



STATE OF CALIFORNIA  
**FRANCHISE TAX BOARD**  
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February 14, 2001

Information Letter No. 200808

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Dear \*\*\*\*\*:

Your letter to \*\*\*\*\* , dated \*\*\*\*\* , has been referred to me for reply. In your letter you ask a series of general questions, each of which will be answered in turn. Tax forms, the Revenue and Taxation Code, the California Code of Regulations and other information cited in this memorandum can be located on our web site at <http://www.ftb.ca.gov>.

1. The provisions of the "Uniform Division of Income for Tax Purposes Act" (hereinafter "UDITPA") have been adopted, with modifications, by California. They are found in Chapter 17, Part 11, of the Revenue and Taxation Code, section 25101 et seq.<sup>1</sup> California's apportionment formula is located in Code section 25128 and Title 18, California Code of Regulations (hereinafter "CCR"), section 25128. Like UDITPA, the apportionment formula is based on three factors: property, payroll and sales. Unlike UDITPA, California double weights the sales factor in most circumstances.

California has also adopted the Multi-State Tax Compact, Code section 38006, which allows a taxpayer to elect the state's allocation/apportionment methods or the standard UDITPA, which is part of the compact. However, the Multi-State Tax Compact is limited by Code section 25128, which provides, among other things, for the double weighting of the sales factor, notwithstanding Code section 38006.

Use of the California apportionment formula is mandatory in California; that is, California does not allow the taxpayer to elect another formula. If the taxpayer can demonstrate that the California apportionment formula apportions a disproportionate amount of income to California relative to the business done by the taxpayer in California, then the taxpayer may file a petition, pursuant to Code section 25137, with the Franchise Tax Board (hereinafter "FTB") to have an alternate accounting. The

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<sup>1</sup> All references to code sections will be to the California Revenue and Taxation Code unless stated otherwise.

FTB must grant the taxpayer's petition, pursuant to Code section 25137, before an alternate accounting may be used.

California has also established special apportionment formulas for industries where it has been demonstrated that the formula provided in Code section 25128, and associated Code sections and regulations, consistently results in distortion. The apportionment formula for special industries is located in CCR section 25137, and 25137-1 through 25137-12. When a taxpayer is in one of the special industries for which the regulation provides, the taxpayer must use the special formula unless the taxpayer can demonstrate that it still results in distortion. If the taxpayer can demonstrate the distortion, then the taxpayer should seek relief by filing a petition under Code section 25137 as discussed above.

2. California's definitions for business and non-business income are found in Code section 25120 and CCR section 25120. California substantially follows UDITPA's definition. The State Board of Equalization, California's administrative appellate body, has held that the language in the California statutes creates both a functional test and a transactional test to determine if the property is business or non-business income. Aspects of this area of law are currently under consideration by the State Supreme Court in *Hoeschst Celanese Corporation v. FTB* (2000) 996 P.2nd 1151 [94 Cal.Rptr.2nd 839]. (See also 76 Cal.App.4<sup>th</sup> 914 [90 Cal.Rptr.2<sup>nd</sup> 768] for a copy of the decision prior to the granting of review.)

3. When a multistate business is subject to tax in California, business income is apportioned pursuant to Code section 25128 and non-business income is assigned based on Code sections 25124 (rents, royalties from real and tangible personal property); 25125 (capital gains and losses); 25126 (interest and dividends); 25127 (patent and copyright royalties); and the corresponding regulations (CCR sections 25124-25127). These rules are substantially similar to the Multi-State Tax Commission model regulations.

The rules for calculating the property ratio of moveable equipment are found in Code section 25130 and the associated regulations including CCR sections 25129(d), 25137-7, 25137-9, and 25137-11. The rules for calculating the property ratio of inventories are found in Code section 25131 and the associated regulations.

4. Code section 18601 requires every taxpayer subject to California's Bank and Corporate Income Tax Laws, Code section 23001 et seq., to file a return with the FTB. California also requires two or more corporations conducting a unitary business within and outside California to use the combined reporting approach to determine California source income subject to tax by California. Two or more corporations conducting a unitary business wholly within California may elect to use a combined report. A

combined report is not a return. Rather it is a means by which the income of a unitary business is divided among the taxing jurisdictions. (See Revenue and Taxation Code, Chapter 17, Allocation of Income, Code section 25101 et seq. and associated regulations. See also FTB publication 1061 (2000) *Guidelines for Corporations Filing A Combined Report.*)<sup>2</sup>

In your letter you ask about consolidated returns. Generally, California does not follow the federal consolidated return regulations provided under Internal Revenue Code section 1502. (See FTB Publication 1061 (2000) *Guidelines for Corporations Filing A Combined Report*, p.5.) Please note that California does allow consolidated returns for railroads pursuant to Code section 23362; however, this a specific exception.

5. Separate accounting is usually not allowed. However, separate accounting can be utilized where a taxpayer files a petition for equitable adjustment of apportionment provisions, pursuant to Code section 25137 and CCR section 25137, and separate accounting is a method that may be granted by the FTB. (See the response to question one for more information on the section 25137-petition process. See also *Honolulu Oil Corporation v. FTB*, (1963) 60 Cal.2d 417, and *Superior Oil Company v. FTB* (1963) 60 Cal.2d 406, for an interesting discussion on this matter.)

6. California does not distinguish between start-up businesses or newly expanded businesses with respect to the apportionment formulas. Consequently, there are no allowances or departures from the income apportionment statutes. However, the regulations do contemplate a weighting of property based on the amount of use. In the early stages of a start-up business or business expansion it is possible that not all property will be in use as it is being held or acquired with an eye towards expansion. This entails a fact and circumstances inquiry, specific to each situation.

7. California's apportionment formula is a fair reflection of activities, not income. As discussed above in question one, a taxpayer can petition with the FTB for an alternate apportionment formula where the taxpayer can demonstrate that the apportionment formula results in distortion. The petition is with the FTB; therefore, the petition must be brought while the FTB still has jurisdiction to hear the matter.

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<sup>2</sup> There are special rules for S corporations. Please refer to FTB Publication 1061 (2000) for a more detailed discussion.

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The above discussion is meant to provide a general understanding of California's multi-state tax laws and does not constitute a legal opinion. Naturally, we cannot offer an opinion absent knowledge of the relevant facts of a particular tax matter.

Cordially,

Kathryn Harker  
Tax Counsel