

DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting Explanation of Discussion Draft Regulation 25137-7 and New Regulation 25101.3, Relating To Air Transportation and Blended Air/Trucking Industry Regulations March 27, 2008

Background

The Franchise Tax Board (Department) has identified the current statute and regulation used to apportion air transportation company income to this state as potentially needing both a new regulation and amendments to an existing regulation. (Rev. & Tax. Code §§ 25137 and 25101.3; Cal. Code Regs., tit. 18, § 25137-7.) The Department hosted an interested parties meeting on September 6, 2007 to provide air transportation company representatives an opportunity to provide input on the need for potential changes and how the income of air transportation companies should be apportioned. Written suggestions were also solicited at the September 6, 2007 interested parties meeting.

The Department took into consideration air transportation company input before crafting the attached discussion draft of new Regulation section 25101.3 and amendments to existing Regulation section 25137-7. These potential regulatory additions and amendments are intended to elicit specific input from the air transportation industry. The Department anticipates adjustments to the discussion drafts before potentially moving forward with this regulation project. The discussion below is keyed to the subdivisions of the discussion draft.

A significant proposed amendment to the discussion draft is splitting revenues of air freight and air express companies between air and ground transportation to calculate the sales factor. The federal excise tax on air transportation is used to split air express company revenue between ground and air revenue. (Discussion Draft, Regulation section 25137-7, subsection (b)(3)(C).)

New Regulation section 25101.3:

The property factor for apportioning income of an air transportation company is calculated according to California Revenue and Taxation Code, section 25101.3. There currently is no regulation interpreting that statute.

Two versions of the discussion draft of Regulation section 25101.3 are presented to interested parties. The first version of Regulation section 25101.3 requires aircraft to be grouped by model of aircraft. The second version of Regulation section 25101.3 requires aircraft to be grouped by type. Interested parties are asked to provide input as to whether using models or type of aircraft enables a fairer apportionment of air transportation company income. Further, should the regulation track the Board of Equalization regulations, including the "widebody" grouping, if type of aircraft is used?

Subsection (a)

This subsection in both discussion drafts clarifies the grouping of aircraft for the property factor calculation in light of the State Board of Equalization's unpublished decision in *Appeal of Alaska Airlines* (2007). Grouping aircraft of an air transportation company by model or by type of aircraft usually results in a more fair calculation of the ratio of property value in this state than calculating the property factor using all of an air transportation company's aircraft. For example, if an air transportation company has both high and low value aircraft, but only low value aircraft enter this state, the ratio of the property factor could be overstated. The property factor ratio could be understated if only high value aircraft enter this state.

Subsection (a) of both Discussion Drafts explains how the aircraft groupings are done. Aircraft types that do not have taxable situs are not included in the calculations used to compute the property factor numerator. Aircraft models or types with taxable situs are grouped model or by type. An allocation ratio is then calculated for each grouping of aircraft.

Subsection (b)

Subsection (b) clarifies that the allocation ratio is computed based on Revenue and Taxation Code section 25101.3.

Subsection (c)

Subsection (c) of the first Discussion Draft requires aircraft to be grouped by model to calculate the property factor. The reasoning behind using model of aircraft is based on the assumption that models of aircraft are generally of the same value. Grouping aircraft by model also enables a more accurate calculation of the property factor than calculating the property factor based on an air transportation company's entire fleet of aircraft. The same logic guides the second Discussion Draft, which would require groupings by type of aircraft.

Subsection (c) of both Discussion Drafts mirror possible amendments to Regulation section 25137-7, subsection (e). Proposed changes to that subsection are discussed below. Interested parties are invited to comment on the proposed use of model or type groupings. Comments are invited on the accuracy of grouping aircraft by model or type.

The Department also invites discussion from interested parties on complying with grouping of aircraft by model. For example, the Department understands that air transportation companies report aircraft models that arrive in this state to county assessors for property tax purposes on Form AH 570-3, Column 2. This information appears easy to duplicate for reporting aircraft models to this Department for allocation and apportionment purposes.

Amended Regulation section 25137-7

The discussion draft of Regulation section 25137-7 includes several major amendments. The explanation below is grouped into possible amendments based on subsections. There are two alternative amendments to subsection (e). The first version of the subsection requires grouping

aircraft by model, which is a major change for the current groupings by type. The second version keeps the grouping by type but updates the types by eliminating aircraft models from the subdivision.

