I. INTRODUCTION

This case is simple. At a fundamental level, the issue is simply whether double-counted receipts with no economic profit should be represented in the California sales factor. Congruent with California Supreme Court precedent, California Court of Appeals precedent, administrative authority, and the Franchise Tax Board's ("FTB") own principles on alternative apportionment, the taxpayer here argues that double-counted sales that are subsequently undone and produce no economic profit should not be represented in the California sales factor.

Daimler North America Corporation and Subsidiaries ("Daimler" or "Taxpayer") is a leading premium car and commercial vehicle manufacturer.[1] When Taxpayer sells a vehicle to a third-party, independent vehicle dealership in California, the receipts from the sale are included in Taxpayer's California sales factor. If a dealership customer purchases that vehicle, there is no further effect on Taxpayer's California sales factor. One car sold, one receipt in Taxpayer's sales factor.

However, when a dealership customer decides to lease a Daimler vehicle, the third-party dealership sells the vehicle back to Taxpayer for the same amount as the original sale price. Taxpayer's initial sale to the third-party dealership is undone, but the initial sale receipt to the dealership is NOT removed from the sales factor.

When Taxpayer leases the vehicle directly to the customer, the vehicle value is captured in the sales factor again. One vehicle is leased, but the value of that vehicle is represented in the California sales factor twice; once with the sale to the dealership that

[1] Daimler North America sells vehicles under the following brand names: Mercedes-Benz, Freightliner, Western Star, and Thomas Built Buses.

is subsequently undone, and then again via the lease and residual payments received on the lease.

Because Taxpayer leases more vehicles in California than it does in other states, the double counted lease receipts make up a large percentage of Taxpayer's California sales factor numerator, which inflates Taxpayer's California business activity by approximately one third of actual business activity. In other words, the standard apportionment formula does not fairly represent Taxpayer's business activity in the state, requiring remedy pursuant to California Revenue & Taxation Code ("CRTC") section 25137. Taxpayer seeks that remedy here.

II. FACTUAL BACKGROUND

In the United States ("US"), before an end-customer can acquire a Daimler vehicle, Mercedes-Benz USA ("MBUSA") sells the Daimler vehicles to third-party, independent dealerships. Receipts from these transactions are included in MBUSA's sales factor. An end-customer can then go to the third-party dealership to either purchase or lease a Daimler vehicle.

A. Vehicle Purchases in the Sales Factor

As briefly described above, if the customer chooses to purchase a Daimler vehicle, the transaction occurs between the third-party dealership and the end-customer, with no further interaction with Taxpayer. The standard apportionment formula in California as applied to Taxpayer reflects a vehicle sale once. For example, if the Daimler vehicle is purchased by the dealership for $50K, then $50K of receipts would be included in Taxpayer's sales factor. To further illustrate the effect on Taxpayer's sales factor, consider that 100 Daimler vehicles are sold nationwide for $50K each, 10 of those 100

vehicles are sold in California. The standard formula in this example would calculate Taxpayer's apportionment percentage like so:

$$\frac{\text{10 vehicles sold to CA dealers } (x \text{ \$50K each})}{\text{100 vehicles sold nationwide } (x \text{ \$50K each})} = \frac{\$500\text{K}}{\$5\text{M}} = \mathbf{10\%}$$

In the example, 10 percent of Taxpayer's business activity is in California, and the standard formula apportions 10 percent of Taxpayer's income to the state for taxation. The standard formula in this example fairly reflects Taxpayer's business activity in the state.

B. Vehicle Leases in the Sales Factor

Alternatively, if the customer chooses to lease the Daimler vehicle, the process has several more steps. First, the dealership sells the vehicle that it initially purchased from MBUSA to Daimler Mobility, a leasing subsidiary in Taxpayer's California combined reporting group. The vehicle is sold back to Daimler Mobility for the same amount as the original sale price. There is no net profit in the two transactions. The sale from the dealership to Daimler Mobility is simply an "undoing" of the prior sale to the dealership. The undone transactions are designed to net to zero profit.

Second, the lessee customer makes lease payments to Daimler Mobility, usually accounting for about half of the vehicle's value. The lease payments are recorded as receipts in the sales factor. Third, at the end of the lease term, Daimler Mobility sells the vehicle again to the lessee customer or to a third party for the remaining half of the vehicle's value.[2] That final sale, called the residual sale, also has a receipt that is reflected in Taxpayer's sales factor.

