

STATE OF CALIFORNIA  
FRANCHISE TAX BOARD  
Legal Division  
Irina Iskander Krasavtseva, Tax Counsel IV  
P.O. Box 1720  
Rancho Cordova, CA 95741-1720  
(415) 904-5824  
Respondent's Representative

BEFORE THE THREE-MEMBER FRANCHISE TAX BOARD  
OF THE STATE OF CALIFORNIA

In the Matter of Revenue and Taxation Code  
Section 25137 Petition of:

DAIMLER NORTH AMERICAN CORPORATION AND SUBSIDIARIES

Taxable Year	Claimed Refund
12/31/2017	\$7,115,299
12/31/2018	\$12,062,125
12/31/2019	\$18,389,439

**STAFF'S BRIEF**

## Introduction

In its March 10, 2021, refund claims covering tax years ending on December 31, 2017, to December 31, 2019 ("tax years at issue"), Daimler North America Corporation ("DNAC") and Subsidiaries ("Taxpayer") made its Section 25137 variance request, seeking to exclude from the sales factor certain gross receipts. Upon audit of the claims, Franchise Tax Board ("FTB") auditor recommended a denial of Taxpayer's request to FTB's Section 25137 Committee. After review of Taxpayer's variance request, FTB auditor's recommendation, and Section 25137 Committee's recommendation, Taxpayer's request was denied based on a finding that Taxpayer failed to meet its burden of proving by clear and convincing evidence that application of the standard apportionment rules unfairly represents Taxpayer's activity in California.

On February 6, 2023, Taxpayer petitioned the Three-Member Franchise Tax Board ("Board") for review of the denial ("Petition").

## Issue

The issue before the Board is whether Taxpayer carried its burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation of Taxpayer's business activities in California, and (2) if the first prong is met, Taxpayer's proposed alternative is reasonable.

## Facts

Daimler AG group ("Daimler") is one of the world's biggest producers of premium cars. During the tax years at issue, DNAC was Daimler AG's United States subsidiary and the parent company for Daimler AG's United States operations. Per Taxpayer's variance request: "Under the corporate umbrella of Daimler AG, Daimler AG's operating activities are managed

under the following three legally separate units: (1) Mercedes-Benz AG (Cars & Vans), (2) Daimler Truck AG (Trucks & Buses), and (3) Daimler Mobility AG."<sup>1</sup> In footnote 2 of the variance request, Taxpayer further explains:

Daimler Financial Services AG was renamed to Daimler Mobility AG as of July 24, 2019. Daimler Mobility is headquartered in Farmington Hills, Michigan and supports the sales of the Daimler Group's automotive brands by offering financing, leasing, fleet management, investments and insurance brokerage, as well as innovative mobility services. Its product portfolio primarily consists of customized financing and leasing packages for its customers and dealers.

Among DNAC's entities and during the tax years at issue, Mercedes-Benz USA, LLC ("MBUSA") was acting as a premium cars wholesale distribution company for Taxpayer's United States market. It "purchases, imports, and distributes vehicles and parts from Daimler AG and other related and/or unrelated parties in order to resell these products to (third-party) authorized dealers and other related parties in the local market."<sup>2</sup>

As presented by Taxpayer in its Petition seeking to exclude certain gross receipts from the apportionment formula, the transactions at issue involve:<sup>3</sup>

- (1) MBUSA's original sale of cars to unaffiliated dealers ("Dealers"),<sup>4</sup>
- (2) Daimler Financial Services' subsequent "repurchase" from unaffiliated Dealers "for the same amount as the original sale price" of the cars Dealers lease to end-customers post-acquisition from MBUSA,<sup>5</sup> and
- (3) Daimler Financial Services' subsequent receipt of lease-related payments, including "finance charges and fees," and "residual sale"<sup>6</sup> payments.<sup>7</sup>

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<sup>1</sup> Exhibit A, Variance Request p.1

<sup>2</sup> Exhibit A, Variance Request, p. 4.

<sup>3</sup> In its Petition, to refer to its financial services business division, Taxpayer uses the term Daimler Mobility or Daimler Mobility AG. Consistent with Daimler's Annual Financial Reports for the tax years at issue, however, FTB refers to the same division as Daimler Financial Services.

<sup>4</sup> Apart from Mercedes-Benz Manhattan Inc., every Dealer to whom Taxpayer sells cars is an independent from Taxpayer's enterprise.

<sup>5</sup> Petition, pp. 1 and 3.

<sup>6</sup> "Residual sale" payments are payments Daimler Financial Services receives when it sells the leased car at the end of the lease term.

While in its Variance Request Taxpayer points out that Daimler Financial Services "financed or leased approximately 50 percent of the vehicles sold by Daimler AG,"<sup>8</sup> in its Petition, Taxpayer also states, albeit inaccurately as to Taxpayer's involvement, that "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."<sup>9</sup>

Based on its oversimplified summary of relevant events that produce related gross receipts for the purposes of the sales factor, Taxpayer argues that including gross receipts from MBUSA's original car sales to Dealers together with Daimler Financial Services' gross receipts associated with the cars subsequently leased in the sales factor results in "double counting"<sup>10</sup> of the gross receipts and in inclusion of receipts "with no economic profit."<sup>11</sup>

More specifically, Taxpayer seeks to exclude from the single sales factor apportionment formula during the tax years at issue the amounts indicated in Table 1 below:

**Table 1**

	<b>2017</b>	<b>2018</b>	<b>2019</b>
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

During audit, Taxpayer provided a table summarizing the above numbers and reconciled these with the single sales factor apportionment formula calculated under (a) the standard rules, i.e., with full inclusion of gross receipts from MBUSA's sales to Dealers and from Daimler Financial Services' leases and lease-related payments, and (b) Taxpayer's proposed alternative formula as indicated in Table 2 below:

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<sup>7</sup> Petition, pp. 2-4.

<sup>8</sup> Variance Request, p. 5.

<sup>9</sup> Petition, p. 2. As indicated later in the brief, an entity within Daimler Financial Services division provides financing to at least some of the end users purchasing Taxpayer's cars from Dealers.

<sup>10</sup> *Ibid.*, at p. 5

<sup>11</sup> *Ibid.*, at p. 2.

