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*California Appellate Court in General Mills rules that net gains, not gross receipts, from hedging transactions are included in the sales factor*

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## ***In brief***

General Mills engaged in certain hedging transactions, which generated significant gross receipts. Such gross receipts are generally included in California's sales factor, unless inclusion does not "fairly represent" General Mills's California business activity. The California Appellate Court found that General Mills's hedging transaction gross receipts did not fairly represent its California business activity because: (1) the hedging transactions were qualitatively different from General Mills's business of selling consumer food products and (2) inclusion of the gross receipts in General Mills's sales factor substantially distorted the percentage of its California apportioned income. Accordingly, the FTB was allowed to apply an alternative apportionment methodology, which required General Mills to include only net gains (as opposed to gross receipts) received from its hedging transactions. [[\*General Mills, Inc. v. Franchise Tax Board\*](#), Cal. Ct. App., No. A131477 (8/29/12)].



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## *In detail*

### *Facts and procedural background*

General Mills was engaged in the manufacture and sale of consumer food products, including flour and grain. During the years at issue, General Mills received revenues resulting from trading in agricultural commodity futures. General Mills engaged in such trades as a hedging strategy to protect against price fluctuations in the basic materials it needed for its business.

On amended California tax returns, General Mills included its gross receipts from hedging transactions in its California sales factor. Since the trading activity did not occur in California, the inclusion resulted in a reduction in General Mills's California sales factor and, accordingly, a reduction in its California tax liability. The California Franchise Tax Board (FTB) sought to apply an alternative apportionment formula.

In 2009, the California Appellate Court ruled that the proceeds from this hedging activity qualified as "gross receipts" under California's sales factor ([click here](#) for our summary of the 2009 Appellate Court decision). However, because the trial court did not reach the alternative apportionment argument, the case was remanded back to the trial court for a determination on alternative apportionment.

On remand, the trial court ruled that including gross receipts from hedging transactions in the sales factor did not fairly represent the extent of General Mills's California business activity. Accordingly, the court allowed the FTB to impose an alternative formula that included only the *net* gains generated by General Mills from its hedging transactions ([click here](#) for our summary of the trial court decision). General Mills appealed to the Appellate Court.

### *California's alternative apportionment*

If the state's general allocation and apportionment provisions do not fairly represent the extent of a taxpayer's California business activity, the FTB may require the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Appellate Court recognized that a "fair representation" of California business activity may not exist if the challenged activity (1) qualitatively differs from the taxpayer's principal business and (2) quantitatively distorts the sales factor formula by a substantial amount. These are not independent inquiries; but rather they both serve to measure the ultimate test - whether a taxpayer's California business activity is "fairly represented."

### *Hedging activities were qualitatively different from General Mills's consumer products business*

The process of hedging protected General Mills against the risk of fluctuations in the price of agricultural commodities General Mills uses in its business. If General Mills did not hedge the price of grain, it would encounter severe fluctuations in its costs of goods and would not be able to achieve its profit margins on its ultimate product sales.

The court found little significance as to whether hedging activity was "critical" or "integral" or just "important" to General Mills's business. The relevant inquiry was

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whether the hedging transactions were similar to General Mills's primary business of selling end products to customers for profit.

The court recognized that hedging transactions serve a "risk management function" unrelated to the selling of products to customers. Even though the underlying commodities being hedged related to General Mills's business inputs, the court nevertheless found that the hedging transactions were qualitatively different from General Mills's consumer product sales because they served *only* a supportive function.

### *Hedging activities quantitatively distorted General Mills's California sales factor*

The court looked to the following quantitative metrics to support a finding of substantial distortion:

- **The amount of business activity attributed to a single state.** Including hedging gross receipts in its California sales factor would result in assigning close to 9% of General Mills's entire business activities to Minnesota.
- **Percentage of income vs. percentage of gross receipts.** General Mills's hedging activities produced at most 2% of the company's income while it generated between 8% and 30% of the company's gross receipts.
- **Profit margin.** On average, General Mills's profit margin measured by its consumer product activity exceeded its hedging profit margin by 81 times.
- **Percentage change in the standard apportionment formula.** General Mills's average California apportionment percentage reduction was 8.2%.

While the court recognized that the percentage impact on the standard apportionment formula was less severe than in past California gross vs. net decisions, the court concluded that the overall distortion from all quantitative categories was sufficient to warrant the application of alternative apportionment.

## *Actions to think about*

Several courts have ruled in favor of alternative apportionment in similar gross vs. net decisions. The two seminal California Supreme Court cases in this area are *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006) and *General Motors Corp. v. Franchise Tax Board*, 139 P.3d 1183 (Cal. 2006). Both decisions, and most of their progeny, involve financial transactions that were completely unrelated to the respective taxpayer's main business.

In *General Mills*, there was some hope that the taxpayer would survive an alternative apportionment challenge because the hedging transactions involved business inputs that were related to its underlying business. The court, however, disagreed, finding that the hedging transactions differed from General Mills's primary business of selling consumer goods. *General Mills* also lowered the bar on the net change to the overall apportionment factor required to prove distortion.

*General Mills* provides support that a court will look at the aggregate result of several quantitative and qualitative factors to make its determination of whether California business activity is "fairly represented" by the inclusion of certain receipts in a

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taxpayer's sales factor. To the extent a taxpayer can measure the impact of its activity against those factors and show less distortion than existed in *General Mills* and similar decisions, an opportunity to defeat the application of alternative apportionment may exist.

The gross vs. net issue is largely moot for tax years beginning in and after 2011 because California law was modified to exclude treasury and hedging transactions from the sales factor. However, gross vs. net may remain relevant for those taxpayers with open years under the statute of limitations or under audit. For more information on California's exclusion of treasury and hedging receipts, please read our summary, [available here](#). Further, there is the potential for taxpayers to make an election under the Multistate Tax Compact following the *Gillette* decision that could include the application of the MTC's broad definition of gross receipts, which arguably includes treasury and hedging receipts. Please read our summary of the *Gillette* decision, [available here](#), for more detail on the MTC compact election.

## ***Let's talk***

If you have questions about the *General Mills* decision, please contact any of the following individuals:

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