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April 26, 2023

Ms. Jozel Brunett
Chief Counsel
State of California
Franchise Tax Board
9646 Butterfield Way
Sacramento, CA 95827

RE: Reply to FTB Opening Brief to the Three-Member Franchise Tax Board
Daimler North America Corporation & Subsidiaries
CNN: 2230130
Taxable Years: 12/2017, 12/2018, 12/2019

Dear Ms. Brunett,

Daimler North America Corporation & Subsidiaries ("Daimler" or "Taxpayer") hereby replies to the Franchise Tax Board's ("FTB") opening brief regarding Taxpayer's alternative apportionment petition to the Three-Member Franchise Tax Board ("Three-Member Board") pursuant to California Revenue & Taxation Code ("CRTC") section 25137.

If you have any questions or wish to discuss further, please do not hesitate to contact me at (916) 601-9707 or jon.a.sperring@pwc.com.

Sincerely,

Jon A. Sperring
Principal, SALT Consulting
PricewaterhouseCoopers, LLP

Enclosure: Daimler's Reply Brief

cc: Ms. Irina Iskander Krasavtseva
Mr. William Gardner
Ms. Delinda Tamagni
Ms. Janice Manston, Mercedes Benz North America Corp.
Mr. Chris Whitney, PwC LLP

I. INTRODUCTION

In this petition for alternative apportionment, Daimler North America Corporation & Subsidiaries ("Daimler" or "Taxpayer") is seeking the removal of receipts from sales of vehicles to dealers when those vehicles were subsequently repurchased to facilitate leases. Including receipts from vehicle sales that were repurchased from the dealers to facilitate leases, double counts the gross receipts associated with leased vehicles because the sales factor includes receipts from the undone sales to the dealer, as well as the lease payments and the receipts from the residual sale of the same vehicle. These amounts equal approximately twice the receipts of a vehicle that is not repurchased from dealers, and yet there is no profit on sales that are repurchased from dealers. Double counting the leased vehicles sales distorts Taxpayer's California activities because Taxpayer leases disproportionately more vehicles in California. As a result, Taxpayer is requesting receipts from sales of vehicles that were repurchased by Taxpayer be removed from the apportionment formula.

Unfortunately, rather than address the truism that it is distortive to include zero-profit, doubled-counted receipts from vehicles sold to dealers that were undone, the Franchise Tax Board ("FTB") staff relies on semantics as well as factually inaccurate and wholly irrelevant arguments in a transparent effort to cloud the issue and confuse the Three-Member Board ("Board"). Here, Taxpayer will reclarify the facts and law at issue, as well as respond to the FTB's inaccuracies and irrelevant arguments.

II. DISCUSSION

A. Inclusion of undone sales facilitating vehicle leases is distortive, and the FTB does not offer any legal argument related to fair apportionment.

There are two issues properly in front of the Board: (1) whether the standard formula fairly reflects Taxpayer's activity in the state, and (2) whether the proposed alternative is reasonable.[1] Specifically, the first question is whether double-counted, undone receipts that do not produce any profit should be represented in the California sales factor when the double-counted receipts cause the standard

[1] Microsoft Corp. v. Franchise Tax Bd., 39 Cal. 4th 750, 765 (2006).

formula to unfairly reflect Taxpayer's activity in the state. The only legally defensible answer to the issue presented is that double-counted, undone sales used to facilitate leases, which are designed to net zero profit, cannot be represented in the California sales factor without running afoul of CRTC section 25137 for two main reasons.