**Table 2**

Daimler North America Inc. and Subs				
California Apportionment Calculation				
		2017	2018	2019
<i>Double-counted Vehicle Sales When Customer Leases instead of Purchase*</i>				
	Leased Vehicles within CA	3,095,210,339	3,122,245,465	3,278,284,650
	Leased Vehicles Everywhere	11,883,448,194	11,469,071,275	12,018,846,334
	Percentage of Leased Vehicles in California	26.05%	27.22%	27.28%
<i>Apportionment per As Filed Return</i>				
	Sales Within CA	7,059,741,978	8,122,858,897	9,055,049,093
	Sales Everywhere	56,557,727,269	60,655,437,956	67,015,303,381
	Apportionment Percentage	12.48%	13.39%	13.51%
<i>Revised Apportionment after removal of duplicated receipts for same vehicle</i>				
	Sales Within CA	7,059,741,978	8,122,858,897	9,055,049,093
	Reversal of Double-Counted Sales	(3,095,210,339)	(3,122,245,465)	(3,278,284,650)
	Revised Sales in CA	3,964,531,639	5,000,613,432	5,776,764,443
	Sales Everywhere	56,557,727,269	60,655,437,956	67,015,303,381
	Reversal of Double-Counted Sales	(11,883,448,194)	(11,469,071,275)	(12,018,846,334)
	Revised Sales Everywhere	44,674,279,075	49,186,366,681	54,996,457,047
	Revised Apportionment Percentage	8.874%	10.167%	10.504%
	* Receipts from the initial sale of the vehicle to the dealership is included in the sales factor. If the end-customer chooses to lease a vehicle rather than purchase, lease payments towards the same vehicle are included again in the sales factor resulting in duplicate gross receipts for each car that is leased.			

Based on Table 2 above, application of the standard rules results in about 12.48, 13.39, and 13.51 percent of Taxpayer's business income being sourced to California during the 2017, 2018, and 2019 tax years, respectively, while the proposed alternative formula would source to California only 8.87, 10.17, and 10.5 percent of the same business income, respectively.

In its Audit Information Document Request No. 014, included herein as Exhibit B, FTB requested that Taxpayer provide support for its seeking to exclude billions of dollars from its sales factors during the tax years at issue. In response, Taxpayer provided screenshots of some query reports, which Taxpayer ran, but which contained very limited information. For

example, to support its numbers for the 2017 tax year, Taxpayer produced the following table:

**Table 3**

2017 Detail Amounts						
Vehicles repurchased by Daimler from Dealers and leased to customers						
Product	(Multiple Items)	<input checked="" type="checkbox"/>	No Syn Lease			
Posting Year	2017	<input checked="" type="checkbox"/>				
Acquisition Year	(Multiple Items)	<input checked="" type="checkbox"/>	2016 Late Caps posted in 2017 + 2017 acquisitions			
Termination Reason	(Multiple Items)	<input checked="" type="checkbox"/>	Excludes Flat Cancels/Rebooks			
State	(All)	<input type="checkbox"/>				
Column Labels		<input type="checkbox"/>				
Values	2200 - 2200		2400 - 2400	7400 - 7400	Grand Total	
Sum of Asset Cost Amt	758,227,894		172,510,932	10,952,709,367	11,883,448,194	11,883,448,194 Everywher
Sum of Down Payment	(538,480)		(834,610)	(348,068,237)	(349,441,328)	
Sum of Mfg Subv	(111,002)		(2,841)	(422,291,242)	(422,405,085)	
Sum of Single Pay Amount	-		-	(241,512,445)	(241,512,445)	
Sum of Gas Guzzler	-		-	(544,400)	(544,400)	
Sum of Tax Cost	757,578,412		171,673,482	9,940,293,043	10,869,544,936	
Product	(Multiple Items)	<input checked="" type="checkbox"/>	No Syn Lease			
Posting Year	2017	<input checked="" type="checkbox"/>				
Acquisition Year	(Multiple Items)	<input checked="" type="checkbox"/>				
Termination Reason	(Multiple Items)	<input checked="" type="checkbox"/>	Excludes Flat Cancels/Rebooks			
State	CA	<input checked="" type="checkbox"/>	CALIFORNIA ONLY			
Column Labels		<input type="checkbox"/>				
Values	2200 - 2200		2400 - 2400	7400 - 7400	Grand Total	
Sum of Asset Cost Amt	11,069,709		64,534,891	3,019,605,739	3,095,210,339	3,095,210,339 CA
Sum of Down Payment	(16,039)		(234,323)	(105,377,627)	(105,627,989)	
Sum of Mfg Subv	(26,912)		-	(113,348,967)	(113,375,879)	
Sum of Single Pay Amount	-		-	(49,399,775)	(49,399,775)	
Sum of Gas Guzzler	-		-	(233,000)	(233,000)	
Sum of Tax Cost	11,026,758		64,300,568	2,751,246,370	2,826,573,696	

While discussing the query reports screenshots during a call, FTB auditors asked Taxpayer to provide them with the full access to the query reports and supporting documentation. Taxpayer refused.

Overall, while Taxpayer is claiming millions of dollars in refunds based on potential exclusion of billions of dollars from its sales factors during the tax years at issue, it also has chosen to provide only cursory, unsubstantiating summaries of how it arrived at the numbers it seeks to exclude under its alternative methodology.

For example, a closer review of Taxpayer's variance request indicates that Taxpayer has not supported its alleged "repurchase at the same price" factual depiction by a representative (re)purchase agreement between Dealers and MBUSA. A Purchase Agreement related to MBUSA's wholesale transaction with Dealers that Taxpayer produced during audit does not contain a repurchase clause with respect to cars Dealers were to lease post-acquisition.<sup>12</sup> Unless such an agreement was reached between Dealers and the original seller, MBUSA, or a Dealer and an entity that was privy to the original sale, it is not clear why Dealers would be obligated to rescind the sale of the leased cars in favor of Daimler Financial Services, here a third party to the original wholesale transaction. In light of the fact that Dealers necessarily incurred expenses leasing cars they purchased from MBUSA, it also makes very little sense that Dealers would sell the leased cars back to Taxpayer "for the same amount as the original sale price."<sup>13</sup>

Furthermore, while Taxpayer continuously refers to a "repurchase," Taxpayer also mentions in its variance request, albeit momentarily in two separate footnotes, that Dealer "assigns the lease to Daimler Trust, an affiliate of MBFS."<sup>14</sup> However, nowhere in its variance request or at any point thereafter does Taxpayer elaborate on the relationship between MBUSA, Daimler Financial Services, Mercedes-Benz Financial Services USA, LLC ("MBFS USA LLC" or "MBFS"), or Daimler Trust. Taxpayer also has not mentioned or provided any details as to what Daimler Trust does or as to the purpose behind assigning leases to the trust. Instead, Taxpayer keeps on reasserting that leased cars were "repurchased" or that MBUSA's "initial sale to the third-party dealership [was] undone."<sup>15</sup>

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<sup>12</sup> Exhibit C, Purchase Agreement.

