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**SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF SAN FRANCISCO**

MICROSOFT CORPORATION, a Washington
corporation

Plaintiff,

vs.

FRANCHISE TAX BOARD, an agency of the
State of California,

Defendant.

Case No. CGC 08-471260

PROPOSED STATEMENT OF DECISION

Hon. John Kennedy Stewart
Dept. 505

1 This action was tried before the Court on the basis of an extensive set of stipulated facts
2 and exhibits submitted jointly by the parties, as well as the testimony of fact witnesses and expert
3 witnesses. Each party has submitted trial briefs and presented oral arguments in support of its
4 respective legal position. At the conclusion of closing arguments, the Court directed each party
5 to prepare and submit a proposed statement of decision. The Court has reviewed the proposed
6 statements submitted by the parties and hereby adopts, with modifications, the following
7 proposed statement as the Court's Proposed Statement of Decision:

8 **FACTUAL BACKGROUND**

9 Microsoft is organized and exists under the laws of the State of Washington. (Stipulation of
10 Facts (Stip.) No. 2.) During the Tax Period, Microsoft was engaged in the business of
11 developing, licensing, manufacturing, and distributing computer software and providing computer
12 software and computer software-related services. (Stip. No. 6.) For California franchise tax
13 purposes, Microsoft and all of its domestic and foreign subsidiaries operated as a single
14 worldwide "unitary business"¹ (Stip. No. 4) and Microsoft filed California corporation tax returns
15 with the FTB for the Tax Period on a "Water's-edge basis" pursuant to Revenue and Taxation
16 Code section 25110.² (Stip. No. 5.) The FTB is an agency of the State of California and
17 is empowered to assess and collect corporate franchise tax under the Corporation Tax Law
18 of the State of California. (Stip. No. 3.)

19 In the year 2000, the FTB commenced an audit of Microsoft's tax returns for the
20 Tax Period. (Stip. No. 9.) On or about June 27, 2002, the FTB issued notices of proposed
21 assessment to Microsoft for additional California tax in the amount of \$3,945,139.00,
22 plus penalties, for tax year 1995 (Stip. No. 10) and in the amount of \$21,329,729.00,
23 plus penalties, for tax year 1996. (Stip. No. 11.)

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26 ¹ "A unitary business is generally defined as two or more business entities that are
27 commonly owned and integrated in a way that transfers value among the affiliated entities."
28 (*Citicorp North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1411, fn. 5.)

² Unless otherwise indicated, all statutory references are to the California Revenue
and Taxation Code.

1 Microsoft protested the tax deficiencies proposed by the FTB. (Stip. No. 12.) On or about
2 January 15, 2008, while its protest was still pending, Microsoft paid the entire amount of the
3 franchise tax deficiencies that the FTB had asserted in the notices of proposed assessment.
4 (Stip. No. 15.) In notices dated February 27, 2008, Microsoft directed the FTB to apply the
5 January 15, 2008, payments to satisfy the tax assessments proposed for the Tax Period, which
6 had the effect of converting Microsoft's protest into a claim for refund (§ 19335).³ (Stip. Nos. 16
7 (Exh. H) & 17 (Exh. I).)

8 On March 10, 2008, the FTB provided schedules to Microsoft for the calculation of tax
9 amnesty penalties imposed pursuant to section 19777.5 in the amount of \$968,591.36 for tax year
10 1995 and \$8,905,352.92 for tax year 1996.⁴ (Stip. No. 18 (Exh. J).) Microsoft's tax payments
11 on January 15, 2008, were in an amount sufficient to pay in full the asserted amnesty penalties.
12 (Stip. No. 19.)

13 On June 4, 2008, the FTB issued notices of action for tax year 1995 and tax year 1996,
14 which informed Microsoft that its claim for refund was denied. (Stip. No. 20 (Exh. K).)

15 On July 7, 2008, Microsoft filed in this Court an amended complaint for refund of corporate
16 franchise tax, which is the subject of this action. For tax year 1995, Microsoft seeks a refund of
17 tax in the amount \$1,847,599, plus applicable interest, and a refund of amnesty penalties in the
18 amount of \$968,591.36. For tax year 1996, Microsoft seeks a refund of tax in the amount of
19 \$19,762,388, plus applicable interest, and a refund of amnesty penalties in the amount of
20 \$8,905,352.92.

21 CALIFORNIA'S METHOD OF TAXING A UNITARY BUSINESS

22 As a unitary business that was engaged in business both in California and in other taxing
23 jurisdictions during the Tax Period, Microsoft was subject to taxation by California on a portion
24

25 ³ Section 19335 states, in relevant part, as follows: "If, with or after the filing of a protest
26 or an appeal to the State Board of Equalization . . . a taxpayer pays the tax protested before the
27 Franchise Tax Board acts upon the protest, or the board upon the appeal, the Franchise Tax Board
28 or board shall treat the protest or the appeal as a claim for refund or an appeal from the denial of
a claim for refund filed under this article."

⁴ The amnesty penalties are unrelated to the penalties that were originally included in the
notices of proposed assessment.

1 of its total worldwide business income. Although the United States Constitution bars a state from
2 taxing extraterritorial income, state taxation of “an apportionable share of the multistate business
3 carried on in part in the taxing State” is permissible. (*Allied-Signal, Inc. v. Director, Div. of*
4 *Taxation* (1992) 504 U.S. 768, 778.) One constitutionally-approved method of apportioning the
5 business income of a unitary business among the taxing jurisdictions in which it operates is the
6 “unitary business/formula apportionment method,” which authorizes a state to approximate the
7 business’ “local tax base by first defining the scope of the ‘unitary business’ of which the taxed
8 enterprise’s activities in the taxing jurisdiction form one part, and then apportioning the total
9 income of that ‘unitary business’ between the taxing jurisdiction and the rest of the world on the
10 basis of a formula taking into account objective measures of the corporation’s activities within
11 and without the jurisdiction.” (*Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755,
12 citing to *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 165.) That apportionment
13 formula is set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA),
14 which California has adopted in sections 25120 et seq.

15 Under UDITPA, the income of a unitary business that operates in multiple taxing
16 jurisdictions is divided between “business income” and “nonbusiness income” for purposes of
17 state taxation.⁵ With some exceptions, nonbusiness income is generally allocated entirely to the
18 state where the unitary business is domiciled for state taxation purposes. (*Hoechst Celanese*
19 *Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 518; §§ 25123-25127.) In contrast,
20 the business income of a unitary business is *apportioned* among the various states in which it
21 operates according to a formula that is designed to reflect the company’s activity within the state.
22 All of Microsoft’s income is business income subject to apportionment.

23 UDITPA’s apportionment formula determines the portion of a unitary business’ business
24 income that is attributable to the economic activity of a given state on the basis of three factors:

25 ⁵ “‘Business income’ means income arising from transactions and activity in the regular
26 course of the taxpayer’s trade or business and includes income from tangible and intangible
27 property if the acquisition, management, and disposition of the property constitute integral parts
28 of the taxpayer’s regular trade or business operations.” (§ 25120, subd. (a).) “‘Nonbusiness
income’ means all income other than business income.” (§ 25120, subd. (d).) None of the legal
issues presented in this case pertains to nonbusiness income.

1 (1) payroll, (2) property and (3) sales. (§ 25128.) The “payroll factor,” the “property factor”
2 and the “sales factor” of the apportionment formula is each expressed as a separate fraction. The
3 numerator of the fraction reflects the activity or assets of the unitary business within a particular
4 state and the denominator reflects its total activities or assets from everywhere. The payroll,
5 property and sales factors are then combined and averaged and the resulting fraction is multiplied
6 against the total business income of the unitary business to determine what percentage of the total
7 business income is attributable to the given state. (*Citicorp North America, Inc. v. Franchise*
8 *Tax Bd, supra*, (2000) 83 Cal.App.4th at p. 1410, fn. 2.) This apportionment formula provides
9 “a rough but constitutionally sufficient approximation of the income attributable to business
10 activity in each state” for state taxation purposes. (*Microsoft Corp., supra*, 39 Cal.4th at p. 756;
11 *Hoechst Celanese Corp., supra*, 25 Cal.4th at p. 517.)

12 In California, the UDITPA formula, as adopted and modified by the Legislature for the
13 Tax Period, adds together the three fractions that reflect the unitary business’ payroll, property
14 and sales and divides by four. (§ 25128, subd. (a).) Division by four, rather than by three, occurs
15 because California gives *double* weight to the sales factor, with certain exceptions that are not
16 applicable here. (*Ibid.*) The result is a percentage that is then multiplied against the unitary
17 business’ total business income from all sources to arrive at the amount of business income that
18 is apportionable to California and subject to state tax. (*Ibid.*)

19 The sales factor, which is the largest component of the UDITPA formula utilized in
20 California and reflects the contribution of marketing activity to the taxpayer’s income, “helps
21 allocate a company’s income to various states in accordance with the amount of gross receipts
22 the company generates in each state.” (*General Motors Corp. v. Franchise Tax Bd.* (2006)
23 39 Cal.4th 773, 778; § 25120, subd. (e); Cal. Code Regs., tit. 18, § 25134, subd. (a).)⁶ Whether
24 a unitary business’ gross receipts are assigned to the California numerator of the sales factor is
25 determined at the outset by the nature of what is being sold. Generally, receipts from the sale of
26 “tangible personal property” are treated as California sales, and thereby included in the California

27 ⁶ Unless otherwise indicated, all references to administrative regulations are to Title 18 of
28 the California Code of Regulations.

1 sales factor numerator, if the property is delivered to a purchaser located within the state.
2 (§ 25135.) In contrast, receipts from the sale of “other than tangible personal property,” such
3 as intangible property, are treated as California sales if all, or the greater portion, of the “income-
4 producing activity” that gave rise to the receipts, based on “costs of performance,” is performed
5 in this state. (§ 25136.)

6 The property factor, which is intended to reflect the investment of capital in the unitary
7 business, is computed as a ratio comparing the value of the unitary business’ “real and tangible
8 personal property” in the state to the business’ total property everywhere. By statute, the value of
9 the business’ intangible property is not included in the computation of this factor. (§ 25129.)
10 Property is included in the California numerator of the property factor to the extent that it is
11 owned or rented and “used in this state.” (*Ibid.*)

12 The payroll factor, which reflects the contribution of labor to the operations and profits of
13 the unitary business, is computed as a ratio of the total payroll paid in California to total
14 compensation paid everywhere during the taxable year. (§ 25132.)

15 In addition to the standard three-factor apportionment formula used to determine what
16 amount of a taxpayer’s business income is subject to tax by California, UDITPA includes a
17 statutory relief provision that allows for reasonable modification of the formula if its provisions
18 do not fairly represent the extent of the taxpayer’s business activity in the state. This relief
19 provision, set forth in section 25137, was enacted as part of UDITPA to address “any
20 unreasonable calculations rote application of the three-factor apportionment formula may yield.”
21 (*Microsoft Corp., supra*, 39 Cal.4th at p. 764.) Section 25137 provides as follows:

22 If the allocation and apportionment provisions of this act do not fairly represent
23 the extent of the taxpayer’s business activity in this state, the taxpayer may petition
24 for or the Franchise Tax Board may require, in respect to all or any part of the
25 taxpayer’s business activity, if reasonable; [¶] (a) Separate accounting; [¶] (b) The
26 exclusion of any one or more of the factors; [¶] (c) The inclusion of one or more
27 additional factors which will fairly represent the taxpayer’s business activity in this
28 state; or [¶] (d) The employment of any other method to effectuate an equitable
allocation and apportionment of the taxpayer’s income.

As the terms of section 25137 indicate, a taxpayer may petition the FTB to modify the
standard apportionment formula upon a sufficient showing that it does not fairly reflect the extent

1 of the taxpayer's activities in California. Moreover, the FTB is authorized to assert on its own
2 that the standard apportionment formula does not fairly represent the extent of the taxpayer's
3 business activities in California and then determine the appropriate modifications. The party
4 invoking section 25137 bears the burden of proving by clear and convincing evidence that the
5 approximation of the taxpayer's business income in California as calculated by the standard
6 formula does not fairly reflect the extent of its business activity in the state. (*Microsoft Corp.*,
7 *supra*, 39 Cal.4th at p. 765; *Colgate-Palmolive Co. v. Franchise Tax Bd.* (1992) 10 Cal.App.4th
8 1768, 1786.) If that burden of proof is met, the FTB may propose a modification of the standard
9 formula that is subject to judicial review for reasonableness. (*Microsoft Corp.*, *supra*, 39 Cal.4th
10 at p. 771; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506, 514-515.)
11 If the FTB's proposal is determined to be reasonable, the courts are not empowered to substitute
12 their own alternative formulas. (*Microsoft Corp.*, *supra*, 39 Cal.4th at p. 771.)

