.)

The Court in *Jim Beam* also recognized that consistency with Commission regulations *by itself* reinforces the uniformity objective of UDITPA.

> Finally, we point out that our position on this issue follows the regulations drafted by the Multistate Tax Commission. …

> These regulations strengthen our conclusion that our view of the issue is better suited to achieve the uniformity that is the objective of UDITPA than is [taxpayer's].

(133 Cal.App.4th at p. 530.)

Here, even more so than in *Jim Beam*, the Commission's interpretation of the relevant uniform statutes strengthens the conclusions of the FTB and the appellate court, and is far better suited to achieving the uniformity objective of UDITPA than is the Taxpayer's proposal.

II. Treating Returns of Principal as Gross Receipts Would Create Distortion.

Not only are returns of principal properly excluded from the sales factor because they are not "gross receipts," but a rule which improperly allows for their inclusion would create unacceptable distortion of apportionment result. The distortion that would be created presents a distinct, but equally strong, rationale for their exclusion. Whatever surface plausibility there might be to stretch the term "gross receipts" to include returns of principal, the distortion it would create in the context of the apportionment sales factor renders such an interpretation unreasonable and unacceptable.

Several early decisions noted a potential for dramatic distortion and looked to the broad authority of Section 18 of UDITPA (Compact, Art. IV.18; Rev. & Tax. Code, § 25137) to provide for an alternative apportionment formula that would "fairly represent the extent of the taxpayer's business activity in [the] state."[11] Likewise, the first of the

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[11] See *Appeals of Pacific Telephone & Telegraph Company*, Cal. St. Bd. of Equal. (May 4, 1978) 78 SBE 028; *American Telephone & Telegraph Co*. v. *State Tax Appeal Board* (Mont. 1990) 787 P.2d 754; *American Telephone & Telegraph Co.* v. *Director, Division of Taxation* (Tax Ct. 1982) 4 N.J. Tax 638, aff'd and modified (N.J. Super. App. Div. 1984) 476 A.2d 800, cert. denied (1984) 97 N.J. 627; *Sherwin-Williams* v. *Indiana Dept. of State Revenue* (Ind. Tax 1996) 673 N.E.2d 849.

Commission's two model regulations on this issue was promulgated under Art. IV. Section 18 of the Compact to address the issue of distortion. MTC Reg. IV.18(c)(4)(A) provides:

> … If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain or loss from those transactions for each treasury function for the tax period is included in the sales factor.

Adoption of this model regulation was predicated on the Commission's finding that inclusion of principal in the sales factor inherently produces incongruous results. As recognized by the appellate court in this case, this incongruity would not be limited to isolated cases, but would systematically distort the apportionment results for every taxpayer engaged in a treasury function for the investment of its excess cash generated by sales of its core unitary business. (Ct. of App. Slip Opn. at p. 5.) Distortion would also be evidenced by significant arbitrary variance in the apportionment results for similarly situated taxpayers.

A. Including Returned Principal in the Sales Factor Would Distort the Apportionment Result for Every Multistate Taxpayer with a Treasury Activity by Incorrectly Reflecting the Source of the Taxpayer's Income from Its Other Business Activities.

The philosophy of UDITPA is that multistate business income should be apportioned based upon the location of the activities that are responsible for its realization. (William J. Pierce, *Uniform Act Urged as Practical Method to Lighten State Tax Compliance Burden,* 12 J.Tax'n 83, 84 (1960); see also, *Appeals of Pacific Telephone & Telegraph Co., supra,* .) The sales factor reflects these contributions by attributing gross receipts from the sale of tangible personal property (in this case, the software) to the "market" states where the sales are delivered, and by attributing gross

receipts from all other transactions (in this case, the treasury activities) to the states where the income producing activities occur. (Rev. & Tax. Code, §§ 25135 and 25136; Compact, Art. IV.16 and IV.17).

Through a treasury function, large sums of excess cash generated from the sales of another product are invested and reinvested as principal in short-term, often overnight, securities that return, often each day, the original principal investment plus a small amount of interest income. If these large sums of principal were continually re-counted as gross receipts attributable to the treasury function and added to the sales factor each time they were returned, then over the course of a year the total "gross receipts" attributed to the treasury function from this multiple counting of the same funds could be enormous.