<sup>13</sup> Petition, p. 3.

<sup>14</sup> Exhibit A, Variance Request, p. 7.

<sup>15</sup> Petition, p. 1.

As FTB describes in greater details below, the leases for Dealer-leased cars were indeed assigned to Daimler Trust, with MBFS providing financing to Daimler Trust to pay for the transaction. Per a pro-forma Motor Vehicle Lease Agreement, to be executed by a Dealer, as a Lessor, and the Dealer's customer, as a Lessee, Dealer/Lessor was to assign "all right, title, and interest to this lease, vehicle and Guarantee to Daimler Trust, subject to the terms and conditions of Lessor's agreement(s) with Mercedes-Benz Financial Services USA LLC."<sup>16</sup> Since neither Daimler Trust nor MBFS was privy to the original wholesale agreement between MBUSA and Dealers, it is unclear how the assignment of titles to the leased vehicles to Daimler Trust, a retail transaction, qualifies as a per se "repurchase."

Furthermore, neither Daimler Trust nor MBFS were MBUSA's subsidiaries or subdivisions. Taxpayer-produced organizational charts, included herein as Exhibit E, indicate that Daimler Trust was an indirect subsidiary entity of Daimler Investment US Corporation ("DIUS"), which is also MBFS's corporate parent entity.<sup>17</sup> It is FTB's understanding that DIUS and its direct and indirect subsidiaries, MBFS and Daimler Trust including, are part and parcel of Taxpayer's Daimler Financial Services division. For example, the organizational chart as of December 31, 2018, and as replicated below in part, indicates that Daimler Trust (identified by a Greek letter T in the picture below) is the entity that exists for the benefit of Daimler Financial Services division, a division "legally separate,"<sup>18</sup> or "legally independent,"<sup>19</sup> from DNAC's wholesale operation. In the chart below, the Daimler Financial Services' entities relevant to this Petition are being enclosed within a red line and include

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<sup>16</sup> Exhibit D, a pro-forma Motor Vehicle Lease Agreement.

<sup>17</sup> While organizational charts indicate that DIUS is a disregarded entity, Taxpayer's California 2017 and 2018 returns clearly identify DIUS as a corporation.

<sup>18</sup> Variance Request, p. 1.

<sup>19</sup> Daimler 2019 Annual Financial Report, p. 47.





each division separately. Also as indicated by Table 4 below, Taxpayer further distinguishes Daimler Financial Services division from its Cars, Vans, Trucks and Buses wholesale divisions by framing the wholesale divisions as its Industrial Business and reporting income of the Industrial and Financial Services businesses separately, e.g.:

Table 4

<b>B.17</b>						
<b>Statement of income<sup>1</sup></b>						
	<b>Consolidated</b>		<b>Industrial Business<sup>2</sup></b>		<b>Daimler Financial Services</b>	
	<b>2018</b>	<b>2017<sup>3</sup></b>	<b>2018</b>	<b>2017<sup>3</sup></b>	<b>2018</b>	<b>2017<sup>3</sup></b>
In millions of euros						
Revenue <sup>4</sup>	167,362	164,154	141,093	139,624	26,269	24,530
Cost of sales <sup>4</sup>	-134,295	-129,626	-111,589	-108,640	-22,706	-20,986
<b>Gross profit</b>	<b>33,067</b>	<b>34,528</b>	<b>29,504</b>	<b>30,984</b>	<b>3,563</b>	<b>3,544</b>
Selling expenses	-13,067	-12,951	-12,174	-12,210	-893	-741
General administrative expenses	-4,036	-3,808	-3,075	-2,815	-961	-993
Research and non-capitalized development costs	-6,581	-5,938	-6,581	-5,938	-	-
Other operating income	2,330	2,259	2,137	2,056	193	203
Other operating expense	-1,462	-1,043	-1,404	-1,000	-58	-43
Profit/loss on equity-method investments, net	656	1,498	1,108	1,497	-452	1
Other financial income/expense, net	210	-210	218	-209	-8	-1
Interest income	271	214	270	214	1	0
Interest expense	-793	-582	-788	-577	-5	-5
<b>Profit before income taxes</b>	<b>10,595</b>	<b>13,967</b>	<b>9,215</b>	<b>12,002</b>	<b>1,380</b>	<b>1,965</b>
Income taxes	-3,013	-3,350	-2,615	-4,064	-398	714
<b>Net profit</b>	<b>7,582</b>	<b>10,617</b>	<b>6,600</b>	<b>7,938</b>	<b>982</b>	<b>2,679</b>
thereof attributable to non-controlling interests	333	339				
thereof attributable to shareholders of Daimler AG	7,249	10,278				

1 The columns "Industrial business" and "Daimler Financial Services" represent a business point of view.  
2 The industrial business comprises the vehicle segments Mercedes-Benz Cars, Daimler Trucks, Mercedes-Benz Vans and Daimler Buses. Intra-group eliminations between the industrial business and Daimler Financial Services are generally allocated to the industrial business.  
3 The prior-year figures have been adjusted due to the effects of first-time adoption of IFRS 15 and IFRS 9. Information on adjustments to prior-year figures is disclosed in Note 1 of the Notes to the Consolidated Financial Statements.  
4 In 2017 at the Daimler Financial Services segment, in addition to the adjustment of prior-year figures due to IFRS 15, the Group's internal revenue and cost of sales have been adjusted by the same amount. These adjustments have been fully eliminated in the reconciliation.

transaction were "undone" when Dealers subsequently leased Daimler's cars to the end users, neither FTB was able to locate, nor Taxpayer produced a single financial statement which clearly reports that MBUSA, or any part of the Mercedes-Benz Cars wholesale division, "repurchases" cars from Dealers.<sup>21</sup> Given Taxpayer's assertion that it "finances or leases" 50

<sup>21</sup> The fact that Taxpayer's consolidated financial statements report its worldwide operations, while Taxpayer files its California tax returns under the water's-edge election –

percent of the cars it sells to Dealers, it appears that the actual "undoing" of such sales should be clearly evident when it comes to review of Taxpayer's financial statements.

