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Subject: California Franchise Tax Board Notice 2006-3
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To Our Clients and Friends:

California continues to scrutinize how taxpayers report proceeds from securities/investment transactions in the receipts factor of the apportionment formula. A recent pronouncement, Franchise Tax Board ("FTB") Notice 2006-3, focuses on the imposition of accuracy-related penalties when taxpayers report excess cash investment transactions.

By way of background, FTB Notice 2004-5 (issued on August 6, 2004) previously memorialized California's policy with respect to the use of alternative apportionment methods by corporate taxpayers. FTB Notice 2004-5 generally provides that a taxpayer may be subject to an accuracy-related penalty if a return is filed using an alternative allocation or apportionment methodology without prior approval from California. On August 17, 2006, the California Supreme Court held in Microsoft Corporation v. Franchise Tax Board (No. S133343) that the total amount received by the taxpayer on the redemption of marketable securities as part of the taxpayer's treasury function qualified as gross receipts for purposes of the receipts factor. Nevertheless, the taxpayer was unable to include the redemption proceeds in the receipts factor because it resulted in an unfair reflection of the taxpayer's business activity in California.

In view of FTB Notice 2004-5 and the Microsoft decision, FTB 2006-3 provides that a taxpayer who excludes from the receipts factor the total amount realized on the redemption of marketable securities as part of its treasury function, and includes only the interest income and net gains from such securities, will not be subject to an accuracy-related penalty. The determination of whether these receipts should be excluded from the receipts factor and whether that exclusion is necessary to provide a fair reflection of a taxpayer's business activities in California will remain subject to possible audit and adjustment on a case by case basis.

If you have any questions regarding the within, or any other state and local tax matters, please do not hesitate to contact me.

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