

TAX AVOIDANCE IN THE SALES FACTOR: COMPARISON BETWEEN THE CCCTB DIRECTIVE AND USA'S FORMULARY APPORTIONMENT TAXATION

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ABSTRACT

Formulary apportionment is a method to allocate taxing rights of states. It is different from the OECD's international taxation rules which are based on bilateral tax treaties and national transfer pricing rules. Formulary apportionment adopts a pre-decided formula to allocate the taxing rights on cross-border taxable activities. In a pre-decided formula, it is common to have various factors, such as sales, labour, asset of the taxpayers.

Since early 20th century, USA has a long history of formulary apportionment in the field of state taxation. Many states of USA adopt their own formulas to allocate their taxing rights upon some cross-state business activities. Based on the experiences and practice in USA, European Union has also an ambitious project: Common Consolidated Corporate Tax Base (CCCTB) Directive Proposal. This Directive aims to harmonize corporate tax base for all EU Member States and provide a uniform sharing formula, to allocate taxing rights of corporate tax to replace the traditional bilateral tax treaties and over complicated transfer pricing rules.

This paper analyses the possibility of inflating the sales factor, both in USA and in the CCCTB Directive Proposal due to including items such as marketable securities and hedging transactions. The sales factor is the ratio between the sales of a specific group member company (the numerator) to the whole corporate group's sales (the denominator). One obvious possibility is to inflate the ratio by including items in the denominator, such as marketable securities, hedging transactions. In USA, these items are no longer defined as sales in the formula, and thus are excluded from the formula. However, the CCCTB Directive has not fully eliminated this problem of inflating the sales factor, and thus leaves a loophole.

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INTRODUCTION

Common Consolidated Corporate Tax Base Directive proposal (CCCTB Directive)² is an ambitious attempt by the European Union. It intends to harmonize the corporate tax base on a group taxation basis within European Union and it will provide a 3 factor formula to allocate the taxing rights of Member States instead of the Bilateral Tax Treaties between EU Member States. The CCCTB formula consists of following : the asset factor, the labour factor and the sales factor.

Therefore, under the CCCTB Directive, to allocate a taxable share of one company from a corporate group, the calculation³ is as follows:

$$\frac{1}{3} \frac{\text{the sales of the group member}}{\text{the sales of the whole group}} + \frac{1}{3} \frac{\text{the asset of the group member}}{\text{the asset of the whole group}} + \frac{1}{3} \frac{\text{the labor of the group member}}{\text{the labor of the whole group}}$$

The European Commission decided to have a three-factor formula for two reasons: first, to strike a balance between different Member States as some EU Member States are “market states” and some are “production states”; second, the Commission argues that a three-factor formula is not as easily manipulated as it is difficult to manipulate three weighting factors at the same time.

This paper will focus on the aspect of the sales factor. The sales factor of one group member or jurisdiction is calculated using the formula of sales attributed to the group member/a jurisdiction (numerator) divided by the overall sales of the whole group (denominator). It is expected to represent the market demand side of the taxpayer’s activities. In this paper, my research question is based on as to how the sales factor in the sharing formula can be inflated and manipulated. The author will discuss the tax avoidance concerns regarding calculation method of cash management activities and risk management activities, i.e. hedging activities, in the sales factor by referencing the USA’s Uniform Division of Income for Tax Purposes Act (UDITPA)⁴ and Multistate Tax Compact,⁵ as well as California legislation⁶ and

² The development of the CCCTB Directive and the working documents of the European Commission are archived at its specific website at <http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm>.

³ Article 28 of 2016 CCCTB Directive Proposal. The full text of the Commission 2011 CCCTB Directive Proposal is published at <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf>.

⁴ The text is published at <<http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf>>.

especially two important California cases, *Microsoft*⁷ and *General Mills I*⁸ and *II*.⁹ These two types of transactions take the form of “sales contract”, but they have different functions than the classical sale-purchase relationship. Therefore, including them in the sales factor might cause inflation or distortion problems for the sales factor of the group. I shall discuss them in detail and elucidate on the sales factor inflation problem, which has been recognized in the USA, can occur under the CCCTB Directive. Therefore it is worthwhile to compare and analyze these cases. After comparing the CCCTB Directive and US laws, I will propose solutions to amend the loopholes in the CCCTB Directive Proposal.

1. THE DEFINITION OF SALES UNDER CCCTB

1.1. “Proceeds of All Sales of Goods and Supplies of Services”

Article 37 and Article 38 of the 2016 CCCTB Directive Proposal¹⁰ provide the sales factor rules. Article 37 provides the composition of the sales factor. It provides:

“Article 37: Composition of the sales factor

1. The sales factor shall consist of the total sales of a group member (including a permanent establishment which is deemed to exist by virtue of the second subparagraph of Article 70(2) as its numerator and the total sales of the group as its denominator.

2. Sales shall mean the proceeds of all sales of goods and supplies of services after discounts and returns, excluding value added tax, other taxes and duties. Exempt revenues, interest, dividends, royalties and proceeds from the disposal of fixed assets shall not be included in the sales factor, unless they are revenues earned in the ordinary course of trade or business. Intra-group sales of goods and supplies of services shall not be included.

3. Sales shall be valued according to Article 20 of Directive 2016/xx/EU.¹¹”

Article 38 provides the attribution rule of the sales factor,

“Article 38 Sales by destination

⁵ The text is published at the Multistate Tax Commission at <<http://www.mtc.gov>>.

⁶ California Revenue and Tax Codes, (hereinafter referred to as R&TC).(incomplete)

⁷ *Microsoft Corp v. Franchise Tax Board* No. S133343, August 17, 2006. As for similar cases regarding calculating the sales from securities before the *Microsoft* case, see Ossie Ravid and William Hays Weissman, Cash Management Activities And The Sales Factor: When Is Gross Really Gross And A Receipt Really A Receipt?, 10 State & Local Tax Law. 93, 2005.

⁸ *General Mills, Inc. v. Franchise Tax Bd.* No. A120492.

⁹ *General Mills, Inc. v. Franchise Tax Bd.* No. A131477.

¹⁰ They are comparable to Article 95 and Article 96 of the 2011 CCCTB Directive Proposal.

¹¹ i.e. Article 20 of 2016 CCTB Directive Proposal.

- 1. Sales of goods shall be included in the sales factor of the group member located in the Member State where dispatch or transport of the goods to the person acquiring them ends. If this place is not identifiable, the sales of goods shall be attributed to the group member located in the Member State of the last identifiable location of the goods.*
- 2. Supplies of services shall be included in the sales factor of the group member located in the Member State where the services are physically carried out or actually supplied.*
- 3. Where exempt revenues, interest, dividends and royalties and the proceeds from the disposal of assets are included in the sales factor, they shall be attributed to the beneficiary.*
- 4. If there is no group member in the Member State where goods are delivered or services are carried out, or if goods are delivered or services are carried out in a third country, the sales shall be included in the sales factor of all group members in proportion to their labor and asset factors.*
- 5. If there is more than one group member in the Member State where goods are delivered or services are carried out, the sales shall be included in the sales factor of all group members located in that Member State in proportion to their labor and asset factors.”*

The CCCTB Directive Article 37 and Article 38 regulates the composition of the sales factor and the calculation method. According to Article 37, the group member's sales factor is a fraction, i.e. the ratio between the specific group member's amount of sales(numerator) and the group's total amount of sales (denominator).