Overall, therefore, evidence Taxpayer has provided to date does not support Taxpayer's statement that MBUSA, which is part of the Taxpayer's Industrial Business, or any other entity or division that was not a party to the MBUSA's original sale of the cars to Dealers, "repurchased" from Dealers the cars Dealer leased post-acquisition.

Further review of Taxpayer's U.S. operations supports a very different story from the one Taxpayer has been telling. For example, nowhere in its Petition or variance request does Taxpayer mention the fact that Daimler Trust is a titling trust created in order to securitize leases via series of fairly complicated, structured finance transactions that involve various trusts, LLCs, and/or otherwise disregarded entities.<sup>22</sup>

Taxpayer's Form SF-3 filed with the U.S. Securities and Exchange Commission ("SEC") on behalf of its entities involved in auto-lease securitization, Daimler Trust and MBFS including, summarizes Taxpayer's structured finance transaction as follows:<sup>23</sup>

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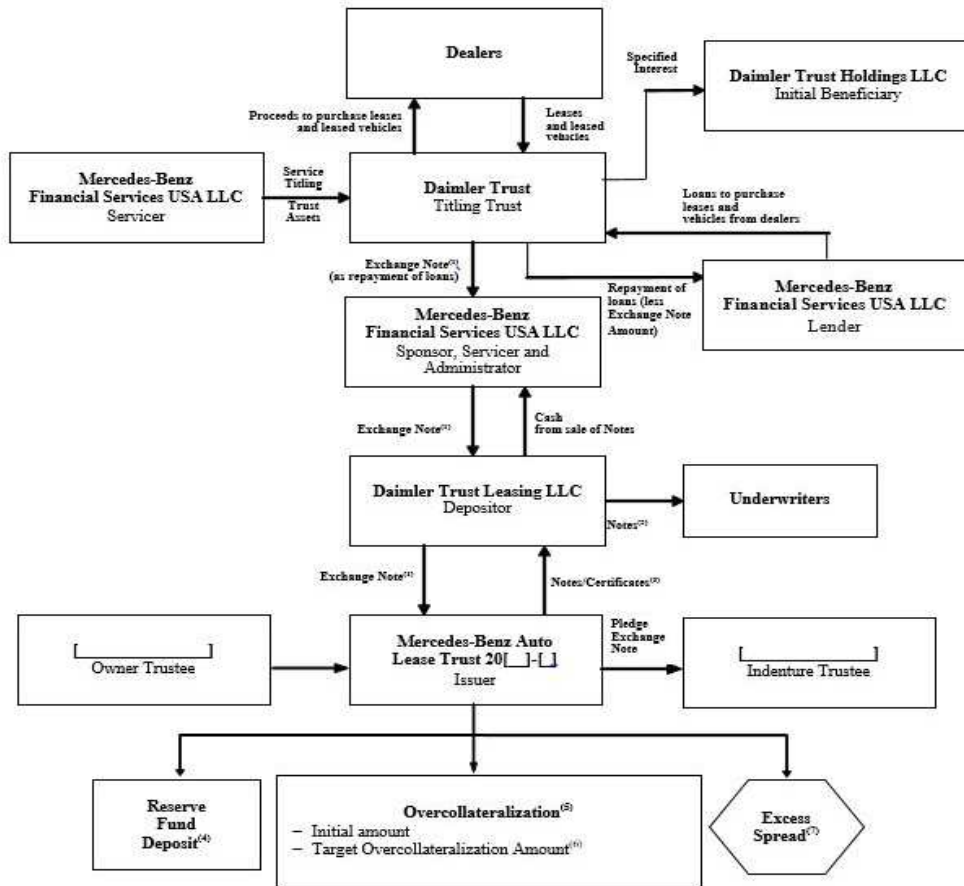
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with most of its non-U.S. operations excluded from the California combined group report, further complicates Taxpayer's attempt to simplify its presentation of relevant facts in order to carry its variance request or Petition towards the outcome Taxpayer is seeking.

<sup>22</sup>

<https://www.sec.gov/Archives/edgar/data/1537806/000114036119003653/formsf3.htm>

<sup>23</sup> *Ibid.*, at p. 6. (Footnotes to the chart as included in the report are omitted.)



Without a doubt, while the above structured finance transaction chart is preceded by a statement, *"This chart provides only a simplified overview of the structure of this securitization transaction and the credit enhancement available for the Notes. Refer to this prospectus for a further description[,]"*<sup>24</sup> the chart displays the very complexity of the transaction, the role auto-lease assignments play in earnings reported by the Daimler Financial Services segment, and the fact that MBUSA – the wholesale entity that originally sold cars to Dealers in a wholesale transaction – is not a party to the lease assignments or any of the arrangements that follow. The fact that MBUSA is not a party to lease assignment or auto-lease securitization by Taxpayer's own design, also confirms the fact that assignment

<sup>24</sup> *Id.*

of leases is not a "repurchase" but is an acquisition in its own right and is being executed by a legally independent division based on its own profit-driven incentives and objectives.

An article in the *Journal of Structured Finance* written by a law firm partner explains a structured finance transaction as an arrangement in which, first, a transfer of assets being financed is required. But, given that actual asset transfer may be an impediment to a successful structured finance transaction in terms of time, effort, and expenses, "auto lease transactions have mitigated this impediment through the use of titling trusts, which allow for the transfer of the beneficial and economic ownership of an asset without the necessity of transferring legal title."<sup>25</sup> In the case at issue, Daimler Trust is the titling trust used as the vehicle to effectuate securitization of auto leases through issuance of auto-lease asset backed securities ("ABS"). The overall scheme, the article continues, also requires legal isolation of the assets from the sponsor's (here, MBFS's) creditors via creation of a bankruptcy-remote, special purpose entity – usually an LLC or a trust, to which the assets being financed are transferred (here, Daimler Trust).

