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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

(Sacramento)

TOYS "R" US, INC., et al., Plaintiffs and Appellants, v. FRANCHISE TAX BOARD, Defendant and Respondent.	C045386 (Super. Ct. No. 01AS04316)

APPEAL from a judgment of the Superior Court of Sacramento County, Brian R. Van Camp, J. Affirmed.

Morrison & Foerster, Eric J. Coffill, and Carley A. Roberts for Plaintiffs and Appellants.

Bill Lockyer, Attorney General, Lawrence K. Keethe, Supervising Deputy Attorney General, and Michael J. Cornez, Deputy Attorney General, for Defendant and Respondent.

Toys “R” Us, Inc. (Toys) sells not only toys for tots but also maintains investments in short-term financial instruments, including debt securities and repurchase agreements. As a nationwide purveyor of toys, Toys pays state income tax proportionate to its profits in each state. In California, a retailer’s tax obligation is based on an apportionment formula: the average of three fractions to arrive at a percentage that is then multiplied times the corporation’s worldwide income to determine the amount of income apportioned to California. The three fractions are California payroll divided by worldwide payroll, California property divided by worldwide property, and California sales divided by worldwide sales. Toys challenges the calculation of the sales fraction of the equation, arguing the worldwide sales figure should include not only the interest earned by its short-term financial investments but also the principal amount of these investments. Since Toys's financial arm operates out of the State of Delaware, the principal and interest income would inure to the worldwide sales figure and, accordingly, significantly reduce the amount of income apportioned to California.

Toys filed a complaint for refund of taxes, requesting a refund of taxes and interest paid to defendant Franchise Tax Board (FTB). The complaint alleged Toys was entitled to a refund on the ground that all gross receipts received by Toys from the sale of short-term financial instruments must be included in the apportionment factor. Following a court trial, the trial court found in favor of the FTB. Toys appeals, contending the trial court erred in interpreting the Revenue and Taxation Code. We shall affirm the judgment.

FACTUAL AND PROCEDURAL BACKGROUND

Toys sells children's toys, games, and furniture through its chain of Toys "R" Us stores.[1] During the years at issue,

[1] The parties stipulated to most of the relevant facts.

Toys maintained a treasury department in New Jersey. The treasury department managed Toys's investments in "repurchase agreements and . . . debt securities held to maturity," referred to as "short-term financial instruments."

For a portion of the relevant period, the treasury department directly invested funds for Toys according to investment guidelines established by Toys. For the remainder of the period, Toys engaged an outside brokerage firm to assist in the management of its short-term financial instruments. Toys's short-term financial instruments are usual, ordinary, and recurring transactions for Toys.

Not surprisingly, toy sales peak during the Christmas season. Retailers manage cash from Christmas sales to build inventory through the summer and fall to prepare for the next Christmas season. At Toys, its treasury department manages this excess cash.

The treasury department invested Toys's excess cash with the objective of maximizing yield while maintaining liquidity as needed for the business. During the years in question, Toys reported the income earned from its short-term financial instruments as business income. This income was apportioned to California based on the apportionment formula set forth in Revenue and Taxation Code section 25120 et seq.[2]

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[2] All further statutory references are to the Revenue and Taxation Code unless otherwise indicated.

In July 2001 Toys filed a complaint for refund of taxes for the income years ending February 2, 1991; February 1, 1992; January 30, 1993; and January 29, 1994, in the amount of $4,812,618 plus interest. The complaint alleged Toys was entitled to a refund on the ground that all gross receipts received by Toys from the sale of short-term financial instruments must be included in Toys’s sales factor under sections 25120, subdivision (e) and 25134.

A court trial followed. Toys presented two witnesses. Jon Kimmins, Toys’s senior vice president-treasurer, testified he was responsible for Toys’s capital structure and cash management during the relevant period. Kimmins explained the operation of Toys’s treasury department and the necessity for cash management in the cyclical toy business. Kimmins stated investments were made based upon the rate of return and the duration of the investment.

