

Executive Summary

In 1988, the California Legislature adopted Revenue and Taxation Code 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. This method is called the "water's-edge" method.

Originally, the Legislature wanted all water's-edge returns reviewed by the Franchise Tax Board. Revenue and Taxation Code section 25114, subdivision (a), required the Franchise Tax Board to examine the 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."

On October 5, 2007, the Governor signed SB 788, Stats. 2007, ch. 306, which amended Revenue and Taxation Code section 25114. Under amended Revenue and Taxation Code section 25114, the Franchise Tax Board is still required to "examine" (i.e., "review"), all returns filed by taxpayers pursuant to the water's-edge rules. However, the amendments to Revenue and Taxation Code section 25114 have deleted the requirement to conduct a detailed examination (i.e., "audit") in cases of potential noncompliance. Under the amended section, the decision to conduct a detailed audit, including a transfer pricing audit, has been left to the discretion of the Franchise Tax Board Audit staff. If a decision to conduct a transfer pricing audit is made, the Franchise Tax Board must still conduct the audit under the federal transfer pricing rules of Internal Revenue Code section 482, unless the Internal Revenue Service is examining the taxpayer for the same years and issues.

The proposed amendments to the existing regulation are necessary to reflect the statutory changes. In addition, consistent with the language of Revenue and Taxation Code section 25114, proposed amendments to regulation section 25114 shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. The proposed amendments specify that 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.

The proposed amendments also set forth a definition of "examine" and "examination" in order to clarify when the changes to the statute apply.

Request for Permission to Proceed with Formal Regulation Process on Amendments to California Code of Regulations, Title 18, Section 25114

Previously, Revenue and Taxation Code section 25114, subdivision (a), required the Franchise Tax Board to examine the 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."

On October 5, 2007, the Governor signed SB 788, Stats. 2007, ch. 306, which amended Revenue and Taxation Code section 25114. Under amended Revenue and Taxation Code 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 Revenue and Taxation Code section 25114 have deleted the requirement to conduct a detailed examination in cases of potential noncompliance.

Because staff wished to have industry input on necessary changes to the existing regulation, an interested parties meeting was held earlier this year to discuss how California Code of Regulations, title 18, section 25114, should be amended to reflect the statutory changes. As a result of the discussion that occurred at that meeting, it was determined that the following areas should be addressed in the amendments to the regulation:

1. A definition of the term "examine" as it is used in Revenue and Taxation Code section 25114, subdivision (a).
2. A definition of the term "examination" as it is used in Revenue and Taxation Code section 25114, subdivision (c).
3. Elimination of the last sentence in existing regulation section 25114(a)(1), which states: "A detailed audit shall be conducted regardless of the fact that there may be no potential tax change or that the potential adjustment to tax shall be less than the cost of the audit".
4. Revise existing regulation section 25114(a)(2) to indicate that only those audits conducted pursuant to Revenue and Taxation Code section 25114 that involve transfer pricing issues are required to adhere to the principles and procedures followed by the Internal Revenue Service in conducting examinations under Internal Revenue Code section 482.

Staff has attempted to reflect the concerns and comments of the interested parties in the draft regulation language.

Pursuant to the statutory language of Revenue and Taxation Code section 25114, proposed amendments to regulation section 25114 shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. 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.

Staff requests permission to proceed into the formal regulatory process under the Administrative Procedure Act.

Section 25114 is amended to read:

§ 25114. Presumptions Arising from Federal Audits.

(a) Examinations.

