OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011756
ROBERT HALF INTERNATIONAL INC. AND SUBSIDIARIES	) Date Issued: October 3, 2019

OPINION

Representing the Parties:

For Appellant:	Anthony Fuller, Deloitte Tax LLP Josh Grossman, Deloitte Tax LLP Mark Jamati, Robert Half International Inc.
For Respondent:	Melissa L. Williams, Tax Counsel IV Craig Swieso, Assistant Chief Counsel
Office of Tax Appeals:	William J. Stafford, Tax Counsel III

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045,[1] appellant Robert Half International Inc. and Subsidiaries appeals the action of respondent Franchise Tax Board (FTB) in proposing additional tax of $104,658, plus interest, for the 2008 tax year.[2]

Office of Tax Appeals (OTA) Administrative Law Judges John O. Johnson, Kenneth Gast, and Jeffrey G. Angeja held an oral hearing for this matter in

[1] Unless otherwise indicated, all "R&TC" references are to sections of the California Revenue and Taxation Code, and all "Regulation" references are to the California Code of Regulations, title 18, in effect for the tax year at issue.

[2] Appellant's appeal originally included an appeal of additional tax of $110,646, plus interest, for the 2007 tax year. The parties stipulated that there is no jurisdiction over the 2007 tax year, and therefore it is not included in this opinion. The audit and protest activity for appellant's 2008 tax year resulted in both a protest of a proposed assessment based on adjustments to appellant's apportionment sales factor, timely appealed to us under R&TC section 19045, and a claim for refund based on enterprise zone credits, to which appellant may have or had separate appeal rights under R&TC section 19324. On appeal, FTB has stated that issues unrelated to the sales factor issue (which presumably include the enterprise zone credits, among other items) have been resolved in appellant's favor. Accordingly, we treat this appeal as only an appeal against the proposed assessment related to the sales factor issue discussed herein.

Sacramento, California, on June 25, 2019. At the conclusion of the hearing this matter was submitted for decision.

ISSUE

Whether value added tax (VAT) imposed on the provision of services should be included in the sales factor of the apportionment formula for the tax year at issue.

FACTUAL FINDINGS

1. VAT is an indirect tax imposed by and remitted to many foreign (non-U.S.) jurisdictions as a consumption tax on the provisions of both goods and services, and is generally treated as an excise tax for California purposes.[3] California does not impose a VAT or other excise tax on services.
2. Appellant is a global human resource consulting firm based in California, and with its subsidiaries, operates as a unitary business. During the year at issue, it provided services within and without California. VAT was billed to appellant's customers in foreign jurisdictions on service fee invoices and was collected from appellant's customers for the services rendered to them.
3. Appellant filed a timely 2008 California corporation franchise tax return on a worldwide unitary basis (i.e., not under a water's-edge election), and included in its apportionment formula sales factor VAT invoiced as part of the purchase price for services. Because VAT was exclusively sourced to jurisdictions other than California, the inclusion of VAT effectively increased the denominator of appellant's sales factor without increasing the numerator.
4. FTB audited appellant's return and determined that it had improperly included VAT in its sales factor denominator in the amount of $198,257,647 for the 2008 tax year.[4] FTB's removal of VAT from appellant's sales factor had the effect of increasing that factor and

[3] This definition is taken generally from FTB's Audit Branch Procedure Statement 99-6, submitted as evidence on appeal. The parties did not dispute the definition of VAT on appeal, and FTB stated that it had no arguments over the calculation of VAT as reported by appellant on its returns. Furthermore, the parties indicated at the oral hearing that some of the audit workpapers involved for appellant used both VAT and goods and services tax (GST) interchangeably, and the parties indicated they had no reason to believe that our decision on this issue regarding VAT would not apply equally to other excise taxes, namely GST, which might have been included in appellant's calculations on its returns.

[4] As noted above, other adjustments, unrelated to this appeal, were also made by FTB. These issues were resolved in appellant's favor.

overall apportionment percentage, which resulted in additional taxable income and tax due.

5. FTB issued a Notice of Proposed Assessment, which appellant protested. FTB later issued a Notice of Action, affirming FTB's proposed assessment based on the exclusion of VAT from the sales factor, and appellant filed this timely appeal.

DISCUSSION

Background

Under the Uniform Division of Income for Tax Purposes Act (the UDITPA) (R&TC sections 25120 through 25139)—adopted by California and certain other states and which seeks to establish uniform rules for the attribution of corporate income—a unitary enterprise's "business income" is apportioned among the tax jurisdictions according to a formula.[5] (See *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755-756 (*Microsoft*).) For the year at issue, California generally required a taxpayer's business income to be apportioned by a four-factor formula composed of a property factor, a payroll factor, and a double-weighted sales factor. (R&TC, § 25128(a).) Only the sales factor is at issue in this appeal.