[2] While the split in the vehicle's value can vary between the lease payments and the residual value sale, together the two transactions represent the full value of the vehicle.

In totality, there are three transactions that result in receipts included in Taxpayer's sales factor for a single vehicle lease: (1) the initial sale from MBUSA to the dealership, which is later undone; (2) the lease payments to Daimler Mobility;[3] and (3) the residual sale from Daimler Mobility to the lessee or a third party. The three transactions total roughly twice a single vehicle's value.

In a simplified example, if one $50K Daimler vehicle is sold to a dealership and then later leased by an end-customer, roughly $100K would be included in Taxpayer's sales factor:

TRANSACTIONS	SALES FACTOR
MBUSA Sells to Dealership	+ $50K
Daimler Mobility Buys Back from Dealership – Undoing First Sale	N/A
Daimler Mobility Receives Lease Payments	+ $25K
Daimler Mobility Makes Residual Sale	+ $25K
TOTAL:	**$100K**

To further demonstrate the greater effect on Taxpayer's apportionment factor, again consider 100 Daimler vehicles are sold to dealerships nationwide, 90 eventually sold to customers outside of California and 10 leased in California. The standard formula in this example would compute Taxpayer's apportionment percentage in the following manner:

$$\frac{\begin{array}{c}\text{10 vehicles sold to CA dealers } (x \text{ \$50K each}) \\ +\text{Lease income } (x \text{ \$25K each}) \\ +\text{residual sale } (x \text{ \$25K each})\end{array}}{\begin{array}{c}\text{100 vehicles sold to dealerships nationwide } (x \text{ 50K each}) \\ +\text{lease income } (10\ x \text{ \$25k}) \\ +\text{residual sale } (10\ x \text{ \$25K})\end{array}} = \frac{\$1\text{M}}{\$5.5\text{M}} = \mathbf{18}\%$$

As shown in the second example, although only 10 percent of the taxpayer's vehicles are ultimately sold in the California market, the standard formula results in an

[3] To the extent there are finance charges and fees, those amounts would also be reflected in the lease payments.

18 percent sales factor as a result of double counting vehicle lease receipts as compared to vehicle purchases. As further detailed below, Taxpayer's vehicles are leased in greater proportions in California compared to the rest of the US.[4] The geographic disparity in leasing patterns causes Taxpayer's business activity to be unfairly overstated in California, which subjects millions of dollars of income earned outside of California to be taxed in the state.

III. Applicable Law

A. California Revenue & Taxation Code section 25137

CRTC section 25137 provides a mechanism whereby a taxpayer or the FTB may challenge the operation of the standard apportionment formula when the statutory formula distorts the amount of income reported to a state with respect to a taxpayer's level of activity in the state. CRTC section 25137 states that, if the standard apportionment formula does "not fairly represent the extent of the taxpayer's business activity" in California, taxpayers may petition for an alternative apportionment method.

CRTC section 25137 lists several remedies for distortion may be used, including "[t]he employment of any . . . method to effectuate an equitable allocation and apportionment of the taxpayer's income." The party requesting relief must show its proposed alternative apportionment scheme is reasonable.

B. Case Law and Administrative Authority

Multiple cases have found alternative apportionment appropriate when receipts with little or no economic profit caused an unfair reflection of a taxpayer's business activity.

[4] As discussed in more detail below, between 26 and 27 percent of all US leasing receipts occur in California.

In *Microsoft Corp. v. Franchise Tax Board ("Microsoft")*,[5] the California Supreme Court analyzed Microsoft's short-term investment receipts under a qualitative and quantitative distortion analysis. That is, the court found that the short-term investment receipts were qualitatively different than Microsoft's software sales and quantitatively distortive because the investment receipts produced 2 percent of the company's income but 73 percent of its gross receipts.[6]

In *General Mills, Inc. v. Franchise Tax Board ("General Mills")*,[7] the California Court of Appeals court found that an activity can be integral or even critical to the taxpayer's main line of business but be qualitatively distortive. Specifically, the court found that hedging activity *not entered into for the purpose of profit was qualitatively distinct from cereal sales entered into for profit*.[8]