By inflating gross receipts attributable to the income producing activity of the treasury function in this way, the influence of the treasury activities in the sales factor ratio could become entirely disproportionate to the taxpayers other business activities and to the portion of multistate business income that is actually earned through those activities, *i.e.*, the interest income. Professor Hellerstein explains that distortion of taxpayers' overall apportionment results would occur because "there is no necessary correlation between the amount of receipts and the corresponding amount of income from certain types of intangible investments:"

> For example, the purchase at a discount of a thirty-day $1 million certificate of deposit at the beginning of each month and its sale or redemption at the end of the month would yield $12 million of receipts during the course of a year, whereas the purchase at a discount and subsequent sale or redemption of a one-year $1 million certificate of deposit would yield only $1 million of receipts. Yet the intangible interest income earned from these investments is likely to be quite similar and clearly will not vary by a factor of twelve.

(Hellerstein & Hellerstein, *State Taxation* (3d ed. 2001) Part IV

¶9.18[4][c].)

This example plainly illustrates the root of the distortion problem. If returns of principal are included in gross receipts, then "gross receipts" attributable to the treasury function could be inflated multiple times over with little or no increase in either the income producing activity taking place in the treasury function state (the activity which the UDITPA sales factor is intended to reflect) or the income generated by that activity.

If the only function represented in the sales factor were a treasury function making homogeneous investments, this inflation of the sales factor would not be a problem. The sales factor apportionment numerators and denominators for the states in which the taxpayer has income producing activity would all simply vary proportionately and the apportionment result would not change.

Indeed, the Commission's regulation allows an exception for taxpayers who are principally engaged in the business of purchasing and selling liquid assets. (MTC Reg. IV.18(c)(4)(C).) Of course, the exception only applies to the extent that the taxpayer's transactions actually generate sales "gross receipts" within the meaning of MTC Reg. IV.2(a)(5). In this manner, the "anti-distortion" regulation of MTC Reg. IV.18(c)(4) provides a back-stop to the gross receipts definition contained in MTC Reg. IV.2(a)(5), and prevents the sales factor from being distorted by sales of treasury investments before they mature.

However, a huge incongruity arises if a treasury function is unitary with another function,[12] so that total business income arising from both functions must be apportioned across the states in which each is performed,

[12] In this case, Taxpayer has stipulated that its treasury function was unitary with its sales of software. (See Microsoft's Opening Brief on the Merits at p. 5, citing to Reporter's Transcript 31:19 and 20; 33:8-13)

based in part on the *relative* amount of gross receipts contributed by each.[13] Including returned principal attributable to the treasury function in gross receipts would allow for a significant shift in the relative percentage of total sales attributable to the states with income producing activity from the treasury function versus the market states for the sales of taxpayer's tangible property.

Gross receipts from the taxpayer's sales of tangible property would become increasingly overwhelmed in the sales factor as the average maturity period taxpayer chooses for its treasury function investments shortens. As the length of the taxpayer's average maturity period drops, the more the principal is "turned over," and the more gross receipts attributable to the location of the income producing activity of its treasury function would climb. As gross receipts attributable to the treasury function climb, unvarying receipts attributable to the market states from sales of tangible property would become increasingly underrepresented in the sales factor ratio. The sales factors attributable to those market states would shrink. The result is that the percentage of total business income apportioned to the market states would also shrink.

Even fairly small variations in average maturity periods for short-term investments could create large variations in the "gross receipts" attributable to the treasury function state. For example, a taxpayer could increase its "gross receipts" attributable to its treasury function, with little

[13] The final apportionment result is also based on a property factor and a payroll factor. Taxpayer in this case argues in its reply brief that UDITPA's exclusion of intangible property from the property factor creates a distortion which offsets any distortion in the sales factor. We disagree. UDITPA's exclusion of intangible property does not distort the intended result. It *is* the intended result (Rev. & Tax. Code, § 25129). But we will not address this contention because it is not before this Court as it was not raised by the Taxpayer in either a Section 25137 request, or in its claim for refund or in the proceedings below.

or no change in its income or income producing activity, by nearly 500 percent simply by changing the average maturity period for its investments from five days to one day.[14]

A rule which allows gross receipts to be inflated in this manner would defeat the purpose of the UDITPA sales factor to reflect the proportionate location of all of the taxpayer's sales-related business activity. Income properly attributed to the states where tangible property is sold would essentially be misattributed to the treasury function state, as the sales factor is overwhelmed by repeatedly reinvested treasury function receipts.[15] In this case, the result of inflating the gross receipts attributable to states with income producing activity from the treasury function would be a vast underrepresentation of the State of California's contribution as a market state for sales of the Taxpayer's other, tangible product – software.