(1) In general. The Franchise Tax Board shall ~~conduct an examination of~~examine the tax returns of any taxpayer which has all taxpayers that have made an election pursuant to Revenue and Taxation Code section 25110. In those cases in which such ~~examination review or inspection~~ reveals that there may be potential noncompliance with arm's-length standards involving the transfer of goods, services or intangibles, or the lending of money between those entities whose income and apportionment factors are required to be considered pursuant to Revenue and Taxation Code section 25110 and other affiliated corporations, an detailed audit examination of such transactions ~~shall~~may be conducted unless the taxpayer has been, or is currently, under examination by the Internal Revenue Service with respect to the same year on the same issue. ~~A detailed audit shall be conducted regardless of the fact that there may be no potential tax change or that the potential adjustment to tax shall be less than the cost of the audit.~~

(2) Principles under which a transfer pricing examination is to be conducted. ~~Examinations required pursuant to Revenue and Taxation Code section 25114 shall be carried out pursuant to~~The Franchise Tax Board shall use the principles and procedures followed by the Internal Revenue Service in conducting examinations under Internal Revenue Code section 482 to prevent the evasion of taxes or to clearly reflect the income of two or more organizations, trades, or businesses.

(b) Presumptions regarding ~~audits~~examinations by the Internal Revenue Service.

(1) ~~Audits~~Examinations. With respect to those taxpayers which have been subject to an detailed audit examination by the Internal Revenue Service involving the application of Internal Revenue Code section 482, it shall be presumed that:

(A) if a final adjustment was made under the authority of Internal Revenue Code section 482 ~~or Subchapter N of Chapter 1 of Subtitle A of the Internal Revenue Code~~, it is correct and that no further adjustment is required for the issue or transaction adjusted,

(B) if no adjustments have been made or proposed under the authority of Internal Revenue Code section 482, none are necessary.

(2) Overcoming presumption. The presumptions set forth in paragraph (1) may be overcome by either the Franchise Tax Board or the taxpayer by a showing that:

(A) an adjustment or a failure to make an adjustment was erroneous,

(B) the result of any possible adjustment would produce a minimal federal tax change because of correlative or offsetting adjustments, including the operation of net operating losses, the federal foreign tax credit or the shifting of income or deductions between years, or

(C) substantially the same result was obtained under other sections of the Internal Revenue Code.

EXAMPLE:

T, a U.S. incorporated entity, has had operating losses of \$1,000,000 for each of the five preceding years, 1-5, giving rise to a \$5,000,000 net operating loss carry forward. In year 6, a possible pricing adjustment was considered between T and its foreign subsidiary F. The adjustment would increase T's income by \$1,000,000. For years 7, 8 and 9 T has operating losses of \$500,000 a year. There are no pricing adjustments between T and F which could affect their federal income tax liability for such years. The Internal Revenue Service makes no adjustment with regard to year 6. There is no presumption attached to the failure to make an adjustment because no federal revenue change would occur.

(3) Lack of ~~audit~~examination. No presumption of correctness arises with respect to any transaction which has not been subject to an ~~an~~ detailed audit examination by the Internal Revenue Service pursuant to Internal Revenue Code section 482.

(4) ~~Detailed audit~~Internal Revenue Service examination. For purposes of this section, a ~~detailed audit~~ transfer pricing examination of a transaction or issue by the Internal Revenue Service requires a referral to an International Examiner and his/her direct participation in the ~~audit~~examination of the taxpayer as documented by notice that the examination was being conducted pursuant to Internal Revenue Code section 482 with respect to such transaction or issue.

(c) Use of federal regulations. Effective as of January 1, 1988, in making distributions, apportionments, and allocations pursuant to Revenue and Taxation Code section 25114, the Franchise Tax Board shall follow the rules, regulations and procedures of the Internal Revenue Service in conducting ~~audits~~examinations under Internal Revenue Code section 482 as described in the regulations to such section applicable to the taxable year being ~~audited~~examined.

(d) Definitions. For purposes of this section, the following definitions are applicable:

(1) Examine. To examine is to review or inspect a tax return, which may or may not include an audit of the return.

(2) Examination. An examination is an audit of a tax return including a desk audit as well as a field audit.

(e) The amendments made to this regulation shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. 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.

Note: Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 25114, Revenue and Taxation Code.

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at _____, _____, at 9645 Butterfield Way, Town Center _____, Sacramento, California, to consider amendment of regulation section 25114 under Title 18 of the California Code of Regulations, pertaining to a water's-edge election.