13 **ULTIMATE LEGAL ISSUES FOR DECISION**

14 Microsoft's amended complaint sets forth four separate causes of action that relate to its
15 efforts to (1) reduce the percentage of its total business income that is apportioned to California
16 under the state's method of taxing a unitary business; and (2) invalidate the FTB's imposition
17 of amnesty penalties for the Tax Period. The ultimate issues presented for decision to the Court
18 are as follows:

- 19 1. Whether Microsoft's royalties from the licensing of its computer software products
20 were properly assigned to the sales factor numerator of the apportionment formula used to
21 determine the amount of its income subject to California tax (First Cause of Action)?
- 22 2. Whether the FTB was warranted in excluding Microsoft's gross receipts from the sale
23 or disposition of its marketable securities from the sales factor denominator in order to fairly
24 reflect the extent of Microsoft's computer software business activity in California
25 (Second Cause of Action)?
- 26 3. Whether California's standard apportionment formula, which by statute omits
27 the value of intangible property from the property factor, should be modified to include the value
28 of Microsoft's intellectual property (Third Cause of Action)?

1 sales of the taxpayer in this state during the taxable year” and the denominator of the fraction
2 reflects “the total sales of the taxpayer everywhere during the taxable year.” A taxpayer’s “sales”
3 are reflected by its “gross receipts” derived in the regular course of its business and includes
4 receipts from licensing activities in the form of royalties. (Reg. § 25134, subd. (a).)

5 **A. Relevant Evidence**

6 On its California tax returns for the Tax Period, Microsoft reported that it received
7 royalties from the licensing of proprietary computer software products to Original Equipment
8 Manufacturers (OEMs) and other licensees. (Stip. No. 44.) OEMs are computer sales
9 organizations that specialize in assembling, and in some cases, manufacturing computer systems
10 for sales to end users. (Stip. No. 23.) OEMs acquire computer equipment from a single vendor
11 or components from various vendors and combine them with software into a single product.
12 (Stip. No. 23.) Software is a set of machine-readable programs that cause hardware to perform
13 predetermined tasks. (Stip. No. 40.) The licensing agreements that Microsoft entered into gave
14 the OEMs the right by virtue of the license to install Microsoft software into OEM computer
15 systems and then sell those computer systems with the pre-installed software.⁸ (Stip. No. 25.)
16 The licensing agreements did not grant an ownership interest in Microsoft’s software to the OEM.
17 (Stip. No. 29.) Rather, under the licensing agreements, the OEM had only a license to use the
18 software within the express limitations set forth in the agreement and Microsoft retained title to
19 the licensed software at all times. (Stip. No. 29.)

20 Microsoft made its licensed software available to the OEMs primarily through the shipment
21 of “Golden Master” disks that allowed OEMs to copy the software onto the hard drives of the
22 computer units that they were assembling and plastic back-up disks that OEMs received from
23 authorized replicators to be bundled with the assembled computer units. (Stip. No. 30.) Royalties

24 ⁸ The licensing agreements entered into by Microsoft also included agreements with
25 Delivery Service Providers (DSPs), which are companies that license software from Microsoft
26 through authorized replicators and then re-sell the product to smaller OEMs. (Stip. Nos. 22 &
27 24.) The smaller OEMs would purchase the Microsoft software from DSPs in the form of prepaid
28 “break the seal” multiple unit packs. (Stip. No. 24.) Under licensing agreements with DSPs,
Microsoft’s primary relationship was with the DSPs and royalties only accrued from the DSPs to
Microsoft. (Stip. No. 27.) The DSPs thus served as a conduit between Microsoft and the smaller
OEMs. (Stip. No. 27.)

1 accrued under the licensing agreements on either a “per system” or “per copy” basis, as
2 designated by the agreement. (Stip. No. 36.) In a per system license, Microsoft would grant the
3 OEM the right to install designated Microsoft computer programs into one of the OEM’s entire
4 product lines. (Stip. No. 36.) Royalties accrued whenever a copy of Microsoft’s products was
5 distributed to the OEM. (Stip. No. 36.) In a per copy license, royalties accrued whenever the
6 software was licensed or distributed by the OEM. (Stip. No. 37.)

7 On its California tax returns for the Tax Period, Microsoft reported in its sales factor
8 denominator that it received royalties from the licensing of its various products, including its
9 computer software, to OEMs and other licensees in the following total amounts: \$1,650,474,000
10 for tax year 1995 and \$2,503,000,000 for tax year 1996. (Stip. No. 44.) Of these total amounts,
11 Microsoft assigned the following amounts to the California numerator of the sales factor:
12 \$234,814,334 for tax year 1995 and \$406,833,604 for tax year 1996. (Stip. No. 45.) The
13 assignment of royalties to the California numerator was made by Microsoft on the basis of the
14 location of the billing addresses of the OEMs. (Stip. at Exh. JJ (Interrogatory No. 13).)

15 **B. Parties’ Contentions**

16 Microsoft contends that the royalties that it received from the licensing of its computer
17 software to OEMs and other licensees with California billing addresses were erroneously
18 included in the California sales factor numerator for the Tax Period. Microsoft alleges that the
19 royalties at issue was not attributable to the licensing of “tangible personal property” (§ 25135),
20 but rather to the licensing of “other than tangible personal property” (§ 25136), i.e., intangible
21 property. As such, Microsoft contends, because the greater cumulative amount of the “costs of
22 performance”⁹ relating to the licensed products was incurred in the State of Washington,
23 the royalties that Microsoft originally reported as California sales should now be completely
24 excluded from the California numerator of the sales factor, thereby significantly reducing
25 its California-based income.

26 ///

27 ⁹ These performance costs related to research and development, sales and marketing,
28 technical support and other support activities. (Stip. No. 50.)

1 The FTB contends that the royalties that Microsoft seeks to remove from the California
2 numerator of the sales factor were attributable to the licensing of computer software that qualified
3 as *tangible* personal property. As such, the FTB contends, the royalties were properly assigned to
4 California in accordance with the California location to which those licensed products were
5 delivered. (§ 25135; Reg. § 25136, subd. (d)(2)(B).)

6 C. Applicable Law

7 Whether the royalties at issue are properly treated as California sales, and therefore
8 includible in the California sales factor numerator, turns initially on whether what is being sold
9 (licensed) constitutes tangible personal property or “other than tangible personal property.”

10 Tangible personal property is defined as “[c]orporeal personal property of any kind;
11 personal property that can be seen, weighed, measured, felt, or touched, or is in any other way
12 perceptible to the senses, such as furniture, cooking utensils, and books.” (Black’s Law Dict.
13 (9th Ed. 2009) pp. 1337-1338.)¹⁰ Receipts from the sale of *tangible* personal property are treated
14 as receipts from sales in California, and thereby included in the California numerator of the
15 sales factor, if the product is delivered or shipped to a purchaser within the state. (§ 25135.)
16 Similarly, where the specific income producing activity that gives rise to the sales receipts is the
17 *licensing* of tangible personal property, the receipts are treated as California sales, to be included
18 in the California numerator of the sales factor, if the licensed property is located in the state.
19 (Reg. § 25136, subd. (d)(2)(B).)

20 A different standard applies to gross receipts from the sale of “other than tangible personal
21 property,” such as intangible property. Intangible property is defined as “rights not related to
22 physical things, but that are merely relationships between persons, natural or corporate, which the
23 law recognizes by attaching to them certain sanctions enforceable in the courts. Intangible
24 property has no physical existence, but may be evidenced by a document with no intrinsic value,
25 such as a stock certificate.” (63C Am. Jur.2d (2009) Property, § 9, pp. 80-81.) Gross receipts
26 from the sale of intangible property are treated as California sales in computing the sales factor

27 ¹⁰ The California Revenue and Taxation Code defines “tangible personal property”
28 for sales tax purposes (§ 6016), but not for corporate franchise tax purposes.

1 numerator if all, or a greater proportion, of the “income-producing activity” that gave rise
2 to the receipts is performed in this state than any other state, based on “costs of performance.”
3 (§ 25136.) The term “income producing activity” applies to each separate item of income and
4 refers to “the transactions and activity directly engaged in by the taxpayer in the regular course of
5 its trade or business for the ultimate purpose of obtaining gains or profit.” (Reg. § 25136, subd.
6 (b).) Likewise, the term “costs of performance” refers to the direct costs of the income producing
7 activity incurred for each separate income item, as determined “in a manner consistent with
8 generally accepted accounting principles and in accordance with accepted conditions or practices
9 in the trade or business of the taxpayer.” (Reg. § 25136, subd. (c).)

10 **D. Findings and Conclusions**

11 **1. Microsoft’s Royalties Were Derived from the Licensing of Tangible 12 Personal Property.**

13 The Court finds that the royalties that Microsoft received from licensees with California
14 billing addresses were derived from the licensing of *tangible* personal property.¹¹ The Court’s
15 bases its finding on the following:

16 *First*, state courts from a number of jurisdictions have determined that computer software
17 constitutes tangible personal property, in that it “is knowledge recorded in a physical form which
18 has physical existence, takes up space on the tape, disc, or hard drive, makes physical things
19 happen, and can be perceived by the senses”:

20 The software itself, i.e., the physical copy, is not merely a right or an idea
21 to be comprehended by the understanding. The purchaser of computer software
22 neither desires nor receives mere knowledge, but rather receives a certain
23 arrangement of matter that will make his or her computer perform a desired function.
This arrangement of matter, physically recorded on some tangible medium,
constitutes a corporeal body.

24 (*South Central Bell Telephone Co. v. Barthelemy* (La. 1994) 643 So.2d 1240, 1246-1247
25 (citations omitted); see *Andrew Jergens Company v. Wilkins* (Ohio 2006) 848 N.E.2d 499,
26 502-503 [application software is tangible personal property subject to personal property tax

27 ¹¹ A list of the OEMs and DSPs with which Microsoft entered into licensing agreements
28 is set forth in Exhibit L of the Stipulation of Facts.

1 for property used in business]; *South Central Utah Telephone Association v. Utah State Tax*
2 *Commission* (Utah 1997) 951 P.2d 218, 223-224 [“Software is information recorded in a physical
3 form which has a physical existence, takes up space on the tape, disc or hard drive, makes
4 physical things happen, and can be perceived by the senses”]; *Wal-Mart Stores, Inc. v. City of*
5 *Mobile* (Ala. 1996) 696 S.2d 290, 291 [gross receipts tax on tangible personal property applies
6 to sales of computer software]; *Hasbro Industries, Inc. v. Norberg* (R.I. 1985) 487 A.2d 124, 128
7 [computer software program “can be seen, weighed and measured and is perceptible in other
8 ways to the senses” and “is no different from other taxable personal property such as films,
9 videotapes, books, cassettes, and records whose value lies in their respective abilities to
10 store and later transmit their contents”].) These state courts, and others, take the view that
11 computer software is corporeal in nature, in that it “is stored on a computer’s hardware, takes up
12 space on the hard drive and can be physically perceived by checking the computer’s files.
13 It remains in the computer and operates the program each time it is used.” (*Graham*
14 *Packaging Co., LP v. Commonwealth* (Pa. Cmwlth. 2005) 882 A.2d 1076, 1086-1087;
15 accord *Dechert v. Commonwealth of Pennsylvania* (Pa. Cmwlth. 2007) 942 A.2d 210, 212;
16 *Dechert v. Commonwealth of Pennsylvania* (Pa. Cmwlth. 2007) 942 A.2d 87, 90-91.) Based on
17 these legal authorities, the Court concludes that the licensing by Microsoft to OEMs and other
18 licensees during the Tax Period of its computer software products amounted to the licensing of
19 tangible personal property for purposes of computing the sales factor numerator.¹²

20 *Second*, California appellate courts have determined that, for sales and use tax purposes,
21 a transfer of tangible personal property (such as a master tape or master recording) that is
22 physically useful in the manufacturing process results in a taxable sale even where the true object
23 of the transfer is an intangible property right like a copyright. (See *Simplicity Pattern Co. v. State*
24 *Bd. of Equalization* (1980) 27 Cal.3d 900, 906 [sale of film negatives and recordings useful in the
25 manufacturing process in conjunction with transfer of intangible property rights in that property

26 ¹² The Court finds unpersuasive Microsoft’s reliance on *federal* treasury regulations to
27 support its claim that software is intangible in nature. These federal regulations provide that
28 intangible property includes copyrights, but otherwise make no provision for the treatment of
computer software as intangible property.