For example, if a CCCTB group consists of A, B, and C, and A has 100 Euro in revenues from sales of goods, B has 200 Euro in revenues from sales of goods sales, and C has 200 Euro in a taxable year, then the group's total amount of sales is 500 Euro, which acts as the denominator in the calculation.

The sales factor of A will be $100 / (100+200+200) = 0.2$

The sales factor of B will be $200 / (100+200+200) = 0.4$

The sales factor of C will be $100 / (100+200+200) = 0.4$

According to Article 37(2), “sales” mean “proceeds of all sales of goods and supplies of services after discounts and returns, excluding value added tax, other taxes and duties”. In

other words, “sales” means remuneration from the taxpayer’s sales of goods and supplies of service, deducting discounts, returns, and any other tax burden from the government.

The meaning of “proceeds” is not clearly defined in the CCCTB Directive Proposal itself. Whether “proceeds” should be defined as gross receipts or net income, it needs further discussion. In the plain language, the word “proceeds” means “the amount of money received from a particular event or activity or when something is sold” and thus it refers to the gross receipts, but not the net amount. In other authentic versions of this proposal, proceeds also refer to the “gross” receipts.¹²

1.2. Several Items Are In Principle Excluded From The Sales Factor

According to Article 37(2), in principle (1) exempt revenues, (2) interest, dividends, royalties and (3) proceeds from the disposal of fixed assets shall not be included in the sales factor. The exception to this principle applies only when these revenues are earned in the ordinary course of trade or business. In this circumstance, these three items will be included again.

1.2.1. Exempted Revenues Are Excluded From The Sales Factor

Exempt revenues, which are provided by Article 8 of 2016 CCTB Directive, in fact do not constitute part of the consolidated tax base because they are exempted. Since exempted revenues do not constitute the consolidated tax base, it is also illogical to include these exempted revenues in the sales factor to apportion the consolidated tax base.

1.2.2. Interest, Dividends, Royalties Are Excluded From The Sales Factor

Moreover, “passive” incomes, such as interest, dividends,¹³ and royalties are also excluded from the sales factor. According to the Commission¹⁴, the underlying reason of such exclusion is to prevent artificial attribution of income, since passive incomes are mobile in

¹² Under EU law, the official texts of 23 official languages are all authentic. For example, the Dutch version of CCCTB Directive Proposal uses “inkomsten”, which means gross receipts.

¹³ According to the Working Document No. 60, paragraph 50, only dividends subject to the participation exemption scheme are excluded from the sales factor. However, Article 11 of the CCCTB Directive Proposal fails to design proper conditions of participation exemption, and results in that “all” received dividends are entitled to a participation exemption. This obvious loophole is discussed and amended in the Council’s compromise proposal in 2012, see Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB) - Presidency comments on the compromise proposal, 2011/0058 (CNS). The Council Presidency suggests Article 11 (of 2011 CCCTB Directive) should be amended as “received profit distributions provided a minimum holding of 10%. This shall not apply to profit distributions from shares held for trading in accordance with paragraph 4 of Article 23 and profit distributions received by life insurance undertakings in accordance with Article 30 (c) (of 2011 CCCTB Directive)”. The Council further comments and explains that the participation exemption in the CCCTB Directive should be the same as the Parent Subsidiary Directive. Therefore a minimum holding of 10% by the parent company is the condition to enjoy the participation exemption of the distributed dividends.

¹⁴ Paragraph 51 of the CCCTB Working Document No. 60.

nature.¹⁵ Besides, it is also difficult and complex to decide the actual location of passive incomes.¹⁶ In order to avoid complex discussions concerning the location, revenues from interest, dividends, and royalties are not included in the sales factor.

1.2.3. Proceeds From The Disposal Of “Fixed Assets” Are Excluded From The Sales Factor

The disposal of “fixed assets” is, in principle, also excluded from the sales factor, according to Article 37. Fixed assets are defined as “means tangible assets acquired for value or created by the taxpayer and intangible assets acquired for value that are capable of being valued independently and that are used in the business for producing, maintaining or securing income for more than 12 months, except where their acquisition or construction cost is less than EUR 1,000. Fixed assets shall also include financial assets, with the exception of financial assets held for trading in accordance with Article 21.”¹⁷

The last sentence of the definition of fixed assets is especially vital because it may also influence the interpretation of Article 37. The last sentence provides that “Fixed Assets include financial assets, with the exception of financial assets held for trading in accordance with Article 21.” In other words, financial assets can be both fixed assets as well as non-fixed assets.

Here is an important question arising here: Shall the taxpayer’s disposal of short-term financial assets, such as short marketable securities, be included in the sales factor or not? In combination of Article 37 and Article 4(19), short marketable securities are not fixed assets, and thus disposal of short marketable securities, will be included in the sales factor. This result will give rise to the problem of “inflating” the sales factor which has been discussed in the cases in California, Microsoft and General Mills, as elaborated below.

2. Definition of “Gross Receipts” in the United States of America

2.1. The Harmonization Effort: The Uniform Division of Income for Tax Purposes Act (UDITPA) and Multistate Tax Compact (MTC)

In the United States of America, companies are subject to federal corporate income tax as well as the state corporate income tax, although some states do not levy corporate income tax

¹⁵ Paragraph 50 of the CCCTB Working Document No. 60.

¹⁶ Paragraph 51 of the CCCTB Working Document No. 60.

¹⁷ Article 4(19) of the 2016 CCTB Directive.

at all. However, due to the constitutional requirement,¹⁸ a state is only entitled to tax a corporation which has “nexus” with the state, and only to the extent of the taxpayer’s activities within the state. In other words, a single state may not levy corporate tax based on a company’s overall multi-state business activities, but the business activities which constitute taxable nexus within that state. If we take the pizza pie metaphor as the group’s tax base here, any state may not arbitrarily grab any big share of the pie, but only take the part having nexus to the jurisdiction.

It is still the state’s freedom to decide the factors and the weight of each factor in the state’s formula, provided the constitutional requirement is met. There are several states adopting the formula with the same factor or weight, whereas the divergence between these systems is still quite huge. Such divergence has caused problems of double/over taxation for multinationals in the United States.

To solve the problem of divergence, there have been a lot of legislative and political efforts. In 1957, the Uniform Division of Income for Tax Purposes Act (UDITPA) was passed by Congress.¹⁹ UDITPA distinguishes non-business income and business income and recommends an equally weighted three-part factor formula, which is similar to the CCCTB formula, to apportion business income. UDITPA also provides uniform definitions of the factors of the sharing formula.