"The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." (R&TC, § 25134.) The term "sales" is defined as "all gross receipts of the taxpayer not allocated [as nonbusiness income] under [s]ections 25123 through 25127 of [the R&TC]." (R&TC, § 25120(e).) Accordingly, a taxpayer's total gross receipts are included in the sales factor denominator, which includes its foreign (non-U.S.) sales. "In the case of a taxpayer engaged in providing services [such as here] . . . 'sales' includes the gross receipts from the performance of such services including fees, commissions, and similar items." (Regulation 25134(a)(1)(C).) The term "all gross receipts" under R&TC section 25120(e) is not defined by the statute or regulation.

[5] The UDITPA divides a unitary enterprise's income into "business income" and "nonbusiness income." However, there is no dispute in this case that appellant's service revenue, including VAT billed to and collected from its customers, is "business income" under R&TC section 25120(a) and consequently apportioned among the states by formula. It is therefore not classified as "nonbusiness income" under R&TC section 25120(d), which is generally allocated directly to the taxpayer's domiciliary state. The nonbusiness income statutes—R&TC sections 21523 through 25127—concern items of income not at issue in this appeal, such as rents, royalties, and capital gains.

As noted above, VAT was collected on behalf of foreign jurisdictions from appellant's customers in those jurisdictions on services rendered to them. Because VAT was assessed on services provided by appellant in foreign jurisdictions, VAT was only included in the denominator of appellant's sales factor, which diluted the sales factor and overall apportionment percentage for California.

Appellant asserts that the term "sales" for purposes of calculating the sales factor is statutorily defined in R&TC section 25120(e) as "all gross receipts." Appellant argues that although "all gross receipts" is undefined by statute or regulation, the California courts have broadly construed that term to include "the whole amount received." (*Microsoft, supra*, 39 Cal.4th at p. 759; see also *The Limited Stores, Inc. v. Franchise Tax Bd.* (2007) 152 Cal.App.4th 1491 (*The Limited*).) Applying this broad definition, appellant contends that its sales factor denominator should include VAT that was imposed and collected on foreign sales of services.

FTB counters that the issue of what constitutes "sales" for purposes of the sales factor is more specifically addressed by Regulation 25134(a)(1), which FTB interprets as allowing for excise or sales tax (including VAT) in the sales factor only for sales of tangible personal property as specifically included in Regulation 25134(a)(1)(A), and not for sales of services because Regulation 25134(a)(1)(C) does not specifically allow for its inclusion.

Definition of "Sales" in R&TC section 25120(e).

For the year at issue, R&TC section 25120(e) defined "sales" as "all gross receipts" of the taxpayer constituting business income. In *Microsoft*, the California Supreme Court was asked to determine whether the taxpayers generated "gross receipts" for purposes of R&TC section 25120(e) in the amount of the entire redemption price of their marketable securities or whether the portion representing the return of principal should be excluded. After acknowledging the term "gross receipts" was undefined, the court noted that "'[g]ross' implies the whole amount received, not just the amount received in excess of the purchase price." (*Microsoft, supra*, 39 Cal.4th at pp. 758-759.) As support, the court referenced the Black's Law Dictionary definition of "gross receipts," which is "[t]he total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions, . . ." (*Microsoft, supra*, 39 Cal.4th at p. 759, fn. 7.)

Finding the language of R&TC section 25120 "not unambiguous," the court reviewed the legislative history of the UDITPA and determined that "the drafters had in mind a definition of

'sales' that encompassed more than just gross income." (*Microsoft, supra*, 39 Cal.4th at p. 760.) The court ultimately looked to the "economic reality" of the taxed transaction based upon the substance, not the form, of that transaction. (*Id*. at pp. 761-762; see also *General Motors Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 773, 783-784 (*General Motors*).) The court focused upon the "actual rights and benefits acquired" in the transaction, from the perspective of the taxpayer. (*Microsoft, supra*, 39 Cal.4th at pp. 760-761.) Ultimately, the court in *Microsoft* held that the full redemption price from marketable securities that the taxpayer actually received upon maturity constituted "gross receipts" to be included in the sales factor. (*Microsoft, supra,* 39 Cal.4th at pp. 760-762.)

