

DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting
Regulation Section 25114: Presumptions Arising from Federal Audits
(For Water's-edge Taxpayers)
March 25, 2008

1. Overview and History of Regulation Section 25114.

In 1988, the California Legislature adopted Revenue and Taxation Code (RTC) section 25110, et seq., which allowed California taxpayers that were members of a unitary group to "elect to account for and determine their income derived from California sources by considering only the income and apportionment factors" of certain affiliated corporations, which are generally only the domestic members of the unitary group, which is called the "water's-edge" method.

Previously, RTC section 25114(a) required the Franchise Tax Board to examine all returns filed by taxpayers pursuant to the water's-edge rules. If the Franchise Tax Board then determined that there was potential noncompliance, it was required to conduct a detailed examination under the federal transfer pricing rules of Internal Revenue Code section 482 unless the Internal Revenue Service was examining the taxpayer for the same years and issues. This detailed examination was required to be conducted notwithstanding the "potential net revenue benefit to the state." The mandatory audit requirement was included in the water's-edge legislation to provide a disincentive for companies to misrepresent their U.S. income through, for example, transfer pricing arrangements between their U.S. and foreign operations.

On October 5, 2007, the Governor signed [SB 788](#) (Stats. 2007, ch. 306), which amended RTC section 25114. Under amended RTC section 25114, the Franchise Tax Board is still required to examine all returns filed by taxpayers pursuant to the water's-edge rules. The amendments to RTC section 25114 have deleted the requirement for the Franchise Tax Board to conduct a detailed examination in cases of potential noncompliance.

2. Discussion Focus

The department anticipates having an open discussion to address concerns that may be present, together with possible approaches to resolve potential problems.

Staff believes that the following core principles provide an objective basis to guide the discussion and to evaluate proposed solutions:

- A. Equity: Are all taxpayers being treated similarly?
- B. Administrability: Is the rule clear and simple? Can taxpayers and the department apply the new rule?
- C. Elimination of potential disputes: Does the new rule raise concerns that could lead to new disputes?

D. Recordkeeping: Does the new rule use existing records as much as possible to minimize taxpayer recordkeeping burdens?

Given this basic framework, staff would like to discuss how to incorporate the amendments made to the statute into the regulation.

For example, RTC section 25114, subdivision (a), now provides that "[t]he Franchise Tax Board, for purposes of administering the provisions of this article, shall examine the returns filed by taxpayers subject to these provisions." RTC section 25114, subdivision (c), further provides that "[t]he amendments made to this section by the act adding this subdivision shall apply to examinations commenced by the Franchise Tax Board on or after the effective date of that act. An examination will be considered commenced when a taxpayer is first contacted by the Franchise Tax Board concerning any examination with respect to the taxpayer's return."

A question has arisen as to how to reconcile the term "examine" in subdivision (a) and "examination" in subdivision (c) without requiring an audit of every water's-edge taxpayer or contact with every water's-edge taxpayer.

Are there areas where examples might be helpful?

Are there provisions of the current regulation that should be removed or amended?

Staff would like input on these questions as well as any other issue participants may have noted in the regulation. You may contact Craig Swieso, the lead legal staff person for Regulation section 25114, at Craig.Swieso@ftb.ca.gov.

Note: In addition, the department is currently reviewing existing Regulation section 25111 and proposed Regulation section 25113, water's-edge elections, as well. An interested parties meeting on these two sections is scheduled for March 25, 2008 at 9:00 a.m. at the Franchise Tax Board, Golden State Room A, 9646 Butterfield Way, Sacramento, CA 95827 (Use North Lobby Entrance). A notice of that meeting and a list of discussion topics can be found at www.ftb.ca.gov. (Highlight "Public Meetings" under the "News and Events" heading on the home page and click on "Interested Parties Meetings.") You may contact Karen Smith, the lead legal staff person for Regulation sections 25111 and 25113, at Karen.Smith@ftb.ca.gov.