**Final Written Determination**

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| **Docket Number:** | **WFD-P-2007-1** |

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| **Tax Type:** | **Corporate Income Tax** |
| **Brief Description:** | **Final assessment of corporate income tax.** |
| **Keywords:** |  |
| **Approval Date:** | **01/08/2007** |

**Body:**

KANSAS DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE APPEALS

January 8, 2007

XXXX
XXXX
XXXX

RE: Request of XXXX for an Informal Conference to Reconsider Agency Action, Docket No. 04-0200.

Dear XXXX:

On May 28, 2004, you timely requested an informal conference with the Kansas Secretary of Revenue. You sought review of the facts and issues that underlie the department's April 1, 2004 final assessment of corporate income tax. That assessment schedules a deficiency of $12,407.00 in tax, penalty, and interest. Your hearing request lists four objections to the assessment. The third one states:

**III. 1999 Sales Factor - Gross Investment Proceeds**

The 1999 sales factor denominator as reflected on the 1999 amended return was adjusted to disallow the inclusion of gross investment proceeds. Under Kan. Admin. Reg. 92-12-95, "sales" for purposes of the apportionment sales factor is defined to include "***all gross receipts*** derived by the taxpayer from transactions and activity in the regular course of such business" (emphasis added). Since the proceeds in question are clearly gross receipts from transactions in the regular court of XXXX business, the must be allowed in the sales factor denominator.

Further, the inclusion of the gross investment proceeds in the sales denominator does not create a level of distortion in the apportionment factor that would require adjustment as suggested by the cases cited in the audit report.

Historically, the department has put forth two alternate arguments to support its treatment of gross investment proceeds. One is that while recycled investment capital satisfies the definition of "gross receipts," K.S.A. 79-3288 allows the department to adjust the resulting apportionment formula because it fails to "fairly represent the extent of the taxpayer's business activities in [Kansas]." The alternate is that receipts from investment capital generated by churning or recycling do not constitute "gross receipts" under the Uniform Division of Income for Tax Purposes Act (UDITPA) and therefore need not be included in the formula denominator. Both arguments are supported by case law from other jurisdictions.

Recently, the California Supreme Court published two cases that deal with gross investment proceeds under UDITPA: *Microsoft Corporation v. Franchise Tax Board*, 39 Cal. 4th 750, 139 P.3d 1169 (2006), and *General Motors Corporation v. Franchise Tax Board*, 39 Cal. 4th 773, 139 P.3d 1183( 2006). Kansas is a UDITPA state. These two cases provide compelling support for the department's argument that while recycled investment capital meets the definition of "gross receipts," the resulting apportionment formula may be adjusted under UDITPA because it fails to "fairly represent the extent of the taxpayer's business activities in this state." *Compare Cal. Revenue & Tax Code Sec. 25137 with K.S.A. 79-3288, which contains the same UDITPA language as Sec. 25137.*

The *Microsoft* decision begins by summarizing the Supreme Court's holding about how the UDITPA applies to "gross investment proceeds" like those of the taxpayer here --- XXXX Corporation & Subsidiaries (XXXX):

Ours is a global economy. In contrast, government, and the taxing authority used to fund it, is national and local. This geographic disparity generates difficulties when each jurisdiction seeks its piece of the economic pie, a pie generated by economic activity that knows no borders.

The Uniform Division of Income for Tax Purposes Act (UDITPA) attempts to address these problems and fairly assess corporate taxes. Adopted by the District of Columbia and 22 states, including California, it seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme-equitable to each jurisdiction, seeking its own fair share, and equitable to the taxpayer, who in the absence of uniform rules faces the prospect of having the same income taxed by two, three, or more different states.

The UDITPA's application is not always clear. This case requires us to resolve how the UDITPA should apply to income arising from the redemption of marketable securities, a critical aspect of the operations of the treasury departments of many large corporations, including plaintiff Microsoft Corporation (Microsoft). We conclude (1) the redemption of marketable securities at maturity generates “gross receipts” that are includible in the formula used to calculate a multistate entity's tax, but (2) the Franchise Tax Board (the Board) has met its burden of establishing that, in this instance, an alternate formula should be used to calculate Microsoft's tax. *(Underlining provided).*

**The UDITPA**

The United States Constitution bars taxation of extraterritorial income. *(Citations omitted).*However, it permits taxation of “an apportionable share of the multistate business carried on in part in the taxing State” *(Citations omitted)* and grants states some leeway in separating out their respective shares of this multistate income, not mandating they use any particular formula *(Citations omitted).*One constitutional method of apportionment, the unitary business/formula apportionment method, “calculates the local tax base by first describing the scope of the ‘unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that ‘unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction.” *(Citations omitted).*The UDITPA is generally based on this method. *(Citations omitted).*