In 1967, US congress passed the Multistate Tax Compact. This is a further step toward harmonization. It should be noticed that Multistate Tax Compact Article IV “division of income” incorporates the UDIPTA word-for-word. In this regard, Multistate Tax Compact is a further development of UDIPTA. Both UDIPTA and Multistate Tax Compact have to be enacted by states. Nowadays, quite a few states adopt UDITPA into their statutes, and some adopt UDITPA by enacting Multistate Tax Compact Article IV, and some states adopt both.²⁰ Besides, the Multistate Tax Commission, an intergovernmental state tax agency based on the Multistate Tax Compact, issues soft laws for these states who enact Multistate Tax Compact. With regard to the sharing formula, the Multistate Tax Commission has recommended special

¹⁸ See Stefan Mayer , *Formulary Apportionment for the Internal Market*, at 3.2.1.3. Constitutional limitations on state taxation and apportionment. Mayer introduces briefly the constitution limitation on state taxation: so-called the Due Process Clause and the Commerce Clause.

¹⁹ The legislative history of UDITPA, see Hellerstein/McLure, “Lost in Translation”, *Bulletin for International Fiscal Documentation* 2004

²⁰ Joe Huddleston, and Shirley Sicilian, *The Project to revise UDITPA at 1.02*, <http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/The%20Project%20to%20Revise%20UDITPA.pdf>.

regulations. Herein, while discussing on the sales factor of a sharing formula, all the regulations and recommendations shall be considered.

2.2. Definition of “Gross Receipts” in Multistate Tax Commission’s Regulation IV

According to UDITPA Section 15, the sales factor is defined as “a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.”²¹

Based on Multistate Tax Compact Article IV, the Multistate Tax Commission’s model regulation, Multistate Tax Commission Allocation and Apportionment Regulations IV (MTC Regulations IV)²² further provides more guidance about the sales factor. According to MTC Regulations IV.15 (a), “sales” are defined as all “gross receipts” of the taxpayer’s business income. Gross receipts means:

“The gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produces business income, in which the income or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code.”

Under MTC Regulations IV.15.(a), “gross receipts” means the amounts realized via various transactions, including “sale or exchange of property”, “the performance of services”, or “the use of property or capital”. In other words, “gross receipts” includes gross amounts of remuneration from all kinds of the taxpayer’s business activities.

In 2001, MTC Reg. IV is amended and a new definition of “gross receipts” is added. The amendment is done in MTC Regulations IV.2.(a).(5). Ten items are excluded from the sales

²¹ UDITPA Section 16 further regulates the sale of tangible property and UDITPA Section 17 deals with intangible property. In other words, UDITPA Section 15 provides the definition, and Section 16 and 17 further regulate the specific scope of “sales”. However, these provisions are still too general and need further interpretation.

²² Multistate Tax Commission Allocation and Apportionment Regulations <http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/AllocationandApportionmentReg.pdf>.

factor, even if they are earned as business income. These amendments are widely discussed in the hearing report of the Multistate Tax Commission.²³ These ten items include:

- (1) repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument;
- (2) the principal amount received under a repurchase agreement or other transaction properly characterized as a loan;
- (3) proceeds from issuance of the taxpayer's own stock or from sale of treasury stock;
- (4) damages and other amounts received as the result of litigation;
- (5) property acquired by an agent on behalf of another;
- (6) tax refunds and other tax benefit recoveries;
- (7) pension reversions;
- (8) contributions to capital (except for sales of securities by securities dealers);
- (9) income from forgiveness of indebtedness; or
- (10) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code.

The rationale to exclude some items from the sales factor is that these items do not actually exchange value in a commercial market,²⁴ although there is "amount of receipts" regarding these items recorded in the taxpayer's accounts, for example, repayment of the principal of a loan, damages, and other amounts received as the result of litigation, tax refunds, etc. The list of "exchanging no value items" is not exhaustive but only illustrative.

In relation to the taxpayer's capital, there are two items excluded from "gross receipts": proceeds from issuance of the taxpayer's own stock or from sale of treasury stock and contributions to capital (except for sales of securities by securities dealers). Issuing stock or selling treasury stock are the means of financing for the company, but do not exchange value in a commercial market. The same rationale is applicable to the taxpayer's contributions to capital, except for sales of securities dealers.

There are two items²⁵ related to the paid-back part of the investment, i.e. the so-called "return of the principal". Such return can be in the form of repayment, maturity, or redemption from a

²³ Final Report of the Hearing Officers regarding the Proposed Definition of "Gross Receipts" available at <<http://www.mtc.gov>> at the section Uniformity Program/ Adopted Uniformity Recommendations <<http://www.mtc.gov/Uniformity/Adopted-Uniformity-Recommendations>>

²⁴ Ibid, the Second Report of Hearing Officers p. 9.

²⁵ MTC Regulations IV.2.(a).(5), 1.2.

loan, bond, or mutual fund, or certificate of deposit or similar marketable instruments, or from a repurchase agreement (i.e. the so-called “Repo”)²⁶ or other transactions properly characterized as a loan. In view of the taxpayer’s product market, the “return of principal” indicated above does not exchange value in the commercial market. In theory, the rationale of exchange-no-value also applies to the situation of “return of principal”. In case of a simple loan contract, return of principal does not exchange any value. It is widely accepted that return of principal should be excluded from gross receipts.

However, whether the sales factor should exclude these marketable financial instruments from gross receipts is sometimes confusing. First of all, there are separate markets for trading these marketable instruments (bond, loan, mutual funds, certificate of deposit, etc.). The repurchase agreement is a form of contract operating in the financial market. Secondly, it is arguable that these financial arrangements are the taxpayer’s investment or reinvestment so that they also exchange value in the commercial market, i.e. use the funds to generate income.²⁷ If the amount of gross receipt of a general sale contract includes both its costs of material and its net profits, why should the special repurchase agreement be treated differently? The Hearing Officers did not respond clearly in this regard, but simply repeated the analogy from a loan that return of principal does not exchange value, but the interest is the result of value exchange.²⁸ For the Hearing Officers, they simply exclude these marketable instruments in an analogy to a “loan”, and do not give a comprehensive explanation.

In my opinion, the Hearing Officers have correctly made the analogy between these marketable instruments and the loans. More precisely, a repurchase agreement of marketable securities is different from a general sale contract. The gross receipt of a general sale of goods contract includes the cost of materials because the cost of materials is the result of the seller’s previous transaction, and it is the result of another value-exchange agreement. On the contrary, when we analyze a repurchase agreement of securities, i.e. the repo agreement, when the taxpayer “sells” its securities back to the financial markets, the part of principal is not the result of another independent transaction, but is resulted from the taxpayer’s own capital. Via the repo agreement, the taxpayer in fact conducts transactions by utilizing “the same capital” repeatedly in the financial market. In this regard, the principal of the securities

²⁶ Repo is an agreement that the securities dealer sells their securities or government bonds to the investors, and two parties agree to buy the securities back at a higher rate on a specific later date.

²⁷ Final Report of the Hearing Officers regarding Proposed Definition of “Gross Receipts”.

²⁸ Final Report of the Hearing Officers regarding Proposed Definition of “Gross Receipts”.

should not be in analogy to the cost of material in a general sales contract, and should be in analogy to a loan, as the MTC hearing officer correctly suggested.

To sum up, the definition and scope of “the sales factor” and “gross receipts” are addressed by MTC Regulation Article 2. The MTC regulation’s rationale to exclude some items from the sales factor is that these items do not exchange value. Since the formula sales factor are expected to represent the taxpayers’ economic activities, and inclusion of non-exchange-value items into the sales factor will influence the formula’s calculation inappropriately.

