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Microsoft Corporation and Subsidiaries vs. Office of Tax Appeals and Senate Bill 167

Where do we go from here?

Microsoft vs. Franchise Tax Board, 2023

Microsoft Corp. and Subsidiaries, No. 21037336, July 27, 2023 (Rehearing denied February 14, 2024).

- The OTA held Microsoft may include 100 percent of its repatriated dividends in the sales factor denominator.
- Microsoft filed a water's-edge combined report for the 2018 fiscal year and included 25 percent of repatriated dividends as apportionable income after applying California's 75 percent dividends received deduction under R&TC §24411. Although only 25 percent of the dividends were treated as apportionable income, Microsoft on an amended returns included 100 percent of the dividends in the sales factor denominator.
- The FTB, denied the refund arguing the "matching principle" should apply and only 25 percent of the dividends should be included in the sales factor denominator.
- The OTA three-judge panel unanimously rejected the FTB's arguments, holding that California statutes and regulations did not preclude including the dividends that qualified for the R&TC § 24411 deduction as "gross receipts" in the sales factor. The panel also found that the FTB did not demonstrate a qualitative difference or quantitative distortion that warrants use of an alternative apportionment methodology

Microsoft Fix

- Senate Bill 167 came as a state budget trailer in June 2024, changing the rules for apportioning corporate global income to determine what portion is taxable in California.
- Senate Bill 167 adopts Legal Ruling 2006-1, which the Franchise Tax Board (FTB) relied on in *Microsoft* as support for its position that only the portion of the qualifying dividends that remained in the tax base were included in the sales factor.
- In addition, the law has been amended to provide that a transaction or activity, to the extent that it generates income or loss not included in “net income,” subject to apportionment, shall be excluded from the apportionment formula.
- “Not included in net income” means income from transactions and activities that is not included in net income subject to apportionment for any reason, including, but not limited to: exclusion, deduction, exemption, elimination, or nonrecognition.
- This amendment, which Senate Bill 167 specifies does not constitute a change in law, applies to tax years beginning before, on, or after the effective date of the bill.

Fall out from “Microsoft Fix”

- The issue centers on whether “corporations should report their global incomes to California and have a calculated percentage subjected to state taxes, or could confine their taxable income reports to actual activities within the state”.
- Two lawsuits were filed to challenge the constitutional validity of SB 167, one by the California Taxpayers Association in Fresno, the other by the National Taxpayers Union in Sacramento.
- “This legislation imposes a retroactive tax hike that would reach back several decades, allowing California’s tax collectors to go after companies that already paid every cent of the taxes owed under the laws that were in place at the time,” CalTax president Robert Gutierrez said. “This egregious violation of taxpayers’ rights cannot go unchallenged.”
- It should be very troubling that California officials claim the right to levy taxes retroactively by changing the law after losing in court.
- Where does this leave Section 965 income and state apportionment?
- Should taxpayers consider protective requests for alternative apportionment?

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