The court states, "this case presents a different but equally valid paradigm warranting invocation of section 25137: sales activity that is not conducted for its own profit, and that has a substantially distortive effect on the standard apportionment formula, resulting in an unfair representation of the company's business activity in California."[9]

The court went on to find that the hedging receipts were also quantitatively distortive as the hedging activities produced at most 2 percent of the company's income but between 8 percent and 30 percent of its gross receipts, while also operating at a loss

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[5] Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750 (2006).
[6] *Id.* at 766, 768 & 771.
[7] Gen. Mills, Inc. v. Franchise Tax Bd., 208 Cal. App. 4th 1290 (2012).
[8] *Id.* at 1305-07.
[9] *Id.* at 1306.

for 2 of 6 years.[10] Additionally, the court held that an 8.2 percent effect on the apportionment formula was enough to meet the test for quantitative distortion.[11]

The Board of Equalization in the *Appeals of Pacific Telephone and Telegraph Company ("Pacific Telephone")*[12] found that investment receipts that produced less than 2 percent of the taxpayer's income, but 36 percent of its gross receipts, also had a distortive effect on the apportionment formula.[13]

Alternative apportionment has also been found necessary to remedy distortion caused by double-counted receipts. Specifically, the Idaho Supreme Court in *Union Pacific Corporation v. State Tax Commission ("Union Pacific")*[14] found alternative apportionment necessary where double-counted freight sales caused significant distortion in the sales factor.[15] The taxpayer, Union Pacific, reported freight sales where it had not yet collected payment from its customers.[16] Union Pacific then sold accounts receivable for the same freight sales so it could have cash in hand.[17] Union Pacific also reported the accounts receivable sales for the original freight sales.[18]

The court found the account receivable sales constituted double counting in the sales factor because two receipts were reported for the same freight sale.[19] One receipt when the freight sale was made, and a second receipt when the accounts receivable was sold. Additionally, the court found that the accounts receivable sales caused significant

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[10] *Id.* at 1310.
[11] *Id.* at 1312.
[12] Appeals of Pacific Telephone and Telegraph Company, 78-SBE-028 (May 4, 1978).
[13] *Id.*
[14] Union Pac. Corp. v. Idaho State Tax Comm'n, 139 Idaho 572 (2004) ("*Union Pacific II*").
[15] *See id.* at 578.
[16] *Id.* at 574.
[17] *See id.*; Union Pac. Corp. v. Idaho State Tax Comm'n, 136 Idaho 34, 35-36 (2001) ("*Union Pacific I*").
[18] *Union Pacific I*, 136 Idaho at 35-36.
[19] *Id.* at 37.

distortion by adding approximately $2 billion of receipts to the sales factor every year.[20] As a remedy to distortion, the court upheld the Idaho District Court's decision to remove Union Pacific's double-counted sales from the sales factor because such sales were considered an inaccurate reflection of the taxpayer's activity in Idaho.[21]

IV. DISCUSSION

Taxpayer's undone sales in the case of vehicle leases are qualitatively distinct from its other business activity, and the undone sales cause significant quantitative distortion in the sales factor.

A. Taxpayer's undone sales to facilitate its vehicle leases are qualitatively different as they are not entered into to produce profit.

The sales from the dealerships back to Daimler Mobility have one purpose, to undo the first sale from MBUSA to the dealership in the case of a lease. That is, the undone sales do not produce any economic profit. Much like the hedging activity in *General Mills*, the undone transactions are *designed to net to zero profit*. The undone transactions facilitate the leasing arrangements just as the hedging transactions in *General Mills* were facilitative of cereal sales.

In *General Mills*, the facilitative nature and the lack of profit motive made the hedging receipts qualitatively distinct from sales for profit.[22] The same is true in this case. The undone transactions being purely facilitative of the lease transactions and being designed to net to zero profit makes the undone sales qualitatively different than Taxpayer's other business activities.

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[20] *Id.*
[21] *Union Pacific II*, 139 Idaho at 578.
[22] Gen. Mills, Inc. v. Franchise Tax Bd., 208 Cal. App. 4th 1290, 1305-07 (2012).