1 results in a taxable sale of tangible personal property]; *A & M Records, Inc. v. State Bd. of*
2 *Equalization* (1988) 204 Cal.App.3d 358, 376 [royalties from licensing of master tapes to record
3 clubs for record production were taxable because master tapes were essential in the ultimate
4 production of the records]; *Capitol Records, Inc. v. State Bd. of Equalization* (1984) 158
5 Cal.App.3d 582, 587 [royalties from licensing of master recording tapes useful in the
6 manufacturing process were subject to tax as sale of tangible personal property].) Here, similar to
7 the film negatives and master recordings useful in the manufacturing process in conjunction with
8 a transfer of intangible property rights in that tangible property, the Golden Master disks and back
9 up disks on which Microsoft's copyrighted software was embedded were physically useful and
10 essential in the ultimate downloading of Microsoft's copyrighted software onto computers
11 manufactured by OEMs. The value of these disks lay in their capacity to store and later display
12 or transmit their contents onto the computers that the licensees manufactured. Without the
13 tangible disks, the copyrighted software was essentially worthless. Because the computer
14 software licensed by Microsoft was inextricably intertwined with the disks on which they were
15 embedded, the Court concludes that the royalties from the licensing of such programs should be
16 classified as deriving from the sale of tangible personal property. (See also *Citizens and Southern*
17 *Systems, Inc. v. South Carolina Tax Commission* (S.C. 1984) 311 S.E.2d 717, 718 [software
18 delivered in a form that can be seen, weighed, measured, felt and touched is tangible personal
19 property and subject to state's sales and use tax]; *Comptroller of the Treasury v. Equitable Trust*
20 *Co.* (Md. 1983) 464 A.2d 248, 254-259 [if information is conveyed on a tangible medium, the
21 whole of the transaction, both information and computer tape, is subject to sales and use tax];
22 *Penn. & W. Va. Supply Corp. v. Rose* (W.Va. 1988) 368 S.E.2d 101, 104 [taxability of a sale of
23 computer software does not depend on the separability of the program from the disk].)¹³

24 _____
25 ¹³ Relying on *Preston v. State Board of Equalization* (2001) 25 Cal.4th 197, Microsoft
26 contends that the licensing agreements in this case constitute "technology transfer agreements"
27 that fall within the purview of section 6011, subd. (c)(10) and section 6012, subd. (c)(10),
28 both of which exempt from sales tax the amount charged for intangible personal property,
such as a patent or copyright interest, transferred pursuant to a technology transfer agreement.
However, both section 6011, subd. (c)(10) and section 6012, subd. (c)(10) are applicable

(continued...)

1 Third, the Court’s finding that the software licensed by Microsoft to OEMs and other
2 licensees constitutes tangible personal property is consistent with the manner in which software
3 that is prewritten, or “canned,” as opposed to customized, is treated by California for sales and
4 use tax purposes. In *Navistar International Transportation Corp. v. State Board of Equalization*
5 (1994) 8 Cal.4th 868, the California Supreme Court determined that the sale of internally
6 developed computer programs by the taxpayer to another company should be regarded as a sale of
7 tangible personal property, and thus subject to sales tax, because the design and development of
8 the computer programs had already been completed or prewritten.¹⁴ (*Id.* at pp. 880-881; see
9 *Touche Ross & Co. v. State Bd. of Equalization* (1988) 203 Cal.App.3d 1057, 1064 [sale of
10 computer program by developer to customer is a “transfer of a tangible personal asset produced
11 by the original programmer’s services” for sales tax purposes].) This view is consistent with the
12 universal practice by states of treating canned software as tangible personal property for sales
13 and use tax purchases. (Hellerstein & Hellerstein, *State Taxation* (3d ed. 2000) ¶ 13.06[3][a].)
14 Here, the evidence suggests that the design and development of Microsoft’s software was already
15 completed by the time of its transfer via disks to its licensees for installation onto (or bundling
16 with) computers that were sold to the public. (See Stip. Nos. 28 & 30; Reporter’s Transcript (RT)
17 222:24-223:12; 225:23-226:1.) As canned software, the disks that Microsoft provided to its
18 licensees were essentially no different from the packaged Microsoft software that is available for
19 direct purchase from retail stores and that is subject to California sales and use tax as a retail sale
20 of tangible personal property.¹⁵ Accordingly, the basic principles underlying the sales and use tax

21 _____
22 (...continued)

23 only to sales and use tax, and the Court is unaware of any corresponding statutes applicable
24 to corporate franchise tax, which is the tax in dispute here. Neither of these statutory provisions
25 is applicable to this case for the additional reason that regulation 1507, subdivision (a)(1)
26 specifically provides that “[a] technology transfer agreement . . . does not mean an agreement for
27 the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, Computers,
28 Programs, and Data Processing.”

¹⁴ In general, retail sales of tangible personal property are subject to sales and use tax by
California, but sales of intangible property and many services are not. (§ 6051 [sales and use tax
imposed on retailer for the privilege of making sales of tangible personal property at retail].)

¹⁵ As explained in *Andrew Jergens Company, supra*, 848 N.E.2d at pp. 502-503:

“When a business purchases canned software it receives a tape, disc, or other medium,
which contains encoded computer instructions. The instructions are recorded on a medium,
(continued...)”

1 law for treating sales of canned software as sales of tangible personal property support a similar
2 finding for franchise and income tax purposes.

3 *Fourth*, although California courts have not addressed the licensing of computer software
4 specifically for purposes of computing the sales factor numerator for income apportionment
5 purposes, the Nebraska Supreme Court in *American Business Information v. Egr* (Neb. 2002)
6 650 N.W.2d 251, has held that computerized information goods licensed by the taxpayer (ABI)
7 to other businesses were tangible personal property for purposes of computing Nebraska's sales
8 factor, which is nearly identical to California's sales factor.¹⁶ In that case, some of the products
9 were licensed in paper versions and others were provided on computer disks, magnetic tape
10 and CD-ROM. The taxpayer (ABI) also "deliver[ed] online data from its database by computer
11 equipment over telephone lines. Customers purchasing online data use computer equipment
12 capable of receiving, interpreting, and storing an electronic signal transmitted by ABI." (*Id.* at
13 p. 254.) Recognizing that the licensee of a tangible embodiment of intellectual property acquires
14 only property rights in that embodiment and does not acquire any rights to the underlying
15 intellectual property itself, the Court ruled that the licensed computerized goods constituted
16 tangible personal property:

17 This distinction between the acquisition of intellectual property rights and the
18 acquisition of a license to use the physical embodiment of intellectual property leads
19 us to conclude that the products sold by ABI constitute tangible personal property.
20 ABI distributes its products under agreements that grant customers a license to use
21 ABI's products in the ordinary course of their businesses. Those agreements also
22 contain terms and conditions prohibiting the unauthorized reproduction of ABI's
23 products. ABI's customers acquired no intangible intellectual property rights
24 when purchasing ABI's products.

25 (Id. at p. 256.)

26 (...continued)

27 often in the form of magnetic fields. To use the purchased software, the purchaser transfers
28 the encoded instructions from the medium to his or her computer. After being transferred to the
computer, the instructions are stored on the hard drive of the purchaser's computer to enable the
computer to perform the desired operation. Thus, the encoded instructions are always stored to
a tangible medium that has physical existence. The magnetic or other coding on a medium is in
a sense a form of writing that can be copied into and physically stored in the computer and then
read by the computer as instructions on how to perform a given application."

¹⁶ Compare Neb. Rev. Stat. § 77-2734.14 with section 25135.

1 The Court finds that a similar finding is warranted here.¹⁷ Like the taxpayer in *American*
2 *Business Information*, the licensing agreements that Microsoft entered into “did not grant an
3 ownership interest in the proprietary software to the OEM licensee.” (Stip. No. 29.) Instead,
4 the OEM had “only a license to use the software within the express limitations set forth in the
5 License Agreements.” (Stip. No. 29.) Moreover, the licensing agreements contained terms and
6 conditions that prohibited the unauthorized use of Microsoft’s products. (Copies of sample
7 licensing agreements entered into by Microsoft can be found in Exhibit M of the Stipulation of
8 Facts.) The failure of an OEM to comply with the licensing agreement resulted in a suspension or
9 loss of the OEM’s rights under the agreement. (See, e.g., Stip. at Exh. M (MO1293-MO1297).)
10 As such, what the OEMs licensed from Microsoft was not any intellectual property “right”
11 in its software, but rather *a property right to a tangible manifestation of intellectual property*.
12 The transfer of this tangible property embedded onto a disk was critical in enabling the
13 licensees to perform the desired tasks and functions set forth in the licensing agreements.
14 As such, the Court concludes that the royalties at issue were derived from the licensing of
15 tangible personal property.

16 **2. The Royalties at Issue Were Derived From the Licensing of Tangible**
17 **Personal Property That Was Shipped or Delivered to a Location in**
18 **California. As such, the Royalties Were Properly Assigned to the**
19 **California Numerator of the Sales Factor.**

20 Having found that the royalties at issue were derived from the licensing of tangible personal
21 property, the Court must next determine whether they were properly assigned to the California
22 sales factor numerator. Under California law, the royalties that Microsoft received from licensing
23 its tangible software products to OEMs with California billing addresses were correctly assigned
24 to the California numerator of the sales factor if the transferred software was located in
25 California. (§ 25135; Reg. § 25136(d)(2)(B).) The Court finds that Microsoft failed at trial

26 ¹⁷ Because Nebraska’s sales factor and California’s sales factor are in essence identical,
27 *American Business Information* is highly persuasive on the issue before this Court. (*Rihn v.*
28 *Franchise Tax Board* (1955) 131 Cal.App.2d 356, 360 [where a statute is patterned after
legislation of another state that has been judicially construed in the jurisdiction of its enactment,
the interpretations and effect given to that legislation are “highly persuasive”].)

1 to produce any evidence that the OEMs with California billing addresses took delivery of the
2 licensed software for installation outside of California. Microsoft witness Frank Donahue
3 testified that none of the licensing agreements called for an OEM to install, or download, the
4 shipped software at a specific location and that Microsoft did not know where any of the ultimate
5 downloading of the software onto computers actually took place. (RT 226:18-22.) Donahue
6 furthermore testified that Microsoft had no control over where an OEM would perform the
7 download of the software that Microsoft licensed. (RT 227:3-5.) In contrast, each of the sample
8 licensing agreements (see Exhibit M of the Stipulation of Facts) between Microsoft and OEMs
9 with California billing addresses provided a California shipping address. (See Stip. at Exh. M
10 at pp. MO1309, MOO847, MOO260, M00047 & M00010.) Based on the evidence at trial,
11 the Court concludes that Microsoft has failed to establish that the royalties generated from
12 licensees with California billing addresses were improperly included in the sales factor numerator
13 as California sales.¹⁸

14 ///

15 _____
16 ¹⁸ The FTB alternatively contends that even if the Court were to conclude that
17 Microsoft's computer software products constituted "other than tangible personal property,"
18 no refund is warranted because Microsoft has failed to satisfy its burden of demonstrating the
19 correct amount of tax. Although the Court's findings in favor of the FTB's principal contention
20 does not require the Court to address the FTB's alternative contention, the Court nonetheless
21 concludes that the FTB's alternative contention is meritorious. At trial, the FTB established that
22 the royalties related to the licensing of three of Microsoft's software products – Microsoft Power
23 Point, Microsoft keyboard and Microsoft Mouse – were properly assigned to the California sales
24 factor numerator. More specifically, the FTB established that because (1) the greater proportion
25 of the costs of performance relating to Microsoft Power Point was incurred in California than in
26 any other state (see § 25136); and (2) Microsoft keyboard and Microsoft mouse were tangible in
27 nature (see § 25135), the royalties from each of those products should remain in the California
28 sales factor numerator. The Court further finds that Microsoft failed to provide sufficient
evidence at trial to establish what portion of the total amount of the royalties at issue were
attributable to the licensing of these three products. As such, the Court concludes that
Microsoft's inability to segregate the royalties that were includible in the sales factor numerator
from the royalties that were not means that it has failed to carry its burden, as the taxpayer, of
establishing the correct amount of tax for the Tax Period. (See *C. R. Fedrick, Inc. v. State Bd. of
Equalization*, *supra*, 204 Cal.App.3d at p. 269 [taxpayer who sought to recover all sales tax paid
on machinery and equipment that was judicially determined to be only partly non-taxable was not
entitled to tax refund due to taxpayer's failure to segregate costs between taxable and non-taxable
items]; *Robinson v. Franchise Tax Board*, *supra*, 120 Cal.App.3d at pp. 82-83 [taxpayer who
sought California tax deduction for paid Hawaii taxes that were judicially determined to be
deductible as to some, but not all, applications was denied tax refund for taxpayer's failure to
carry burden of proving what amount of taxes fell within the deductible application].)