Considering the overall complexity of the transaction, it is somewhat understandable, therefore, that Taxpayer, while claiming millions of dollars in refunds, chooses to support its refund claims by its repeated reference to the auto-lease related transactions as simply a "repurchase." Had Taxpayer been forthcoming with available to it evidence that details the full set of transactions at issue, including the issuance by Daimler Financial Services' auto-lease ABS, the evidence would establish the actual purpose behind lease assignments to the Daimler Trust, which are being paid by MBFS's loans to Daimler Trust, with MBFS acting

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<sup>25</sup> Van Gorp, John D., Beyond Auto Leasing: The Use of Titling Trust in Structured Finance Transactions. *The Journal of Structured Finance*, Mayer Brown, Vol. 25. N. 4, Winter 2020. ([Mayer Brown JSF Winter 20 Beyond Auto Leasing \(pm-research.com\)](https://www.pm-research.com).)

not only as a Lender, but also as a Servicer, Administrator, and Sponsor.<sup>26</sup> In its attempt to keep things simple, however, Taxpayer have chosen not to provide in its Variance Request, in its subsequent communication with FTB staff, and in its Petition to the Board any evidence that clearly reflects how lease-related transactions generate various gross receipts, including gross receipts from Taxpayer's structured finance transactions which involved sale of auto-lease ABS to underwriters.

A more detailed picture of Taxpayer's operations affirmatively points to various ways in which Taxpayer earns revenue on the cars its manufactures. First, Taxpayer's Industrial Business segment, of which MBUSA is a part, reports revenue from its sale of cars to Dealers as a wholesaler. Second, when Dealers lease cars post- acquisition in Dealers' retail market, Taxpayer's Daimler Financial Services segment earns auto-lease-related revenue via its purchase of the leases and then in the financial market by immediately monetizing auto-leases through engagement in a series of complex transfers which turn pools of auto leases into ABS or "various classes of Notes" sold to underwriters. When it comes to ABS sales in 2018, for example, "Daimler issued asset-backed securities (ABS) in the United States, Canada, China, Germany and the United Kingdom. In the United States, the company generated a refinancing volume of \$7.6 billion through six transactions in 2018."<sup>27</sup>

As to the gross proceeds from its sale of ABS, it is not clear how much of the gross receipts Taxpayer has included in the sales factor because Taxpayer has not shared this information with FTB audit, FTB's Section 25137 Committee, or the Board. What is clear

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<sup>26</sup> See <https://www.sec.gov/Archives/edgar/data/1723535/000114036118002593/form424b2.htm>

<sup>27</sup> 2018 Annual Financial Report, p. 97.

however is the fact that, to the extent \$7.6 billion in gross receipts from the ABS sales were related to the sale of auto-lease ABS, Taxpayer must have included these gross receipts in its 2018 sales factor. And, whether Taxpayer should have been including both lease payments and gross proceeds from the sale of the same lease payments as auto-lease ABS is a question, which, as FTB will explain below, the Idaho court decision to which Taxpayer cites provides the answer in the negative. Overall, it is very curious that Taxpayer does not mention ABS sales or how it sources receipts from the sale of the auto-lease ABS to underwriters for the purposes of the sales factor during the tax years at issue.

### Legal Analysis

**I. Taxpayer has not sustained its burden of proving by clear and convincing evidence that application of the standard rules does not fairly reflect Taxpayer's activity in California.**

California law related to taxation of multistate activity by a unitary business has been succinctly summarized by the California Supreme Court as follows:

The United States Constitution bars taxation of extraterritorial income. ... However, it permits taxation of "an apportionable share of the multistate business carried on in part in the taxing State" ... and grants states some leeway in separating out their respective shares of this multistate income, not mandating they use any particular formula. One constitutional method of apportionment, the unitary business/formula apportionment method, "calculates the local tax base by first describing the scope of the `unitary business'[3] of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that `unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." The UDITPA is generally based on this method.

Under the UDITPA, a unitary enterprise's income is divided into "business income" and "nonbusiness income." With some exceptions, nonbusiness income is generally allocated directly to the taxpayer's domiciliary state. In contrast, business income is apportioned among the states according to a formula. The portion of a taxpayer's business income attributable to economic activity in a given state is determined by combining three factors: payroll,

property, and sales. Each factor is a fraction in which the numerator measures activity or assets within a given state, while the denominator includes all activities or assets anywhere. The combination of these fractions is used to determine the fraction of total global business income attributable to the given state. This method provides a rough but constitutionally sufficient approximation of the income attributable to business activity in each state.

Only the sales factor is at issue here. The sales factor is a ratio comparing sales in a given state to total sales everywhere. Sales are measured by counting a business's "gross receipts." Increases in in-state gross receipts will lead to a larger fraction, greater apportioned income, and higher tax; conversely, increases in out-of-state gross receipts will lead to a reduction in the fraction attributable to California and a reduction in California tax.

The UDITPA contains a relief provision. If application of the foregoing provisions fails to "fairly represent the extent of the taxpayer's business activity in this state," the taxpayer may seek or the Board may impose an alternate method of calculation to achieve an equitable result.<sup>28</sup>

Pursuant to Rev. & Tax. Code ("R&TC") section 25128.7 applicable to the tax years at issue, unless R&TC section 25128, subd. (b), applies, the standard rules call for "all business income of an apportioning trade or business... be apportioned to this state by multiplying the business income by the sales factor." As subd. (b) of R&TC section 25128 does not apply to Taxpayer, this Petition involves calculation of only the sales factor during the tax years at issue.

For California tax purposes, "[b]usiness income" is defined in R&TC section 25120, subd. (a), as:

income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property in the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

As applicable here, R&TC section 25135, subd. (a)(1), states that sales of tangible personal property "are in this state if the property is delivered or shipped to a purchaser ...

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<sup>28</sup> *Microsoft Corp. v. Franchise Tax Bd.*, 39 Ca. 4th 750, 751 (2006) ("*Microsoft*"). Internal citation and footnotes are omitted.



within this state regardless of the f.o.b. point or other conditions of the sale." In turn, R&TC section 25120, subd. (f)(1), defines "sales" as "all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive." And, subd. (f)(2) of R&TC section 25120, in relevant part, defines "gross receipts" as:

[T]he 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 of capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code, as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold....

Taxpayer filed its original California tax returns for the tax years at issue applying the standard apportionment methodology, i.e., it calculated its sales factor for each tax year at issue by including, among others, MBUSA's gross business receipts from its sale of cars to Dealers at wholesale and Daimler Financial Services' gross business receipts from Dealers-secured auto-leases on their retail end which Dealers subsequently assigned to Daimler Trust.