2.3. The Reform of the definition of “Gross Receipts” in 2014

In 2014, MTC further launched a reform project on the definition of “gross receipts” and amended the Multistate Tax Compact Article IV, Section 1(g)²⁹ to:

(g) “Receipts” means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer’s trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

The new Multistate Tax Compact Article IV, Section 1(g) clearly excludes receipts earned from “hedging transactions” and “the maturity, redemption, sale, exchange, loan or other disposition of cash or securities”. In other words, the cash management activities and risk management activities via marketable securities and hedging transactions are not included in the sales factor. Such exclusion is actually triggered by the two California cases whose disputes are in regard to “inflating the sales factor” by including these two types of “receipts”. The details are discussed in the following Section 4.

3. Disputes over the “Gross Receipts” Definition in California

Even after enacting UDITPA or Multistate Tax Compact, there are still disputes over the definition and scope of the sales factor, or gross receipts, in a state sharing formula. The disputes about gross receipts in California are very useful reference to the CCCTB Directive Proposal. Therefore I will introduce relevant legislation in California first. After that I will

²⁹ The project progress is published at <<http://www.mtc.gov>>. Since 31 July 2014, Multistate Tax Compact Article IV, Section 1(g) has been amended, and there will be corresponding amendments in the Regulation IV. The project is still ongoing, and the discussions are based on the status quo as of 2015.

discuss two important cases: Microsoft and General Mills, which later triggered law amendments in California.

3.1. Introduction to the California Sharing Formula

California enforces UDITPA and Multistate Tax Compact into its own state legislation: Revenue and Taxation Codes (R&TC). The California sharing formula³⁰ consists of three factors: sales, labour, and assets.

The weight of the sales factor has been changed by the legislators several times.³¹ From 1978 to 1992, California adopted the equally weighted three-factor formula; therefore the sales factor is weighted as 33.33%. From 1992 to 2010, California adopted the three-factor formula with the double weighted sales factor.

$$\frac{1 \text{ sales in California}}{2 \text{ worldwide sales}} + \frac{1 \text{ labor in California}}{4 \text{ worldwide labor}} + \frac{1 \text{ assets in California}}{4 \text{ worldwide assets}}$$

Since 1 January 2011, the taxpayers³² may elect irrevocably to adopt the single sales factor formula to calculate its taxable income in California.

R&TC Section 25120 provides the definition of sales as gross receipts. Before 1 January 2011, Section 25120 is identical to MTC Regulation IV.2.(a).(5) above. Sales are defined as gross receipts and there are ten items excluded from the gross receipts as indicated above. After 1 January 2011, there are two more items to be excluded from the sales factor. The amendment is the response to two cases, *Microsoft* and *General Mills*. I will discuss these two cases in Section 4.2 below and explain the amendment further in Section 4.3.

3.2. How to Calculate Cash Management and Treasury Activities in the Sales Factor?

The *Microsoft* Case

The definition of “gross receipts” is important in calculating the amount of denominator of the sales factor. When items are defined as sales, and included in the denominator, i.e. the amount of the taxpayer’s “total sales”, the denominator will increase. However, when the denominator increases, the taxpayer’s corresponding in-state numerator does not necessarily

³⁰ See R&TC Section 25128

³¹ See J. Bernthal, D. Gavril, K. Schumacher, S. Spencer and K. Sydor, Single Sales-Factor Corporate Income Tax Apportionment: Evaluating the Impact in Wisconsin, Appendix D: Catalogue of Apportionment Law Changes, 2012 at p. 41 <<http://www.lafollette.wisc.edu/publications/workshops/2012/DOR.pdf>>.

³² Except for the taxpayers who earn more than 50% of their business income from “the qualified activities”. See R&TC Section 25128(b) and (c). The qualified activities are provided at Section 25128(c), which include four specific industries: (1) An agricultural business activity. (2) An extractive business activity. (3) A savings and loan activity. (4) A banking or financial business activity.

increase simultaneously since such items might not be in-state sales, but sales conducted outside the state. The consequence of increasing the denominator is a reduction in the overall fraction of the sales factor. The fraction of the sales factor will be smaller and the state can consequently only tax at a smaller ratio. In other words, the sales factor is inflated. When the sales factor's denominator includes large amounts of marketable securities, the problem of inflating the ratio of the sales factor is serious.

The difficulty of calculating "cash management activities, such as the trade of marketable securities, in the sales factor has been dealt with in a series of administrative decisions in California since late 1970.³³ Prior to the *Microsoft* case before the California courts, these administrative decisions of the California tax authority Franchise Tax Board (Hereafter FTB), and its appeal body the California State Board of Equalization (hereafter BOE) focused on the discussions of the distortive effect of including cash management activities in the sales factor, rather than whether the definition of gross receipts should still include cash management activities, i.e. selling or redeeming the short-term marketable securities as such.

As Ravid and Wiessman's analysis,³⁴ the *Microsoft* case is especially significant in the development of case law on the sales factor because it is for the first time that the trial court concluded directly that the marketable securities should be defined as "gross receipts". In other words, the *Microsoft* case judgment first touches upon the definition of gross receipts, and then analyzes further whether there is distortion.

The dispute that arises in the *Microsoft* case in California is described as follows:³⁵ Microsoft is a company that mainly designs and sells the operation systems for computers. Its headcounter is in the State of Washington and its production activities take place in California. In 1991, Microsoft had a gain of \$10.7 million on its marketable securities, which yields gross proceeds of \$5.7 billion. These marketable securities are held and sold for the treasury function. In other words, when Microsoft needs cash, it sells some securities to maintain the cash flow. These securities' liquidity is almost the same as cash. Trading, i.e. selling/redeeming and purchasing, these marketable securities is similar to liquidating cash from a bank account and later saving it back. It is part of the cash management activities and

³³ The overview of development of calculating cash management activities in the sales factor, see the analysis of Ravid and Wiessman, *Cash Management Activities and the Sales Factor: When Gross Really Gross and A Receipt Really A Receipt?*, State and Local Tax Lawyer, 2006, at p.106.

³⁴ Ravid and Wiessman, *Cash Management Activities and the Sales Factor: When Gross Really Gross and A Receipt Really A Receipt?*, State and Local Tax Lawyer, 2006.

³⁵ *Microsoft Corp v. Franchise Tax Board* No. S133343, August 17, 2006.

serves as the Microsoft treasury function. The sale of these marketable securities will only produce very marginal profits, but Microsoft conducts this type of transaction very frequently.

The issue is whether Microsoft's sale of marketable securities as short-term investments to maintain its cash flow can be included in Microsoft's gross receipts, i.e. its total sales in the denominator of the sales factor. Microsoft would like to include the entire gross amount of its securities transactions into its sales factor in the formula in order to make the ratio smaller. The FTB nevertheless decided that Microsoft's gross receipts only include the amount of price differential between the redemption price and the purchase price, i.e. the net profits, not the full amount, from the redemption of marketable securities.

There are two main questions in discussion: The first is whether the entire amount of redemption of maturity securities be defined as "gross receipts". The second is whether including the entire amount of redemption of maturity securities will distort the fair representation of Microsoft's business activities in California.