Subsection (a)(1)

The word "unitary" was added as clarification. The second sentence to this subsection is intended to clarify that entities that are engaged in the business of air transportation within a unitary group, even if the group's main business is not air transportation, must apportion the income of the entities involved in the air transportation business using Regulation section 25137-7. An example of this kind of entity is a unitary conglomerate that owns an air transportation business as part of its unitary business.

Subsection (b)(3)(C), (b)(3)(C)1., and Example

This amendment to the sales factor calculation requires air express companies that use both ground and air transportation to move customer packages, to calculate their sales factor based on the air transportation company apportionment formula and the trucking formula. The new provisions are intended to fairly reflect the extent of an air express company's business activity in California.

Because air express companies currently utilize the sales factor rules in Regulation section 25137-7, they are only recognizing the market for their services to the extent of the arrivals and departures and time in state of airplanes. This seems incorrect, as the ground activity is an integral part of the services provided and in some cases is the only transportation necessary to deliver the freight to its intended destination. For example, if an express company contracts to ship freight from Sacramento to San Francisco in two days, it is unlikely that the freight will be sent by air, despite the fact that the company has a fleet of airplanes. If only trucks are utilized in this example, the receipt derived by the taxpayer will not be properly represented in the sales factor because there is no mechanism in Regulation section 25137-7 to do so. The proposed regulation language addresses this situation by providing a splitting mechanism for revenues based on the requirements of federal law.

Air express companies should include trucks, facilities and other ground property in the property factor. Payroll of ground personnel should be included in the payroll factor. But ground activity is not represented in the sales factor as the regulation is currently written. The proposed regulation amendment would measure ground activity including, among other things, trucks moving packages between cities including across California's borders, and moving freight from an aircraft to a delivery address.

Air express industry representatives have asserted in some cases that an air transportation formula should apply to revenue earned from air transportation but that an air transportation formula should not be applied to revenue earned from ground transportation. This discussion draft of Regulation section 25137-7 would, if adopted, enable air express companies to separate air revenue from ground revenue for allocation and apportionment purposes.

Subsection (b)(3)(C)1. requires air express companies that use ground transportation to calculate the sales factor using the trucking companies formula (Cal. Code Regs., tit. 18, § 25137-11) to the extent revenue is earned from ground transportation. The air transportation formula would apply to members of a unitary group that are doing business related to aircraft and air transportation.

The example in the discussion draft illustrates how the regulation is applied to an air express company.

Air express companies report revenue from air transportation to the federal government for excise tax purposes. Air express companies collect excise tax from customers and remit the amounts collected to pay federal excise tax. Air express companies therefore already segregate a customer receipt between air and ground transportation. Whether this is done on a receipt-by-receipt basis or by a ratio applied to receipts in total, the effect is that there is a determination of receipts solely from air transportation. These receipts would be apportioned the same way that receipts of air transportation companies are apportioned.

The remaining receipts would then be designated as the ground portion of receipts. The sales factor numerator of the air express companies for these receipts would be calculated based on the sales factor provisions of Regulation section 25137-11, the allocation and apportionment of income of trucking companies. Revenues from ground transportation would be the sum of the receipts from ground transportation that begins and ends in this state and the portion of receipts from movement or shipments that originate in one state and terminate in another state determined by application of the interstate ratio provisions of Regulation section 25137-11.

The resulting air revenue numerator and ground revenue numerator amounts are added together to reach the total California numerator. This figure is divided by revenue everywhere to reach the sales factor percentage.

Interested parties are asked to specifically address whether this discussion draft amendment would fairly reflect the extent of their California business activity. Interested parties are specifically asked about the practicality of determining air revenue using the federal excise tax on transportation by air.

Subsection (e)

Two alternative amendments to this subsection are presented for discussion. The first discussion draft amendment is based on existing subsection (e) but aircraft are grouped by model rather than type. Interested parties are asked to provide input as to whether using models or type of aircraft enables a fairer apportionment of air transportation company income. Should the statute track the Board of Equalization regulations, including the "widebody" grouping, if type of aircraft is to be used?

The alternative discussion draft amendment to Regulation section 25137-7, subsection (e), would update the current groupings by type of aircraft. The amendment would eliminate aircraft

models that are currently listed as types in the regulation. These aircraft would be grouped based on the type and number of engines.

The grouping of aircraft by type of aircraft is similar to California Code of Regulations, title 18, section 202, which is used by the State Board of Equalization to assess property taxes on air transportation companies. The property tax regulation requires grouping aircraft by type using engine type and number of engines. The property tax regulation also includes "widebody" as a type of aircraft, a category not used in the proposed amendment to Regulation section 25137-7, subsection (e), to limit the aircraft groupings by type and number of engines.