1 Second Cause of Action

2 **II. THE FTB WAS WARRANTED IN EXCLUDING MICROSOFT'S GROSS RECEIPTS FROM**
3 **THE SALE OR DISPOSITION OF ITS MARKETABLE SECURITIES FROM THE SALES**
4 **FACTOR DENOMINATOR IN ORDER TO FAIRLY REFLECT THE EXTENT OF**
5 **MICROSOFT'S BUSINESS ACTIVITY IN CALIFORNIA.**

6 The second cause of action relates to Microsoft's challenge to the FTB's decision to modify
7 the standard apportionment formula pursuant to section 25137 by excluding Microsoft's gross
8 receipts from the sale or disposition of marketable securities by its treasury department in
9 Washington State from the sales factor denominator. As this Court has previously discussed,
10 California's sales factor is a ratio – expressed as a fraction – that compares a taxpayer's sales in
11 California (numerator) to its total sales everywhere (denominator), as measured by the amount of
12 gross receipts generated by the taxpayer's business. (§ 25134; § 25120, subd. (e).) Because the
13 sale or disposition of Microsoft's marketable securities occurred entirely outside of California, the
14 inclusion of the gross receipts generated from these activities in the sales factor inflated the size
15 of Microsoft's sales factor denominator, but not its sales factor numerator. This in turn had the
16 effect of decreasing the size of the sales factor for California, thereby resulting in a substantial
17 decrease in the amount of Microsoft's business income that was subject to California tax.
18 The issue before this Court is whether the FTB's exclusion of these gross receipts in the
19 calculation of the sales factor denominator of the standard apportionment formula was authorized
20 by the relief provisions of section 25137.

21 Microsoft contends that the FTB, as the party invoking section 25137, failed to meet
22 its burden of proving by clear and convincing evidence that a modification of the standard
23 apportionment formula to exclude Microsoft's gross receipts from the sale or disposition of its
24 Marketable Securities from the denominator of the sales factor was warranted. The FTB contends
25 that the stipulated evidence establishes that Microsoft's inclusion of the full redemption price of
26 its gross receipts from the sale or disposition of its Marketable Securities in the sales factor results
27 in an apportionment of income that does not fairly reflect the extent of its business activity in
28 California. Accordingly, the FTB proposes to modify the standard apportionment formula to

1 include only the net receipts from Microsoft's redemption of its Marketable Securities in the sales
2 factor denominator for the Tax Period.

3 **A. Relevant Evidence**

4 During the Tax Period, Microsoft maintained a treasury operation in its Redmond,
5 Washington headquarters. (Stip. No. 64.) This treasury operation was responsible for all cash
6 management of Microsoft's worldwide operation. (Stip. No. 64.) The treasury operation was
7 also responsible for Microsoft's activity of buying, managing and disposing of financial
8 instruments, including commercial paper, loan participations, corporate bonds, municipal bonds,
9 discount notes, fixed rate auction preferred securities, money market preferred securities, United
10 Kingdom preferred money market securities, floating rate securities, certificates of deposit, time
11 deposits, U.S. Treasury bills, U.S. Treasury notes and loan repurchase agreements (collectively,
12 Marketable Securities). (Stip. No. 64.) A total of 21 Microsoft employees were engaged in the
13 purchase, maintenance, sales or disposition of its Marketable Securities during the Tax Period.
14 (Stip. Nos. 67 & 69.) By contrast, the number of Microsoft employees who were engaged in the
15 business of developing, licensing, manufacturing and distributing computer software and
16 providing computer software-related services was 17,801 in tax year 1995 and 20,561 in tax year
17 1996. (Stip. Nos. 68 & 70.)

18 For tax year 1995, the total proceeds reported by Microsoft from the sale or disposition of
19 its Marketable Securities were \$26,752,051,212. (Stip. No. 77.) For tax year 1996, the total
20 proceeds that Microsoft contends were received from the sale or disposition of its Marketable
21 Securities were \$43,834,447,385 (Stip. No. 78) and the total proceeds that the FTB contends were
22 received from the disposition of Marketable Securities were \$28,024,271,126 (\$35,735,619,802
23 (Stip. No. 108) less \$7,711,348,676 (Stip. No. 107)). Because the operations and gross receipts of
24 a corporate treasury department are attributed to the state where it operates (§ 25136), Microsoft's
25 treasury receipts from Marketable Securities would be credited to Washington State, thereby
26 contributing to Microsoft's overall sales (sales factor denominator) but not to its California sales
27 (sales factor numerator). (See Stip. at Exh. A (last two pages).)

28 ///

1 On audit, the FTB adjusted the denominator of the sales factor by removing this amount
2 for tax year 1996.¹⁹ (See Stip. at Exh. E (p. 2).) The effect of the FTB's action was to increase
3 the California sales factor, which correspondingly resulted in an increase to the amount of
4 Microsoft's business income that was subject to tax by the state.

5 **B. Applicable Law**

6 Section 25137 allows for reasonable modification of the standard apportionment formula
7 if its provisions do not fairly represent the extent of the taxpayer's business activity in the state.
8 As the party invoking section 25137, the FTB bears the burden of proof by clear and convincing
9 evidence that (1) the approximation of Microsoft's California-based income is not reflected
10 under the standard formula and (2) the FTB's proposed alternative is reasonable." (*Microsoft*
11 *Corp.*, *supra*, 39 Cal.4th at p. 765.) If the FTB meets that burden, it is authorized to propose
12 a modification of the standard formula that is subject to judicial review for reasonableness.
13 (*Id.* at p. 771; *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506, 514-515.)
14 And if that proposal is deemed reasonable, this Court is not empowered to substitute its own
15 alternative formula. (*Microsoft Corp.*, *supra*, 39 Cal.4th at p. 771.)

16 In *Microsoft Corp.*, the California Supreme Court relied on decisions of the State Board
17 of Equalization (SBE) to formulate a two-pronged analysis to determine whether section 25137
18 may be applied to modify the standard formula. Addressing the identical issue presented here –
19 the application of the standard formula to gross receipts arising from Microsoft's redemption
20 of its Marketable Securities by its treasury department – the Supreme Court concluded that
21 "Microsoft's treasury functions are qualitatively different from its principal business, and the
22 quantitative distortion from inclusion of its investments receipts is substantial." (*Microsoft Corp.*,
23 *supra*, 39 Cal.4th at p. 766.) Accordingly, the Supreme Court permitted the FTB to invoke

24 _____
25 ¹⁹ On its original tax return for tax year 1995, Microsoft did not include the gross
26 receipts generated by its treasury department from the redemption of its Marketable Securities
27 in the sales factor denominator in computing its California tax. Later, however, Microsoft filed
28 an amended tax return and claim for refund that requested the inclusion of \$26,752,051,213
from such treasury activity in the sales factor denominator for that tax year. (Stip. at Exh. A
(last two pages).) Accordingly, for tax year 1995, the disputed amount relates not to what
Microsoft reported in the original tax return, but to the amount that it claimed in its refund claim.

1 section 25137 to correct distortions that resulted from treating the full redemption price of its
2 Marketable Securities as gross receipts in the sales factor of the standard formula. (*Id.* at p. 765.)

3 **C. Legal Findings and Conclusions**

4 **1. Microsoft's Treasury Functions Are Qualitatively Different**
5 **From Its Principal Business.**

6 Applying the two-prong analysis formulated in *Microsoft Corp.*, the Court first finds
7 that Microsoft's treasury functions were "qualitatively different from its principal business"
8 as a software company. (*Microsoft Corp.*, *supra*, 39 Cal.4th at p. 766.) In *Microsoft Corp.*,
9 the Supreme Court cited with approval the State Board of Equalization's conclusion in *Appeal of*
10 *Crisa Corp.* (June 20, 2002) [2000-2003 Transfer Binder] Cal. Tax Reports (CCH) ¶ 403-295,
11 p. 30,352, that the operation of a large treasury department unrelated to the taxpayer's main line
12 of business represented a "paradigmatic example" of circumstances that warranted the application
13 of section 25137. (*Microsoft Corp.*, *supra*, 39 Cal.4th at p. 766.) In reaching this conclusion, the
14 SBE included in a nonexclusive list of indicators of such circumstances that "[o]ne or more of
15 the standard apportionment factors is biased by a substantial activity that is not related to the
16 taxpayer's main line of business. For example, the taxpayer continuously reinvests a large pool
17 of 'working capital,' generating large receipts that are allocated to the site of the investment
18 activity. However, the investments are unrelated to the services provided by the taxpayer as
19 its primary business." (*Crisa Corp.*, *supra*, at p. 30,360.)²⁰ For tax year 1995 and tax year 1996,
20 the Court finds that Microsoft's treasury functions were also qualitatively different from its
21 principal business of developing, licensing, manufacturing, and distributing computer software
22 and providing computer software-related services. (Stip. No. 6.)

23 In *Limited Stores, Inc. v. Franchise Tax Bd.* (2007) 152 Cal.App.4th 1491, which similarly
24 involved the application of the standard formula to gross receipts arising from a large

25 _____
26 ²⁰ The Supreme Court also found persuasive the State Board of Equalization's
27 administrative decision in *Appeals of Pacific Telephone & Telegraph* (May 4, 1978) [1978-1981
28 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 205-858, p. 14,907-36, which similarly interpreted
section 25137 to allow for correction of distortions arising from the operation of a large corporate
treasury department. (*Microsoft*, *supra*, 39 Cal.4th at pp. 765-766.)

1 corporation's redemption of its marketable securities by its treasury department, the taxpayer
2 attempted to distinguish itself from *Microsoft Corp.* by contending that its treasury function
3 was an "integral and fundamental segment" of its retail operations. (*Id.* at p. 1499.) The
4 Court of Appeal, however, rejected this contention by finding that the function performed by
5 the taxpayer's treasury department was no different from the one performed by Microsoft's:

6 For each company, the treasury invests excess funds in short-term marketable
7 securities to increase corporate revenue. (Citation omitted.) Whether or not this
8 revenue is used to complement the company's primary business is not the test
9 imposed by *Microsoft*, nor should it be. It is almost always true that a treasury
department's revenue production will be utilized to support or enhance the company's
primary business. The qualitative test adopted in *Microsoft* would be illusory if
The Limited's interpretation of it were adopted.

10 (*Ibid.*) Similar to the taxpayer in *Limited Stores, Inc.*, Microsoft contends that its treasury
11 department activity was an integral material income-producing element of Microsoft's business
12 during the Tax Period. The Court finds, however, that none of the evidence presented at trial
13 demonstrates that Microsoft's treasury functions were any less qualitatively different from its
14 principal software business for the Tax Period than during the tax period (1991) in *Microsoft*
15 *Corp.* The evidence at trial establishes only that, similar to the tax year 1991 in *Microsoft Corp.*,
16 Microsoft utilized its treasury department's revenue production to support and enhance its
17 primary software business. As *Limited* concluded, however, such a showing is insufficient to
18 overcome the conclusion that Microsoft's treasury functions were qualitatively different from
19 its principal business during the Tax Period.

20 **2. The Quantitative Distortion Arising From Microsoft's Inclusion of**
21 **Its Gross Receipts From Marketable Securities in the Sales Factor**
22 **Is Substantial.**

23 Applying the two-prong analysis set forth in *Microsoft Corp.*, the Court next finds that the
24 FTB met its burden of proving by clear and convincing evidence that the quantitative level of
25 distortion from Microsoft's inclusion of the full redemption price from the sale or disposition of
26 its marketable securities was substantial. In evaluating the quantitative level of distortion in
27 *Microsoft Corp.*, the Supreme Court observed that Microsoft's inclusion of the full price
28 (including return of capital) from the redemption of its marketable securities in computing the
gross receipts for the sales factor had the effect of grossly distorting the extent of its business

1 activity in California. (*Microsoft Corp.*, supra, 39 Cal.4th at pp. 765-766.) The Supreme Court
2 illustrated the distortional impact of Microsoft's practice by noting that, for tax year 1991,
3 its short-term treasury investments produced less than 2 percent of the company's income,
4 but 73 percent of its gross receipts. (*Id.* at p. 765, fn. 17.) Similarly, in *Limited*, supra, the Court
5 of Appeal found that the taxpayer's short-term investments produced less than 1 percent
6 of the company's business income in both tax years 1993 and 1994, but over 62 percent of
7 its gross receipts in 1993 and over 52 percent of its gross receipts in 1994. (*Limited*, supra,
8 152 Cal.App.4th at p. 1500.) The Court finds that the evidence presented here shows that
9 the level of quantitative distortion for the Tax Period similarly warrants modification of
10 the standard formula.

