May 23, 2024

Mr. Mark Ibele, Director
Office of Tax Appeals
P.O. Box 989880
West Sacramento, CA 95798-9880

Via email to precedential@ota.ca.gov

RE: Appeal of Microsoft Corp. and Subsidiaries, California Office of Tax Appeals, 2024-OTA-130 and -131

Dear Director Ibele:

I write on behalf of the Multistate Tax Commission (the MTC) as its Executive Director. [1] The MTC requests that the Office of Tax Appeals continue to treat its decision in the Appeal of Microsoft Corp. and Subsidiaries, 2024-OTA-130 and -131, as non-precedential. We understand others may urge you to change this designation to precedential, but we believe this is not appropriate for reasons explained below.

<u>The MTC's Role and Relationship to the California Franchise Tax Board</u>

As the OTA's decision in this case acknowledges, California's tax system is based on the Uniform Division of Income for Tax Purposes Act (UDITPA) enacted as a uniform law "by California and certain other states to establish uniform rules for the attribution of a unitary enterprise's business income among the taxing jurisdictions."[2] The MTC was formed by the Multistate Tax Compact that also incorporated UDITPA. Two of the compact's purposes are facilitating the proper determination of state and local tax liability of multistate taxpayers and promoting uniformity or compatibility in significant components of tax systems.[3]

Throughout its existence, the MTC has benefited from the experience and assistance of the California Franchise Tax Board. California enacted UDITPA in 1966 and joined the MTC as a compact member in 1974. See *Gillette Co. v. Franchise Tax Bd.*, 363 P.3d 94 (Cal. 2015). California is currently a sovereignty member of the MTC. As the largest state economy in the United States, California often encounters emerging income tax issues or otherwise establishes approaches to administering income taxes before other states encounter them.

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[1] The MTC is an intergovernmental state tax agency whose mission is to promote uniform and consistent tax policy and administration among the states, assist taxpayers in achieving compliance with existing tax laws, and advocate for state and local sovereignty in the development of tax policy. The MTC has 16 compact member states (including the District of Columbia), 10 sovereignty member states, and 24 program member states. See the MTC's website here: https://www.mtc.gov/.

[2] See the decision in Appeal of Microsoft Corp. and Subsidiaries, California Office of Tax Appeals, 2024-OTA-130 and -131.

[3] See the original and recommended versions of the Multistate Tax Compact here: https://www.mtc.gov/the-commission/multistate-tax-compact/.

UDITPA's Formulary Apportionment System has a Structure and Logic which the Decision Ignored

The question in this case was whether the 75% of repatriation dividends excluded by California from net income should also be excluded from the receipts apportionment factor. The OTA decided that for this to be the case, California law must provide not only a specific exclusion from net income but a separate exclusion from the receipts factor as well. This determination ignores the fundamental structure and logic of UDITPA on which California's apportionment system is founded.

The formulary apportionment system created by UDITPA recognizes an essential connection between the receipts factor and the net income to be apportioned. This connection is also found in the federal income tax law, to which California, like most states, conforms in many ways. Net income—the base to be apportioned—is the taxpayer's gross receipts less related business expenses. Not all types of receipts are included in calculating net income; some receipts may be exempt or deferred. The receipts factor of the apportionment formula—or "sales factor" as UDITPA traditionally refers to it—includes these same gross receipts and generally attributes them to the taxpayer's market.

State tax laws recognize differences in how certain types of gross receipts are treated. To put it simply, there are four possible categories:

1. Receipts that are included in the net income base and are also included in the receipts factor.
2. Receipts that are NOT included in the net income base and are also NOT included in the receipts factor.
3. Receipts that are included in the net income base but are NOT included in the receipts factor.
4. Receipts that are NOT included in the net income base but are included in the receipts factor.

It would not be feasible to imagine every possible type of receipts that may arise over time and provide, for each, the specific category into which those various receipts fall. Nor is this necessary. Instead, the structure and logic of UDITPA, and the laws of states that conform to it, simply recognize that the default rule is represented by categories 1 and 2—consistent treatment of receipts for purposes of computing net income and the receipts factor. In contrast, categories 3 and 4—inconsistent treatment—are effectively exceptions. But these exceptions are fundamentally different. And this means how they are specified must also vary.

First consider category 3. California and other states have recognized that there may be receipts included in net income that should be excluded from the receipts factor. For example, the MTC has long had model general allocation and apportionment rules, including the current version of those rules, which explicitly exclude certain types of receipts from the receipts factor, even though they are included in net income.[4] But what is important here is that there is a reason why these exceptions are created by specific provisions; the basic logic of UDITPA assumes that receipts included in the net income base will also be included in the receipts factor. See category 1.

