

REPORT ON INTERESTED PARTIES MEETING TO CONSIDER REGULATORY CHANGES TO THE AIR TRANSPORTATION AND AIR/TRUCKING INDUSTRY REGULATIONS

(Amendments to California Code of Regulations, Title 18, Section 25137-7, and Adoption of California Code of Regulations, Title 18, Section 25101.3)

The interested parties meeting was held at 1:00 p.m. on September 6, 2007, at the Franchise Tax Board's Central Office in Rancho Cordova, California. The facilitator was Kathryn Harker, Tax Counsel for the Franchise Tax Board.

Prior to the interested parties meeting, a discussion paper was made available setting forth the special apportionment rules as currently administered by the department. It also discussed the administration of these special rules following the 2007 unpublished State Board of Equalization decision in *Appeal of Alaska Airlines*. It had been the department's practice to allocate items to the property and sales factor on the basis of airplane type, with type determining by reference to model number, e.g., 747, DC-10, etc. The department looked to the make and model of aircraft to remove planes that never enter the state from the numerator of the apportionment factor. In *Alaska Airlines* the taxpayer took the position that type should be construed more broadly on the basis of the types of planes listed in subsection (e) of Regulation section 25137-7, without providing a mechanism for removing planes that never enter the state. In light of this decision, the department is currently allowing the use of two separate formulas -- the traditional method applied by the department, and the formula applied in the *Alaska Airlines* decision (blended method). In the discussion paper, the department informed interested parties that it is seeking to adopt a single, uniform formula that can be easily and fairly administered by the department without overburdening the reporting requirements imposed on the affected industry. Another goal of the proposed regulatory change is to devise a methodology for assigning factor representation between air and trucking activities for parcel shipping companies. Staff provided possible solutions to the issues above but did not provide proposed language as it is seeking industry input before it proposes a specific methodology.

The interested parties meeting was attended by air transportation industry representatives as well as representatives from the parcel shipping industries. Representatives from accounting firms also participated. Many of the attendees stated that they disliked the Multistate Tax Commission Model Rule for the air transportation industry. They also stated that California currently has the most complex formula for air transportation apportionment.

Participants acknowledged that the current California rules grew out of the Legislature's desire to address the property tax allocations and to use that allocation, to the extent possible, for income tax apportionment purposes. One goal of this legislation was to limit compliance burdens for this industry. However, some argue that formula apportionment for income tax purposes was an afterthought, with property tax considerations being the primary focus.

The current rules are modeled on the property tax system. Participants voiced some displeasure with this approach, arguing that the property tax has a purpose quite different from franchise tax apportionment of income and that this should be acknowledged in the apportionment factor by moving away from the property tax approach. For example, time on the ground is counted in the amount of time spent in California for both property tax allocation and formula apportionment

purposes, but, it was argued, this makes no sense for apportionment of income, as the planes earn no income when they are on the ground. This argument was met with some resistance as part of the apportionment formula is based on property located in the state (the property factor) and it was felt by some participants that the amount of property determined for property tax purposes should be the figure used for property factor apportionment purposes as both are measuring the location of capital in the state.

On the question of allocating property and receipts by aircraft types, some airlines preferred California's traditional method by model type and other airlines preferred the blended method. Representatives acknowledged that the choice of allocation method would depend on the circumstances of the individual carrier. The blended formula, while preferable to some, does not benefit all airlines and some would naturally be opposed to the blended formula.

There seemed to be less concern with record keeping and retention issues because of the advances in technology and the amounts of records they need to keep for other government purposes.

When asked if there was a formula used by other states that they might prefer, some airlines suggested the methodology applied by the States of Texas, Illinois or Pennsylvania. Texas and Illinois are hub states for some airlines. The formula in these states is based on passenger revenue miles, which several industry representatives thought was a better measure of economic activity than the current California rules based on time and the number of arrivals and departures. Staff reminded these representatives that the current rule is not entirely within the regulatory scheme of Revenue and Taxation Code (R&TC) section 25137, and instead resides in a separate statute (R&TC section 25101.3), so that a switch to a system based solely on passenger revenue miles could not be accomplished by this regulatory process, but would necessarily entail a legislative amendment as well.

With respect to package shipping companies, industry representatives claimed that some businesses already have an internal mechanism and/or corporate structure that separate receipts between trucking and air activities. However, other businesses may use different business strategies and structures that do not lend to the easy division of receipts between the two activities. Industry representatives did not offer a universal formula or position on how to separate receipts, claiming that each business operates differently. It was suggested that regardless of the form of the business enterprise, that there is a need to track revenue earned through air transportation separately due to a federal excise tax that is levied on freight carried by air. This could be used as a basis to split receipts between air and ground transportation.

At the conclusion of the meeting, staff reiterated its interest in hearing and receiving additional comments. At this point in time, staff does not have a preconceived idea as to how the formula should work in the future and is committed to work with industry for regulatory, and even legislative, change if needed. Additionally, staff would try to make itself available if the air transportation industry wants to convene its own meeting and industry wanted the department's attendance. Staff also agreed to provide this summary to interested parties that attended the interested parties meeting. After receipt of this summary, industry is requested to review the summary and offer any additional comment or suggestions.