Richard Pomp, a professor of tax law, testified as an expert witness. Professor Pomp opined there was no principled reason under tax policy why the gross receipts from the disposition of financial instruments should be treated any differently than the gross receipts from the disposition of inventory, which is fully includable as gross in the sales factor.

Under Professor Pomp’s analysis, the company has a certain amount of cash at the end of the day. The company can convert the cash into inventory, a doll for example, and sell it the following day. However, if conversion to inventory is not a good use of the money, the company can instead invest the cash in a financial instrument. As Professor Pomp explained: "That these are alternatives, and . . . one of the functions of the treasurer is to decide what the best use of that cash might be. And I guess I see a financial asset as a competitor for inventory. And each one, in a sense, is using the funds generated by the business. Each one is an investment, [one] in an inventory and one in a financial asset. Each one gets turned over in some period of time. . . . [¶] The financial instruments generate a small-profit margin . . . that could be true of toys too or in the case of diapers, no profit margin. So I guess I see that the money being fungible, all of this just would generate the income which now the state is taxing. . . . I don't see any fundamental difference in the gross receipt generated by a financial instrument or by a Cabbage Patch doll."

The FTB presented testimony by Steven Sheffrin, an economics professor. Professor Sheffrin testified regarding whether the inclusion of the total amount received from the financial investment transactions would fairly represent Toys's business activity in California.

Sheffrin, in forming his opinion, made a number of calculations based on the data in the Toys annual reports and the stipulations between the parties. In 1991, for every dollar of sales of toys, clothes, and furniture, Toys generated about 30.62 cents of gross profit. If gross receipts are included in the return of principal, then for every dollar of sales in the treasury function, Toys generated about .043 cents of gross profit. The ratio of these two numbers is approximately 711. This meant the retail sales portion of the business generated 711 times more gross profit than the treasury function.

Sheffrin next compared the ratio of net income before taxes to sales and determined that for every dollar of sales, the profit was 9.47 cents. The ratio here was 220, meaning that the sales in a store are 220 times more powerful in terms of generating income than the treasury function.

Sheffrin then testified as to the potential effect of including the return of principal from short-term investments in the sales factor. For 1991, if the principal is included in total receipts, they would constitute about 35.34 percent of all receipts. If this number is divided by 3, because of the three-factor apportionment formula, the number is 11.78. If the treasury function were moved from New Jersey to New York, 11.78 percent of Toys's apportionable income would be moved from New Jersey to New York. In Sheffrin's opinion, it was implausible that by simply moving six employees responsible for the treasury function, Toys could move 11.78 percent of its income to another state.

Sheffrin considered the remaining years and found similar results. For 1992, retail sales generated 346 times more net income before taxes than the treasury function. Toys's stores in California constituted about 11.3 percent of its total stores. This percentage is close to the sales factor percentage for California under the FTB's interpretation of the statute. If the return of principal is included in gross receipts, the treasury function constitutes 68.57 percent of total receipts. When divided by 3, as in the apportionment formula, the treasury function equals 22.86 percent. Sheffrin testified this meant that by moving six employees to another state, Toys could move 22.86 percent of its apportionable income to another state.

For 1993, retail sales generated 844 times more gross income per dollar of sales than the treasury function. Retail sales generated 267 times more net income before taxes per dollar of sales than the treasury function. Toys's stores in California constituted about 11.11 percent of total stores, a percentage close to the sales factor percentage under the FTB's analysis. If the return of principal is included in gross receipts, the treasury function would constitute 57 percent of total receipts, or 19 percent when divided by 3. Again, Sheffrin testified that under this analysis, by moving six employees to another state Toys could move 19 percent of its apportionable income to another state. When Sheffrin applied this analysis to 1994, he reached similar results.[3]

The trial court issued a ruling on submitted matter in favor of the FTB. The court began by considering the meaning of

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[3] The FTB provides a breakdown of the difference in the percentage income apportioned to California with and without the inclusion of the principal in the sales factor denominator. In 1991: without the principal, 12.04 percent; with the principal, 10.42 percent. In 1992: without the principal, 11.96 percent; with the principal, 7.5 percent. In 1993: without the principal, 10.78 percent; with the principal, 7.42 percent. In 1994: without the principal, 10.17 percent; with the principal, 7.19 percent.