In *General Motors*, a companion case of and decided on the same day as *Microsoft*, the court concluded that "'gross receipts' generally refers to the whole amount received, without deduction." (*General Motors, supra*, 39 Cal.4th at p. 783.) The court analyzed the substance of the taxpayer's investment in repurchase agreements and held that, because a "repo" is analogous to a secured loan for purposes of the UDITPA, only the interest received should be treated as gross receipts to be included in the sales factor. (*General Motors, supra*, 39 Cal. 4th at pp. 787-788.)

One year after *Microsoft* and *General Motors* were decided, the Court of Appeal, in *The Limited, supra*, 152 Cal.App.4th 1491, was asked to determine whether "gross receipts" included the full amount received by the taxpayer from treasury department sales of securities. Relying on *Microsoft*, the court concluded that the full redemption price should be treated as gross receipts. (*The Limited, supra*, at p. 1497.) Further, the court noted that in *Microsoft* the Supreme Court had stated that treating the full redemption price as gross receipts was consistent "with the application of 'gross receipts' to a wide range of other transactions." (*Ibid.*)

Shortly after the decision in *The Limited*, the Court of Appeal, in *General Mills v. Franchise Tax Board* (2009) 172 Cal.App.4th 1535 (*General Mills I*), addressed whether receipts from General Mill's commodity hedging contracts were properly included as "gross receipts" in the sales factor. Relying on *Microsoft*, the court found that receipts from the commodity hedging contracts were properly included as "gross receipts" in the sales factor. (*General Mills I, supra*, 172 Cal.App.4th at p. 1548.) It emphasized the economic reality of the transactions and the legally binding nature of the commodity contracts, and found that "'[g]ross' means the full amount received, not the company's net gain on the transaction or 'gross income' from the

transaction." (*Id*. at pp. 1544-1545, 1548.) Lastly, to underscore the broad nature of the type of receipts included in the sales factor, the court noted that "many transactions that do not generate profit are nevertheless included as 'sales' for UDITPA purposes." (*Id*. at p. 1547.)

Regulation 25134

Regulation 25134 provides inclusive rules for the types of gross receipts includible in the sales factor (without distinguishing between the numerator or denominator).[6] It states, in relevant part, that "the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business." (Regulation 25134(a)(1).) The regulation provides rules for determining "sales" in various situations, as shown below.

> (a)(1)(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling ***goods and products***, "sales" includes all gross receipts form the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the income year) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales, less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. ***Federal and state[7] excise taxes (including sales taxes) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product***.
>
> (B) . . . .
>
> (C) In the case of a taxpayer engaged in providing ***services***, such as the operation of an advertising agency, or the performance of equipment service contracts, research and development contracts, "sales" includes the gross receipts from the performance of such services including fees, commissions, and similar items. (Emphasis supplied.)

FTB states that Regulation 25134(a)(1)(A) expressly allows for excise and sales taxes as part of gross receipts for sales of tangible personal property (i.e., goods). FTB notes that, in

[6] Regulation 25134 therefore does not provide sourcing rules for purposes of the sales factor numerator. (See Regulation 25134(b), (c).) For example, Regulation 25134 instructs a taxpayer that the gross receipts from its sales of services are includible in the sales factor (i.e., the denominator), but it does not tell the taxpayer whether those same receipts are also includible in the numerator, as the sourcing provisions are found elsewhere (e.g., R&TC section 25136). As noted above, there is no dispute under the facts of this appeal that if VAT is includible in the sales factor at all, it is only includible in the denominator and not the numerator.

[7] For purposes of our analysis, the term "state" includes any foreign country. (R&TC, § 25120(f).)

contrast, Regulation 25134(a)(1)(C) does not specifically mention or address excise or sales tax when dealing with sales of services. FTB thus argues that VAT for sales of services is excluded from "gross receipts" for purposes of the sales factor.

In response, appellant reiterates that the term "sales" for purposes of calculating the sales factor has been broadly construed by California courts[8] and therefore appellant's sales factor denominator should include VAT that was imposed and collected on foreign sales of services. Appellant contends that the silence of Regulation 25134(a)(1)(C) cannot be interpreted as an exclusion of excise and sale tax, such as VAT, from "gross receipts" for purposes of calculating the sales factor, in light of the California courts' broad interpretation of the statute.

