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Calif. OTA Ruling May Limit Foreign Income State Can Reach

By **Maria Koklanaris**

Law360 (March 5, 2024, 7:58 PM EST) -- With its newly revealed opinion allowing Microsoft to include all of its foreign dividends in the denominator of its California sales factor, the state's Office of Tax Appeals has made plain that multinational corporations in similar circumstances can ultimately reduce the amount of foreign income the state may tax.

In its ruling, obtained Monday by Law360, the OTA concluded that Microsoft can include 100% of dividends received from foreign affiliates in the denominator of its California sales factor even though only 25% of its foreign dividends were included in income subject to apportionment. As a result, all of Microsoft's qualifying dividends, totaling about $109 billion, were included in its sales factor denominator, and the income apportionable to California was greatly reduced, triggering a $94 million refund.

The Microsoft opinion comes on the heels of two other similar matters heard by the tax appeals office, in which it came to similar conclusions. In addition, it follows a 2006 California Supreme Court decision, also regarding Microsoft, that held that the state Franchise Tax Board could use an alternative apportionment method to determine the company's taxable income. But there the court also determined that the company, which had redeemed marketable securities in gross receipts, could include the full redemption amount to its sales factor.

The OTA ruling and other decisions all add up in imposing some firmer limits on the state's inclusion of foreign income in the tax base of multinational corporations, and could serve as a lesson to other states, said William Gorrod, tax partner at Morgan Lewis & Bockius LLP.

Gorrod said he sees California, among other states, seeking to expand the income tax base of multinational corporations to include more foreign income, even as policies such as the water's-edge election were enacted specifically to prevent that. A water's-edge election gives multinational corporations the option to exclude overseas income from state returns.

"I think there's been this creep into more and more foreign income, and so I think it's important to note that this is some sort of limitation on that, for California purposes," Gorrod said.

Gorrod noted that when California enacted its water's-edge election, "it was a policy decision that it wasn't appropriate for California to tax certain foreign income." He said he has seen the state try to chip away at that with policies such as what is known in California as "the matching principle." It's important

the OTA rejected the Franchise Tax Board's application of the matching principle in Microsoft, Gorrod noted.

The matching principle in California provides that only that percentage of foreign income included in the tax base may be included in the sales factor. In the Microsoft case, the company deducted 75% of the dividend income from the tax base, so use of the matching principle would mean 75% of the dividend income would also have to be excluded from the denominator of its California sales factor.

Michael Cataldo, a solo practitioner in California and a former FTB counsel, said the case turned in part on a key distinction. The dividend income from foreign affiliates was not eliminated from apportionable income, Cataldo said. It was included and then a deduction was applied. Therefore, the full dividend income could be placed in the denominator of the sales factor, and OTA didn't give much credence to the matching principle.

"The OTA said, 'what matching principle?'" Cataldo said. "Where is that in the law?"

The OTA opinion "does give a clear answer that taxpayers aren't necessarily bound by this matching principle idea," Gorrod said. As a result, he and other practitioners with expertise in California said they expect many more multinational corporations to file for refunds on the same basis.

The FTB declined to comment.

Shail Shah, tax partner at Greenberg Traurig LLP, said he expects the FTB to interpret the OTA opinion as narrowly as possible. One way, he said, is for the tax agency to take the position that the ruling only applies to dividends repatriated as called for in the 2017 federal tax overhaul. The Microsoft case dealt with repatriated dividends.

But the OTA's opinion took a much broader view than looking only at repatriated dividends, and other OTA opinions on inclusion of gross receipts, and sales factors, back up that broader view, Shah said.

"There has been a clear line of reasoning from the OTA that they view the inclusion of gross receipts from the sales factor very liberally, and that it's an expansive view," both of what constitutes gross receipts and whether gross receipts are includable on the sales factor, Shah said.

As examples, Shah cited a case involving a beet sugar manufacturer in Minnesota and another involving the now-bankrupt Bed Bath & Beyond. In the former, OTA said in a decision issued a year ago and released in August that a beet sugar manufacturer can include out-of-state business activities that resulted in deductible income in its California apportionment formula, rejecting the FTB's arguments that such activities should be excluded.

The office said in a pending precedential opinion that Southern Minnesota Beet Sugar Cooperative could factor in property, payroll and sales attributed to income that it took an agricultural cooperative deduction for when calculating the California income tax liabilities for its combined group, which included a California-based business. The office declined to adopt the FTB's stance that the factors that led to deductible income should have been disregarded for apportionment purposes.

In Bed Bath & Beyond, decided two years ago and released in May 2022, the OTA dealt with litigation of treasury receipts. But in that ruling, the OTA held that vendor allowances such as rebates were gross receipts for sales factor purposes.

"In that regard, it is consistent with the broad 'gross means gross' interpretation under the 2006 California Supreme Court decision in Microsoft," said Timothy Gustafson, tax partner at Eversheds Sutherland. "Southern Minnesota Beet and the recent Microsoft decision are in line with that interpretation."

The OTA's recent decision in Microsoft was issued in July. The FTB then petitioned the OTA for the case to be heard again. In a separate opinion issued Feb. 14, the OTA said no. Neither opinion is published yet on the OTA's website. An official told Law360 that the two opinions will be published in April. At that time, it will be known whether the July opinion is precedential.

Cataldo noted that the FTB has no right of appeal. Therefore, he said, the question of whether the opinion is precedential will be crucial.

"It's a huge question," Cataldo said. "If this comes out as precedential, the FTB is not going to have a lot of options."

--Editing by Tim Ruel and Nick Petruncio.