In its later filed variance request and its subsequent Petition, Taxpayer argues that application of these standard rules does not fairly reflect its California business activities; Taxpayer, therefore, is seeking to apply an alternative apportionment methodology. More specifically, Taxpayer is seeking to exclude from its sales factor the gross receipts MBUSA realized from its car sales to Dealers in its wholesale transaction and to the extent the wholesale transaction can be traced to the subsequent retail transaction of Dealer's leasing the cars. Taxpayer calls these transactions "undone" sales. According to Taxpayer, removing these so-called "undone" sales would result in a reduced apportionment factor, with only the reduced sales factor, also according to Taxpayer, fairly representing the extent of Taxpayer's

California business activities. As such, Taxpayer appears to think that, since removing the so-called "undone" sales results in a smaller apportionment factor during the tax years at issue, Taxpayer should be allowed to use the alternative apportionment formula that reduces its California tax liability.

The rule that the party seeking to deviate from the standard apportionment formula must carry the burden of proving unfair representation has been in place for over 45 years.<sup>29</sup> Courts will not find distortion merely because the standard rules result in "more-tax-to-California" and a mere difference "between the two figures derived under two different accounting methods does not prove that one set of figures is distorted."<sup>30</sup> The party invoking section 25137, "has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable."<sup>31</sup>

To ease over the burden, Taxpayer begins its brief with an apparently clear conclusion – "[t]his case is simple."<sup>32</sup> Yet, a lengthy factual description of Taxpayer's various business activities indicates that its legally distinct and separate divisions – i.e., Industrial Business of which MBUSA is a part and Daimler Financial Services division which includes Daimler Trust and MBFS – generate their income and respective gross receipts in distinct ways, with each having its own profit-driven objectives.

As an oversimplification, MBUSA realizes gross business receipts on and earns income from its sale of cars to Dealers in the wholesale market. In turn, when it comes to Daimler Financial Services division and its auto-lease related gross receipts and income,

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<sup>29</sup> *Appeal of New York Football Giants, Inc.*, Feb. 3, 1977, 77-SBE-014.

<sup>30</sup> *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.* June 2, 1989, 87-SBE-017.

<sup>31</sup> *Microsoft, supra*, 39 Cal.4th at p. 765. Internal citations omitted.

<sup>32</sup> Petition, p. 1.

Daimler Financial Services division participates in the retail transaction, realizing gross receipts in a form of lease-related payments and earning income in the form of various fees as well as from its concurrent securitization of leases and auto-lease ABS sales to underwriters. When reporting its income for California tax purposes, Daimler Financial Services also depreciates leased property that Dealers assign to Daimler Trust. During 2017, 2018, and 2019 tax years, Daimler Financial Services' depreciation expense related to the operating leases in California amounted to \$5,906,408,881.00, \$6,854,960,124.00, and 7,915,561,655.00, respectively.

In addition to generating income from auto leases, MBFS also earns interest income from providing financing to Dealers when they purchase cars from MBUSA and to Dealer's customers when the customers purchase Taxpayer's cars from Dealers.<sup>33</sup> When it comes to consumer financing, therefore, while MBUSA realizes proceeds from the sale of cars to Dealers at wholesale, MBFS earns interest on loans which pay for the same cars MBUSA sold to Dealers but purchased by the end users at retail.

Taxpayer's insistence to recharacterize two legally unlinked transactions involving two of its legally separate business segments as a "repurchase" does not change the substance of these two separate transactions. Taxpayer's sample Purchase Agreement supports the finding that the wholesale transaction involves MBUSA's outright sale of cars to Dealers. Per Taxpayer-provided pro-forma Motor Vehicle Lease Agreement between a Dealer (Lessor) and the Dealer's customer (Lessee), Dealer/Lessor concurrently assigns "all right, title, and interest to this lease, vehicle and Guarantee to Daimler Trust, subject to the terms and conditions of Lessor's agreement(s) with Mercedes-Benz Financial Services USA LLC."<sup>34</sup>

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<sup>33</sup> Daimler 2018 Annual Financial Report, p. 242.

<sup>34</sup> Exhibit D, a pro-forma Motor Vehicle Lease Agreement.

Taxpayer's annual financial reports, its variance request, and its organizational charts support the fact that neither Daimler Trust nor MBFS is a division of MBUSA; instead, both are part of Daimler Financial Services segment, which is a legally independent from the Industrial Business unit. Furthermore, while MBUSA earns revenue from its wholesale transactions with Dealers for the Industrial Business segment, the Daimler Financial Services segment earns revenue on the retail side, including revenue from lease payments, proceeds from leased cars sales, various fees, and proceeds from its sale of auto-lease ABS to underwriters. Facts also do not support a finding that either Daimler Trust or MBFS was privy to the original wholesale agreement between MBUSA and Dealers. Dealers' subsequent assignment of leases to Daimler Trust, therefore, neither reverses the original wholesale transaction between MBUSA and Dealers nor deems a lease assignment to the Daimler Financial Services segment a "repurchase."

Merriam-Webster online dictionary defines "repurchase" as "to buy something back."<sup>35</sup> If Daimler Financial Services is not the original seller, it cannot "buy back," or "repurchase," what it did not originally sell. Note that, while a wholesale and a retail lease transaction might involve the same car, these transactions do not reflect the same asset. For example, the cars MBUSA sells to Dealers at wholesale are unencumbered by a concurrent obligation – e.g., a lease or a lien; cars pass to Dealers without a requirement or condition that Dealers lease vs. sell their inventory post-acquisition. In contrast, when Dealers assign leases to Daimler Trust, the Daimler Financial Services division ends up buying an encumbered right to the leased cars, e.g., it cannot resell the leased cars during the lease term and instead monetizes auto-leases by selling these as ABS. Furthermore, when it comes to each party – whether MBUSA or Daimler Trust/MBFS – the parties

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<sup>35</sup> [https://www.merriam-webster.com/dictionary/repurchase.](https://www.merriam-webster.com/dictionary/repurchase)

negotiate and enter their respective transactions independently and based on their own cost-benefit analysis. For instance, when MBUSA negotiates the original sale, the parties to the purchase agreement enter in the arrangement at arm's length, with the seller seeking to maximize its revenue from the sale of premium cars. Similarly, when Daimler Financial Services finances its purchase of the right to leases and the titles to leased cars, it seeks to maximize its revenue from subsequent securitization of the auto leases, backing the issued ABS Notes by the collateral held by its titling trust, Daimler Trust.<sup>36</sup> On their end, Dealers pay or finance the cars they purchase from MBUSA, earn revenue from their activities that lead to car leases (or sales), and, most likely, earn service revenue from continuing to service the leased cars post-assignment. Neither of these subsequent transactions cancels out the original sale nor does it erase any of the amounts realized from a prior transaction.