i. Qualitatively Distortive

First, as discussed in Taxpayer's opening brief,[2] the undone transactions are qualitatively distinct from Taxpayer's for-profit sales because the undone sales are designed to net to zero profit. The sales from the dealerships back to Taxpayer have a singular purpose: to undo the first sale from Taxpayer to the dealership in the case of a lease. The undone sales are essentially a return of merchandise and are not intended to produce any profit, like the hedging activity found to be distortive in the *General Mills v. Franchise Tax Board*.[3] The undone transactions facilitate the leasing transactions just as the hedging transactions in *General Mills* were facilitative of cereal sales. In contrast, the receipt of lease payments and the residual payment received at the end of the lease are intended to, and in fact do, produce the profit reflected in the sales factor. It is clear how double-counted, zero profit sales to dealers that are repurchased to facilitate the leasing transactions are qualitatively different from the lease and residual sale receipts as well as sales to dealerships that are not undone.

ii. Quantitatively Distortive

Second, as extensively evidenced in Taxpayer's opening brief,[4] the double-counted, undone sales cause significant quantitative distortion in the standard formula, as applied to Taxpayer. To ascertain why, it is vital to understand that during these years, Taxpayer leased a far higher percentage of vehicles in California than the rest of the country, thereby artificially inflating Taxpayer's California apportionment percentage.

[2] Taxpayer, Opening Brief at 8.
[3] Gen. Mills, Inc. v. Franchise Tax Bd., 208 Cal. App. 4th 1290, 1305-07 (2012).
[4] Taxpayer, Opening Brief at 9-11.

That is, the undone sales occur in California in a far greater proportion than the rest of the United States ("US"), causing more income to be unfairly apportioned to California. For illustration, the double-counted, undone sales to dealerships make up between 36 and 44 percent of all California activity in the years at issue, and yet produces zero income.[5] Conversely, over the same period, the double-counted, undone sales in the rest of the country average far less than half of those in California. There is clearly a mismatch between the income generating activity and the activities represented in the apportionment formula. The result is that California business activity is significantly overstated.[6] Comparatively, the impact on the apportionment formula in this case exceeds the level of distortive impact in *General Mills* by 300 percent.[7] In sum, the standard apportionment formula includes double-counted, undone sales which are qualitatively and quantitively distortive, and therefore, the standard formula is not fairly reflective of Taxpayer's California activity.

iii. The FTB does not argue against Taxpayer's legal position related to fair apportionment.

Ironically, the only legal issue in front of the Board is not addressed by the FTB brief. The FTB's position at audit was that double-counted, undone sales that are not intended to produce profit should be represented in the California sales factor. However, in front of the Board, the FTB has pivoted and does not make that argument or cite any legal authority in support of its audit position.[8]

Instead, in an effort to obfuscate the issue, the FTB in its brief raises irrelevant factual points, argues semantics, and indiscriminately hurls unsupported and inaccurate accusations that Taxpayer was somehow unresponsive or untruthful. Without the law or facts to support a denial of Taxpayer's alternative apportionment petition, the FTB resorts to frantically pounding the proverbial table. Below, Taxpayer will address and respond to the specific arguments, accusations, and inaccuracies the FTB brief raises.

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[5] *Id.* at 9.
[6] *Id.* at 10.
[7] The court in *General Mills* found that an average impact of 8.2 percent was quantitatively distortive. *General Mills*, 208 Cal. App. 4th at 1312.
[8] The FTB does not make these arguments because there is not a single legal authority that supports such a position.

B. Relying on semantics, the FTB claims that Taxpayer did not "repurchase" the leased vehicles and contradicts unitary theory in the process.

Puzzlingly, the FTB devotes several pages of its brief to arguing that if MBUSA sold the vehicles, and Daimler Trust (an affiliate of Daimler Mobility)[9] purchases them, it should not be labeled as a "repurchase."[10] Rather, the FTB insists that these are two separate transactions entered into by two legally separate and independent divisions of Taxpayer.[11] For example, the FTB states that, "Taxpayer keeps on reasserting that leased cars were 'repurchased' or that MBUSA's 'initial sale to the third-party dealership [was] undone,'"[12] but "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."[13] The FTB further states:

> Merriam-Webster online dictionary defines "repurchase" as "to buy something back." 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.[14]

The FTB seems to conveniently forget that in the context of California state apportionment, whether business is conducted within a single legal entity or legally separate entities is irrelevant. Under California law, entities that are unitary[15] are treated as a single unitary business.[16] MBUSA, Daimler Trust, Daimler Mobility and every single other entity mentioned in the FTB's brief are all commonly owned and part of the same unitary group in California. If MBUSA sells the vehicles to dealerships and Daimler Trust buys them back, that is a repurchase of the same vehicle by the same unitary business.