First of all, although the statutory language in the UDITPA refers to sales as "gross receipts", for redemption of marketable securities, FTB argues that only "the amounts as consideration", i.e. the net difference, should be included as sales.

FTB argues that redemption of the securities is different from selling the securities to a third party. FTB concedes that only selling the securities to a third party is really a "sale", but "redemption" on maturity of securities is not.³⁶ The Court rejects³⁷ this argument and concludes that there is no actual difference for the taxpayer in these two situations. These two situations have identical economic substances to the taxpayer, and thus should be treated the same. The Court concludes that the full redemption price, like the full sale price, must be treated as gross receipts.

The second question is whether the inclusion of the full redemption price in the sales factor would distort the fair representation of Microsoft's business activities. The Court's quantitative approach³⁸ to deciding whether there is a distortion on the sales factor is quite insightful. First of all, the Court did not agree with the tax authorities that the problem of distortion simply lies in allowing inclusion of the marketable securities and thus the calculation should exclude them completely. Rather, according to the Court's analysis, the

³⁶ *Microsoft Corp v. Franchise Tax Board* No. S133343, [47 Cal.Rptr.3d 223].

³⁷ *Microsoft Corp v. Franchise Tax Board* No. S133343, [47 Cal.Rptr.3d 224].

³⁸ *Microsoft Corp v. Franchise Tax Board* No. S133343, [47 Cal.Rptr.3d 229-230].

real problem lies on the scale of inclusion.³⁹ The profits margin of redemption of marketable securities is much lower than Microsoft's primary business activities. Inclusion of the entire amount of redemption is so huge in the denominator of the sales factor that the ratio of the sales factor becomes quite small, compared to the hypothetical situation that only the sales from Microsoft's primary activities are included in the sales factor.

Besides, according to the Court,⁴⁰ entire inclusion of the full price of redemption of marketable securities will attribute a great portion of Microsoft's business activities to the state of Washington, because Microsoft's headquarter/treasury department is located in the state of Washington. Its marketable securities from its treasury department are traded in the state of Washington. Based on these quantitative analyses, the redemption of marketable securities should be adjusted in the sales factor.

Therefore, the Court concludes that including the whole amount of its marketable securities will indeed distort the sales factor of the sharing formula adopted in California. The denominator will be too huge and thus the ratio of apportioned tax base is inflated. The court takes a position partially favoring Microsoft: Although the redemption amount is still conceptually included in the gross receipts, the precise extent to which Microsoft is entitled, includes only the "net" income of its marketable securities transactions in its California sales factor.

In brief, the Court takes a position that, in principle, the entire amount of redemption of market securities is defined as gross receipts; however, in the Microsoft case, including the entire amount will distort the fair representation of Microsoft's business activities in California. The Court adjusted the calculation of the total sales of Microsoft: Only the net amount of redemption should be included as "sales". In this regard, FTB did not win the whole case. If FTB wants to adopt an alternative formula, they have to bear the burden of proof to demonstrate distortion, and the attempt to completely exclude marketable securities is not successful.

³⁹ *Microsoft Corp v. Franchise Tax Board* No. S133343, [47 Cal.Rptr.3d 229].

⁴⁰ *Microsoft Corp v. Franchise Tax Board* No. S133343, [47 Cal.Rptr.3d 230], the Court's footnote 19 especially has done the calculation on the profits margin of Microsoft's treasury department in Washington State.

3.3. How to Calculate Risk Management Activities in the Sales Factor? *General Mills I&II*

Cash management activities are not the only activities that can cause problems. There can be other type of transactions also can also be disputed. In the case of *General Mills I*,⁴¹ the disputed issue lies in the hedging activities, i.e. a series of “commodities futures sales”. General Mills, as a food producer, argues that the entire amount of selling future contracts should be included in its gross receipts in the sharing formula, whereas the California tax authority argues that General Mills’ hedging activities should be excluded entirely or, alternatively, only be included to the extent of “net profits” of the futures contracts. The disputed points are comparable to the *Microsoft* case: First, whether the disputed activities should be defined as gross receipts; second, to what extent the disputed activities should be the gross receipt; and third, whether inclusion of these activities will be distortive to the standard sharing formula in California.

3.3.1. The Risk Management by Hedging

Before discussing the hedging activities further, it is important to explain also what a futures contract is. A futures contract is an agreement to purchase or sell a commodity for delivery in the future at a price that is determined at initiation of the contract. The parties of the contract agree to fulfill the contract at that specific price. The futures contracts can be satisfied by commodity delivery or offset and they are settled daily.⁴² The purpose of a futures contract is to avoid risk of commodity price fluctuation.⁴³ Hedging refers to the process of offsetting two futures contracts in order to avoid commodity price fluctuation, and sometimes even making profits via the process.

It is also necessary to introduce some basic mechanics of trading futures sales. As the California Court indicates,⁴⁴ the mechanics of the futures market include the trading platforms (which can be physical locations or digital networks) and a clearinghouse. In the trading platforms, the traders, i.e. buyers and sellers or their brokers, can agree to buy or sell certain amounts of commodities at a certain price in a given month. The clearinghouse acts as the

⁴¹ *General Mills v. Franchise Tax Board* No. A120492, April 15 2009.

⁴² J.C. Hull, *Options, Futures, And Other Derivatives*, 8th edition, 2012, at p. 7.

⁴³ The purpose of hedging futures contracts is to avoid the price fluctuation risk according to the traditional economic theory, whereas there are also academic disputes claiming that this purpose is exaggerated. In the *General Mills* case, neither party disputes this issue, so in this paper I also discuss the case on the same premise. For more discussions, see Leland L. Johnson, *The Theory of Hedging and Speculation in Commodity Futures*, *The Review of Economic Studies*, Vol. 27, No. 3 (Jun 1960), p. 140.

⁴⁴ *General Mills v. Franchise Tax Board* No. A120492, April 15 2009, [172 Cal.App.4th 1540].

counterparty for the transactions and assumes the credit risk that traders will default on their contracts. In other words, the clearinghouse becomes the buyer for each seller and becomes the seller for each buyer.

Buyers and sellers must maintain their margin accounts with the clearinghouse, by depositing money or collateral, to ensure the clearinghouse can meet their financial obligations. The deposits usually are between 2% to 10% of the value of the futures contracts. As indicated above, these futures contracts will be satisfied by physical delivery or offset. At the end of each trading day, all “open positions”, i.e. futures purchases and sales which are not yet satisfied or closed by delivery or offset, settled, i.e. “marked to the market” at the end-of-day settlement price, and the net gains or losses are posed to the margin accounts. If the futures contract is offset at the end of each trading day, the only money exchanged is through the market-to-market process to the margin accounts in the clearinghouse; no other money exchange actually takes place and no commodities are delivered.

The process of hedging⁴⁵ is as follows: General Mills signs a buyer’s futures contract that stipulates the commodity’s price at a specific price on a specific future time. The counterparty of this buyer’s futures contract is the clearinghouse, as indicated above. Later, General Mills offsets its buying contract by signing another seller’s futures contract. After offsetting, sometimes there will be a margin “profits” recorded to its account at the trading forum, and sometimes a margin losses. By utilizing the recorded profits, General Mills can compensate the commodity price rising later. In other words, its risk of price rising has been mitigated and diminished.