Furthermore, as already indicated above, review of Taxpayer's financial statements included in its annual financial reports does not support a claim that MBUSA booked or reported a "repurchase." The mere fact that Daimler Financial Services and Industrial Business are entities and/or divisions owned by the same U.S. parent does not change the fact that the original sale transaction and subsequent lease assignment transaction were unrelated transactions, with each involving Taxpayer's "legally separate unit" and an unaffiliated counterparty. Frankly, Taxpayer could have chosen to structure its transactions differently, e.g., by entering into a service vs. sale agreement with Dealers with respect to the cars Dealers were expected to lease, and then assigning leases and leased cars to an affiliated entity within Daimler Financial Services division without having a third-party Dealer to do so. Had Taxpayer kept assignment of leases internal to the group, then assignment of leases and leased cars to Daimler Trust by MBUSA, most likely, would have been treated as

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<sup>36</sup> Daimler 2018 Annual Financial Report, p. 264.

an intercompany transaction, with gross proceeds and income from the assignment excluded from the sales factor. Yet, for reasons of its own, Taxpayer chose a different route – a route that provided more certainty to MBUSA, provided MBUSA with instant access to funds upon the original sale of the cars to Dealers wholesale, and provided Daimler Financial Services segment with an opportunity to earn income at the retail market when some of the cars MBUSA sold to Dealers were leased. MBUSA's original sale and Daimler Financial Services' purchase of the lease which it securitized and sold as ABS *each* produced an economic benefit.

While the sample Purchase Agreement between MBUSA and Dealers does not include a "repurchase" obligation when it comes to cars Dealers subsequently lease, Daimler's consolidated financial statements for the worldwide enterprise mention the following:

Operating leases relate to vehicles that the Group produces itself and leases to third parties. Additionally an operating lease may have to be reported with sales of vehicles for which the Group enters into a repurchase obligation:

- Sales of vehicles in the form of a forward (an entity's obligation to repurchase the asset) and a call option (an entity's right to repurchase the asset) are reported as operating leases.
- Sales of vehicles including a put option (an entity's obligation to repurchase the asset at the customer's request) are reported as operating leases if the customer has a significant economic incentive to exercise that right. Otherwise a sale with a right of return is reported. Daimler considers several factors when assessing whether a customer has a significant economic incentive to exercise his right at contract inception. Amongst others these are the relation between repurchase price and the expected future market value (at the time of repurchase) of the asset or historical return rates.

...

Operating leases also relate to vehicles, primarily Group products that Daimler Financial Services acquires from non-Group dealers or other third parties and leases to end customers. These leases are presented at (amortized) cost of acquisition under leased equipment in the Daimler Financial Services

segment. If these vehicles are Group products and are subsidized, the subsidies are deducted from the cost of acquisition. After revenue is received from the sale to independent dealers, these Group products generate revenue from lease payments and subsequent resale on the basis of the separate leasing contracts. **The revenue received from the sale of Group products to the dealers is estimated by the Group as being of the magnitude of the respective addition to the leased equipment at Daimler Financial Services.**<sup>37</sup>

Again, the wholesale agreement between MBUSA and Dealers that Taxpayer produced during audit does not include a "repurchase" obligation or right when it comes to the cars Dealers subsequently lease; and if it had, then according to the notes to the financial statements above, these repurchase rights or obligations would have been reported as operating leases, not as car sales, on the MBUSA books. During audit and in its Petition, however, Taxpayer did not provide any evidence that substantiated a "repurchase." The only evidence on file substantiating an MBUSA sale to Dealers is the Purchase Agreement attached as Exhibit C; and it does not contain a repurchase clause specific to lease acquisition or assignment. In contrast, the excerpt above supports FTB's explanation that each division earned respective revenue when it came to their business activities, i.e., MBUSA when it sold cars to Dealers wholesale, and Daimler Financial Services when it financed purchase of leases acquired on the retail end and when it concurrently sold these leases via structured finance transactions as auto-lease ABS. Therefore, Taxpayer's argument that:

The sales from the dealership back to Daimler Mobility [aka, Daimler Financial Services] 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.

is not supported by evidence.<sup>38</sup> The same argument is also not supported by the way

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<sup>37</sup> Daimler 2018 Annual Financial Report, p. 246. (Emphasis added.)

<sup>38</sup> Petition, p. 8.

Taxpayer has chosen to organize its business and structure its transactions. As such, Taxpayer's interpretation of the facts and its related argument should each be rejected as untrue and not supported by the evidence.

Review of MBUSA and Daimler Financial Services' activities in California also does not support Taxpayer's argument that application of the standard apportionment rules unfairly reflects the extent of Taxpayer's California business activities. When it comes to each division's California activity, MBUSA's California car sales to U.S. Dealers amounted to about 11.5, 11.7, and 11 percent during the 2017, 2018, and 2019 tax years, respectively. In turn, California leases owned by Daimler Financial Services segment, compared to the entity's overall U.S. leases, represented 28.78, 25.96, 29.31 percent during the 2017, 2018, and 2019 tax years, respectively.<sup>39</sup> Given Taxpayer's substantial California footprint in terms of sales, Taxpayer's apportionment factors for the same respective tax years of 12.48, 13.29, and 13.51 percent, as calculated under the standard apportionment rules, do not appear unreasonable. And, given that more than  $\frac{1}{4}$  of the total auto leases were in California, it is not clear why the entity that reported the lease sales – i.e., DIUS – was included in the combined report as an entity that is not doing business in California.<sup>40</sup>

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<sup>39</sup> See MBFS-filed prospectuses on behalf of Mercedes-Benz Auto Lease Trust 2017-A, p. 77, available at <https://www.sec.gov/Archives/edgar/data/1700323/000114036117015698/form424.htm>; of Mercedes-Benz Auto Lease Trust 2018-A, p. 74, available at <https://www.sec.gov/Archives/edgar/data/1723535/000114036118002593/form424b2.htm>; of Mercedes-Benz Auto Lease Trust 2019-A, p. 76, available at <https://www.sec.gov/Archives/edgar/data/1763960/000114036119001579/form424b2.htm>; and, of Mercedes-Benz Auto Lease Trust 2019-B, p. 80, available at <https://www.sec.gov/Archives/edgar/data/1791507/000114036119019929/form424.htm>. Note that two prospectuses were filed for 2019 year, with the 29.31 percent representing California activity calculated as an on average.)