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[9] Also known as Daimler Financial Services.
[10] FTB, Opening Brief at 7-12 & 20-22. Taxpayer's financial statements do reflect Taxpayer's "repurchases" that undo the initial sales to the dealership. The initial sales to the dealerships are reflected in Taxpayer's Statement of Income pictured in the FTB's brief in Table 4. Those sales, even when the sales are undone to effectuate leases, are not removed from the financial statements. Additionally, the repurchases from dealers are also reflected in Taxpayer's financial statements in the Statement of Cash Flows.
[11] *Id.* at 8-12 & 20-22.
[12] *Id.* at 7.
[13] *Id.* at 10.
[14] *Id.* at 20. The FTB also half-heartedly attempts to argue that Taxpayer sells the car and buys back the lease, rather than the car, and thus, the transactions are separate even though they involve the same car. Yet, the FTB acknowledges multiple times that Taxpayer owns the title to the vehicle. Just because the vehicle is physically possessed by the lessee and not by Taxpayer, does not mean that Taxpayer does not own the vehicle.
[15] I.e., have common ownership, operations, uses and/or are interdependent and contribute to each other.
[16] *See* CAL. REV. & TAX. CODE § 25105.

Regardless of what the FTB calls the "repurchase," including the amount paid to the dealers for vehicles that are leased by Taxpayer's financing entity artificially inflates the amount of taxable income attributable to the leasing activity, causing distortion in the state. The FTB's desire to separate out the undone sale of the car to the dealership from the lease fails to explain how including the receipts derived from selling a car to the dealer that is subsequently purchased back for the same amount (albeit by an affiliated entity) could ever generate a profit. Yet, the standard formula apportions more taxable income to California for every undone sale that occurs in the state. No matter how many circles the FTB draws around entities in the organizational chart, Taxpayer sells a vehicle to a dealership, and (in the case of lease) Taxpayer buys it back to undo the original sale. The only issue in this case is whether including undone sales in the standard apportionment formula unfairly reflects Taxpayer's activity in the state.

i. While arguing against unitary theory, the FTB cites to evidence that leased vehicles are repurchased by Taxpayer for the same amount as the original sale price.

The FTB quotes from Taxpayer's financial statements to show that there is no repurchase obligation[17] on the part of MBUSA for Daimler vehicles that are subsequently leased.[18] The quote offered by the FTB states in relevant part:

> 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. . . . 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. . . . 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.**[19]

[17] The FTB seems to think it is important that the contracts between Taxpayer and the dealerships do not contain an obligation for the dealer to sell the vehicle back to Taxpayer in the event of a customer lease. FTB, Opening Brief at 7. The contracts do not contain an obligation for the dealership to sell the vehicle back to Taxpayer because the customer ultimately gets to choose the company from which they lease the vehicle (i.e., a third party or Daimler). The vehicles are repurchased by Taxpayer when the end customer chooses to lease directly from Daimler. This is the most popular option, but it is not required. The lack of a contractual obligation to sell leased vehicles back to Taxpayer in the dealer contracts has no bearing on the reality of the undone sales represented in the apportionment formula. As detailed, the repurchases occur. Whether the repurchases occur as a matter of business course or because of a contractual obligation, they nonetheless occur, and the value of leased vehicles end up in the sales factor twice, causing significant distortion.

[18] FTB, Opening Brief at 7.

[19] *Id.* at 22-23, *citing* Daimler, 2018 Annual Report (emphasis added by the FTB).

