



This Week in State Tax (TWIST)

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California: FTB Seeks Rehearing in Dispute Addressing Dividend Inclusion

The Franchise Tax Board has recently petitioned the California Office of Tax Appeals (OTA) for rehearing in *Matter of Appeal of Microsoft Corporation*, a case addressing whether foreign dividends deducted from a taxpayer's income should be included fully in the sales factor. The request for rehearing follows the OTA's issuance of an Opinion that reversed the FTB's denial of the taxpayer's \$93 million refund. The opinion has not yet been released to the public. The substantive issue in Microsoft is what portion of a qualifying dividend paid by a qualified foreign subsidiary and received by a California water's-edge group member is reflected in the sales factor. Specifically, is the entire dividend amount included in the sales factor or just the amount remaining after applying the 75 percent dividends received deduction allowed under Cal. Rev. & Tax Cd. § 24411? On its original return, Microsoft included in its sales factor denominator only the 25 percent of the dividend amount. Subsequently, Microsoft filed an amended return including the full amount of dividends in the sales factor; this resulted in a refund. The dividends at issue were paid following the taxpayer's payment of the one-time transition tax under IRC section 965.

Without a written opinion, the OTA's rationale for reversing the refund denial must be gleaned from the FTB's petition for rehearing. The FTB asserts in the petition that the Opinion is contrary to California law in that it disregards the legislature's intent that the sales factor includes only sales that relate to apportionable income included in the tax base. In the FTB's view, the OTA also erred when it concluded that the dividends were not excluded from the sales factor under an exclusion for receipts from a substantial, occasional sale of a fixed asset or other property held in the regular course of the taxpayer's trade or business. Further, the OTA erred when it concluded that the FTB did not meet its burden of proving by clear and convincing evidence that the standard apportionment formula did not fairly represent the extent of Microsoft's activities in California. The FTB also asserts that there were irregularities in the appeal proceedings that prevented fair consideration of the appeal, including the denial of a request for additional briefings and interruptions during the opening arguments. In addition, the FTB alleges the taxpayer provided unsubstantiated (and erroneous) evidence regarding the amount of dividends repatriated in the years after the year on appeal, which was relied on by the OTA when it concluded that the occasional sale exclusion did not apply. Please contact Oksana Jaffe with questions.

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