Analysis

The California Supreme Court has interpreted "all gross receipts" under R&TC section 25120(e) as being the "whole amount received, without deduction." (*General Motors, supra*, 39 Cal.4th at p. 783.) The court has further concluded that "'[g]ross' implies the whole amount received, not just the amount received in excess of the purchase price," referencing the Black's Law Dictionary definition of "gross receipts," which is "[t]he total amount of money or other consideration received by a business taxpayer for goods sold or services performed in a year, before deductions, . . ." (*Microsoft, supra*, 39 Cal.4th at p. 759, fn. 7; *General Motors, supra*, 39 Cal.4th at p. 786.) As discussed above, the courts have found amounts reported from the redemption of marketable securities (*Microsoft* and *The Limited*) and commodity hedging contracts (*General Mills I*) to constitute "gross receipts" that are included in the sales factor, despite not being specifically listed in R&TC section 25120 or Regulation 25134.

FTB's arguments focus on Regulation 25134, which FTB interprets as allowing for excise and sales tax (including VAT) in the sales factor only for sales of tangible personal property, and not for sales of services. FTB does not dispute that VAT on sales of tangible personal property is included in "all gross receipts." FTB is simply arguing that VAT on sales of

[8] Citing *Microsoft, The Limited,* and *General Mills, Inc. & Subs. v. Franchise Tax Bd.* (2012) 208 Cal.App.4th 1290 (*General Mills II*). In addition, appellant cites *Appeal of Polaroid Corp*., a "Summary Decision" issued by the California State Board of Equalization on May 28, 2003. We note, however, that the Summary Decision specifically states that it is "Not to be Cited as Precedent."

services should not be included in "all gross receipts" because Regulation 25134(a)(1)(C) is silent on the matter.[9]

Here, we find that VAT on sales of services comes within the court's interpretation of "all gross receipts" under R&TC section 25120(e). "Adherence to the precedent is a foundation stone of the rule of law," and we thus are obligated to follow precedent set by the determinations of the courts of California, as discussed above. (*Kisor v. Wilkie* (2019) 139 S.Ct. 2400, 2422 (*Kisor*).) Regulation 25134(a)(1)(C) contains no language of limitation when discussing the word "sales" for service businesses. Rather, it contains only words of inclusion, such as "includes" and "including." (See *Ornelas v. Randolph* (1993) 4 Cal.4th 1095, 1101 [noting that the term "includes" is "ordinarily a term of enlargement rather than limitation"].) Accordingly, we find no reason to limit the inclusion of VAT in the definition of "gross receipts" to only VAT collected on transactions involving goods or products and not on services.

FTB argues, however, that the reference to excise and sales tax in relation to sales of tangible personal property in Regulation 25134(a)(1)(A) implies that the silence as to excise and sales tax in subparagraph (a)(1)(C) of that same regulation excludes such taxes (including VAT) in relation to sales of services.

The court in *Microsoft* directly addressed a similar argument of negative implication proposed by FTB regarding Regulation 25134(a)(1)(A). Because subparagraph (a)(1)(A) includes in its definition of gross receipts "all interest income," FTB argued "that by negative implication gross receipts exclude a return of principal." (*Microsoft*, *supra*, 39 Cal.4th at p. 763.) The court disagreed. It found that the surrounding language of subparagraph (a)(1)(A) revealed the error in this argument, as the inclusive nature of that subparagraph showed that both interest and the principal price for any sale of goods or products were included in the definition of gross receipts. (*Ibid*.) Similarly, we find that subparagraph (a)(1)(C), dealing with service receipts, is also inclusive in the types of receipts that are included in the sales factor, particularly

[9] FTB adds that its position of excluding VAT on sales of services from "gross receipts" has remained consistent over the years, as it has never issued a publication stating otherwise. In response, appellant asserts that in Audit Branch Procedure Statement 99-6, FTB identified VAT among the excise taxes to be included in the sales factor without specifically excluding VAT on sales of services. FTB provided two Multistate Audit Newsletter editions that were issued in 1999 and 2000, which seem to generally be focused on VAT related to the sales of tangible personal property, and remain silent as to VAT on services.

when it uses the terms "includes," "including," and "and similar items."[10] We also note that in Regulation 25134(b), which is also inclusive by nature in its broad, general description of the composition of the sales factor denominator, the drafters were clearly capable of specifically excluding items if they so intended (e.g., "except receipts excluded under Regulation 25137(c)").