“sale,” concluding “the term ‘sales’ must be a function, or derivative, of ‘gross receipts.’ Therefore, if no ‘sale’ has occurred, no gross receipts have been produced. If that is true, then Toys’ return of principal from its short-term paper cannot reasonably be deemed to be ‘gross receipts’ from ‘sales,’ since Toys was not selling anything when they invested their spare cash. Interest is not received from the ‘sale’ of money.”

The court reviewed the statutory scheme and found: “The sales factor is included in the apportionment formula in order to reflect the market for the taxpayer’s goods and services. [Citation.] No market is exploited by engaging short-term investments. The return of capital thereon has everything to do with the repayment of Toys’ lent funds, and virtually nothing to do with selling toys or children’s clothing. Clearly, inclusion of Toys’ return of principal does not serve to accomplish the basic function of the sales factor and thus cannot be included [in] its total sales.”

The court concluded the term “gross receipts” in section 25120, subdivision (e) could not be construed to include the return of working capital from Toys’s investment in short-term financial instruments because to do so “ignores economic reality, conflicts with the goal of UDITPA and could lead to unreasonable or absurd results.”[4] In addition, the court found the inclusion of the gross receipts as urged by Toys would not

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[4] UDITPA refers to the Uniform Division of Income for Tax Purposes Act codified in sections 25120 through 25139.

fairly represent the extent of the corporation's business in the state.

Following entry of judgment, Toys filed a timely notice of appeal.

DISCUSSION

I. STANDARD OF REVIEW

The record in this case rests on stipulated facts supplemented by oral testimony and documentary evidence. Many facts are undisputed. On those matters where the decisive facts are undisputed, we are confronted by questions of law and are not bound by the trial court's findings. Where facts are disputed and the trial court made factual findings, we review those findings under the substantial evidence standard. (*Tenneco West, Inc. v. Franchise Tax Bd.* (1991) 234 Cal.App.3d 1510, 1520-1521.) The proper interpretation and application of tax statutes presents a question of law that we examine de novo. (*Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.* (1991) 229 Cal.App.3d 784, 794.)

In a suit for a tax refund, the taxpayer bears the burden of affirmatively proving its right to a refund of the taxes by a preponderance of the evidence. (*Consolidated Accessories Corp. v. Franchise Tax Board* (1984) 161 Cal.App.3d 1036, 1039 (*Consolidated Accessories*).) The FTB's determinations are presumptively correct and the taxpayer bears the burden of proving them incorrect. (*Hall v. Franchise Tax Board* (1966) 244 Cal.App.2d 843, 848.)

II. APPORTIONMENT UNDER SECTION 25120, SUBDIVISION (e)

The Statutory Scheme

California employs the unitary method of corporate income taxation. Under this method, the state calculates its tax base by first defining the scope of the "unitary business" of which the taxpayer's activities in California form a part. The state then apportions the business income of that unitary business between California 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." (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 517 (*Hoechst*).)

California taxes a portion of the business income of a taxpayer engaged in a unitary business.[5] California uses an objective formula to apportion the income to California. The percentage of income apportioned to California is an average of three fractions: "The first fraction, known as the 'property factor,' has a numerator of the average value of California real and tangible personal property and a denominator of all real and tangible personal property. (§ 25129.) The second fraction is the 'payroll factor,' which is the total amount of compensation paid by the taxpayer in California divided by the total

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[5] Section 25120, subdivision (a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

compensation paid everywhere. (§ 25132.) The third fraction is the 'sales factor,' which is the total sales in California divided by the 'total sales of the taxpayer everywhere during the income year.' (§ 25134.) Each fraction has a numerator representing the amount attributable to California and a denominator representing the worldwide amount." (*Citicorp North America, Inc. v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1412.)[6]

Here, the parties dispute the amount to be included in the denominator of the sales factor. Section 25134 provides: "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year."[7] Section 25120, subdivision (e) defines sales as "all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code."[8]

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[6] The parties stipulated that the income earned from the transactions at issue was business income to be included in the numerator and apportioned under the formula.

