Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Cogdill	Analyst:	Anne Mazur	Bill Number:	SB 788
Related Bills:	See Legislative History	Telephone:	845-5404	Introduced Date:	February 23, 2007
		Attorney:	Tommy Leung	Sponsor:	Franchise Tax Board

SUBJECT: Water's Edge Audits

SUMMARY

This bill would permit the Franchise Tax Board (FTB) to conduct audits of water's-edge taxpayers on a discretionary, rather than mandatory, basis.

PURPOSE OF THE BILL

The purpose of this FTB-sponsored bill is to allow for more efficient tax administration for both the taxpayers and the department.

EFFECTIVE/OPERATIVE DATE

If enacted in 2007, this bill would be effective on January 1, 2008, and would specifically apply to audits commenced on or after that date.

POSITION

Support.

On December 4, 2006, the Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

ANALYSIS

FEDERAL LAW

The Internal Revenue Service (IRS) is authorized to allocate income and deductions among two or more entities owned or controlled by the same interests in order to prevent tax evasion or to reflect the true taxable income of any of those entities. This authority assures taxpayers report and pay the correct amount of tax by preventing improper shifting of income and deductions among related taxpayers.

Board Position:			Department Director	Date
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Under advance pricing agreements (APAs) with the IRS, taxpayers prospectively determine and apply transfer pricing methodologies to international transactions by related foreign or domestic taxpayers. APAs memorialize the agreement between the taxpayer and IRS of the transfer pricing methods that should be applied before the tax return is filed. Negotiating an APA prior to tax return filing provides certainty and eliminates the need for intrusive and resource intensive transfer pricing audits.

Internal Revenue Code section 482 requires that all transactions between related entities be transacted at arm's length. "Arm's-length" refers to the uncontrolled price that would be used in the open marketplace had the entities been unrelated. The analysis needed for a transfer pricing examination, more specifically, the process of determining an "arm's length" price, is extremely time consuming, necessitating not only significant audit hours, but also the skills of economists and industry experts.

STATE LAW

California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes the income and apportionment factors of foreign corporations from the calculation of business income. The effect of a water's-edge election is that some foreign unitary entities are no longer part of the combined reporting group, which raises the same transfer pricing audit issues that arise under federal law.

Revenue and Taxation Code (R&TC) section 25114 requires FTB to examine water's-edge returns for potential noncompliance. If potential noncompliance is found, current law requires FTB to conduct a detailed examination of the issue, regardless of the net revenue benefit to the state, unless the IRS is addressing the issue. These examination requirements have been in place since the water's-edge statutes[1] were originally enacted in 1986.

A significant issue for water's-edge taxpayers is the assignment of income among related taxpayers within and without the water's-edge group; thus, when the water's-edge statutes were enacted, language was included that requires FTB to examine the annual filings for taxpayers making the water's-edge election. FTB evaluates each water's-edge case that it audits for potential noncompliance with this issue—known as transfer pricing—and generally follows the results of federal examinations of this issue.

[1] R&TC sections 25110 - 25115 were added by SB 85 (Stats. 1986, Ch. 660), applicable to taxable years beginning on or after January 1, 1988. The language of section 25114 was originally part of section 25110. SB 85 (Stats. 1988, Ch. 989) amended this language out of section 25110 and into section 25114, replacing the original language of section 25114. SB 1229 (Stats. 1999, Ch. 987) subsequently amended section 25114.

THIS BILL

This bill would amend R&TC section 25114(a), relating to the examination of water's-edge taxpayers, to eliminate the requirement for FTB to conduct a detailed examination—primarily of transfer pricing issues—when an initial examination reveals potential noncompliance, regardless of the potential net revenue benefit to the state. As a result, FTB would be allowed to apply discretion for deciding when to examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of all factors, including the relative levels of noncompliance and materiality.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

FISCAL IMPACT

Savings that may result from this bill would be applied to other workloads.

ECONOMIC IMPACT

Under this bill, FTB would no longer be required to conduct detailed water's-edge audits for noncompliance issues, including transfer pricing, that are unlikely to produce additional revenue. Therefore, this bill would have no impact on state income tax revenues.

ARGUMENTS/POLICY CONCERNS

Allowing FTB discretion to review and examine water's-edge taxpayers for noncompliance issues, including transfer pricing, based on an analysis of all factors, including the relative levels of noncompliance and materiality, would result in more efficient tax administration for both taxpayers and the department. Mandatory transfer pricing examinations are time consuming and burdensome to both the department and the taxpayer.

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