Under the UDITPA, a unitary enterprise's income is divided into “business income” and “nonbusiness income.”*(Citations omitted).*With some exceptions, nonbusiness income is generally allocated directly to the taxpayer's domiciliary state. *(Citations omitted).*In contrast, business income is apportioned among the states according to a formula. The portion of a taxpayer's business income attributable to economic activity in a given state is determined by combining three factors: payroll, property, and sales. *(Citations omitted).*Each factor is a fraction in which the numerator measures activity or assets within a given state, while the denominator includes all activities or assets anywhere. *(Citations omitted).*The combination of these fractions is used to determine the fraction of total global business income attributable to the given state. *(Citations omitted).*This method provides a rough but constitutionally sufficient approximation of the income attributable to business activity in each state. *(Citations omitted).*

Only the sales factor is at issue here. The sales factor is a ratio comparing sales in a given state to total sales everywhere. *(Citations omitted).* Sales are measured by counting a business's “gross receipts.” *(Citations omitted).*Increases in in-state gross receipts will lead to a larger fraction, greater apportioned income, and higher tax; conversely, increases in out-of-state gross receipts will lead to a reduction in the fraction attributable to California and a reduction in California tax.

The UDITPA contains a relief provision. If application of the foregoing provisions fails to “fairly represent the extent of the taxpayer's business activity in this state,” the taxpayer may seek or the Board may impose an alternate method of calculation to achieve an equitable result. *(Citation omitted) . . . .*

After summarizing the facts of the case, the California Supreme Court reasons that an adjustment of Microsoft's reporting of its gross investment proceeds is warranted under Cal. Revenue & Tax Code Sec. 25137:

In language we find persuasive, the SBE *[California State Board of Equalization]* has interpreted section 25137 to allow correction of distortions arising from the operation of a large corporate treasury department. In *Pacific Telephone & Telegraph,* *(citations omitted)*, as here, the taxpayer corporate group maintained an out-of-state treasury department that invested in short-term securities. These investments produced less than 2 percent of the company's business income, but 36 percent of its gross receipts. The SBE described the sales factor as intended to "reflect the markets for the taxpayer's goods or services" and asked whether inclusion of all investment receipts would serve that function. *(Citations omitted).* It answered in the negative: "The inclusion of this enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all other states, including California, which supply the markets for the ... services provided by [taxpayer]. Moreover, we are unable to accept, even for a moment, the notion that more than 11 percent of [taxpayer's] entire unitary business activities should be attributed to any single state solely because it is the center of working capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses. We conclude, therefore, that UDITPA's normal provisions 'do not fairly represent the extent of the taxpayer's business activity in this state,' and that [the Board] is authorized, under section 25137, to require a deviation from the normal rules." (Ibid.) If one substitutes "Washington" for "New York" and "24 percent" for "11 percent," these words are equally applicable to this case.

More recently, in *Crisa Corp.,* *(Citations omitted),* the SBE reiterated that operation of a large treasury department unrelated to a taxpayer's main business is a paradigmatic example of circumstances warranting invocation of section 25137. It included in a nonexclusive list of such circumstances that "[o]ne or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, the taxpayer continuously reinvests a large pool of 'working capital,' generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business." *(Citations omitted).*

The SBE and these sister-state courts implicitly recognize that the problem arising from inclusion of the full sale or redemption price of a short-term security is not that the full price is not gross receipts. Rather, the problem is one of scale: short-term securities investments involve margins (i.e., differences between cost and sale price) that may be several orders of magnitude different than those for other commodities. When a short-term marketable security is sold or redeemed, the margin will often be, in absolute terms, quite small (though of course the annualized returns may well be perfectly respectable). Microsoft's treasury activities provide a perfect illustration. Its 1991 redemptions totaled $5.7 billion, while its income from those investments totaled only $10.7 million --a less than 0.2 percent margin. In contrast, its nontreasury activities produced income of $659 million and gross receipts of $2.1 billion, for a margin of more than 31 percent, roughly 170 times greater.