[4] See a copy of the MTC's current Model General Allocation and Apportionment Rules here: https://www.mtc.gov/wp-content/uploads/MTCImages&Files/MTC/media/AUR/FINAL-APPROVED-2018-Proposed-Amendments-042020.pdf.

But with category 4, this fundamental logic is reversed. Category 4 involves receipts that are NOT included in the calculation of net income but are nevertheless included in the receipts factor. This is an exception to the default rule that exclusions from net income are presumed to apply to the receipts factor as well. See category 2. Therefore, with the receipts in category 4, one would not expect to find a specific state-law exception *excluding* the receipts from the receipts factor, but would instead assume such receipts are excluded *unless there is a specific exception including them.*

This category 4 is the category into which the receipts in this case fall—that is, 75% of the repatriated dividends, which are not included in net income but which, according to the OTA, are included in the receipts factor. In requiring that there must be a specific provision excluding the same receipts from the receipts factor, as well as from net income, the OTA ignored the logic of UDITPA's apportionment system.

Not only does the OTA's determination that there must be a specific exclusion here ignore the long-standing structure and logic of UDITPA, and the income tax system to which it relates, but it potentially imposes on state lawmakers an unreasonable burden of specifying how every type of gross receipts will be treated. Presumably, under the OTA's approach, the state may not assume that there is any relationship or consistency between the gross receipts included in net income and those included in the gross receipts factor.

<u>Recognition of UDITPA as a Uniform Law also Entails Accepting Its Logic</u>

The specific interpretation and application of UDITPA's formulary apportionment system has evolved over time, particularly through state litigation and case law. This adjudicatory process has played an important part in the development of specific rules since no state can anticipate all the specific factual circumstances and transactions that may exist, or have in place laws that address them all.

When it comes to uniform state laws, it is a recognized rule of construction that states should consider the effect that it was intended to serve as a uniform law. See, for example, the Uniform Law Commission, Uniform Statute and Rule Construction Act (1995), Sec. 18(b) which provides: "A statute that is intended to be uniform with those of other States is construed to effectuate that purpose with respect to the subject of the statute."[5] The annotations to this provision also state: ". . . if uniformity of law among enacting States is the purpose of a statute or rule, courts should seek to interpret them uniformly. If a state statute is enacted to conform to federal legislation so as to make a state program eligible for participation in a federal program, the state statute should be interpreted so that it remains consistent with interpretations of the federal act. *Christgau v. Woodlawn Cemetery Ass'n*, 293 N.W. 619 (Minn. 1940)."

<u>Use of the Term "Deduction" Does Not Change the Nature of the Exclusion Here</u>

We also recognize that the California legislature used different terms—"exemption," or "exclusion," or "deduction"—at times to refer to the treatment of gross receipts. But the use of any such general terms, without more, cannot, by itself, drive so important a conclusion as the one reached here. Regardless of the term used, if receipts of the taxpayer that would normally be included in net income are excluded (in whole or in part), the effect is the same.

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[5] Available on the ULC website, here: https://www.uniformlaws.org/committees/community-home?CommunityKey=aeacd732-88fa-4f23-ae86-4e383f416cf3. See also Section 20(b)(1).

Nor does the simple use of the term "deduction" to refer to the 75% reduction in gross receipts from repatriation dividends turn that exclusion into some kind of tax deduction for *expenses*—similar to trade or business expenses that are deducted from gross income to get to net income under federal and state income tax systems. There is simply no similarity between the 75% "deduction" from gross receipts included in net income here and the other expense-related deductions typically allowed in computing taxable net income.

<u>The Decision Here Should Not be Made Precedential</u>

Had the OTA recognized the foundational structure and logic of UDITPA, it would not have gone in search of some explicit exclusion from the receipts factor for the 75% reduction in repatriated dividends. Rather, it would have looked for the requisite *inclusion* of that amount, despite its exclusion from net income. And finding none, the OTA would have reached the conclusion that the FTB's position in this case was the correct one. Nor does the simple use of the term "deduction" by lawmakers to describe the exclusion here change this conclusion.

This disregard for the structure and logic of UDITPA is not something we would want to see taxpayers cite when litigating issues involving UDITPA in other states. Therefore, to the extent that there may be any reasons to limit the precedential effect of this ruling, whether based in California-specific law, or in the factual or procedural issues in the case, or the respect for the careful development of uniform state apportionment rules in a difficult and complex areas, the MTC asks that the OTA continue to designate this decision as non-precedential.

Sincerely,

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