[7] For purposes of the sales factor, "sales" is defined as "all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business." (Cal. Code Regs., tit. 18, § 25134, subd. (a)(1).)

[8] Sections 25123 through 25127 refer to the allocation of nonbusiness income and are irrelevant to this action.

Construing Statutes

In determining another provision of the UDITPA, the Supreme Court outlined the rules of statutory construction: "To construe this definition, we apply the well-established rules of statutory construction and seek to '"ascertain the intent of the Legislature so as to effectuate the purpose of the law."' [Citation.] As always, we begin with the words of a statute and give these words their ordinary meaning. [Citation.] If the statutory language is clear and unambiguous, then we need go no further. [Citation.] If, however, the language is susceptible to more than one reasonable interpretation, then we look to 'extrinsic aids, including the ostensible objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part.' [Citation.] Where the Legislature adopts a uniform act, the history surrounding the creation and adoption of that act is also relevant." (*Hoechst*, *supra*, 25 Cal.4th at p. 519.)

With these precepts in mind, we consider the parties' gloss on "gross receipts."

The Parties' Positions

The phrase "all gross receipts" forms the eye of this appellate hurricane. Toys argues the total amounts, both interest and principal, earned by its short-term financial interests constitute "gross receipts" to be included in the sales denominator. Toys contends the plain language of the statute mandates that “all gross receipts” include the interest and principal received on the sale of short-term investments.

According to Toys, the plain language of section 25120, subdivision (e) states that sales means all gross receipts. Dictionary definitions reveal “gross” to mean “‘consisting of an overall total exclusive of deductions’” and “receipts” to mean “‘[t]he amount or quantity received.’” This language, Toys argues, is clear and unambiguous: the total amounts received by Toys from the sale of its short-term financial instruments should be included in gross receipts for the sales apportionment factor.

The FTB disagrees, contending that only the interest earned on the short-term financial instruments constitutes gross receipts under the statute. According to the FTB: “In the case of transactions which are not sales of property, but which generate ‘receipts,’ the portion which is the ‘receipt’ should be the consideration received by the taxpayer. The amount of consideration received is determined by looking at the bargained-for exchange from the transactions. The transactions in question were short-term loans. The nature and purpose of the transactions was to earn income to support the business while retaining liquidity to meet business needs. [Citation.] Toys bought debt securities and held them to maturity. [Citation.] Toys also entered into repurchase agreements and held them to disposition. [Citation.] These transactions were in government securities. [Citation.] In essence, Toys loaned money and at the end of the loan term (albeit a short term), Toys received back the amount loaned plus interest."

"Gross Receipts"

A variety of courts have grappled with the definition of "gross receipts" in the apportionment formula in the UDITPA, reflecting both Toys's and the FTB's reading of the term. Some courts find only net gains from the sale of short-term investments are included in the sales factor. Other courts conclude "gross receipts" refers to both the interest and the principal received on short-term investments. A number of courts find "gross receipts" includes both the interest and principal but apply the equitable apportionment provision of section 25137 to preclude inclusion of the total revenues from short-term sales.

Historically, the treatment of receipts from temporary cash investments became a significant legal issue with the breakup of the American Telephone & Telegraph (AT&T) communications system. AT&T possessed an enormous portfolio of short-term investments, and inclusion of the principal in the allocation formula apportioned billions of dollars in income away from other taxing jurisdictions to New York State. Consequently, a number of New Jersey courts required AT&T and its subsidiaries to include only the net income from their temporary cash investments in the sales factor.

In *American Tel. & Tel. Co. v. Director, Div. of Taxation* (1984) 194 N.J.Super. 168 [476 A.2d 800] (*AT&T*), the court considered whether proceeds from AT&T's maturing securities and from its sales of securities should be included as gross receipts for purposes of New Jersey's receipts factor.[9] The court held: "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 court] 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

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[9] New Jersey defines its "receipts" factor as a fraction consisting of receipts from activities within the state over receipts from activities everywhere. (N.J.S.A. 54:10A-6(B).)

some ingenious path may be found to that end.' [Citation.]" (*Id.* at p. 802.)