11 For tax year 1995, Microsoft reported treasury income in the total amount of
12 \$168,581,795²¹ (Stip. No. 80 & No. 81) and total business income in the amount of
13 \$1,186,230,507 (Stip. No. 82). This means that Microsoft's treasury department produced
14 14.21 percent of the company's income. In contrast, Microsoft reported total gross receipts from
15 its treasury activity in the amount of \$26,752,051,212 (Stip. 77) and total overall gross receipts
16 in the amount of \$31,564,905,691 (Stip. No. 99), which means that the total proceeds from
17 Marketable Securities in the amount of \$26,752,051,212 accounted for 84.75 percent of its total
18 gross receipts. As a result, for tax year 1995, Microsoft's treasury activity produced only
19 14.21 percent of the company's income, but 84.75 percent of its gross receipts.

20 For tax year 1996, Microsoft reported treasury income in the total amount of
21 \$299,713,041²² (Stip. No. 85 & No. 86) and total business income in the amount of
22 \$2,416,316,654 (Stip. No. 87). This means that Microsoft's treasury department produced
23 12.40 percent of the company's income. In contrast, Microsoft reported total gross receipts from
24 its treasury activity in the amount of \$28,024,271,126²³ and total overall gross receipts in the

25 ²¹ The sum of \$147,479,600 in interest income (Stip. No. 80) plus \$21,102,194.96
26 in net gains from trading (Stip. No. 81).

26 ²² The sum of \$236,619,198 in interest income (Stip. No. 85) plus \$63,093,843 in net
27 gains from trading (Stip. No. 86).

27 ²³ Total gross receipts of \$35,735,619,802 (Stip. No. 108) less receipts from non-treasury
28 activity of \$7,711,348,676 (Stip. No. 107).

1 amount of \$35,735,619,802 (Stip. No. 108), which means that the total proceeds from Marketable
2 Securities in the amount of \$28,024,271,126 accounted for 78.42 percent of its total gross
3 receipts. As a result, for tax year 1996, Microsoft's treasury activity produced only 12.40 percent
4 of the company's income, but 78.42 percent of its gross receipts.²⁴ Based on this evidence,
5 the Court finds that the overall impact of this distortion for both tax year 1995 and tax year 1996
6 was to significantly understate California's contribution as a market for Microsoft's sales.²⁵

7 In *Microsoft Corp.*, the Supreme Court noted that the problem arising from including
8 the full redemption price of short-term marketable securities relates to the "margins," i.e.,
9 the difference between cost and sale price. (*Microsoft Corp.*, *supra*, 39 Cal.4th at p. 767.)
10 When a short-term marketable security is sold or redeemed, the margin will often be quite small.
11 Thus, in 1991, the Supreme Court found that Microsoft's redemptions "totaled \$5.7 billion, while
12 its income from those investments totaled only \$10.7 million – a less than 0.2 percent margin.
13 In contrast, its nontreasury activities produced income of \$659 million and gross receipts of
14 \$2.1 billion, for a margin of more than 31 percent, roughly 170 times greater." (*Ibid.*) The effect
15 of this difference is to "distort[] the level of business activity in every state, to the disadvantage of
16 all states that do not host the treasury department." (*Limited*, *supra*, 152 Cal.App.4th at p. 1500;
17 *Microsoft Corp.*, *supra*, 39 Cal.4th at pp. 767-768.)

18 In *Limited*, the difference in the margins for the company's principal business was even
19 more glaring. In 1993 and 1994, *Limited*'s redemptions totaled approximately \$20 billion
20 while its income from these transactions was approximately \$16 million. (*Limited*, *supra*,
21 152 Cal.App.4th at p. 1500.) This resulted in a margin of less than 0.1 percent. In contrast, from

22
23 ²⁴ Put differently, the percentage of Microsoft's total business income that was attributable
24 to the State of Washington, by virtue of the treasury activity, under California's apportionment
25 formula was approximately 42.38 percent in tax year 1995 and 39.21 percent (per FTB) in tax
26 year 1996. These percentages were derived by calculating the ratio of Microsoft's treasury gross
27 receipts to its total gross receipts and then dividing the result (84.75 percent for tax year 1995 and
28 78.42 percent for tax year 1996) by two to account for the double-weighting of the sales factor.

²⁵ Including the full redemption price of Marketable Securities in the sales factor meant
that the gross receipts produced by the 21 employees in Microsoft's treasury department in
Washington State during the Tax Period exceeded the gross receipts generated by the 17,801
employees in tax year 1995 and 20,561 employees in tax year 1996 that were directly related to
its principal software business. (Stip. at Nos. 67, 68, 69 & 70.)

1 nontreasury sales in 1993 and 1994, Limited had \$14.5 billion in gross receipts and \$6.7 billion
2 in income, a margin of over 46 percent, roughly 460 times greater. (*Ibid.*)

3 In this case, the Court finds that the difference in the margins for Microsoft's software
4 business and its treasury functions is also dramatic:

5 In tax year 1995, Microsoft's redemptions totaled \$26,752,051,212 (Stip. No. 77) while
6 its income from these redemptions totaled \$168,581,795 (Stip. Nos. 80 & 81), for a 0.63 percent
7 margin. By comparison, Microsoft's sales from its nontreasury activity resulted in (1)
8 \$4,773,032,812²⁶ in gross receipts and (2) \$1,017,648,712 (Stip. No. 83) in income, for a margin
9 of 21.32 percent, roughly 34 times greater (21.32 percent/0.63 percent).

10 In tax year 1996, Microsoft's redemptions totaled \$43,834,447,385 (Stip. No. 78 (per
11 Microsoft)) while its income from these redemptions totaled \$299,713,041 (Stip. Nos. 85 & 86),
12 for a 0.68 percent margin. By comparison, Microsoft's sales from its nontreasury activity
13 resulted in (1) \$7,411,635,635²⁷ in gross receipts and (2) \$2,116,603,613 in income
14 (Stip. No. 88), which results in a margin of 28.56 percent, roughly 42 times greater
15 (28.56 percent/0.68 percent).

16 The FTB's expert, Dr. Atulya Sarin, explained the significance of all of these figures:

17 Well, it distorts the picture very very completely. Very large portion of their total
18 receipts would be receipts from the sale of marketable securities, for example, from
19 1995, 85 percent of their gross receipts would essentially be from sale of marketable
20 securities. Or almost 85 percent. Which kind of at the end of the day doesn't seem
21 to make a lot of sense.

22 Clearly 85 percent of their business or their sales of not being generated out of
23 Washington. They are clearly, they are spread all over the world. And normally
24 it would not be a problem. But the problem really happens... when you are looking
25 at very, very different margin businesses.

26 ///

27 ///

28 ²⁶ Sales factor denominator of \$4,941,614,607 (Stip. No. 98) less income from
redemptions of Marketable Securities of \$168,581,795 (Stip. Nos. 80 & 81).

²⁷ Sales factor denominator of \$7,711,348,676 (Stip. No. 107) less income from
redemptions of \$299,713,041 (Stip. Nos. 85 & 86).

1 And when you look at – what it boils down to is that there is, the investment, the
2 investment gross receipts of 85 percent of the total receipts. But they only generate
3 15 percent of the total business income. So just kind of a very distorted – and I am
approximating here. It's really 85.75 percent and 14.21 percent.

4 But either way you cut it, we are really talking about night and day. Because a very
5 very large portion of the income is being derived by the business activities, and
6 a very, very small fraction of the revenue being assigned to the business activities.
Completely gives a picture which doesn't really make a lot of sense.

7 (RT 383:12-385:9.)

8 The Court finds that the overall distortive impact from Microsoft's inclusion of
9 the full redemption price from its trading of Marketable Securities is substantial. Because the
10 redemptions of Marketable Securities were credited to Microsoft's treasury department in
11 Washington State, they contributed to Microsoft's sales factor denominator but not its California
12 sales factor numerator. As a consequence, inclusion of the full price in the sales factor
13 denominator had the effect of diluting that factor from 22.3277 percent (Stip. No. 100) to 2.7516
14 percent (Stip. No. 101) for 1995 and from 21.2619 percent (Stip. No. 109) to 3.4496 percent
15 (Stip. No. 110).²⁸ This, in turn, had the effect of (1) reducing California's apportionment
16 percentage from 12.62 percent to 2.84 percent for tax year 1995, thereby resulting in a distortion
17 of 9.78 percent (12.62 percent less 2.84 percent); and (2) reducing California's apportionment
18 percentage from approximately 11.90 percent to 2.99 percent for tax year 1996, resulting
19 in a distortion of 8.91 percent (11.90 percent less 2.99 percent). Accordingly, by including
20 the full redemption price from Microsoft's Marketable Securities in the apportionment formula,
21 Microsoft's California income is reduced by approximately 77 percent (9.78 percent/12.62
22 percent) for tax year 1995 and 75 percent (8.91 percent/11.90 percent) for tax year 1996.

23 **3. The FTB's Proposed Modification to Exclude the Gross Receipts**
24 **From Its Treasury Activity From the Sales Factor Denominator**
for the Apportionment Formula is Reasonable.

25 Finally, the Court finds that the FTB's proposal to include in the sales factor denominator
26 only the net receipts from Microsoft's redemptions of its Marketable Securities is reasonable.

27 ²⁸ By comparison, in *Limited, supra*, 152 Cal.App.4th at p. 1495), the level of distortion
28 was 1.77 percent in 1993 and 2.336 percent in 1994.

1 The Supreme Court in *Microsoft Corp., supra*, approved an identical proposal: “Because the net
2 receipts are so small in comparison with Microsoft’s nontreasury income and receipts, the
3 inclusion of net receipts here is reasonable. If the [FTB’s] proposal is reasonable, we are not
4 empowered to substitute our own formula. [Citations.]” (*Microsoft Corp., supra*, 39 Cal.4th
5 at p. 771.) The Court of Appeal in *Limited* reached the same result. (*Limited, supra*, 152
6 Cal.App.4th at p. 1501.) Both *Microsoft Corp.* and *Limited* compel a finding by the Court
7 that the FTB’s proposed alternative in this case was also reasonable.

8 **4. The Court Is Not Empowered to Substitute an Alternative Formula.**

9 Microsoft has argued that any distortion resulting from the inclusion of its treasury income
10 and receipts may be essentially offset by the alleged distortion resulting from the omission of its
11 intangible property from the standard apportionment formula. (See § 25129.) Accordingly, as an
12 alternative to the FTB’s proposed modification, Microsoft proposes that the Court should either
13 refrain from making any modification to the standard formula or, alternatively, to further modify
14 the formula by including its intangible property and by requiring the sales factor to be single-
15 weighted, rather than double-weighted, as currently required under the formula.

16 The Court rejects Microsoft’s request to adopt either one of its alternate proposals. Having
17 determined that the FTB’s proposed modification is reasonable, this Court is not empowered to
18 substitute an alternative formula. (*Microsoft Corp., supra*, 39 Cal.4th at p. 771; *Limited, supra*,
19 152 Cal.App.4th at p. 1501.) As the Supreme Court in *Microsoft Corp.* observed, “[t]he Board
20 had to establish a source of distortion; having done so, it did not have to disprove the existence
21 of every other conceivable source of distortion.” (*Microsoft Corp., supra*, 39 Cal.4th at p. 771,
22 fn. 22.)

23 To summarize, the Court concludes that the FTB has met its burden of proving under
24 section 25137 that the approximation of Microsoft’s business activity in California is not fairly
25 reflected under the standard formula when its gross receipts from the sale or disposition of its
26 marketable securities are included in the sales factor denominator. The Court further concludes
27 that the FTB’s proposed alternative to the standard formula is reasonable.

28 ///

1 Third Cause of Action

2 **III. MICROSOFT HAS NOT MET ITS BURDEN OF PROVING BY CLEAR AND CONVINCING**
3 **EVIDENCE THAT CALIFORNIA’S STANDARD APPORTIONMENT FORMULA, WHICH**
4 **BY STATUTE OMITTS THE VALUE OF INTANGIBLE PROPERTY FROM THE PROPERTY**
5 **FACTOR, SHOULD BE MODIFIED TO INCLUDE THE VALUE OF MICROSOFT’S**
6 **INTELLECTUAL PROPERTY**

7 The third cause of action relates to Microsoft’s contention that California’s standard three-
8 factor apportionment formula – which includes the value of real and tangible personal property
9 in the property factor, but not the value of *intangible* property (§ 25129) – must be modified
10 pursuant to section 25137 to account for its intellectual property. Microsoft contends that its
11 intellectual property must be included in the property factor of the apportionment formula
12 because such property represents a major business income producing asset that is part of
13 Microsoft’s core business. The FTB contends that Microsoft has not presented clear and
14 convincing evidence either that (1) the absence of its intangible property from the standard
15 formula, as statutorily mandated, actually results in an unfair reflection of the level of its business
16 activity in the state; and (2) its proposed alternative is reasonable. (*Microsoft Corp., supra,*
17 *39 Cal.4th at p. 765.*)

18 During closing argument, Microsoft argued that it was no longer seeking to modify the
19 standard apportionment formula to include value of its intangible property under section 25137,
20 as originally alleged in the third cause of action. Instead, Microsoft proposed that its intangible
21 property should be included in the apportionment formula as part of an alternative modification to
22 the FTB’s proposed modification to exclude Microsoft’s gross receipts from the redemption of its
23 Marketable Securities from the sales factor denominator (Second Cause of Action). Having
24 concluded, however, that the FTB’s proposed modification to the standard formula is reasonable,
25 the Court is not empowered to substitute Microsoft’s proposed alternative formula or any other
26 formula. Accordingly, the Court will address Microsoft’s proposed modification within the
27 context of section 25137.