B. *Taxpayer's undone sales are quantitatively distortive as they produce zero percent of the company's income but between 36 percent and nearly 44 percent of its California gross receipts.*

As discussed above, the discrepancy between income and gross receipts has been consistently used as a metric to measure the level of distortion when the sales factor contains a significant percentage of receipts from a low margin business activity. The Board of Equalization and California courts have found that receipts with some, but relatively little profit, can be distortive. The level of distortion in this case far exceeds that in found in the *Pacific Telephone*, *Microsoft*, and *General Mills* decisions because the receipts in those cases sometimes produced profit.

Here, Taxpayer's sales factor is being skewed by the inclusion of receipts that do NOT generate any income or profit, yet between *36 percent and almost 44 percent* of Taxpayer's California sales consist of double-counted, undone sales to dealerships. The standard formula essentially includes two gross receipts for a single economic output. The result is that California business activity is overstated by between approximately 36 and 44 percent.

The double-counted, undone sales also occur in California in a greater proportion than the rest of the US, causing more income to be unfairly apportioned to California. For example, in the years at issue, between 26 and 27 percent of all undone sales in the country are done in California while the Taxpayer's total California sales were less than half that amount. In fact, California has a greater percentage of the undone sales used to facilitate leasing than any other place in the country:

	2017	2018	2019
Undone Sales in CA	$3,095,210,339	$3,122,245,465	$3,278,284,650
Undone Sales Everywhere	$11,883,448,194	$11,469,071,275	$12,018,846,334
CA % of Undone Sales[23]	26.05%	27.22%	27.28%
Apportionment % as filed	12.48%	13.39%	13.51%
Apportionment % w/o Undone Sales[24]	**8.874%**	**10.167%**	**10.504%**

Another metric of distortion used by the Courts in *General Mills* and *Microsoft* is the impact of removing the distortive receipts on the apportionment formula. As mentioned above, *General Mills* was the lowest impact on the apportionment formula found to be distortive by a California court. Specifically, the court in *General Mills* found that an average impact of 8.2 percent was quantitatively distortive.[25] In this case, the impact on the apportionment formula exceeds the level of distortive impact in *General Mills* by an average of 300 percent in the years at issue:[26]

	2017	2018	2019
Overstatement of Taxpayer's Apport.[27]	28.91%	24.08%	22.26%
Overstatement in General Mills[28]		8.2% average	

As demonstrated by the above facts, the undone sales are a substantial portion of the California sales factor numerator, causing significant quantitative distortion in the standard formula as applied to Taxpayer.

C. *Removing the double-counted, undone sale receipts is a reasonable remedy.*

Taxpayer believes that simply removing the undone sales from MBUSA to the dealerships from the sales factor would equitably and reasonably relieve the present

[23] Dividing the total undone sales in California by the total undone sales in the US.
[24] This represents the true market for Taxpayer's vehicles in California.
[25] *General Mills*, 208 Cal. App. 4th at 1312.
[26] As represented in the corresponding table, the impact on the apportionment percentage in this case is an average of 3 times the impact on the apportionment percentage in *General Mills*.
[27] Relative impact on the apportionment formula after removal of the undone sale receipts from the sales factor.
[28] Relative impact on the apportionment formula after removal of hedging receipts from the sales factor in *General Mills*.

distortion, similar to the remedy in *Union Pacific*. The remedy is reasonable because not only does it remove the distortive effect present in the standard formula, but the remedy also has no impact on any sales which are not subsequently undone. All activity generating income and profit will still be fairly and accurately represented in the sales factor. In the above examples, removing the undone sales would result in a 10 percent apportionment percentage, consistent with the percentage of vehicles ultimately sold in California, as opposed to the inflated 18 percent apportionment percentage resulting from double counting leasing receipts. In other words, removing the undone sales fairly reflects the market for Taxpayer's vehicles.

D. The FTB determination misconstrues Taxpayer's argument and fails to explain how receipts from undone sales fairly reflect Taxpayer's activities in California under the applicable authorities.

The FTB's determination states that Taxpayer argues that "sales to third-party dealership[s] . . . should not be reflected in the sales factor[,]"[29] and "only the sales to its end-customers should be reflected in the sales factor."[30] The FTB's argument is that sales to dealerships properly reflect Taxpayer's wholesale market and must be reflected in the sales factor. The FTB plainly misstates Taxpayer's position and rebuts a straw-man argument. Taxpayer has *never* argued that "sales to the third-party dealership are not sales to customers and should not be reflected in the sales factor."[31] Rather, Taxpayer argues that sales to dealerships that are subsequently undone to facilitate leases should not be represented in the sales factor because they do not produce economic profit, are not intended to do so, and distort Taxpayer's activity in the state.