B. Including Returned Principal in the Sales Factor Would Produce Distortion by Allowing Substantially Different Apportionment Results Across Similarly Situated Taxpayers.

In addition, including returned principal in gross receipts would

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[14] The court below applied this type of reasoning in concluding that FTB's invocation of Section 25137 was justified. (See Ct. of App. Slip Opn. at pp. 2-3.) Microsoft challenges the appellate court's conclusion by asserting that it was based upon a "separate accounting analysis" that, Microsoft claims, can never be used to support a finding of distortion under Section 25137. (Microsoft's Reply Brief at p. 21.) However, nothing in Section 25137 limits the scope of permissible inquiry in determining whether the business activity of a taxpayer in this State is being fairly reflected in the apportionment formula. Such an inquiry requires a comparative analysis of the activity in different states. This Court should not turn a blind eye to the evidence such an inquiry produces.

[15] Because no state currently includes such treasury function activity in its sales apportionment factor (FTB's Br. at pp. 17-19), the misattributed income would actually escape state taxation altogether.

allow for substantially different apportionment results between similarly situated taxpayers. If one taxpayer invested in securities with an average six month maturity to match its capital needs cycle and another invested overnight, the gross receipts attributable to the treasury function state of one would be hundreds of times that of the other. Thus, even if the two taxpayers had identical income and location of business activity as measured by property, payroll and sales, the two could apportion a significantly different share of their income to each state in which they did business.

There is simply no rationale in tax policy that would support such a divergence in these taxpayers' apportionment factors, nor the consequential divergence in their state income apportionment and tax results. Certainly, this amount of variation for essentially similarly situated taxpayers cannot have been the intended, and is not an acceptable, result of the UDITPA apportionment formula.

Your *Amicus* respectfully submits that only the interest income, and not the return of principal, should be considered gross receipts and included in the sales factor used to apportion business income under UDITPA; and that, for the reasons stated above, adhering to this principle is necessary in order to avoid serious systematic distortion, and potential manipulation, of the UDITPA sales factor and apportionment results.

CONCLUSION

In the interest of maintaining significant uniformity in the application of UDITPA and the Multistate Tax Compact, *Amicus Curiae* Multistate Tax Commission respectfully suggests this Court affirm the decision below and adopt an interpretation of UDITPA that recognizes returns of principal are not included in gross receipts. Maintaining the line on this central definition means that states have taken seriously the need to

employ *uniform* division of income rules if they are to defend successfully state tax sovereignty against federal regulation and preemption.

Respectfully submitted this ____ day of January, 2006.

_____

Frank Katz (State Bar No. 42901)
General Counsel
Shirley Sicilian
Deputy General Counsel
Multistate Tax Commission
444 North Capitol Street, N.W. Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
Attorneys for *Amicus Curiae*
Multistate Tax Commission

CERTIFICATE OF COMPLIANCE

Pursuant to California Rule of Court (14)(c)(1), I hereby certify that this Amicus Curiae brief is in 13-point type and, according to the word count of the computer program used to prepare this brief, contains 5,506 words (including footnotes).

Dated: January ___, 2006

_____
Shirley Sicilian
for Amicus Curiae
Multistate Tax Commission

PROOF OF SERVICE BY MAIL

I am employed by the Multistate Tax Commission, whose address is 444 North Capitol Street, N.W., Suite 425, Washington, D.C. 20001-1538. I am over the age of eighteen years and not a party to the within cause.

On January ____, 2006, I served a true copy of:

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Julian O. Standen
Deputy Attorney General
455 Golden Gate Avenue,
Suite 11000
San Francisco, CA 94102-7004

James P. Kleier
Reed Smith LLP
Two Embarcadero Center
San Francisco, CA 94111

Michael P. Boyle
One Microsoft Way
Redmond, WA 98052-6399

J. Pat Powers
Baker & McKenzie
660 Hansen Way
Palo Alto, CA 94304

Court of Appeal
First Appellate District
Division Three
350 McAllister Street
San Francisco, CA 94102

Honorable Donald S. Mitchell
Superior Court of California
County of San Francisco
400 McAllister Street
San Francisco, CA 94102

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Shirley K. Sicilian