The FTB's chosen quote evidences Taxpayer's representation of the facts exactly:[20] in the case of leases, Taxpayer repurchases the vehicle and related lease from the dealer. It then receives lease payments from the end customer. The end of the quote even states that, overall, the revenue received from the sale of vehicles that are later repurchased and leased is of the same magnitude as the addition (purchase) of the leased vehicles. As Taxpayer has repeatedly pointed out, Daimler has no profit when it repurchases vehicles it sold to the dealerships for essentially the same price. The two transactions are necessary for Taxpayer to lease vehicles.[21] Taxpayer generates profit from the subsequent lease payments and final residual payment, not from the undone sales to the dealerships, which only serve to double count the lease transactions in the standard apportionment formula.

In its attempted mischaracterization of the facts and the issue, the FTB proves that in the case of leases, vehicles sold to the dealerships are repurchased by Taxpayer for the same price.[22] In other words, the initial sales to the dealerships are subsequently undone in the case of vehicle leases.

C. The FTB argues for form over substance in an effort to blame Taxpayer for a failure in the standard apportionment formula.

Bafflingly, the FTB brief then asserts:

> 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.[23]

Even if the FTB agreed that Taxpayer's situation is an unfair reflection of its California business activity, the FTB's answer is that Taxpayer should have engaged in better tax planning. Specifically, the FTB advises that Taxpayer should have entered service agreements with

[20] The quote also lays out the transactions as reflected in the financial statements. Namely, the sale to the dealership is reflected as a sale in the financial statement. When a repurchase obligation occurs (the customer chooses to lease), the vehicle is purchased from the dealer, is leased back to the customer, and reported as an operating lease.
[21] As discussed later, vehicle manufacturers cannot lease cars directly to consumers by law. It must go through a dealership. *See* CAL. VEH. CODE § 11713.3 (This statute prevents manufacturer competition with established dealerships selling the manufacturer's make of vehicle).
[22] In a related point, the FTB states, "it also makes very little sense that Dealers would sell the leased car back to Taxpayer 'for the same amount as the original sale price.'" FTB, Opening Brief at 7. The dealers do earn a commission for the lease, they are also eligible for incentives and volume discounts. Additionally, the dealers make significant profit on other services they sell to the customer (insurance, prepaid maintenance packages, and ongoing service/repairs).
[23] FTB, Opening Brief at 21.

dealerships rather than sale agreements. Not only does this argument value form over the substance of Taxpayer's business activity, but such a scenario is not legally permissible in California. Under California franchise law, car manufactures that make cars sold by third party dealerships — like Taxpayer — are not permitted to sell or lease directly to consumers.[24] The vehicle must always be sold to a dealership first.

While the FTB offers poor legal advice, the real problem with its argument is that it ignores the intended role and purpose of California's apportionment formula. The US Supreme Court in *Mobil Oil Corp. v. Franchise Tax Board* states that the due process clause of the Constitution requires that apportionment formulas maintain "a rational relationship between the income attributed to the state and the interstate value of the enterprise."[25] That is, there must be a rational relationship between the income attributed to the state and the business activity in that state. Conversely, the FTB is espousing that two similarly situated taxpayers should be treated differently under the standard formula — to the tune of tens of millions of dollars in tax — based on their entity structure, even if their business activities are the same in the state. The FTB's suggestion is staggeringly problematic as it erodes the rational relationship between the business activities in the state and the income attributed to the state.

D. The FTB brief seeks to obfuscate the issue by raising red herring arguments that are completely unrelated to apportionment.

The FTB brief raises several arguments that cloud the only issue in front of the Board and have no bearing on the transactions in question. Taxpayer will respond to the FTB's arguments and attempt to reclarify the issue.

i. Daimler Trust is not relevant to double counting in the apportionment formula.