In *Sherwin-Williams Co. v. Indiana Dept. of State Revenue* (Ind.Tax 1996) 673 N.E.2d 849 (*Sherwin-Williams*), the Indiana Tax Court reached a similar conclusion. The court reviewed the Department of State Revenue's determination that apportionment cannot include "rolled over" securities in the sales factor.[10] At issue was whether the denominator of Sherwin-Williams's sales factor should be increased to include the principal or capital element of investments. As in the present case, the answer turned on the definition of "gross receipts." (*Id.* at p. 851.) The court cited *AT&T* and concluded: "'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; see also *Walgreen Arizona Drug Co. v. Dept. of Rev.* (Ariz.Ct.App. 2004) 97 P.3d 896.)

All of these cases focus on the "absurd result" of including both principal and income in gross receipts, a focus at least one commentator finds problematic. State Taxation:

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[10] Indiana's sales factor and definition of "sales" are identical to California's definitions. "The term 'sales' means all gross receipts of the taxpayer not allocated . . . ." (Ind. Code § 6-3-1-24.)

Third Edition by Hellerstein and Hellerstein criticizes the decision in *AT&T* and, by implication, other cases that reach the same result. They note: "From a policy perspective, the result the New Jersey court reached is desirable, in view of the distortion in the apportionment that the inclusion of the proceeds of the very large sales of investments produced. The statutory provisions that the court construed, however, do not support the holding. The limitations of receipts from the sales in question to the profits is inconsistent with the inclusion of the entire gross proceeds of other transactions, such as receipts from sales of inventory, in the sales factor. Both types of transactions are governed by the same statutory measure -- 'receipts from sales of tangible personal property . . . [and] all other business receipts.' The court's view that the inclusion of the receipts from the investments would produce 'absurd results' suggests that this may have been an appropriate case for the invocation of the equitable apportionment provision of the statute, which is the basis for other court's opinions . . . ." (Hellerstein & Hellerstein, State Taxation (3d ed. 2006) Westlaw, WGL-STATE, 1999 WL 1398942, ¶ 9.18[4][c][i], p. 40, fn. 883.)

Some courts have concluded the plain meaning of the sales factor statute requires that total gross receipts should include the total sale of short-term investments. (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* (SBE 1989) Westlaw, 1989 WL 95886; *Illinois Tool Works, Inc. v. Lindley* (1982) 70 Ohio St.2d 175 [436 N.E.2d 220].)

The treatment of the term “gross receipts” in cases finding the principal not included in the sales fraction of the equation is problematic. These cases link receipts to sales as a means of excluding the principal realized on short-term investments. However, we have found no definition of gross receipts that implies any necessary connection between a sale and a receipt. One tax encyclopedia provides the following definition: “‘Gross receipts’ ordinarily means total receipts before anything is deducted. . . . Receipts ‘from the business’ include receipts from incidental business carried on by the corporation in addition to its principal business.” (Fletcher, Fletcher Cyclopedia of the Law of Private Corporations (as of Sept. 2005) Westlaw, FLTR-CYC § 6966, fns. omitted.)

The term “gross receipts” does not appear ambiguous; it means the total receipts taken in by a corporation. As one commentator notes, the sales factor in the apportionment formula “has a much broader scope than receipts from sales of tangible personal property. It typically covers receipts from services, rentals, royalties, sales of stock, and business operations generally, at least in the absence of some specific statutory or regulatory limitation on its scope.” (Hellerstein & Hellerstein, *supra*, at § 9.18.) Thus defined, “gross receipts” necessarily includes the full amount realized on the redemption or sale of short-term securities. Only the invocation of the equitable apportionment provision under section 25137, or legislative action, provides a satisfactory means of limiting gross receipts to interest.[11]

Equitable Apportionment, Section 25137

In the alternative, the FTB argues that inclusion of the return of principal from short-term investments in the sales factor denominator does not clearly represent Toys's activity in California. At trial the FTB presented evidence in support of this position. The trial court found: "[T]he evidence produced at trial is compelling for this Court to find that if the principal from Toys' transactions in short-term paper is included in the denominator of the sales factor, then the income apportioned to California under the statutory apportionment formula does not fairly represent the extent of plaintiffs' business activity in this state."