The stipulated evidence establishes that mixing the gross receipts from Microsoft's short-term investments with the gross receipts from its other business activity seriously distorts the standard formula's attribution of income to each state. These transactions generated minimal income (just under 2 percent of Microsoft's business income for 1991) but enormous receipts (approximately 73 percent of gross receipts for 1991). Their inclusion in the standard formula would result in reducing roughly by half the estimated income attributed to California, and likely every state other than Washington, depending on property and payroll factors. The distortion the Board has shown here is of both a type and size properly addressed through invocation of section 25137; application of the standard formula does not fairly represent the extent of Microsoft's business in California. Like the Court of Appeal, we hold the trial court's contrary conclusion was not supported by substantial evidence.

Both *Microsoft* and *General Motors* find Cal. Revenue & Tax Code Sec. 25137 to be controlling. Section 25137 is a UDITPA provision that allow an allocation and apportionment formula to be adjusted when the formula fails to "fairly represent the extent of the taxpayer's business activities in this state." K.S.A. 79-3288 contains the same UDITPA language as that California Supreme Court relies on from Cal. Revenue & Tax Code Sec. 25137:

If the allocation and apportionment provisions of this act including the provisions of K.S.A. 79-3279, do not *fairly represent the extent of the taxpayer's business activity in this state*, the taxpayer may petition for or the secretary of revenue may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
(a) Separate accounting;
(b) the exclusion of any one or more of the factors;
(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income; or
(e) in the case of two or more businesses, whether or not incorporated and whether or not organized in Kansas, owned or controlled directly or indirectly by the same interests, which contrive through inter-company transactions to evade taxes imposed under this act, the secretary of revenue may distribute or allocate the gross income and deductions between or among such businesses or may require returns on a consolidated basis. The burden of proof of any contrivance to evade taxes under this act shall rest upon the director of taxation or secretary of revenue. *(K.S.A. 79-3288,*u*nderlining and italics added).*

The California decisions provide a sound basis for the department's administrative action of disallowing the inclusion of gross investment proceeds in the 1999 sale factor denominator.

State court decisions that support the alternate argument are cited in the lower court decision that gave rise to *General Motors Corporation v. Franchise Tax Board*, 39 Cal. 4th 773, 139 P.3d 1183 (2006). In *General Motors Corporation v. Franchise Tax Board*, 120 Cal. App. 4th 114, 16 Cal. Rptr. 3d 41 (2004), the California Court of Appeals reasoned:

**II. *Inclusion of Net Securities Proceeds in “Gross Receipts*”**

We conclude that the trial court correctly decided that the return of principal from securities transactions in the repurchase agreements and maturities categories should not be included as “gross receipts” in the denominator of the sales factor in apportioning income to California. The reason for this conclusion is that such a return of principal does not arise out of a sales transaction.

Section 25120, subdivision (e), defines “ ‘[s]ales' ” as “all gross receipts of the taxpayer····” The parties have excluded from our concern GM's “direct sales” of securities. It is reasonably clear that such transactions do constitute sales. However, the UDITPA does not otherwise define “gross receipts.” Thus, aside from the obvious determination that “gross receipts” must be sales, we are left without statutory guidance. The question we face then is whether GM's transactions involving repurchase agreements and maturities constitute sales. We conclude that they do not. . . .

In our view, the activity represented by these Treasury Department transactions is not akin to a sale at all but rather is more easily comparable to a taxpayer who takes “idle cash” or, merely to remain liquid, repeatedly deposits and withdraws his cash from his bank or savings and loan accounts. As decided in *American Tel. & Tel. v. Taxation Div. Director* (A.D.1984) 194 N.J.Super. 168, 476 A.2d 800, 802: “We uphold as a general matter the exclusion of gross revenues received by plaintiff from the sale or maturity of investment paper. As [the trial judge] observed, idle cash can be turned over repeatedly by investment in short term securities. It is no true reflection of the scope of AT & T's business done within and without New Jersey to allocate to the numerator or the denominator of the receipts fraction the full amount of money returned to AT & T upon the sale or redemption of investment paper. To include such receipts in the fraction would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account. The bulk of funds flowing back to AT & T from investment paper was simply its own money. Whatever other justification there is for excluding such revenues from the receipts fraction, it is sufficient to say that to do otherwise produces an absurd interpretation of [the statute]. ‘It is axiomatic that a statute will not be construed to lead to absurd results. All rules of construction are subordinate to that obvious proposition. [Even the rule of strict construction] does not mean that a ridiculous result shall be reached because some ingenious path may be found to that end.’ [Citation.]”

We agree with the trial court that the *Sherwin-Williams* line of cases provides ample precedent from other states to uphold the trial court's interpretation of the statute. (*Sherwin-Williams v. Dept. of State Revenue* (Ind.Tax 1996) 673 N.E.2d 849, 853; *Sherwin-Williams Co. v. Johnson* (Tenn.App.1998) 989 S.W.2d 710.)