FTB argues that its position with regard to Regulation 25134 represents an "interpretation [that] is contemporaneous with the enactment of the statute and [that] has been consistent since the enactment of the regulation," and therefore should be given deference, citing *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1. First, we note that Regulation 25134 is based on the proposed Allocation and Apportionment Regulations of the Multistate Tax Commission (MTC), which is a model regulation that is not a creature unique to FTB's creation or necessarily implemented with any specific intent attributable to FTB.[11]

Second, "before concluding that a rule is genuinely ambiguous," and possibly deferring to an agency's interpretation, "a court must exhaust all the 'traditional tools' of construction." (*Kisor*, *supra*, at p. 2415.) When construing a statute, a beginning point is to examine the statutory language, giving words the usual and ordinary meaning. (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 519.) As noted above and as shown by *Microsoft*, *The Limited*, and *General Mills I*, the term "gross receipts" as used in R&TC section 25120 and Regulation 25134, for the year at issue, is inclusive in its language, not exclusive. To read a negative implication in the inclusion of certain language in subparagraph (a)(1)(A) (i.e., that excise taxes are included in the sales factor for sales of tangible personal property) but not in subparagraph (a)(1)(C) (i.e., that excise taxes are not so included because the subparagraph is silent), as FTB argues on appeal, would be to create a specific exclusion in subparagraph (a)(1)(C) that goes beyond the plain reading of that subparagraph.

[10] As proposed by appellant, not specifically including excise taxes in the subparagraph regarding services may likely have been a biproduct of the fact the excise taxes were typically, if not exclusively, levied on sales of goods and products, and not services, in the United States in the early 1970s when the Regulation was promulgated, meaning such an inclusion would be irrelevant at the time. While we do not conclude whether this speculation is true, we simply note that it appears to be a plausible explanation why excise taxes were omitted in the subparagraph.

[11] Furthermore, we note that FTB has not published a legal ruling or other official declaration regarding Regulation 25134(a)(1)(C) and its interpretation on whether excise taxes are or are not included for that subparagraph, so it is unclear what consistent interpretation of the regulation FTB is seeking to be given deference, other than its assertions made on appeal.

Ultimately, we find support in *Microsoft* and the other cited authorities above, and in the plain reading of the statute and regulation, for the position that Regulation 25134(a)(1)(C) does not exclude VAT on the sales of services from the definition of sales in R&TC section 25120(e).

FTB argues that to allow a foreign trade taxpayer to include VAT on services in its sales factor denominator while its U.S. trade-only counterpart does not have a comparable tax would be to give a foreign trade taxpayer an advantage over a U.S. trade taxpayer because the foreign trade taxpayer will have a much larger sales factor denominator than the U.S. trade taxpayer. FTB made a similar argument for the first time at the oral hearing, arguing that such a result would affect the "symmetry" of apportionment because California does not impose a VAT.

However, FTB's symmetry argument is unconvincing because symmetry appears to also be lacking for sales of tangible personal property. For example, some states do not impose a sales or use tax on tangible personal property. Therefore, in those states, a taxpayer's gross receipts from sales of tangible personal property would not include sales or use tax in the denominator of its California sales factor, whereas a similarly-situated taxpayer doing business in states that do impose a sales or use tax on tangible personal property would be able to include such taxes in its denominator. In an income year, the former taxpayer would generally be disadvantaged compared to the latter. Accordingly, the lack of symmetry that FTB asserts would exist by including excise taxes on services in the sales factor would similarly exist for sales of tangible personal property in certain situations; however, Regulation 25134(a)(1)(A) explicitly includes excise taxes on sales of tangible personal property as part of gross receipts included in the sales factor, and therefore the law does not agree with the symmetry argument as presented by FTB. If there is a concern of symmetry in the apportionment formula for a given set of facts, then an alternative apportionment under R&TC section 25137 might be the appropriate remedy for that specific situation.

R&TC section 25137 provides a relief provision pursuant to which either appellant or FTB may argue (1) the standard apportionment provisions fail to fairly represent the extent of the taxpayer's California business activity, and (2) the taxpayer's or FTB's proposed alternative method of calculation is reasonable. (See also *Microsoft*, *supra*, 39 Cal.4th at p. 764-772.) "What must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. (89-SBE-017) 1989 WL 95886.) Here, FTB concedes that the alternative apportionment provisions of R&TC section

25137 should not be invoked in this appeal because the additional income that would be sourced to California is minimal and thus there is no distortion.

Accordingly, we find that VAT on sales of services comes within the California Supreme Court's interpretation of "all gross receipts" under R&TC section 25120(e).

HOLDING

VAT imposed on the provision of services is included in the sales factor of the apportionment formula for the tax year at issue.[12]

DISPOSITION

FTB's action is modified to allow for VAT imposed on the provision of services to be included in the sales factor of the apportionment formula for the tax year at issue.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

[12] R&TC section 25120 was revised for taxable years beginning on or after January 1, 2011, to include a definition of "gross receipts." (See R&TC, § 25120(f)(2).) Our decision only concerns the law in effect for the year at issue, and does not speculate as to the effect of the subsequent revision to the law.