3.3.2. The Disputed Issues in the General Mills Case: Definition and Distortion

The disputed points are: Firstly, whether such hedging transactions are defined as gross receipts and to what extent they should be included as gross receipts. Secondly, whether an alternative formula should be applied in this case. The taxpayer General Mills takes the position that the full amount of these futures contracts should be included in the gross receipts. The FTB argues that none of the received amounts of futures contracts should be included. Alternatively, even if the Court decides to include the futures contract into the gross receipts, an alternative formula should be applied in the current case. In either case, FTB argues that

⁴⁵ Basic principles of hedging strategies using futures, see J.C. Hull, *Futures, And Other Derivatives*, 8th edition 2012, at p. 47.

the hedging transactions should be completely excluded from the sales factor, both the numerator and the denominator.

The court gives affirmative answers to the first question. The hedging fulfills the definition of sales. Although FTB argues that General Mills', 97% futures sales contracts are satisfied by merely offsetting, and never physically delivered, so these futures sales contracts do not have consideration and "have no value", the court rejects⁴⁶ these arguments and affirms that futures sales contracts are in fact legally binding contracts to the full extent. The fact that these hedging contracts are offset with each other in the end does not influence their legally binding nature.

Furthermore, the Court affirms that General Mills' future sales indeed "reflect" its "income producing activity". According to the Court,⁴⁷ hedging its futures sales contracts is done on a daily basis and is so important to protect General Mills against the commodity price fluctuation. It's a common industry practice. Hedging futures sales is done "for the ultimate purpose of obtaining gains or profits" even though General Mills does not merely seek to make profits on its futures trade. The Court agrees that hedging is an "integral part of the company's business activities", just as important as the physical delivery of its raw materials for its products manufacturing. Therefore, the Court concludes that the full amount of futures sales should be included in the gross receipts while calculating the formula's sales factor.

As for the second question of whether the alternative formula should be applied, the court of appeal further remands⁴⁸ the case to the trial court, i.e. the lower court of first instance in California which can examine facts and evidence. Based on the trial court's additional evidence and re-examination, the Court rules⁴⁹ (hereafter *General Mills II*) that the inclusion of General Mill's futures sales will distort the result of apportionment, and thus an alternative formula should be applied. To decide whether there is a distortive effect, the Court of Appeal conducts both the qualitative⁵⁰ and quantitative analysis.⁵¹ Although, the General Mills' hedging activities are an integral part of its business activities, inclusion of all amounts of the futures contracts will make the standard formula not fairly represent General Mills' activities

⁴⁶ *General Mills v. Franchise Tax Board* No. A120492, April 15 2009, [172 Cal.App.4th 1545].

⁴⁷ *General Mills v. Franchise Tax Board* No. A120492, April 15 2009, [172 Cal.App.4th 1548].

⁴⁸ *General Mills v. Franchise Tax Board* No. A120492, April 15 2009, [172 Cal.App.4th 1548].

⁴⁹ *General Mills v. Franchise Tax Board* No. A131477. 208 Cal.App.4th 1290 (2012).

⁵⁰ *General Mills v. Franchise Tax Board* No. A131477. 208 Cal.App.4th 1290 (2012) [208 Cal.App.4th 1304-1307].

⁵¹ *General Mills v. Franchise Tax Board* No. A131477. 208 Cal.App.4th 1290 (2012) [208 Cal.App.4th 1307-1313].

in California. Therefore, the Court accepts the alternative method that only includes the net profits of the futures sales into gross receipts.

In brief, in the *General Mills* case, the court addressed the definition issue and the distortion issue respectively. The Court concludes⁵² that hedging activities should be included in the gross receipts when calculating the California standard formula's sales factor, but only to the extent of "net profits", not the entire value of futures contracts, because the inclusion of the entire amount of futures contracts will lead to a distortive result of apportionment. The court's quantitative analysis is especially inspiring and comprehensive.

Although this decision is quite comparable and similar to the *Microsoft* case's line of reasoning, the Court still emphasizes herein that the risk management activities, i.e. hedging transactions, are different from the cash management activities, i.e. marketable securities.⁵³ Both hedging transactions and trading short-term marketable securities are in the form of purchase-sale contracts, but they have different functions than the normal purchase-sales contracts. The treasury function paradigm developed in the *Microsoft* case should not apply per se in the risk management cases, such as *General Mills I & II*. Instead, the different reasoning is still necessary. Technically the Court's approach is quite similar: Only the net amounts received from the hedging transactions and marketable securities can be included in the sales factor.

3.4. California's Legislative Response from 2011 onwards

After the rulings in the *Microsoft* and *General Mills* cases, the dispute regarding the definition of gross receipts in the UDITPA 2 and MTC Regulations VI 15(a)(5) and California Revenue and Taxation Code (R&TC) Section 25120 becomes quite clear: By interpreting the provisions simply in the plain language and the original purpose, the UDITPA's exclusion list does not cover the amount received from the redemption of marketable securities nor the amount received from hedging contracts. Although it is possible for the tax authority to adjust the formula's sales factor on the case-by-case basis, there will be enormous disputes and the solutions to this loophole will not be consistent in different cases.

Therefore, R&TC Section 25120 is amended in 2009 and adds two items in the exclusion list for the sharing formula's sales factor. This amendment entered into force from 1 January

⁵² *General Mills v. Franchise Tax Board* No. A131477. 208 Cal.App.4th 1290 (2012) [208 Cal.App.4th 1316].

⁵³ *General Mills v. Franchise Tax Board* No. A131477. 208 Cal.App.4th 1290 (2012) [208 Cal.App.4th 1301].

2011 onwards. The amendment is the legislative response to the court rulings in the *Microsoft* and *General Mills I & II* cases.

To be more precise, the newly added R&TC Section 25120(K)⁵⁴ is in response to the *Microsoft* case. It provides that the redemption of short-term securities shall be excluded from the sales factor.

Section 25120(L)⁵⁵ is the legislative response to the *General Mills* case. It provides that the hedging transactions shall be excluded from the sales factor. The California legislators decide to exclude them completely as well. Although not expressly stipulated, the California legislators regard hedging transactions as just a special type of “insurance” for the taxpayers to avoid risk of commodities price fluctuation. It is clearly unreasonable for a taxpayer to include its received amount of compensation from the insurance company as “gross receipts” into the formula’s sales factor; with the same rationale, it is also unreasonable to include the entire received amount of hedging transactions into the sales factor. The received amount of hedging transactions is used to hedge, i.e. compensate, the adverse price fluctuation. By excluding risk management activities completely, the California legislators aim to prevent the sales factor from being inflated or manipulated.

4. Comparison between CCCTB and the California Law and Cases

4.1. The CCCTB Cannot Solve the Same Problems in the *Microsoft* and *General Mills* cases

Comparing the 2016 CCCTB Directive Proposal and the UDITPA as well as California R&TC, there is a sharp difference: In the CCCTB Directive Proposal, there is no clear definition for “sales”, whereas in the UDITPA and California, “sales” is at least defined as “gross receipts” and there are many soft law regulations issued from the Multistate Tax

Section 25120(K), R&TC) Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. For purposes of this subparagraph, "treasury function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function, for purposes of this subparagraph, with respect to income so produced.