First, the FTB questions why Taxpayer did not explain that Daimler Trust is the specific affiliate of Daimler Financial Services (i.e., Daimler Mobility) that holds the title to the leased vehicles and

[24] *See* CAL. VEH. CODE § 11713.3.
[25] Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 436-37 (1980).

securitizes leases for a series of finance transactions.[26] Taxpayer did not address Daimler Trust or securitization of leases because they have zero relation to the apportionment formula or the transactions at issue. The transactions at issue are: (1) the sale to the dealerships, which are subsequently undone; (2) the receipts from lease payments; (3) the residual sale of the vehicle. All three of these receipts total twice a vehicle's value and end up in the standard apportionment formula causing double counting for a single vehicle. Discussion of anything else is beyond the scope of this petition and shifting focus away from the issue under consideration by this Board.

However, since the FTB accuses Taxpayer of hiding something, Taxpayer will clarify the unrelated transactions. The titles of the leased vehicles are held by a titling trust, Daimler Trust, because it allows Taxpayer to bundle the vehicle leases together and borrow money against the bundled leases (also known as Asset Backed Securities or "ABS"). Putting the titles to the vehicles in a titling trust permits Taxpayer to engage in these borrowing transactions without moving the legal title of each vehicle for each subsequent finance transaction. Taxpayer borrows money against the vehicle assets rather than traditional unsecured loans because the interest rates for borrowing are lower for loans secured by property. While these financing transactions can be complicated, the reasoning is simple and has nothing to do with the double-counted, undone sales that are reflected in the apportionment formula. Whether Taxpayer borrows funds using a line of credit, issuing debentures, or issuing ABS has no bearing on the issue in this petition.

ii. ABS transactions are loans and not gross receipts or income.

Second, the FTB states that Taxpayer sold ABS in the US, Canada, China, Germany, and the United Kingdom to the tune of $7.6 billion in 2018.[27] While not relevant to the issue in this case, Taxpayer borrows money as needed through the issuance of ABS, which are secured by vehicles. However, the FTB then erroneously states, "to the extent $7.6 billion in gross receipts from the ABS

[26] FTB, Opening Brief at 11.
[27] *Id.* at 14.

sales were related to the sale of auto-lease ABS, Taxpayer must have included these gross receipts in its 2018 sales factor."[28] What the FTB should already know is that ABS transactions are not gross receipts at all. ABS is a form of borrowing money against assets, and borrowing money is not considered a gross receipt because a loan must be paid back. One has an obligation to repay the funds borrowed, resulting in no profit. Thus, proceeds from borrowing are not reflected in the sales factor in California, by statute.[29]

The FTB then writes, "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."[30] It is not curious at all because there are no gross receipts from ABS transactions, and the transactions are not reflected in Taxpayer's sales factor in any way. As stated, issuing ABS is a borrowing transaction, and as the FTB should be aware, borrowing money does not generate income or receipts that are included in the sales factor. ABS simply have no impact on the apportionment formula whatsoever and have nothing to do with the double-counted, zero profit sales which are the subject of this petition.

iii. The FTB seemingly justifies the distortion in the standard formula by asserting that leasing provides a tax benefit to Taxpayer through depreciation deductions.

Third, the FTB seems to suggest that the double counting present in the standard formula is justified because Taxpayer receives a tax benefit in the form of depreciation deductions on leased vehicles.[31] Before illustrating that any benefit from depreciation deductions is illusory at best, it is important to note that depreciation deductions are completely irrelevant to the issue of whether the inclusion of double-counted, undone transactions that produce no profit causes distortion in the standard apportionment formula. The FTB even issued Legal Ruling 2019-01 to state that the determination of income and deductions is not relevant to alternative apportionment petitions under CRTC section

[28] *Id.* at 15.
[29] CAL. REV. & TAX. CODE § 25120(f)(2).
[30] FTB, Opening Brief at 15.
[31] *Id.* at 19 & 28.

25137.[32] Depreciation deductions are related to the determination of income. The issue in front of this Board is one of apportionment. The FTB conducted a thorough audit of Taxpayer's returns for the years at issue and raised no concerns with the depreciation deductions taken by Taxpayer.

