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NOT TO BE PUBLISHED IN OFFICIAL REPORTS

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION THREE

MICROSOFT CORPORATION,
Plaintiff and Respondent,
v.
FRANCHISE TAX BOARD,
Defendant and Appellant.

A105312

(City and County of San Francisco Super. Ct. No. 400444)

Following an audit of its 1991 tax return, Microsoft Corporation paid an additional assessment and pursued this action seeking a refund. The matter was tried to the court based on stipulated facts, with additional oral and documentary evidence presented at trial. The court ruled in favor of Microsoft. We reverse.

The parties' dispute centers around the characterization for tax purposes of the gross proceeds from Microsoft's transactions in marketable securities. Microsoft claims these proceeds must be included in its "gross receipts" for purposes of the apportionment prescribed by the Uniform Division of Income for Tax Purposes Act (UDITPA, Rev. & Tax. Code, § 25120 et seq.[1]; see § 25128 [apportionment formula].) The Franchise Tax Board (FTB) contends the portion of the gross proceeds from Microsoft's securities transactions that represents the return of Microsoft's principal should not be considered a "receipt." If these funds are deemed receipts, the FTB argues it should be permitted to use an alternative apportionment methodology under a UDITPA provision that applies

[1] UDITPA provides a method for apportioning corporate income from a multistate business to a particular state for income tax purposes. (See *Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 517-518.) Further statutory references are to the Revenue and Taxation Code.

when the "apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state." (§ 25137.)[2]

In 1991, Microsoft invested its sizable cash portfolio in marketable securities, in order to earn a reasonable rate of return while meeting its requirements for liquidity and protection of principal. The average monthly total cost of Microsoft's holdings in such securities was around $480 million. Most of the securities were short-term; 32.84 percent of the annual proceeds from Microsoft's portfolio came from securities held for 1 day, 61.56 percent from securities held for 7 days or less, and 81.03 percent from securities held for 30 days or less.

Microsoft realized a gain of $10.7 million from its dispositions of marketable securities in 1991. However, the gross proceeds of these transactions, including returned principal, was $5.7 billion. Microsoft's gross receipts for 1991, excluding the $5.7 billion in securities proceeds, were $2.1 billion, from which it derived $659 million of income. The FTB calculated that if the entire $5.7 billion from securities transactions were included in Microsoft's gross receipts for purposes of the apportionment formula, instead of including only the gains realized from these transactions, Microsoft's sales factor would be reduced from 15.3412 percent to 3.067 percent, and its total apportionment factor from 6.859 percent to 2.9821 percent.[3]

Microsoft's argument is based on the following definition provided in section 25120:

"As used in . . . 'this act' [UDITPA], unless the context otherwise requires:

"(e) 'Sales' means all gross receipts of the taxpayer not allocated under [the nonbusiness income provisions of UDITPA]."

The trial court ruled that the plain language of this statutory definition included all Microsoft's receipts, with no limitation for return of principal. It also found that the FTB

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[2] These issues are currently pending before our Supreme Court, following a ruling in the FTB's favor by Division Two of the Second District Court of Appeal. (*General Motors Corp v. Franchise Tax Bd.* (2004) 120 Cal.App.4th 114, 128-131, review granted Oct. 13, 2004, S127086.)

[3] The apportionment formula employs a property factor, a payroll factor, and a sales factor. (§ 25128, subd. (a).)

had failed to meet its burden of proving that the standard apportionment formula did not fairly represent the extent of Microsoft's business activity in California, nor had the FTB proposed an "alternative formula" that might warrant a different apportionment under section 25137.

We have no difficulty reaching the conclusion that the court's second finding was not supported by substantial evidence. The stipulated facts established beyond question that including returned principal in Microsoft's gross receipts seriously distorted the representation of its worldwide business activity, necessarily including its California business. In 1991 six Microsoft employees in its Treasury Department in Washington state generated a gain of $10.7 million from securities transactions yielding total "proceeds" of $5.7 billion. When these figures are compared with the $659 million in income derived from Microsoft's other operations, conducted worldwide by around 8,200 employees, and yielding only $2.1 billion in gross receipts, it is obvious that the returned principal portion of Microsoft's "gross receipts" swamps the revenues attributable to its normal business activity, and amply justifies the FTB's invocation of the relief provisions of section 25137. Similar conclusions have been reached by courts in other UDIPTA jurisdictions. (*Sherwin-Williams Co. v. Johnson* (Tenn.App. 1998) 989 S.W.2d 710, 715-716; *American Tel. & Tel. Co. v. State Tax Appeal Bd.* (Mont. 1990) 787 P.2d 754, 759. See also *Appeal of Pac. Tel. & Tel. Co.* (1978) 78-SBE-028, Cal. Tax. Rptr. (CCH) ¶ 205-858, 1978 WL 3941.)