28 **A. Relevant Facts**

At trial, Microsoft presented expert witness testimony from Dr. Irving Plotkin
and Dr. Mohan Rao. The FTB presented expert witness testimony from Dr. Atulya Sarin.

1 Dr. Plotkin, a microeconomist, provided opinion testimony on the subject of whether
2 UDITPA's three-factor standard apportionment formula, which omits consideration of intangible
3 property, fairly reflected the extent of the Microsoft's business activities in California.
4 Dr. Plotkin opined that California's apportionment formula should be modified to include
5 the relative value of Microsoft's intellectual property in that the formula fails to account for
6 the company's substantial intangible assets that generated most of its business income.

7 Dr. Rao, an economist, provided opinion testimony relating to (1) the importance of
8 Microsoft's intangible assets in generating its market value during the Tax Period; (2) his
9 calculation of the value of Microsoft's intangible property and his determination as to what
10 portion of that value is assignable to California; and (3) his calculation of California's
11 apportionment percentage based on proposed alternative modifications to the standard
12 apportionment formula that included the value of Microsoft's intangible assets.

13 Dr. Sarin, a university professor specializing in economic issues relating to intellectual
14 property, provided opinion testimony on the subjects of (1) the nature of Microsoft's intangible
15 assets; (2) whether those intangible assets should be included in California's apportionment
16 formula; and (3) whether any justification existed for modifying the apportionment formula
17 in the manner proposed by Dr. Rao. Dr. Sarin opined that Dr. Rao's methodology in arriving at
18 a valuation of Microsoft's intangible assets was flawed, that Dr. Rao had made an incorrect
19 assignment of those intangible assets to California and that Dr. Rao's analysis failed to
20 demonstrate a level of quantitative distortion from the omission of Microsoft's intangible assets
21 from the standard apportionment formula that was sufficient to warrant formula modification.

22 **B. Findings and Conclusions**

23 **1. Microsoft Has Not Demonstrated That the Omission of** 24 **Its Intellectual Property From the Standard Apportionment** 25 **Formula Failed to Fairly Reflect the Extent of Its Business Activity** **in California.**

26 The Court finds that California's standard formula does not unfairly reflect the extent
27 of Microsoft's California business activity in the absence of persuasive evidence that the omission
28 of intangible property from the formula results in a level of quantitative distortion that is

1 substantial. At trial, Microsoft's expert witness, Dr. Rao, provided evidence that revealed that the
2 level of "distortion" to California's apportionment percentage resulting from the omission of
3 Microsoft's intellectual property was *de minimus* at best and did not establish the necessity for
4 formula modification. That evidence is set out in Defendant's Exhibit 500, which was "Tab 9" of
5 Dr. Rao's expert report. Defendant's Exhibit 500 reflects Dr. Rao's "Recalculation of California
6 Tax Apportionment Percentage" when California's existing property factor is revised to
7 incorporate the full value of Microsoft's intangible property.

8 Most revealing in Defendant's Exhibit 500 is Dr. Rao's first "alternative calculation,"
9 which revises the property factor to include the value of Microsoft's intellectual property and
10 exclude Microsoft's marketable securities from the sales factor (as warranted by section 25137),
11 but otherwise making no modifications to the standard three-factor formula. Under that
12 calculation, Dr. Rao determined that when Microsoft's intellectual property is reflected
13 in the standard formula, California's tax apportionment percentage changes from 12.6 percent
14 to 12.3 percent for tax year 1995 and from 11.9 percent to 11.4 percent for tax year 1996,
15 for a "distortion" of 0.3 percent and 0.5 percent, respectively.

16 A comparable result is reached when the above calculation is refined to include
17 only the value of Microsoft's intellectual property in the revised property factor (without any
18 consideration to its tangible personal property). Dr. Rao testified that when the value of
19 Microsoft's intellectual property is considered as a separate property factor in the three-factor
20 apportionment formula, the resulting difference is only 0.35 percent for tax year 1995.

21 (See RT 278:24-285:6.)

22 The Court finds that such a showing of *de minimus* distortion resulting from the omission of
23 Microsoft's intellectual property from California's standard formula falls far short of the requisite
24 showing of "substantial" distortion needed to support a modification of the standard formula.
25 (*Microsoft, supra*, 39 Cal.4th at p. 766.) This is so because formula apportionment was designed
26 not to provide an exact determination of a taxpayer's activity in the state, but only "a rough
27 but constitutionally sufficient approximation of the income attributable to business activity"
28 in California for state taxation purposes. (*Id.* at p. 756.) Dr. Sarin, the FTB's expert, opined that

1 a “distortion” of 0.3 percent (tax year 1995) and 0.5 percent (tax year 1996) is “trivial” and
2 “very much within the margin of error” of rough approximation of Microsoft’s California income
3 (RT 375:16-25). Microsoft’s own expert witness, Dr. Plotkin, agreed that the inclusion of
4 intangible property in the standard formula was not necessary unless its omission resulted in
5 distortion that was “material.” (RT 156:26-157:5.) By way of comparison, the level of
6 quantitative distortion to California’s apportionment percentage from Microsoft’s inclusion of its
7 enormous gross receipts from the sale or disposition of its marketable securities in the sales factor
8 denominator resulted in a change to California’s tax apportionment percentage from 12.62
9 percent to 2.84 percent for tax year 1995, and from 11.90 percent to 2.99 percent for tax year
10 1996, for a quantitative distortion of 9.78 percent and 8.91 percent, respectively. Microsoft has
11 presented no comparable showing of distortion with regard to its intellectual property. As such,
12 the Court finds that Microsoft has failed to present clear and convincing proof of the existence
13 of distortion of a substantial nature.

14 **2. Microsoft’s Methodology for Calculating the “Distortion”**
15 **From the Omission of Its Intellectual Property Is Fundamentally**
16 **Flawed.**

17 The Court further concludes that even if Microsoft could demonstrate quantitative
18 distortion of a substantial nature, its contention that the omission of its intellectual property from
19 the standard formula results in an unfair reflection of its California business activity is based on
20 a methodology that is flawed. That methodology, as set forth by Dr. Rao, (1) erroneously
21 calculates the California property factor numerator on the basis of where the research and
22 development of Microsoft’s intellectual property occurred; and (2) fails to account for the value
23 of Microsoft’s extensive *marketing* intangibles that are pervasive everywhere that Microsoft does
24 business, including California. As discussed below, the consequence of this flawed methodology,
25 as set forth Dr. Rao, is to understate the extent to which the inclusion of Microsoft’s intellectual
26 property would be reflected in the California property factor numerator. Accordingly, the Court
27 rejects Dr. Rao’s call for modification of the standard formula.

28 *First*, in attempting to demonstrate the level of “distortion” resulting from the omission
of Microsoft’s intellectual property from the California apportionment formula, Dr. Rao

1 hypothesizes the effect of adding intangible property to the current property factor and then
2 making an assignment to the California numerator on the basis of where Microsoft conducted its
3 research and development of its product intangibles. (See Plaintiff's Exhibit 7.) In doing so,
4 Dr. Rao assigns to California only 1.1 percent of Microsoft's total intangible property for tax year
5 1995 and an even smaller 0.8 percent of such costs for 1996 (for a combined intangible/tangible
6 property factor of 1.2 percent for 1995 and 0.9 percent for 1996) on the basis on the percentage of
7 research and development costs incurred in the state. (See Plaintiff's Exhibits 7 & 8.) The Court
8 finds, however, that an assignment of Microsoft's intangible property to the California property
9 factor numerator that is determined on the basis of where the costs of developing its products
10 were incurred is contrary to California law.

11 As set forth in section 25129, California's property factor, which by statute includes only
12 the value of real property and tangible personal property, provides that property is included in
13 the California numerator of the property factor to the extent that it is owned or rented and
14 "used in this state," not where it is developed. No correlation exists between where Microsoft's
15 intellectual property is "used" and where it is developed and Microsoft has not explained the legal
16 justification for Dr. Rao's unsupported manner of determining California's share of that property.
17 As such, the Court finds that Dr. Rao's methodology for determining the distortive effect from
18 the omission of Microsoft's intangible property lacks legal support.

19 *Second*, the Court finds that by determining the amount of distortion in the property factor
20 on the basis of where Microsoft's research and development costs are incurred, Dr. Rao's analysis
21 suffers from his failure to account for Microsoft's extensive "marketing intangibles," which
22 are not reflected in research and development costs. As explained by Dr. Sarin, marketing
23 intangibles consist chiefly of the value of Microsoft's "network effects," trademarks and trade
24 names. (RT 366:27-367:4.) Microsoft's network effects represent the effects that one user of
25 a Microsoft product has on the value of the product to other people, as Dr. Sarin described
26 in addressing the necessity for consumers to have Microsoft Word available on their computers
27 in order to share word processing documents with other Word users. (See RT 367:11-368:6.)
28 Because the value of Microsoft's pervasive network effects arises through the "use" of its

1 products by Microsoft customers everywhere, including those in California, an assignment of
2 the value of this marketing intangible must be made to the California property factor numerator.²⁹
3 The Court finds that Dr. Rao's failure to account for Microsoft's network effects as intangible
4 property renders his analysis unreliable.³⁰

5 **3. Sound Reasons Exist for Not Modifying California's Apportionment**
6 **Formula to Include Microsoft's Intellectual Property.**

7 Apart from the inherent flaws in the analysis of Microsoft's expert witness, the Court
8 finds that Microsoft has not met its burden of proving by clear and convincing evidence
9 that modification of the standard apportionment formula is compelled because (1) the standard
10 formula already takes into account much of the value of Microsoft's intellectual property;
11 and (2) Microsoft's proposed modification is contrary to the UDITPA goal of uniformity.

12 *First*, the Court finds, as discussed by Dr. Sarin, that the absence of intangible property
13 from the property factor does not mean that California's standard apportionment formula does not
14 take into account the value of Microsoft's intellectual property. (RT 372:5-373:18.) That value
15 is reflected in the standard formula in at least two ways. California's payroll factor takes
16 into account the contribution made by Microsoft's employees in Washington State who were
17 responsible for the research and development of the hundreds of patents, copyrights, and
18 trademarks (see RT 52-78) that comprise the bulk of its intangible property during the Tax Period
19 by placing the amount of their employee compensation in the denominator of the payroll fraction.
20 (See RT 372:11-373:6.) Moreover, the payroll factor reflects the contribution of Microsoft

21
22 ²⁹ The importance of Microsoft's marketing intangibles to its business is reflected in Dr.
23 Sarin's determination that the amount spent by Microsoft on sales and marketing during the Tax
24 Period exceeded the amount spent on research and development by 2.2 times in tax year 1995
and 1.86 times in tax year 1996. (RT 371:9-22.)

25 ³⁰ Similar to network effects, marketing intangibles such as Microsoft's trademarks and
26 trade names also derive their value through positive customer interactions, which have the effect
27 of increasing the value of those trade names and in turn leads to new customer users in California
and elsewhere. (RT 369:8-20.) The value of Microsoft's trademarks and trade names also arise
28 from the use of its products by its California customers. (RT 370:3-13.) Accordingly, the Court
finds that a California property factor assignment, such as Dr. Rao's, that fails to reflect the value
of marketing intangibles such as trademarks and trade names in California cannot accurately
reflect whether distortion of California's apportionment percentage has actually occurred.

1 employees in Washington State who were responsible for the acquisition, management
2 and protection of the intellectual property that led to the production of its business income (see
3 RT 50:14-52:13) by placing the amounts of their compensation in the payroll factor denominator.
4 Similarly, California's sales factor took into account Microsoft's costs of performing the work
5 that produced the sales revenues that it realized from the licensing of its intellectual property by
6 placing the receipts from such sales in the denominator of the sales factor. (See RT 373:7-18.)
7 Thus, the Court finds that for the Tax Period, California's standard formula took into account
8 much of the income producing activities and expenses related to Microsoft's software business.