Further, as the FTB itself evidences in its quote from Taxpayer's annual report above, the vehicles are repurchased for approximately the same amount as the vehicles were initially sold to the dealership in the first place, and hence, produce no profit. As the FTB is well aware, California does not allow the full expensing of the cost to acquire capital equipment (such as vehicles) up front, but instead requires that the cost of capital equipment be recaptured over time through depreciation deductions. The FTB complains that Taxpayer recovers the cost of repurchasing and holding a depreciating asset in the manner required by California law.

It is also important to note that depreciation deductions are unrelated to the initial sale to the dealers. That is, the continued ownership of a depreciating leased vehicle is not affected by removing the initial sale to the dealer from the apportionment formula, as proposed by Taxpayer's remedy. If the initial sale to the dealer never occurred and Taxpayer was able to lease directly to consumers, [33] Taxpayer would still take depreciation deductions on the leased vehicles.

Moreover, depreciation deductions from ownership of leased vehicles are unlikely to afford Taxpayer a tax benefit as compared to the sale of vehicles. Again, when Taxpayer repurchases the vehicle from the dealer, the initial sale to the dealer is undone and Taxpayer has not earned a profit. However, because full expensing of the vehicle is not permitted by California law, the cost to repurchase must be deducted via depreciation over time, and a lease transaction would typically put Taxpayer in a worse tax position as compared to a purchase transaction.

All told, none of the points posed by the FTB are relevant to the issue of alternative apportionment or under the jurisdiction of this Board. The Three-Member Board's purview is to decide

[32] FTB, Legal Ruling 2019-01.
[33] Contrary to California law, as specified above.

if the standard formula fairly reflects Taxpayer's activity in the state, and if not, if the proposed remedy is reasonable. Instead of discussing fair apportionment, the FTB spends 28 pages arguing about the presentation of the Taxpayer's financial statement income, complexities associated with certain borrowing transactions, the unitary nature of the business, statutory depreciation deductions, and other trivial matters[34] wholly unrelated to Taxpayer's request for alternative apportionment. The FTB simply attempts to distract and confuse rather than address the legal merits of Taxpayer's alternative apportionment petition because there are no legal arguments for including double-counted, zero profit receipts that cause significant distortion in the apportionment factor.

E. The FTB falsely claims that Taxpayer was unresponsive to the FTB's requests for information.

The FTB brief claims that Taxpayer "has chosen to provide only cursory, unsubstantiating summaries of how it arrived at the numbers it seeks to exclude under its alternative methodology."[35] The FTB based its broad and prejudicial statement on a single note from a phone call where the auditor wrote that Taxpayer refused to provide the FTB with "full access to the query reports and supporting documentation."[36] Not only is the FTB's statement largely inaccurate, it is a gross mischaracterization designed to prejudice the Board and paint Taxpayer as a bad actor.

To clarify, the FTB auditor requested full, unfettered access to Taxpayer's internal accounting software, which is live and editable. Taxpayer denied the auditor full access to the software but did NOT refuse to provide the FTB "supporting documentation" at any point during the audit. The FTB was provided apportionment workpapers, intercompany transactions detail, and comprehensive trial balances with account level detail, including descriptions of the accounts corresponding to leasing and buybacks

[34] One minor point the FTB raises that was not significant enough to address in the text of Taxpayer's Reply Brief, was that Daimler Investments US ("DIUS") was not registered to do business in California but held lease receipts. FTB, Opening Brief at 24. Daimler Trust actually receives the lease payments from California customers. Those receipts flow up to DIUS. DIUS has no other business activity in California, and thus, is not registered to do business in the state. Further in 2019, DIUS became a disregarded entity under Daimler North America Corporation. Like many of the points raised by the FTB, this point has no impact on apportionment and is not relevant to the issue in front of the Board.
[35] FTB, Opening Brief at 6.
[36] *Id.*

from dealers.[37] Further, in response to IDR 018, Taxpayer explained the process used to arrive at the numbers provided in the query reports that the FTB complains about in its opening brief.[38]