⁵⁵ (L) Amounts received from hedging transactions involving intangible assets. A "hedging transaction" means a transaction related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

Commission. The missing definition for “sales” for the purpose of calculating is a serious loophole in the 2016 CCCTB Directive Proposal.

4.1.1. The Exclusion List of the 2016 CCCTB Directive is too short

As for the items excluded from the sales factor, both UDITPA and California provide a longer exclusions list than the CCCTB Directive Proposal.

Being different from UDITPA and California, the CCCTB Directive provides neither a definition nor a long exclusions list for calculating the sales factor. As for the UDITPA’s exclusion list of 10 items which do not exchange value, the CCCTB Directive Proposal Article 37 does not exclude any of them. In my opinion, this is a loophole in the CCCTB Directive. The underlying reason for the CCCTB Directive Article 37 only considers the easy and convenient method for the tax authorities to calculate “sales”, but ignores that the inclusion of the non-exchange-value items in the sales factor can directly distort the apportionment formula. Although CCCTB’s original aim of simplifying the calculation may work in the beginning and aims to provide a simple rule, lacking this list to exclude no-exchange-value items will cause distortions.

4.1.2. Excluding the Disposal of “Fixed Assets” Does Not Help The Problem of Inflating The Sales Factor By Including The Entire Amount of Redemption of Short-Term Marketable Securities

Furthermore, if cases such as the *Microsoft* or *General Mills* take place under the CCCTB system, the CCCTB Directive can very likely be interpreted to cover cash management—such as redemption of marketable securities and risk management activities like hedging futures contracts—in the sales factor. As for the redemption of marketable securities as occurs in the *Microsoft* case, the CCCTB Directive Proposal Article 37 does not exclude redemption of marketable securities from the sales factor per se. As long as these marketable securities are held for less than 12 months, they are classified as non-fixed assets, and sales of these short-term marketable securities will be inevitably included in the sales factor.

Although the disposal of short-term securities is still taxable and constitutes the tax base, it does not necessarily represent the taxpayer’s economic activities more than the disposal of the long-term securities; however, the disposal of short-term securities exchanges only very marginal economic value. Contrary to the disposal of long-term securities, which are excluded from the sales factor, the disposal of short-term marketable securities is included in the sales factor, quite illogically. In my opinion, such distinction between the disposal of

long-term securities and short-term securities is unreasonable, because long-term and short-term marketable securities might represent the taxpayer's economic activities to a similar degree, but they are treated differently under the CCCTB Directive. Only excluding the disposal of fixed assets but not excluding disposal of short-term financial assets is thus illogical and unreasonable, not to mention that it further results in the problem of inflating the sales factor. In brief, the problem of inflating the sales factor in the *Microsoft* case can also happen under the CCCTB Directive Proposal.

Moreover, the sales by 'destination principle', which is emphasized by the European Commission, will also be seriously hampered if inclusion of the entire amount of the redemption of marketable securities is allowed. The taxpayer can easily manipulate the sales factor by choosing a Member State where these securities are traded. Allowing the entire amount of the redemption of marketable securities to be included in the sales factor contradicts the destination principle of calculating the sales factor.

4.2. The General Clause of "in the Course of Ordinary Trade and Business" Are Too Broad

The CCCTB Directive Proposal, Article 37(2) provides a general exception clause to include the excluded passive income, to the sales factor, if these passive incomes are earned "in the ordinary course of the trade of business". The Commission states that passive income in principle does not involve the core business, such as sales of goods or supplies of service.⁵⁶ Such exclusion of passive income is based on the same rationale as the exclusion of intangibles or financial assets from the asset factor.⁵⁷ Intangibles and passive income are too difficult to value and trace their locations; therefore, the CCCTB's sharing formula's sales factor and assets factor both in principle exclude passive income and financial assets. According to the CCCTB Working Document 60,⁵⁸ only when the taxpayer's "core business" earns such passive income can their passive income be included in the formula's sales factor. Although the Commission does not give examples, we can easily numerate some applicable industries, such as securities dealers who trade securities as their main core business, or intellectual properties management companies who own a lot of patents and earn their regular revenue via royalties from licensing activities.

⁵⁶ CCCTB Working Document 56, paragraph 28.

⁵⁷ CCCTB Working Document 56, paragraph 28.

⁵⁸ CCCTB Working Document 60, paragraph 15.

As for cash management activities via redeeming marketable securities in the *Microsoft* case, it is quite controversial whether they fall within the scope of the course of regular business according to the CCCTB Directive Proposal Article 37. First of all, Article 37's wording does not require "the ordinary course of trade and business" to be "the core business". In other words, Article 37's wording in fact deviates from the Commission's original intention, that the scope of sales should only cover "the core business" in the working document,⁵⁹ and thus the scope of the sales factor becomes wider than the original working document. Secondly, just as Microsoft argues before the California court, maintaining smooth cash flow is so fundamental and important to the company. Such cash management activities indeed take place in the course of regular trade and business, even for the taxpayers whose core business activities do not involve marketable securities.

This "ordinary business clause" in Article 37 designed by the Commission seems very unclear regarding what the precise applicable scope is. As for the disputes over the definition of sales in the sales factor, such as was the case in the *Microsoft* case before the California court, this clause cannot help solve the problem, but rather allows the situation to remain controversial. If the *Microsoft* case took place under the CCCTB Directive, Article 37 could have solved it by excluding all marketable securities' interests if no such exceptional ordinary business clause was provided. However, the current Article 37 of the 2016 CCCTB Directive Proposal simply can't deal with cases such as Microsoft. Adding a general exception clause to allow the inclusion of passive income earned in the course of regular trade and business just makes the Commission's original exclusion list in vain. I think that it is not the Commission's main idea to widen the scope of the sales factor again by adding such a clause, but rather that it is a mistake due to its variation from the Working Document. Such a clause not only does not solve cases such as *Microsoft*, but can cause more confusion and disputes between the tax authorities and taxpayers.

5. Suggestions to the Current CCCTB Directive Proposal

5.1. Refining the Exclusion List Under Article 37 of 2016 CCCTB Directive Proposal for the Cash Management Activities

Article 37 needs amendment in three specific aspects: (1) to exclude items that do not exchange economic value from the sales factor; (2) to amend the excluded item "the proceeds

⁵⁹ CCCTB Working Document 60, paragraph 50.

from disposal of fixed assets”; and (3) to reduce the scope of the general clause of “in the ordinary course of trade and business”.

Article 37 of the CCCTB Directive excludes proceeds from the “disposal of fixed assets” from the sales factor. As discussed above, proceeds from the disposal of long-term marketable securities are excluded from the sales factor, whereas the proceeds from the disposal of short-term marketable securities are still included. It does not make sense to distinguish long-term or short-term marketable securities when calculating the sales factor. The problem of inflating the sales factor takes place by frequently trading short-term marketable securities, not long-term ones. Therefore, I suggest that Article 37 should add another new paragraph to deal with proceeds from short-term marketable securities.