9 *Second*, the Court finds that modifying California's standard apportionment formula to
10 account for Microsoft's intellectual property would violate a primary UDITPA objective of
11 promoting uniformity among the states. (See *Hoechst Celanese Corp. v. Franchise Tax Bd.*,
12 *supra*, 25 Cal.4th at p. 526; § 25138 [UDITPA "shall be so construed as to effectuate its general
13 purpose to make uniform the law of those states which enact it"].) The California Legislature,
14 in enacting California's three-factor apportionment formula, has determined that only the value of
15 a taxpayer's real and tangible personal property should be directly considered in determining its
16 California income. No evidence exists that any of the modifications made by the Legislature to
17 the standard formula over the years has ever included the consideration of intangible property.
18 As Dr. Plotkin acknowledged at trial, no state that follows UDITPA has ever modified
19 its standard apportionment formula to reflect intangible property. (RT 153:14-21.) In the
20 interests of promoting uniformity, the Court declines to do so in this case.

21 Moreover, the Court finds that to allow only Microsoft to modify the standard
22 apportionment formula in this particular case would not only fail to promote the goal of
23 uniformity among the UDITPA states, but also among similarly situated taxpayers. Microsoft is
24 not unique in claiming that its intangible property constitutes a major income producing asset of
25 its core business. According to Dr. Plotkin, every company that is profitable because of the
26 contribution of its significant intangible assets could make an argument identical to Microsoft's.
27 (RT 156:15-25.) Were the courts to allow every such company to modify the standard formula to
28 allow for its intangibles under section 25137 solely on the basis that intangibles were significant

1 to their businesses, the exception that Microsoft seeks would eventually swallow the rule in
2 California. The Court concludes that such a drastic revision to the standard formula is a matter
3 best left to the Legislature.

4 **4. Microsoft's Proposed Modifications to California's Standard**
5 **Apportionment Formula Should Be Rejected as Unreasonable.**

6 Even assuming that Microsoft could make a showing of substantial quantitative distortion,
7 the Court finds that Microsoft has not demonstrated by clear and convincing evidence that
8 either of its proposed alternative methods of calculation is reasonable.

9 *First*, the Court finds that Dr. Rao's proposal to remedy the alleged distortion from
10 the omission of Microsoft's intangible property by modifying California's standard three-factor
11 formula to not only add a separate fourth factor for intangible property, but to also require the
12 sales factor to be equally weighted with the other apportionment factors (payroll, tangible
13 property, intangible property) (RT 264:27-265:24) is not reasonable. Dr. Rao offered no sound
14 basis at trial as to why the omission of Microsoft's intangible property from the property factor
15 should also necessitate a modification to the sales factor, which by statute is assigned twice the
16 weight of the payroll factor and the property factor. (§ 25128 ["all business income shall be
17 apportioned to this state by multiplying the business income by a fraction, the numerator of which
18 is the property factor plus the payroll factor plus *twice the sales factor*, and the denominator of
19 which is four" (italics added)].) As Dr. Sarin noted, Dr. Rao's explanation as to why he believes
20 that a double-weighted sales factor necessarily leads to distortion of California's apportionment
21 formula (see RT 266:5-267:22) lacks economic logic. (RT 378:3-382:24.) California's
22 legislatively-determined apportionment formula is currently structured to afford a weight of
23 50 percent to sales, 25 percent to payroll and 25 percent to property. This formula reflects
24 the Legislature's determination of the important and equal contributions of both marketing
25 (sales) and production (labor (payroll) and property) to the generation of business income.
26 (RT 378:8-15.) As Dr. Sarin testified, "[t]he effect of the double weighted revenue formula . . .
27 is to apportion roughly half of its apportionable income to the market state and the remaining half
28 to the production state." (RT 379:5-9.) Dr. Rao's proposal to create a fourth factor for intangible

1 property and to assign only a single weight to the sales factor would have the effect of changing
2 the relative weight of the sales factor by attributing only 25 percent of Microsoft's income to the
3 contribution of marketing (sales factor) and 75 percent (payroll factor, property factor and
4 intangible property factor) to the contribution of production. (RT 381:16-19.) The Court finds
5 that Dr. Rao has offered no sound economic justification for such a modification to California's
6 formula that, contrary to the policy determination made by the Legislature, would have the result
7 of favoring the contributions of production over the contribution of sales by a three-to-one
8 margin.

9 *Second*, the Court finds that Microsoft has similarly presented no persuasive legal or
10 economic rationale for its alternative proposed remedy of allowing Microsoft to include its
11 enormous receipts from the sale or disposition of its Marketable Securities in the sales factor as
12 an "offset" to the omission of intangible property from the property factor of the standard
13 apportionment formula. The FTB has demonstrated that the distortion caused by the inclusion of
14 Microsoft's Marketable Securities receipts in the sales factor is "of both a type and size properly
15 addressed through invocation of section 25137." (*Microsoft Corp., supra*, 39 Cal.4th at p. 771.)
16 The Court finds that the source of that demonstrated distortion has no correlation to the alleged
17 distortion caused by the omission of intangible property from the standard formula. Moreover,
18 Microsoft has presented no evidence that the proposed offset would effectuate an equitable
19 apportionment of its California-based income. The magnitude of the distortion resulting from
20 the inclusion of Microsoft's Marketable Securities in the apportionment formula far exceeds the
21 magnitude of any distortion from the omission of intangibles. Accordingly, the Court rejects
22 Microsoft's proposed modification for failure to show that it is reasonable.

23 *Third*, even if the Court were to conclude that a modification to the standard apportionment
24 formula is compelled under section 25137, the FTB is entitled to propose an alternative
25 modification to the standard formula that the Court reviews for reasonableness. (See *Microsoft*
26 *Corp., supra*, 39 Cal.4th at p. 71.) The FTB's proposed modification would require Microsoft to
27 make an assignment of *all* of its intangible property, both product intangibles *and* marketing
28 intangibles, on the basis of where they were "used," in accordance with section 25129. The Court

1 finds that the FTB's proposed modification is reasonable as consistent with the manner in which
2 tangible personal property is assigned to the state under California law. In the case of intangible
3 property, California law suggests that where Microsoft's intellectual property is "used" is best
4 reflected by the location from which its sales receipts are generated. (See Reg. § 25137-
5 8(c)(1)(C)(ii) [extent to which motion picture film is "used" in the state for determining
6 California numerator of property factor shall be determined "in the same ratio in which the total
7 California receipts from such films . . . pertaining to the sales factor bears to the total of such
8 receipts everywhere."].) Because the percentage of Microsoft's California sales, as reflected
9 by the sales factor, is greater than the percentage of Microsoft's California property, as reflected
10 by the property factor for both tax year 1995 and tax year 1996 (see Stip. Nos. 100, 103, 109,
11 & 112), the Court notes that an assignment of Microsoft's intangible property to the California
12 numerator of the property factor based on California sales would actually result in the assignment
13 of a *greater* portion of Microsoft's total business income to California than originally reported
14 by Microsoft on its tax returns.

15 Fourth Cause of Action

16 **IV. THE FTB WAS AUTHORIZED TO ASSESS AMNESTY PENALTIES AGAINST** 17 **MICROSOFT FOR THE TAX PERIOD AS A RESULT OF ITS FAILURE TO PAY** 18 **ITS TAX LIABILITIES DURING THE TWO-MONTH PERIOD OF TAX AMNESTY.**

19 The fourth cause of action relates to Microsoft's various legal challenges to the FTB's
20 imposition of amnesty penalties that arose from Microsoft's failure to pay its outstanding tax
21 liabilities for the Tax Period within the two-month period of tax amnesty from February 1, 2005
22 through March 31, 2005.

22 **A. Relevant Evidence**

23 Microsoft filed California tax returns for the Tax Period. (Stip. No. 8.) In June 2002,
24 following an audit, the FTB issued to Microsoft a notice of proposed assessment for additional
25 California tax in the amount of \$3,945,139.00, plus penalties, for the tax year 1995 and in
26 the amount of \$21,329,729.00, plus penalties, for the tax year 1996. (Stip. Nos. 10 & 11.)
27 In August 2002, Microsoft filed a protest of the notices of proposed assessment. (Stip. No. 12.)

28 ///

1 In 2004, the California Legislature enacted section 19777.5 as part of the California
2 Tax Amnesty Program (§§ 19730 et seq.). Section 19777.5 afforded applicable taxpayers
3 with outstanding tax liabilities the opportunity to avoid tax penalties on unpaid amounts if the tax
4 was paid, with interest, during the two-month amnesty period of February 1, 2005 through
5 March 31, 2005. Section 19777.5 provides:

6 There shall be added to the tax for each taxable year for which amnesty could
7 have been requested:

8 (1) For amounts that are due and payable on the last day of the amnesty period,
9 an amount equal to 50 percent of the accrued interest payable under Section 19101
10 for the period beginning on the last date prescribed by law for the payment of that tax
(determined without regard to extensions) and ending on the last day of the amnesty
11 period specified in Section 19731.

12 (2) For amounts that become due and payable after the last date of the amnesty
13 period, an amount equal to 50 percent of the interest computed under Section 19101
14 on any final amount, including final deficiencies and self-assessed amounts, for the
15 period beginning on the last date prescribed by law for the payment of the tax for the
16 year of the deficiency (determined without regard to extensions) and ending on the
17 last day of the amnesty period specified in Section 19731.

18 By its statutory terms, the amnesty penalty applies to two classes of taxpayers. The first
19 class is those taxpayers for whom a final tax deficiency for an amnesty-eligible tax year already
20 exists during the amnesty period, but who did not pay that deficiency prior to the end of that
21 period. (§ 19777.5, subd. (a)(1).) The second class is those taxpayers, such as Microsoft,
22 for whom a final tax deficiency arises after the end of the amnesty period, whether that deficiency
23 is identified by the FTB or is self-assessed, to the extent that any payment made before the end of
24 the amnesty period did not satisfy the deficiency. (§ 19777.5, subd. (a)(2).) Once the period of
25 tax amnesty ended, any qualified taxpayer that did not participate in the program was subject to
26 an amnesty penalty under section 19777.5 on any eligible tax amount that either remained or
27 became “due and payable” after the end of the amnesty period.

28 Microsoft did not take advantage of the amnesty program by paying the full amount of
its proposed tax deficiencies during the amnesty period, but rather waited until January 15, 2008,
before making payments in an amount sufficient to cover the entire amount of the tax
deficiencies, plus interest, asserted in the notices of proposed assessment. (Stip. No. 15.)

1 At trial, Microsoft does not dispute that it did not remit its payment of its tax deficiencies
2 for the Tax Period until almost three years after the close of the period of tax amnesty. Microsoft
3 contends, however, that the FTB's assessment of amnesty penalties was contrary to due process
4 under both the federal and state constitutions on the grounds that (1) section 19777.5 applies
5 retroactively; (2) section 19777.5 is unconstitutionally vague; (3) section 19777.5 provides
6 no opportunity for pre-payment or post-payment review of the penalties; and (4) the penalties
7 were imposed on tax deficiencies that were not "due and payable" within the meaning of
8 section 19777.5.

9 The FTB contends that it was authorized by section 19777.5 to impose amnesty penalties
10 for the Tax Period as a result of Microsoft's failure to pay its tax deficiencies until almost three
11 years after the close of the two-month amnesty period of February 1, 2005 to March 31, 2005.
12 The FTB further contends that Microsoft's claims that section 19777.5 unconstitutionally
13 operates retroactively and that amnesty penalties are not owed because its underlying tax liability
14 was not "due and payable" within the meaning of section 19777.5 have been recently rejected by
15 the First District Court of Appeal in *River Garden Retirement Home v. Franchise Tax Board*
16 (2010) 186 Cal.App.4th 922 (*River Garden*). Finally, the FTB contends that Microsoft has failed
17 to demonstrate either that section 19777.5 is unconstitutionally vague or that section 19777.5
18 provides no opportunity for judicial review of the amnesty penalties.

19 **B. Findings and Conclusions**

20 **1. The California Court of Appeal Has Ruled That Section 19777.5**
21 **Does Not Operate Retroactively.**

22 The Court finds that section 19777.5 does not operate retroactively. In *River Garden*
23 *Retirement Home, supra*, 186 Cal.App.4th at p. 957, the California Court of Appeal declared
24 that section 19777.5 is *not* retroactive because, under its terms, the amnesty penalty does not
25 operate to increase a taxpayer's liability for past conduct, but rather provides an incentive
26 for *future* conduct:

27 ///

28 ///

1 Section 19777.5 does not apply retroactively. The amnesty penalty does not
2 operate to increase a taxpayer's liability for past conduct. Instead, it functions as an
3 incentive for future conduct: apply for amnesty, or pay everything before the close of
4 the amnesty period, and avoid the amnesty penalty. It is not past conduct that
5 subjects a taxpayer to the amnesty penalty – not the past transactions or conduct that
6 created the underpayments or deficiencies – but rather the *current failure* to discharge
7 those liabilities according to the rules of the amnesty legislation.