Section 25137 states, in part: "If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, . . . if reasonable: [¶] . . . [¶] . . . [t]he employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

At the outset, the parties disagree over who bears the burden of proving whether or not section 25137 applies. Toys

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[11] We deny the FTB's request for judicial notice filed August 2, 2004. We also deny the FTB's second request for judicial notice, filed February 24, 2006.

places the burden squarely on the FTB to prove application of the standard apportionment formula does not fairly represent its business activity in California. The FTB, in return, claims Toys bears the burden of proving the FTB's use of an apportionment formula other than that provided for by the state is wrong.

As the FTB concedes, no California court has addressed the question of who has the burden of proof under section 25137. However, prior to the enactment of section 25137, former section 25101 governed apportionment and stated, in part: "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, value and situs of tangible property . . . or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State." (Former Rev. & Tax. Code, § 25101, added by Stats. 1955, ch. 938, § 20, p. 1649 and amended by Stats. 1966, ch. 2, § 6, p. 177.)

Under former section 25101, where the taxpayer challenged the apportionment as arbitrary and unreasonable, "the burden is on the taxpayer to establish such facts by clear and convincing evidence." (*RKO Teleradio Pictures, Inc. v. Franchise Tax Board* (1966) 246 Cal.App.2d 812, 819.) The California Supreme Court, also considering former section 25101, stated the FTB possesses the discretion to select the factors to be used to apportion income, and where “the taxpayer contends that the formula is arbitrary and reaches an unreasonable result, the burden is on the taxpayer to establish such facts by clear and convincing evidence.” (*McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506, 512.)

In general, in a suit for a refund, the taxpayer bears the burden of proof and must affirmatively establish the right to a refund by a preponderance of the evidence. (*Consolidated Accessories*, *supra*, 161 Cal.App.3d at p. 1039.) The FTB argues this general proposition supports its argument that Toys bears the burden of proof under section 25137.

We agree. Here, as in most tax cases, the taxpayer is in possession of the facts. While the FTB can audit the taxpayer, the taxpayer remains the sole conduit of information.

Toys launches two broadsides against any invocation of section 25137 to exclude the principal on short-term financial investments. First, Toys contends the FTB’s section 25137 argument relies solely on impermissible “separate accounting” within Toys’s worldwide unitary business. Therefore, Toys argues, the FTB cannot establish that the apportionment formula does not fairly represent the extent of Toys’s California business activity.

Section 25137 allows the FTB to utilize methodologies other than the standard apportionment formula, “[i]f the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer’s business activity in this state.” This language suggests the court must contrast the result of applying the standard apportionment formula with the actual business done in the state. Once the court determines the standard apportionment formula does not adequately reflect the business done in California, the equitable provisions of section 25137 kick in to insure the tax properly reflects the company’s business in the state.

In order to determine whether the apportionment formula provides a reliable indicator of a company’s business, the court must necessarily consider the challenged quantitative arguments. In this case, the FTB presented extensive testimony by its expert, Steven Sheffrin, regarding Toys’s California revenues, both with and without inclusion of the principal in the sales component of the apportionment formula.

Toys claims Sheffrin’s testimony cannot be considered because it utilizes impermissible “separate accounting” within a single unitary business. As Toys explains, the basic concept of a unitary business recognizes that a unitary business is to be treated as a single unit, and income cannot be arbitrarily segregated along geographic or corporate lines within the unitary business. Toys cites several cases in which courts rejected challenges to the apportionment formula based on separate accounting.