In *Sherwin-Williams v. Dept. of State Revenue, supra,* 673 N.E.2d at page 850, the Indiana Tax Court reviewed the Indiana State Department of Revenue's determination that apportionment cannot result from an inclusion of “rolled over” securities in the sales factor. The question was therefore whether the denominator of Sherwin-Williams's sales factor should be increased to include the principal or capital element of investments. The court's analysis centered on how to define “gross receipts.” (*Id.* at p. 851.) The court especially focused on the notion that repeated rolling over of the investment would amount to an absurd abuse if these “same funds” could be included several times over in the gross receipts denominator. (*Id.* at p. 852.) The court thus concluded that “ ‘gross receipts' for the purpose of the sales factor includes only the interest income, and not the rolled over capital or return of principal, realized from the sale of investment securities. Thus, the Department was correct in including only the interest earned as part of the total receipts in the denominator of the sales factor of the apportionment formula.” (*Id.* at p. 853.)

Certainly, as the FTB posits, the return of one's own funds is not a receipt from a sale. Therefore, while interest thereon is income, the taxpayer's capital funds are not proceeds from a sale. (See *County of Sacramento v. Pacific Gas & Elec. Co.* (1987) 193 Cal.App.3d 300, 311, 238 Cal.Rptr. 305, and *City of Los Angeles v. Clinton Merchandising Corp.* (1962) 58 Cal.2d 675, 681, 25 Cal.Rptr. 859, 375 P.2d 851.) The regulations pertaining to section 25134 also support the FTB view. Section 25134, subdivision (a)(1)(A), describes what is includable and excludable as gross receipts. That section states that “[g]ross receipts for this purpose means gross sales, less returns and allowances and includes all interest income.” (Cal.Code Regs., tit. 18, § 25134, subd. (a)(1)(A).) As the FTB asserts, the procedure of subtracting returns recognizes that any sale is negated and that there is no receipt, except the interest. Although, the judiciary must take ultimate responsibility for the construction of a statute, we accord great weight and respect to the administrative construction. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 12, 78 Cal.Rptr.2d 1, 960 P.2d 1031.)

Respondent FTB also points out that GM did not report the proceeds from Treasury Department activities as sales on their federal tax returns, financial statements, or annual reports. It only reported the interest it received from the securities transactions. Section 448 of the United States Internal Revenue Code (26 U.S.C. § 448) allows taxpayers with under $5 million of gross receipts to compute their income using the cash method of accounting. Section 448 is incorporated into the California Revenue and Taxation Code by section 24654. The federal regulations relating to section 448 include the following provision: “Gross receipts do not include the repayment of a loan or similar instrument ( *e.g.,* a repayment of the principal amount of a loan held by a commercial lender).” (26 C.F. R. § 1.448-1T(f)(2)(iv)(A).)

We are not persuaded by GM's argument invoking IRC section 1271, which provides that maturing securities are “exchanges.” That provision does not relate to apportionment of income; instead it merely ensures that gain from discounted corporate debt instruments is treated as capital gain rather than as ordinary interest income. (*KVP Sutherland Paper Company v. United States* (1965) 170 Ct.Cl. 215, 344 F.2d 377, 382.) Indeed, it is well settled that payment of an obligation or retirement of a maturity is not a sale or an exchange other than with regard to the limited exception of section 1271. (*Ibid;* *Graham v. C.I.R.* (2d Cir.1962) 304 F.2d 707, 708, citing *Fairbanks v. United States* (1939) 306 U.S. 436, 59 S.Ct. 607, 83 L.Ed. 855.)

California has also concluded that security repurchase transactions should be considered loans. “Repurchase agreements, commonly known as ‘repos,’ ” the California Supreme Court has held, “are ··· nothing more than financing arrangements by which one party provides funds to another for a short period of time. There are two parties to a repurchase agreement: one has money to lend, the other needs cash and has securities. The repurchase agreement itself consists of two transactions that are agreed to simultaneously, but are performed at different times: (1) the seller-borrower agrees to transfer securities to the buyer-lender in exchange for cash; and (2) the seller-borrower agrees to repurchase the securities from the buyer-lender at the original price plus ‘interest’ on a specified future date or upon demand.” (*Bewley v. Franchise Tax Bd.* (1995) 9 Cal.4th 526, 529, 37 Cal.Rptr.2d 298, 886 P.2d 1292.) The United States Supreme Court came to essentially the same conclusion with regard to repurchase transactions. (*Nebraska Dept. of Revenue v. Loewenstein* (1994) 513 U.S. 123, 134, 115 S.Ct. 557, 130 L.Ed.2d 470 [noting that “in economic reality the [taxpayer] receive[s] interest on cash [it has] lent ···”].)