8 The amnesty penalty is applicable only to amounts that either remained due and payable at
9 the close of the amnesty period (§ 19777.5, subd. (a)(1)) or to amounts that were determined to be
10 due and payable after the close of the amnesty period (§ 19777.5, subd. (a)(2)). As such,
11 the amnesty penalty is not retroactive because it does not increase the amount of a taxpayer's
12 underlying tax liability, but instead increases “the consequences of not paying the proper amount
13 for the years at issue within the dictates of the amnesty program.” (*River Garden, supra*,
14 186 Cal.App.4th at p. 957.)

15 The Court concludes that *River Garden* controls the outcome of this case. The manifest
16 legislative goal of tax amnesty was to encourage both taxpayers with an assessed tax deficiency
17 and taxpayers with understated tax liabilities on their original tax returns to come forward and pay
18 the additional amounts by the end of the amnesty period. (*River Garden, supra*, 186 Cal.App.4th
19 at p. 954.) The events that subjected Microsoft to the amnesty penalties were not the past
20 transactions or conduct that gave rise to their tax underpayments for the Tax Period, but rather
21 Microsoft's decision not to come forward with payments of its outstanding tax deficiencies for
22 the Tax Period, as set forth in the written notices of proposed assessment, during the two-month
23 period of tax amnesty of February 1, 2005 through March 31, 2005. As such, the Court finds
24 that section 19777.5 does not operate retroactively.

25 **2. The California Court of Appeal Has Rejected Microsoft's**
26 **Contention as to the Statutory Meaning of “Due and Payable.”**

27 The Court concludes that *River Garden* also compels the rejection of Microsoft's claim
28 that the “due and payable” provision of section 19777.5 should be interpreted to preclude
imposition of the amnesty penalty so long as the taxpayer pays the amount of any deficiency
prior to the time that it becomes due and payable, even if, as here, payment does not occur
until years after the close of the two-month period of tax amnesty. The Court of Appeal

1 in *River Garden* rejected a taxpayer interpretation of “due and payable” similar to that made
2 by Microsoft as “flawed”:

3 [I]t is apparent that the tax amnesty program aimed to accelerate the collection
4 of unreported and underreported tax liabilities, bringing taxpayers into the tax
5 system through outreach and streamlined efforts, all to the end of achieving fiscal
6 benefits. *River Garden*’s interpretation of the amnesty legislation would allow a
7 nonparticipating, noncompliant taxpayer to escape the amnesty penalty by paying its
8 tax liability following a final assessment issued years after the close of the amnesty
9 period, but within 15 days of a notice and demand for payment. Surely this result
10 does not comport with the legislative intent. To the contrary, the intent is to afford
11 taxpayers the chance to avoid the harsher amnesty penalties that would come into
12 play if amnesty could have been requested but was not, while reaping the benefit of
13 forgiven penalties and possible criminal action by participating in the program.

14 (*River Garden, supra*, 186 Cal.App.4th at p. 954.) The Court finds that the same reasons that
15 compelled the Court of Appeal to refuse to adopt the taxpayer’s proposed statutory construction
16 are equally applicable here. The amnesty penalty under section 19777.5, subdivision (a)(2)
17 would be meaningless if, as Microsoft contends, an eligible taxpayer who chose not to participate
18 in the amnesty program could dodge the very penalty that is aimed at that taxpayer simply by
19 paying the underlying tax deficiency before the time that the deficiency assessment achieved
20 finality, thus becoming “due and payable,” even if finality does not occur until years after the
21 close of the amnesty period. (See *id.* at p. 953.)

22 **3. Microsoft Has Not Shown How Section 19777.5 Is Void for**
23 **Vagueness as to the Amnesty Penalties Imposed for the Tax Period.**

24 The Court rejects Microsoft’s contention that section 19777.5 is void for vagueness because
25 “it fails to adequately inform taxpayers whether or how the [amnesty penalty] would apply to
26 taxpayers who, during the Amnesty Period, lacked any reasonable basis for knowing they would
27 owe an additional tax liability, or in what amounts, as determined subsequent to the conclusion of
28 the Amnesty Program.”

Courts have declared that a statute is not unconstitutionally vague in violation of due
process unless “it fails to provide people of ordinary intelligence a reasonable opportunity to
understand what conduct it prohibits [or] if it authorizes or even encourages arbitrary and
discriminatory enforcement.” (*Patel v. City of Gilroy* (2002) 97 Cal.App.4th 483, 486, quoting
Hill v. Colorado (2000) 530 U.S. 703, 732.) A challenged statute “comes before the court with

1 a presumption of correctness and regularity” (*Barclays Bank Internat. Ltd. v. Franchise Tax Bd.*
2 (1992) 10 Cal.App.4th 1742, 1759) and will not be held to be void for vagueness if any
3 reasonable or practicable construction can be given its language or its terms may be made
4 reasonably certain by reference to other definite sources. (*Duffy v. State Bd. of Equalization*
5 (1984) 152 Cal.App.3d 1156, 1173.) “To be valid, a tax statute must describe a standard
6 sufficiently definite to be understandable to the average person who desires to comply with it.”
7 (*Ibid.*) Moreover, a statute will be held to be unconstitutional only if it is vague in “all of its
8 applications,” not merely in just some instances. (*Evangelatos v. Superior Court* (1988)
9 44 Cal.3d 1188, 1201; *Patel v. City of Gilroy, supra*, 97 Cal.App.4th at p. 488.)
10 Unless its unconstitutionality “clearly, positively, and unmistakably appears,” a statute will
11 pass muster under the federal and state due process clauses. (*Walker v. Superior Court* (1988)
12 47 Cal.3d 112, 143.)

13 Viewed against this standard, the Court finds that there is nothing either vague or
14 ambiguous about section 19777.5, as it applied to taxpayers for whom a final tax deficiency did
15 not become due and payable until after the end of the amnesty period. The California Tax
16 Amnesty Program required the FTB to “made reasonable efforts to identify taxpayer liabilities
17 and, to the extent practicable,” “send written notice to taxpayers of their eligibility for the tax
18 amnesty program. (§ 19736, subd. (b); see *River Garden, supra*, 186 Cal.App.4th at p. 955.) In
19 the case of Microsoft, because the FTB had issued notices of proposed assessments nearly three
20 years prior to the commencement of the amnesty period, Microsoft had more than “a reasonable
21 opportunity to understand” its potential liability for the amnesty penalties under section 19777.5
22 if it elected not to apply for tax amnesty during the amnesty period.

23 The Court finds that Microsoft has not presented any evidence at trial to show that it
24 was in any way misled or confused by the statutory language of section 19777.5 as to its potential
25 liability for amnesty penalties in the event that it did not fully pay its outstanding tax deficiencies
26 for the Tax Period within the two-month period of tax amnesty. Microsoft received notice of
27 the FTB’s proposed tax assessments for the Tax Period in June 2002, nearly three years before
28 the commencement of the amnesty period in February 2005. Microsoft then chose to challenge

1 the proposed assessments through the administrative process but without first paying the
2 proposed tax underpayments within the period of tax amnesty. Microsoft could have paid the
3 proposed assessments prior to March 31, 2005, and pursued its various administrative remedies
4 without fear of incurring amnesty penalties, but chose not to do so. Having made its choice, and
5 without any evidence that it was in any way misled about the consequences of its action,
6 Microsoft must now accept the result of its decision.

7 **4. No Evidence Exists That the FTB Seeks to Deny to Microsoft the**
8 **Opportunity for Post-Payment Judicial Review of the Amnesty**
9 **Penalties Imposed for the Tax Period.**

10 Finally, the Court rejects Microsoft's contention that section 19777.5 is invalid because
11 it denies to Microsoft the opportunity for pre-payment and post-payment review of the FTB's
12 imposition of the amnesty penalties for the Tax Period.

13 Although due process requires states to provide taxpayers with procedural safeguards
14 against "unlawful exactions" (*McKesson Corp. v. Florida Alcohol & Tobacco Div.* (1990)
15 496 U.S. 18, 36.), states are not bound to offer a form of "predeprivation process." Rather, states
16 may discharge their constitutional obligation by providing for a "postdeprivation refund action"
17 that affords taxpayers with "a fair opportunity to challenge the accuracy and legal validity of
18 their tax obligation." (*Id.* at pp. 36-39.)

19 The Court finds that Microsoft's procedural due process right to challenge the amnesty
20 penalties is satisfied, in part, by section 19777.5, subdivision (e)(2), which provides a
21 postpayment administrative claim for refund procedure to taxpayers who wish to challenge the
22 amnesty penalty "on the grounds that the amount of the penalty was not properly computed by
23 the Franchise Tax Board." Procedural due process is also satisfied by Article XIII, section 32,
24 of the California Constitution, which provides that "[n]o legal or equitable process shall issue
25 in any proceeding in any court against this State or any officer thereof to prevent or enjoin
26 the collection of any tax. After payment of a tax claimed to be illegal, an action may be
27 maintained to recover the tax paid, with interest, in such manner as may be provided by the
28 Legislature." That "manner" is set forth in section 19382, which provides to California taxpayers

1 a "postdeprivation refund action" by authorizing the bringing of a suit for tax refund following
2 payment of the challenged tax:

3 Except as provided in section 19385, after payment of the tax and denial
4 by the Franchise Tax Board of a claim for refund, any taxpayer claiming that the tax
5 computed and assessed is void in whole or in part may bring an action, upon
6 the ground set forth in that claim for refund, against the Franchise Tax Board for
7 the recovery of the whole or any part of the amount paid.

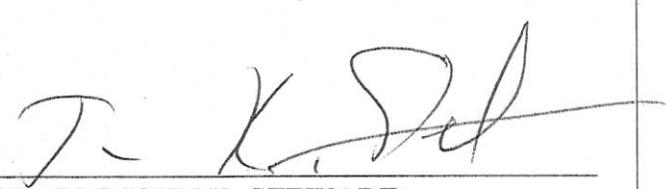
8 The Court concludes that nothing in section 19777.5 preempts a taxpayer's right to bring such
9 a postpayment refund action under section 19382.

10 The Court further finds that Microsoft's contention fails for lack of proof that it has been
11 denied an opportunity to challenge either the amnesty penalties imposed by the FTB or the
12 underlying tax on which those penalties are computed. The FTB has made no attempt
13 to challenge Microsoft's right to assert its various challenges to the amnesty penalties in this
14 postpayment suit for tax refund. Microsoft has made no showing at trial that the FTB has
15 attempted in any way to deny to Microsoft, or to any other taxpayer, the opportunity to seek
16 review of the amnesty penalties in a court of law. Accordingly, the Court rejects Microsoft's
17 constitutional challenge and concludes that the FTB was legally authorized to impose amnesty
18 penalties for both tax year 1995 and tax year 1996.

19 This Proposed Statement of Decision will become the Statement of Decision unless,
20 within 10 days after the service of this Proposed Statement of Decision, any party files objections
21 on the ground that it omits findings on critical issues controverted at trial or that its findings as to
22 such issues are ambiguous. (See Code Civ. Proc., § 634; Cal. Rules of Court, rule 3.1590(g).)
23 If any such objections are received, the Court may order a hearing on the objections or may rule
24 on such matters without a hearing. (See Cal. Rules of Court, rule 3.1590(k).)

25 Dated: _____

11/14/11

26 
HONORABLE JOHN K. STEWART
27 Judge of the Superior Court
28

SUPERIOR COURT OF CALIFORNIA
County of San Francisco

MICROSOFT CORPORATION, A
WASHINGTON CORPORATION

Plaintiff(s),

vs.

FRANCHISE TAX BOARD, AN AGENCY OF
THE STATE OF
CALIFORNIA,

Defendant(s).

Case No. CGC-08-471260

CERTIFICATE OF MAILING
(CCP 1013a (4))

I, Robert Goulding , a Deputy Clerk of the Superior Court of the County of San Francisco, certify that I am not a party to the within action.

On January 18, 2011 I served the attached *Proposed Statement of Decision* by placing a copy thereof in a sealed envelope, addressed as follows:

BRIAN TOMAN
Reed Smith, LLP
101 Second Street, Suite 1800
San Francisco, CA 94105

DAVID LEW, Dep. Attny. General
Department of Justice, Attorney General
1515 Clay Street, Oakland, CA 94612-1413

LUCY F. WANG, Dep. Attny. General
Department of Justice, Attorney General
455 Golden Gate Avenue, Suite 11000
San Francisco, CA 94102.7004

I then placed the sealed envelopes in the outgoing mail at 400 McAllister Street, San Francisco, CA. 94102 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: January 18, 2011

T. MICHAEL YUEN, Clerk

By: Rob Goulding
Robert Goulding , Deputy Clerk