For further context, Taxpayer's claims for refund were filed in March of 2021. The FTB audit took nearly two years and the FTB auditor issued numerous Information and Document Requests ("IDRs"). Taxpayer answered every IDR and provided the information requested in the IDR with one exception. In IDR 012, the FTB auditor requested a copy of the Mercedes Benz Accounting Manual. Taxpayer did not provide the accounting manual and explained in writing that the manual outlined internal reporting requirements that contain proprietary metrics.[39] Taxpayer further explained that the accounting manual does not dictate how dealerships or Taxpayer account for income and expenses for financial statement reporting or for federal and state income tax purposes.[40] Thus, Taxpayer clarified that the document would not provide the relevant information sought by the FTB and contained sensitive, propriety information. Taxpayer instead offered an alternative source for the information requested by the FTB: "Please refer to Taxpayer's Response to IDR #017, which outlines the eliminations done at the Federal/State level."[41] The FTB auditor accepted the alternative information and did not issue a follow up request.

Save for IDR 012, Taxpayer provided a full and accurate response to every single IDR issued by the FTB. There is not a single piece of external documentation that suggests Taxpayer was unresponsive during this audit. The FTB could have issued more IDRs if it had questions or concerns. After the final round of IDRs, the FTB did not inform Taxpayer that it had any issues with respect to the numbers or documentation provided in the claim. To now complain otherwise is to mislead this Board and is wholly inappropriate.

[37] Taxpayer, IDR 007-011, 013-019 Responses.
[38] Taxpayer, IDR 018 Response.
[39] Taxpayer, IDR 012 Response.
[40] *Id.*
[41] *Id.*

Moreover, the FTB conducted a nearly two-year audit and issued numerous IDRs and determinations.[42] Not one document sent to Taxpayer raised a single concern or question about the information provided by Taxpayer. Yet, the FTB is now arguing for the first time in front of this Board that Taxpayer has not met its burden because it was unresponsive. The FTB's characterization of this case is patently false and must be rejected.[43]

F. As a remedy to unfair apportionment, the FTB has proposed increasing Taxpayer's income subject to apportionment.

The second issue in front of the Board is whether Taxpayer's proposed alternative is reasonable. The FTB brief argues that even if Taxpayer's alternative apportionment petition is granted, Taxpayer's proposed remedy of removing double-counted, undone sales is unreasonable.[44] The FTB states that depreciation deductions on the leased vehicles would have to be reversed if double-counted, undone sales were removed from the apportionment factor.[45] However, there are three fundamental flaws with the FTB's proposed remedy.

One, the FTB's numbers are incorrect and are not relevant to apportionment in any way. The FTB brief incorrectly states that Taxpayer's depreciation deductions relating to leases with California customers amounted to $5,906,408,881, $6,854,960,124, and $7,915,561,655 for 2017, 2018, and 2019, respectively.[46] The numbers cited by the FTB are actually the depreciation deductions taken on the California return for *all* leased vehicles in the US, not just those leased in California.

Not only are the depreciation numbers inaccurate for the purpose cited by the FTB, but the FTB's requested remedy is not related to apportionment at all. Rather, the FTB's proposed remedy is related to the income base. As the FTB has declared in its own Legal Ruling, determinations of business

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[42] FTB issued an AIPS, a draft recommendation, a final recommendation, and a 25137 Committee final determination.
[43] With respect to the petition in front of the board, however, the Board's jurisdiction in this matter is to decide if the standard formula is fairly representing Taxpayer's activity in the state. It is not the Board's responsibility to re-audit the refund claims nor determine the correct amount of any refund due. The FTB attempts to inappropriately foist its audit responsibilities onto this Board in a transparent attempt to sow doubt. If the FTB Legal Bureau wishes to have the Audit Bureau re-verify the figures provided, they have that authority, and Taxpayer will be cooperative and responsive, as it has been throughout this two-year process.
[44] FTB, Opening Brief at 26-28.
[45] *Id.* at 28.
[46] *Id.*

income and expense are not appropriate topics for alternative apportionment petitions.[47] Aside from being unrelated to apportionment, the FTB's requested remedy is absurd on its face. If the Board were to find that the standard formula unfairly reflects Taxpayer's activity in California, the FTB proposes to remedy unfair apportionment by increasing the income subject to apportionment.[48] That is truly an absurd result.