However, as the FTB points out, Sheffrin testified repeatedly that he was not utilizing “separate accounting” in formulating his testimony. During redirect, the FTB’s attorney asked, “Is your opinion that you have given today based on . . . the concept of separate accounting?” Sheffrin answered, “Well, . . . I don’t believe any of the calculations that I presented today were based on separate accounting. As we know, that term is a tax term. What I did do, was to segregate the income and measure the income in the treasury function in order to make the calculations. [¶] . . . I didn’t use separate accounting as used in the tax sense in any other way.”

Sheffrin testified that, in his opinion, the inclusion of the return of principal in the sales factor gross receipts would result in the apportionment formula’s not fairly reflecting Toys’s California income. Sheffrin considered Toys’s revenues and found that when the return of principal was included, the retail sales operations generated 225 times more net profit per dollar of sales. As the FTB notes, Toys offered no evidence at trial to challenge or contradict Sheffrin’s calculations.

Toys argues Sheffrin is “attempting to do in this case <u>precisely</u> what has been continually rejected by the courts -- i.e., take a ‘piece’ of a taxpayer’s unitary business, and then argue that piece -- based on an analysis of that piece’s <u>separate</u> income/profits/receipts, etc. -- requires the standard apportionment formula for the unitary business to be modified to account for the separate data provided for that piece of the unitary business.”

What Toys fails to explain is how any court can determine whether or not the apportionment formula accurately reflects a company’s business in California without considering the various factors that go into the three components of the formula. Under Toys's analysis, both taxpayers and the FTB are forbidden from arguing any component is skewing the apportionment formula. Concomitantly, courts are forbidden from considering the impact of any single component. Toys's analysis results in stasis -- no one can challenge any portion of a unitary business in order to ascertain whether the apportionment formula reflects true activity within a state.

We do not find such an argument compelling. The cases cited by Toys, which it argues compel this prohibition, concern taxpayers who argued that geographic components of the apportionment formula skewed the results.

In *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159 [77 L.Ed.2d 545] (*Container Corp.*), the taxpayer argued its foreign subsidiaries were much more profitable than its domestic parent corporation. California's standard apportionment formula ignored differences in profitability by relying on indirect measures of income such as payroll, property, and sales. The taxpayer argued the formula distorted the true allocation of income and requested a special apportionment formula. (*Id.* at p. 181.) The Supreme Court rejected the request, since "the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." (*Ibid.*) The court in *Container Corp.* found the taxpayer's alternative formula no more reliable than the California apportionment formula. (*Id.* at pp. 184-185.)

In *John Deere Plow Co. v. Franchise Tax Bd.* (1951) 38 Cal.2d 214 (*John Deere*), the California Supreme Court rejected a challenge to California's apportionment formula based on differences in wage rates and productivity among multistate operations of a unitary business. The taxpayer presented evidence of wide differences in profitability between its California branch and branches in other states. (*Id.* at pp. 217-223.) The Supreme Court found the activities in the integrated overall business were interrelated, and the business conducted in California was not truly separate and distinct so as to allow a segregation of income under the separate accounting method. (*Id.* at p. 223.)

Toys reads these cases as setting forth a complete bar to any introduction of evidence concerning a separate, discrete aspect of a business in challenging the accuracy of the apportionment formula. However, while the courts in *Container Corp.* and *John Deere* reaffirm the basis and accuracy of the California apportionment formula and reject an alternative separate accounting approach, they do not forbid a party challenging the accuracy of the apportionment formula from identifying aspects of the equation that the challenger believes distort the result. Under Toys's analysis, no one could ever challenge the apportionment formula because to do so requires proving the formula fails to accurately reflect the sales, payroll, or property in the state. To show a discrepancy, the challenger must be able to segregate some aspect of the formula, something Toys believes is forbidden by *Container Corp.* and *John Deere*.

Therefore, we do not find the evidence set forth by Sheffrin impermissible. Sheffrin testified that the inclusion of the return of principal in the sales factor gross receipts would cause the apportionment formula to distort Toys's income in California. Sheffrin calculated the impact including the principal would have on the sales factor in each year. With the inclusion of the principal in the sales factor, the sales operation generated 225 times more profit per dollar of sales than the treasury function.