Thus, we conclude that maturities and so-called “repos” are not sales, but rather secured monetary transactions that are the equivalent of loans. Since the transactions are not sales, the return of capital is not includable in the sales factor as “gross receipts.”

The cases from New Jersey, Indiana, Nebraska, and Tennessee that are cited by the California Court of Appeals are persuasive. This is so even though the California Supreme Court believed the better argument to be that "repos" are required to be included in General Motor's report of its gross receipts. These two alternate theories are the inconsistent since one holds that the taxpayer's gross investment proceeds are gross receipts while the other holds they are not. However, this inconsistency is of no consequence here since the underlying facts support both legal theories, whether inconsistent or not. *See Western Machinery Co. v. Consolidated Uranium Mines, Inc., 247 F.2d 685,688-9(10th Cir. 1957), citing Blazer v. Black, 196 F.2d 139, 144 (10th Cir. 1952); see also K.S.A. 2005 Supp. 60-208(e)(2).*

The case law show that gross investment proceeds can and do unfairly distort the taxes that are apportioned to a state under UDITPA. Kansas has addressed this problem in the following Instruction found on page 15 of the 2007 Kansas Corporate Income Tax booklet:

In the case of a taxpayer engaged in the sale of redemption of investment securities, "sales" includes the interest of other income from such transactions. The term "sales" does not include the return of capital or the recovery of principal utilized to make such investment.

These same instructions were published in the 1997 through 2006 Kansas Corporate Income Tax booklets. This means that XXXX had construction knowledge of the department's policy both when it filed its 1999 corporate income return and when it filed amendments to it that the department rejected in the April 1, 2004 final assessment of corporate income tax, which XXXX appeals from.

Audit assessments are generally afforded a presumption of correctness. *Portillo v. Commissioner,* 932 F.2d 1128, 1133 (5th Cir. 1991); *Anastatsato v. Commissioner*, 794 F.2d 884, 886 (3rd Cir. 1986) ; *United States v. Janis*, 428 U.S. 433, 441 (1976); *Helvering v. Taylor*, 293 U.S. 507, 515 (1935); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Baird v. Commissioner*, 438 F.2d 490, 492 (3rd Cir. 1970). This procedural scheme means that the department's assessment is presumed to be accurate and correct. Because both alternate legal theories are supported by the same facts and are persuasive, the department's action regarding the treatment of the gross investment proceeds in this appeal is upheld.

A second issue raised by XXXX concerns a adjustment made to disallow the subtraction of $107,886 claimed on its 1999 amended return relating to foreign dividends. Allowing this foreign dividend modification would net a tax reduction for XXXX of approximately $551. My file notes on this issue indicate that additional documentation is needed before this request can be approved. A third issue concerns XXXX's contention that it qualifies for retroactive certificate of HPIP credits in light of the Kansas Court of Appeals' holding in *Hallmark Cards, Inc. v. Kansas Department of Commerce and Housing*, 32 Kan. App. 2d 715 , 88 P.3d 250 (2004). My file notes indicate that XXXX has asked to withdraw this issue from consideration. XXXX has also requested a penalty waiver. The department has not received sufficient documentation to grant a penalty waiver at this time.

The department acted properly when it issued its April 1, 2004 assessment letter which adjusted XXXX's amended income tax returns. The department's action is upheld for the reasons stated in this order.

This written determination constitutes final agency action subject to administrative review by the Board of Tax Appeals (BOTA). If you wish to appeal this determination you must, pursuant to K.S.A. 74-2438 or 74-2433f, file a notice of appeal with the Secretary of the Board of Tax Appeals within 30 days after the date of this final determination and serve a copy of the notice upon the Secretary of Revenue or her designee. There may be a filing fee for filing with the BOTA. See www.accesskansas.org/bota/apps.html or call 785/296-2388 for further information. BOTA’s address is Suite 451; Docking State Office Building; 915 Southwest Harrison Street; Topeka, Kansas 66612-1505.

Sincerely,

Thomas E. Hatten
Designee of the Secretary of Revenue
cc: Charles Reimer; Pat Verschelden

**Date Composed: 01/18/2007 Date Modified: 01/18/2007**