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[29] FTB, 25137 Committee Determination 2.
[30] *Id.* at 2.
[31] *Id.*

Of course, sales to dealerships that are not subsequently undone should be reflected in the sales factor because they are intended to produce a profit and they properly reflect the market for Taxpayer's vehicles. Taxpayer has never argued otherwise. It bears repeating that Taxpayer's remedy for the distortion present in this case has NO impact on receipts which are not subsequently undone whether the sales or leases are made to dealerships or customers.

The FTB determination then goes on to state:

> According to the trial balances provided and explained Taxpayer, the sale to an authorized dealership and the purchase of those vehicles by Taxpayer's financial subsidiary are recorded and accounted for as two separate transactions. This information mitigates Taxpayer's claim that receipts in its sales factor for the same vehicles are duplicated.[32]

The FTB claims the above facts — that the transactions are recorded separately for accounting purposes — "mitigates" Taxpayer's receipt duplication claim. Not only does the FTB's argument lack substance, the FTB ironically makes Taxpayer's point here. The fact that the transactions are treated separately for accounting purposes creates the problem in the first place. The initial sale to the dealership and the separately recorded buyback is designed to put Taxpayer in the same economic position as before the initial sale. The buyback economically "undoes" the first sale much like a customer return of merchandise, which is not treated as a separate transaction for accounting purposes. However, because the initial sale is separately recorded from the buyback, it is NOT removed from the sales factor under the standard apportionment formula. When Taxpayer later leases and residually sells the vehicle, the receipts go into the sales

[32] *Id.* at 3.

factor again. The separateness of the transactions causes, rather than "mitigates", the problem. Fundamentally, one vehicle lease causes the value of one vehicle to be reflected in the sales factor twice. The FTB determination fails to address this point.

The FTB determination further states that "unlike *Microsoft Corporation v. Franchise Tax Board*, the receipts in question do not overload the sales factor in favor of another State."[33] The FTB is correct that the double-counted receipts in this case do not overload the sales factor in another state. Instead, the distortive receipts in this case *overload the California sales factor* because there is more leasing activity in California than the rest of the US. If Taxpayer leased more vehicles in Nevada than it did in California, thereby overstating the Nevada factor and understating California activity, the FTB would have no qualms raising distortion. Contrary to the FTB's misreading of *Microsoft*, distortion is not only permitted when the standard formula operates to overstate the activities in other states. An overstatement of California activity, as in this case, is distortive under the analyses in *Microsoft* and *General Mills*.

Finally, and perhaps the most specious of the FTB's arguments, the FTB determination states that since "Taxpayer leases more vehicles in California than in any other state . . . it is intentional that the standard apportionment formula would reflect [a greater number of receipts]."[34] Taxpayer's lease receipts and receipts from the residual sale of the vehicle include the retail price of the vehicle, finance charges on the lease and all fees associated with the lease in

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[33] *Id.*
[34] *Id.*

contrast to its sales to the dealerships, which necessarily do not include the above-mentioned revenue components. Therefore, the standard formula already reflects the activities and profits associated with leasing without the need to include the double-counted, undone dealership sales, which unlike the lease payments and residual sales, are not intended to generate a profit for Taxpayer.

Every dollar of Taxpayer's income and profit generated by its additional California leasing activity is properly reflected in the sales factor when double-counted, undone receipts are removed. Including the double-counted, undone receipts in the sales factor only serves to overstate, rather than fairly reflect, Taxpayer's activity in California.

V. CONCLUSION

As detailed above, the standard formula is failing to fairly reflect Taxpayer's business activity in the state and alternative apportionment is necessary. In short, Taxpayer is in a unique situation where undone, double counted sales that produce no profit are heavily skewed towards California, resulting in severe distortion in the standard formula. The extent of the distortion present in the standard formula as applied to Taxpayer requires the invocation of CRTC section 25137.

Based on the foregoing, Taxpayer has shown by clear and convincing evidence that distortion is present in the standard formula, and Taxpayer has separately evidenced that the proposed alternative is reasonable