Two, removing the first sale to the dealership that is subsequently undone from the sales factor does not mean that Taxpayer no longer owns a depreciating asset. Taxpayer's proposed remedy suggests that in the case of leased vehicles, the first sale to the dealer should be removed from the sales factor because those sales are later undone and produce no profit. Nothing in Taxpayer's proposed remedy removes Taxpayer's ownership of the depreciating vehicle. Taxpayer still owns the leased vehicles until the residual sale.[49] As explained above, the depreciation deductions are unrelated to the initial sale to the dealership and would be properly allowed on leased vehicles even if California law permitted leasing directly to end customers.

Three, the FTB's proposed remedy amounts to a timing difference. The FTB's remedy is based upon the idea that the distortion caused by the standard apportionment formula is justified by the tax benefit Taxpayer enjoyed from the depreciation deductions taken on the repurchased vehicles. Taxpayer has already demonstrated that although Taxpayer has no profit from the undone sales, California law requires that the cash outlay to repurchase the vehicles be recovered through depreciation over time and not up front. This is not a benefit to Taxpayer. However, if depreciation deductions were not required by California law, Taxpayer would be entitled to take a large loss at the end of the lease term on the

[47] FTB, Legal Ruling 2019-01.
[48] That is, if the Board decides that the standard formula unfairly reflects Taxpayer activity in California, the FTB's requested remedy is to increase Taxpayer's income apportioned to the state by an average of nearly $7 billion a year.
[49] The FTB seems to be confused by the economic concept of depreciation in this case. When Taxpayer repurchases a vehicle from the dealership, it has no cash in hand, owns a depreciating asset, and must still include the undone sale of the vehicle to the dealer in income. A full expense deduction would fairly eliminate the taxable income from the original sale to the dealer and reflect the economic reality: no cash in hand, no taxable income. However, California does not permit a full-expensing deductions in the year of purchase. Instead, California requires that deductions are deferred as the lease income from lease payments is received.

residual sale.[50] This would put Taxpayer in essentially the same position as depreciation deductions, albeit at a later date. Reversing depreciation deductions for assets still owned by Taxpayer does not cause the standard formula to fairly reflect Taxpayer's business activities in the state. It adds insult to injury and is disingenuous.

III. CONCLUSION

As reiterated above, the standard formula fails to fairly reflect Taxpayer's business activity in California, and alternative apportionment is required under CRTC section 25137. The proposed remedy of removing double-counted, undone sales from the sales factor is reasonable. The FTB's brief does not argue that double-counted, undone sales without profit fairly reflect Taxpayer's activity in California. Instead, the FTB brief is chockfull of unsubstantiated claims, inaccuracies, and issues entirely unrelated to apportionment or the transactions at issue. The FTB's arguments are designed to obfuscate, bias, and shift focus away from the only issue properly in front of the Board.

Based on the facts and the law appropriately in front of the Board, Taxpayer has shown by clear and convincing evidence that distortion is present in the standard formula, and Taxpayer has also demonstrated that the proposed alternative is reasonable.

[50] This is because the vehicle physically and economically depreciates in value over time and is sold for a residual value at the end of the lease that is substantially lower than the original cost to repurchase the vehicle from the dealer. Further, the basis of the leased vehicle would not be lowered by annual depreciation deductions. Thus, when the vehicle was sold for the residual value, Taxpayer would be entitled to a loss to the extent the basis in the vehicle exceeded the proceeds from the residual sale.