Nor can we agree with the trial court's ruling that the FTB failed to advance an alternate method of apportionment under section 25137. The FTB proposed simply omitting the returned principal part of Microsoft's securities dispositions from the gross receipts element of the sales factor. Such a solution is both reasonable and well within the authorization provided in section 25137, subdivision (d): "The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

A more difficult question is posed by the FTB's principal argument, which is that returned principal should not be deemed a "receipt" at all for purposes of the definition of "sales" provided in section 25120, subdivision (e) — " '[s]ales' means all gross receipts

of the taxpayer." An Arizona appellate court, relying in part on the Second District's decision in the case now before our Supreme Court (see fn. 2, *ante*) has adopted that view under Arizona's version of UDIPTA. (*Walgreen Arizona Drug Co. v. Arizona Dept. of Revenue* (Ariz. App. 2004) 97 P.3d 896, 899-900.) The *Walgreen* court reasoned that the UDIPTA definition of "sales" is not "susceptible of a plain-reading construction," and that "the context of the transaction must be considered in determining whether a 'sale' actually occurred." (*Id*. at p. 901.) The court concluded that "the 'strict' interpretation approach urged by the Taxpayer would create a tax loophole for non-domiciliary businesses neither intended by the Arizona legislature nor required by the plain meaning of [the statutory definition of 'sales'] and the related statutory scheme. Accordingly, we reject the Taxpayer's mechanistic interpretation of the term 'sales' . . . and hold that the return of principal from the type of short-term investments at issue here is not includable in the sales factor denominator . . . ." (*Id*. at p. 902.)

Several courts have reached similar conclusions under statutory schemes analogous to UDITPA. (*American Tel. & Tel. Co. v. Director, Div. of Taxation* (N.J. Super A.D. 1984) 476 A.2d 800, 802-803 [returned principal excluded from "receipts fraction"]; *Sherwin-Williams Co. v. Indiana Dept. of State Revenue* (Ind. Tax Ct. 1996) 673 N.E.2d 849, 853 ["gross receipts" includes only interest from sale of securities]; *H.J. Heinz, Co., Inc. v. Department of Treasury* (Mich. App. 1992) 494 N.W.2d 850, 853 [securities repurchase agreements are "collateralized loans not sales"].)

On the other hand, the Oregon Supreme Court has concluded in a memorandum opinion that return of capital from cash management securities transactions *was* included by the UDIPTA definition of "sales" now before us. (*Sherwin-Williams Co. v. Department of Revenue* (2000) 996 P.2d 500, 501.) The court noted, however, that Oregon's legislature had amended its version of UDITPA to provide that gross receipts arising from the sale of intangible assets shall not be treated as "sales" unless derived from the taxpayer's primary business activity. (*Id*. at p. 501, fn. 1.) (The court did not

consider whether Oregon's equivalent of section 25137 might justify a different result in the case before it.) [4]

Here, we need not decide whether Microsoft's returned principal should be excluded from its "gross receipts" for purposes of the sales factor. This case can be resolved by resort to the relief provisions of section 25137, as discussed above. Our Supreme Court will provide the rule to be followed in future cases. We believe, however, that there are persuasive considerations favoring the systematic exclusion of returned principal from "sales" when securities transactions are utilized for cash management purposes. The UDITPA definitions provided in section 25120 are expressly conditional — they apply "unless the context otherwise requires." The context in which the "returned principal" issue arises — repeated short-term securities transactions generating enormous gross proceeds relative to the net gain realized by the taxpayer — is one that is particularly well-suited to recognizing an exception to the statutory definition of "sales."[5] While the problem can be dealt with on a case-by-case basis under section 25137, that would require the FTB to document an unfair representation of the taxpayer's business activity in California in each case. Inevitably, distortions created by at least some smaller scale cash management operations involving reinvestments in short-term securities would escape correction. A uniform treatment is preferable, for reasons of both equity and administrative efficiency.

DISPOSITION

The judgment is reversed. The FTB shall recover its costs on appeal.

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4 We grant the FTB's request for judicial notice of sister-state legal authority.

5 Indeed, many of the securities transactions in question cannot be described as a "sale" by the taxpayer at all, in the ordinary sense. The taxpayer purchases and then redeems a security, without ever "selling" anything. In this case, the FTB did not challenge Microsoft's inclusion in gross receipts of its sales of securities before maturity to third parties. The trial court found this treatment "illogical." While we agree the net effects of a sale before maturity and a redemption upon maturity is practically the same for a short-term security instrument, the FTB's approach at least has the virtue of recognizing that an actual "sale" to a third party has occurred.

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Parrilli, J.

We concur:

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McGuiness, P. J.

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Pollak, J.