As for calculating the redemption of short-term marketable securities, I agree with the California court’s reasoning in the *Microsoft* case, that including the full value of the marketable securities will cause distortions and inflate the sales factor. Since short-term marketable securities can create an easy scenario to inflate the sales factor, I agree with the solution by the legislative amendment in California: amending the definition of gross receipts to completely exclude cash management activities. Furthermore, exclusion redemption of the short-term marketable securities is also clear and simple for the administration. Since simplicity is also an important principle for the CCCTB Directive, complete exclusion is a more feasible approach than the “net amount” inclusion approach developed by California courts.

5.2. Excluding Risk Management Activities in the Sales Factor

As for the calculation of hedging futures contracts in the gross receipts such as in the *General Mills* case, there are two approaches from the California experiences. The first approach is complete exclusion from the sales factor, as the amendment of R&TC Section 25120. The second approach is the approach adopted by the court in *General Mills II*: only the net profits of the futures sales can be included in the gross receipts. What option should CCCTB take for calculating risk management activities such as futures contracts for the sales factor?

The rationale of the amendment of R&TC Section 25120 is discussed in Section 4.4 above. Briefly speaking, the California legislators regard hedging futures as a form of risk management, and comparable to the price insurance, so that hedging transactions should be totally excluded from the formula’s sales factor.

It is worthwhile to look closely again at the Court's analysis about distortion in the *General Mills* case. In its qualitative analysis, the Court agrees with the trial court that hedging is qualitatively different from General Mills' main business activities such as selling grains, flour, and consumer food products. Even though the court still acknowledges that hedging is quite critical and important to General Mills' business operations, it serves only a supportive function. In its comprehensive quantitative analysis, the Court analyses not only the futures sales and General Mills' other business activities separately, but also compares the quantitative results on inclusion and exclusion of the futures sales.⁶⁰ On the one hand, the Court of Appeal acknowledges the importance of risk management activities and recognizes it as an integral part of General Mills' business activities; but on the other hand, it also observes correctly the distortive effect that can occur if the entire amount of futures sales is included. It is difficult to decide to what extent the inclusion is reasonable and not distortive. The Court of Appeal adopts the alternative approach of including only the net profits of futures contracts.

In my opinion, as to calculating hedging activities in the sales factor, the CCCTB Directive should adopt the position of California Legislature and MTC's 2014 reform rather than the California Court's approach in the *General Mills* case. The Court has the limitations of interpreting the law as it is, and it invokes the adjustment provision, which is invoked exceptionally. The CCCTB Directive now has the opportunity to solve the problem from the beginning. Although the risk management activities, such as hedging, do take place in the regular course of trade and business, they do not really represent the taxpayers' market activities, but function as insurance against price fluctuation. Therefore, if the legislation can be clearly amended to exclude the hedging activities, it is still consistent with the theory of the sales factor. The amendment of R&TC Section 25120(L) is very simple and excludes the futures sales directly. Such policy choice is more in line with the CCCTB Directive's underlying principle that the system should be administratively simple and not vulnerable to the manipulation.

⁶⁰ The Court of Appeal compares the four quantitative points: the attribution of business to a single state; the futures sales' percentage of the whole income and percentage of the gross receipts; the profits margin of the futures sales and the primary business activities; and percentage change in the standard formula, if including the futures sales. The Court of Appeal finds that inclusion of entire futures sales will be distortive by these quantitative analyses. Inclusion of the entire amount of futures sales will substantially attribute 9% of General Mill's entire business activities to Minnesota; hedging activities only produce 2% of the entire income, but generates between 8% and 30% of the gross receipts; the profit margin of primary business activities is on average 81 times higher than futures sales; entire inclusion will substantially change the standard formula from 3.6% to 13.9% in different years.

5.3. The Re-Refining of “In The Ordinary Course of Trade and Business” Clause

Last but not least, the ambiguous concept of “in the ordinary course of trade and business” should be understood differently. First of all, as indicated above, Article 37 can create a list and numerate specifically in what circumstances the excluded items from the sales factor. As for cash management activities and hedging activities, Article 37 can directly exclude them by adding to the exclusion list. Therefore, it is not necessary to argue whether such activities are in the ordinary course of trade and business.

More importantly, we have to go back to the fundamental rationale of the sales factor in the formulary apportionment. The sales factor is designed to reflect the taxpayers’ economic activities from the demand side of the market: the taxpayers are acting as a service provider or a good provider and their service/goods providing activities are reflected in their sales factor. Such rationale is also reaffirmed as “the destination principle”. Conducting cash management such as selling and purchasing short-term securities, or risk management such as hedging activities in the form selling/purchasing/offsetting futures contract, is indeed as integral part and in the regular course of the business, but neither of them represents taxpayers’ economic activities as a provider. Instead, taxpayers such as Microsoft or General Mills, are making use of the security market or the futures market, to maintain their cash flow and reduce the price fluctuation risk. When they conduct these activities in another market, they actually have the status as “consumers” of these markets, not the providers. This is the fundamental rationale why these activities should not be included in the taxpayers’ sales factor: these transactions are in the form of sales by the taxpayers, but these are actually inconsistent with the criterion of “providing sales or services”. The general clause in Article 37 of 2016 CCCTB Directive, therefore, should be narrowed to “in the ordinary course of trade and business when the taxpayers act as goods or service provider”.

CONCLUSION

After comparing the CCCTB system with formulary taxation legislations in the USA and analyzing the *Microsoft* and *General Mills* cases in California, I conclude that the problem of inflating sales factor may also take place in the CCCTB system. Article 37 of the CCCTB Directive needs comprehensive amendments in order to prevent the problem of inflating the sales factor by including items in the denominator.

As for the definition of the sales factor in the formula, Article 37 of the 2016 CCCTB Directive has several shortcomings. First of all, the definition and the scope of the sales under Article 37 are too obscure. Both the USA legislation UDITPA and the California R&TC Section 25120 provide a very long exclusion list to exclude items from the sales factor. The underlying theory in the USA for excluding some items from the sales factor is that the sales factor of the sharing formula should reflect the taxpayer's economic activities in the market of providing the products or services. The excluded items are those that do not exchange economic value. Therefore, I suggest that Article 37 should add a longer exclusion list like UDITPA and Multistate Tax Compact.

The exclusion of passive incomes under Article 37's current text cannot solve the problem that occurred in the *Microsoft* case either, because cash management activities, such as short-term marketable securities, are not easily defined as a loan contract. Furthermore, the redemption of short-term marketable securities might easily fall into the scope of revenue "earned in the regular course of business or trade". Then it will be included in the sales factor under Article 37 of the CCCTB Directive again. The problem of inflating the sales factor, such as in the instance of *Microsoft* and *General Mills* cases, is likely to happen within Article 37, and thus it is necessary to add two items in Article 37(2)'s list: hedging transactions and redemption of the short-term marketable securities are also completely excluded from the sales factor.

To sum up, in addition to add a comprehensive list to exclude items that do not exchange values and items such as marketable securities and hedging transactions, Article 37 of the CCCTB Directive should be interpreted consistently with the fundamental rationale of the sales factor of the sharing formula: to reflect the taxpayers' economic activities from the demand side of the market. When taxpayers conduct transactions as a status of a consumer, such transactions, even in the form of sales contracts, are not legitimate to defined as the taxpayers' sales factor of the formula. By amending Article 37 of the CCCTB Directive in these two aspects, it will close the current loophole of the sales inflation problem.