In addition, Sheffrin found, with principal included in the sales factor, Toys could move 11 percent to 28 percent of its apportionable income from one state to another merely by moving its treasury department and its six employees to another state. These factors led Sheffrin to conclude that inclusion of principal in the sales factor distorted the normal apportionment formula, causing it to fail to accurately reflect Toys's business activity in California.

Toys also argues section 25137 relief is unavailable because FTB regulation 25137 limits such relief to "unique and nonrecurring" circumstances, and Toys's treasury activity is routine and commonplace. Regulation 25137 states, in part: "Section 25137 permits a departure from the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act only in limited and specific cases. [¶] Section 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions . . . ." (Cal. Code Regs., tit. 18, § 25137, subd. (a).)

Toys reads the regulation as prohibiting any challenges to the allocation formula, unless made in conjunction with a unique and nonrecurring situation. However, we cannot read either section 25137 or the regulation so narrowly. Section 25137 allows deviation from the allocation formula when the formula fails to "fairly represent the extent of the taxpayer's business activity." The regulation limits section 25137 to limited and specific cases, which will *ordinarily* be unique and nonrecurring. The regulation does not limit section 25137 to only unique and nonrecurring situations.

The FTB bolsters its request to exclude the return of principal from the sales factor in order to ensure a fair representation of income by citing other cases in which courts have invoked section 25137. In *Appeals of Pacific Telephone & Telegraph Co.* (SBE 1978) Westlaw, 1978 WL 3941 (*Pacific Telephone*), a group of communications companies sought to include the gross receipts from its investment activities. The State Board of Equalization (SBE) held that a company's treasury function receipts could be excluded from the sales factor in the apportionment formula. According to the SBE, the inclusion of receipts from investment activities distorted the apportionment formula in favor of the state where the treasury function occurred.

The SBE reasoned: "[W]e are unable to accept, even for a moment, the notion that more than 11 percent of The Bell System'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 respondent is authorized, under section 25137, to require a deviation from the normal rules." (*Pacific Telephone*, *supra*, 1978 WL 3941 at p. 10.)

The FTB also notes the decision in *Sherwin-Williams Co. v. Johnson* (Tenn.Ct.App. 1998) 989 S.W.2d 710 (*Sherwin-Williams*), in which the appellate court held that the inclusion of receipts from securities transactions in the taxpayer's apportionment factors failed to accurately reflect the taxpayer's activities. The court in *Sherwin-Williams* reasoned: "In essence, the Commissioner found, as this court does, a very high probability that the same investment basis may be used in these admittedly efficient short-term purchases and sales to barely increase the company's overall net worth, while profoundly increasing the out-of-state portion of their 'gross receipts' for UDITPA purposes. In such a situation, the above transactions do not fairly represent the taxpayer's income connection to Ohio. The resulting transactions do not amount to $35,046,069.45 of taxable income in that state. Consider the logical result, if these transactions had Tennessee [or, in this case, California] as their situs. If the Commissioner were to apply the statutory scheme, then the taxpayer would be on the steps of the courthouse claiming an abuse of discretion." (*Id.* at p. 716.)

Section 25137 allows the employment of an alternative method of allocation if the allocation and apportionment provisions of section 25120 do not fairly represent the taxpayer's business activity in California. The evidence presented by the FTB persuades us that inclusion of the return of principal from short-term investments in the sales factor distorts the apportionment formula, preventing the formula under section 25120 from accurately reflecting Toys's business activity in California. Therefore, application of section 25137 is appropriate to mandate inclusion of only the interest earned by short-term investments in the sales factor. Accordingly, we affirm the trial court's judgment in favor of the FTB, finding section 25137 allows only inclusion of interest in the sales factor.

DISPOSITION

The judgment is affirmed. The FTB shall recover costs on appeal.

RAYE, J.

We concur:

BLEASE, Acting P.J.

MORRISON, J.