<sup>40</sup> Exhibit G, 2017 and 2018 Schedules R-7.



Overall, the Taxpayer-provided evidence does not support its argument that any of its gross receipts generating transactions were "undone" or that any of its gross receipts were double counted. In fact, the evidence tells a very different story – each segment made income independent of each other and in different markets – wholesale, retail, and financing, with each segment's respective gross receipts reflecting the way each generated apportionable business income during the tax years at issue.

Taxpayer also has not provided *any* evidence that supports its calculation of the gross receipts amounts it is trying to "undo." For example, the query report screenshots that Taxpayer provided does not allow FTB to ascertain with reasonable certainty that the numbers Taxpayer puts forward are supportable. Upon FTB auditor's request, Taxpayer refused to provide FTB with full access to the actual data upon which the query reports were generated; Taxpayer also refused to provide FTB auditors with Taxpayer's Accounting Manuals for the tax years at issue.

Lastly, in its argument, Taxpayer points the Board to the Idaho Supreme Court's decision in *Union Pacific Corp. v. State Tax Comm'n* ("*Union Pacific*"),<sup>41</sup> in which the court considered as “double counting” the inclusion in the sales factor of “accounts receivables from freight sales under the accrual accounting method, and ... the sales of those same accounts receivable under the cash accounting method.” While not precedential for California tax law purposes, in Taxpayer's context, *Union Pacific* addresses a set of transactions distinct from those Taxpayer attempts to apply the decision to. In Taxpayer's context, if Daimler Financial Services has been including in its sales factor gross receipts from lease payments and gross receipts from the sale of the same leases as auto-lease ABS, then Taxpayer's inclusion of both would exemplify the "double-counting" situation the

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<sup>41</sup> *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 573 (2004).

*Union Pacific* court addressed. The Idaho Supreme Court in its *Union Pacific* decision did not address a situation where a taxpayer's one separate legal unit realized gross proceeds from the sale of inventory in wholesale market, while another legally separate unit of the same taxpayer realized gross proceeds from leasing the same inventory but upon purchasing it on its own, legally distinct account from the original wholesale buyer, but in the retail market. As such, *Union Pacific* decision does not help Taxpayer; instead, it raises an issue of whether inclusion of gross receipts from ABS sales, if any, is appropriate. However, this is a very different issue from that which Taxpayer is covering in its Petition.

Based on the above, Taxpayer has not sustained its burden of proving beyond clear and convincing evidence that the application of the standard rules results in unfair representation of Taxpayer's business activity in California.

- II. **If the Board finds that Taxpayer sustained its burden of proving beyond clear and convincing evidence that the application of the standard rules results in unfair representation of Taxpayer's business activity in California, Taxpayer did not sustain the burden of proving beyond clear and convincing evidence that its proposed alternative is reasonable.**

Given that Taxpayer did not sustain its burden of proving by clear and convincing evidence that the application of the standard rules results in unfair representation of Taxpayer's business activity in California, FTB is not required to address the issue of whether a proposed alternative is reasonable. Likewise, the Board need not entertain the question of whether the proposed alternative is reasonable.

Nonetheless, if the Board finds for Taxpayer on the unfair representation issue, it is FTB's position that exclusion of gross receipts in the amount equal to the fees paid by Daimler Financial Services to Dealers for Dealers' assignment of the leases to Daimler Trust is an unreasonable remedy.

As explained above, when MBUSA sells cars to Dealers wholesale, it realizes gross business receipts on and earns income from the wholesale transaction with Dealers. In turn, when it comes to Daimler Financial Services division and its auto-lease related gross receipts and income, Daimler Financial Services division realizes its gross receipts in a form of lease-related payments that trace back to Dealer's retail transaction. Not only does Daimler Financial Services realize revenue from lease, fees, and residual payments it receives, but it also earns revenue from securitization of leases, selling these as ABS to underwriters. Consequently, each legally separate and independent unit of Taxpayer operates with its own profit objective and purpose, with each segment's respective gross proceeds accurately reflecting its business activities, and with its respective California presence being accurately reflected in Taxpayer's sales factor.

In addition to generating income from auto leases, Daimler Financial Services also earns interest income from providing financing to Dealers when they purchase cars from MBUSA and to Dealer's customers when the customers purchase Taxpayer's cars from Dealers.<sup>42</sup> When it comes to financing, therefore, while MBUSA realizes proceeds from the wholesale transaction with Dealers, Daimler Financial Services also earns interest on loans which pay for the same cars, but sold in the retail market. While it is accurate to note that Daimler Financial Services' financing of an end-user's purchase of Taxpayer's car from a Dealer does not require it to pre-purchase the car from the Dealer first, it is worth noting that, when it comes to leases, Daimler Financial Services division also gets to depreciate the collateral asset- i.e., a leased car - assigned to Daimler Trust with the leases. Overall, therefore, finance and lease transactions are somewhat similar when it comes to earning income in different ways but with respect to a single vehicle. On the finance side, Taxpayer's

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<sup>42</sup> Daimler 2018 Annual Financial Report, p. 242.

one division earns income from its wholesale transaction with Dealers, while another division earns interest income by financing retail transaction involving the same car. Similarly, when it comes to leases, while one division earns income from wholesale transaction with Dealers, another division earns income in the retail market but from leasing the car instead of financing it. Depreciation expenses appear to be the only significant accounting difference between the two retail transactions.

During the 2017, 2018, and 2019 tax years, Daimler Financial Services' depreciation related to the operating leases with California residents amounted to \$5,906,408,881.00, \$6,854,960,124.00, and \$7,915,561,655.00, respectively. The same depreciation expenses directly relate to the leased cars which Daimler Financial Services segment acquires as a result of the lease assignments. Therefore, if the Board agrees with Taxpayer on the first issue and finds that inclusion of so-called "undone" sales in the sales factor results in unfair representation of Taxpayer's California activities, a reasonable alternative will then require concurrent reversal of the depreciation expense that Taxpayer claimed with respect to the ultimately "undone" sales, i.e., to the full extent claimed during each year at issue. Simply removing the "undone" sales while allowing Taxpayer to keep the depreciation expenses deduction directly related to the potentially removed "undone" sales is not a reasonable alternative.

For the reasons stated above, Taxpayer has not carried its burden of proving beyond clear and convincing evidence that its proposed alternative is reasonable.