An employee of the Franchise Tax Board will conduct the hearing. Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action if any person makes such a request in writing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., _____. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY & REFERENCE

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. The proposed regulatory action makes necessary amendments to regulation section 25114 to conform to statutory changes made to section 25114 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Previously, Revenue and Taxation Code section 25114, subdivision (a), required the Franchise Tax Board to examine the 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."

On October 5, 2007, the Governor signed SB 788, Stats. 2007, ch. 306, which amended Revenue and Taxation Code section 25114. Under amended Revenue and Taxation Code section 25114, the Franchise Tax Board is still required to review all returns filed by taxpayers pursuant to the water's-edge rules. However, the amendments to Revenue and

Taxation Code section 25114 have deleted the requirement for the Franchise Tax Board to conduct a detailed examination in cases of potential noncompliance. The decision to conduct a detailed audit, including a transfer pricing audit, has been left to the discretion of the Franchise Tax Board Audit staff. If a decision to conduct a transfer pricing audit is made, the Franchise Tax Board must still conduct the audit under the federal transfer pricing rules of Internal Revenue Code section 482, unless the Internal Revenue Service is examining the taxpayer for the same years and issues.

The proposed amendments to the existing regulation are necessary to conform to the statutory changes requiring examinations of returns filed by taxpayers that have made a water's-edge election. In addition, consistent with the language of Revenue and Taxation Code section 25114, proposed amendments to regulation section 25114 shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. The proposed amendments specify that 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.

Questions have arisen as to how to reconcile the term "examine" in subdivision (a) with the term "examination" in subdivision (c) of Revenue and Taxation Code section 25114 without requiring an audit of every water's-edge taxpayer or contact with every water's-edge taxpayer. The proposed amendments set forth a definition of examine and examination in order to address this question.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Potential cost impact on private persons or businesses affected: The Franchise Tax Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None. The Franchise Tax Board has been required to conduct a detailed examination on all water's-edge tax returns when it has found potential noncompliance since 1988 when water's-edge elections first became part of the Revenue and Taxation Code. Revenue and Taxation Code section 25114 was amended to make the decision to conduct a detailed examination discretionary rather than mandatory. The amendments to this regulation should reduce the effect on businesses currently doing business in California by eliminating the requirement that mandatory examinations be conducted by the Franchise Tax Board.

Effect on small business: The regulation is generally utilized by large multinational corporations and not small businesses.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

The proposed regulatory action pertains to corporate taxpayers and therefore does not affect private persons.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation and the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website mentioned below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the

public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance, should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen.berwick@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.

INITIAL STATEMENT OF REASONS FOR THE
AMENDMENT OF CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25114

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR
CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

The proposed amendments to the existing regulation are intended to conform to recent changes in the statutory language of Revenue and Taxation Code section 25114.

SPECIFIC PURPOSE OF THE REGULATIONS

The proposed amendments to the existing regulation are necessary to reflect the statutory changes to Revenue and Taxation Code section 25114 requiring examinations of returns filed by taxpayers that have made a water's-edge election. In addition, consistent with the language of Revenue and Taxation Code section 25114, proposed amendments to regulation section 25114 shall apply to examinations commenced by the Franchise Tax Board on or after January 1, 2008. The proposed amendments specify that 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.

The proposed amendments also set forth a definition of "examine" and "examination" in order to clarify when the changes to the statute apply.

NECESSITY

On October 5, 2007, the Governor signed SB 788, Stats. 2007, ch. 306, which amended Revenue and Taxation Code section 25114. Regulation section 25114 is proposed to be amended to conform to those statutory changes.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS.

The Franchise Tax Board examined and considered the legislative history of Revenue and Taxation Code section 25114, including bill analyses and public hearing documents. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY
ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS.

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed amendments to regulation section 25114 or would be as effective and less burdensome to affected private persons or small businesses than the proposed amendments. In addition, the proposed amendments pertain to corporate taxpayers and therefore do not affect private individuals.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that proposed amendments to regulation section 25114 of Title 18 of the California Code of Regulations will not have a significant overall economic impact on business. The proposed regulation simply implements and makes specific the new and revised statutory language of Revenue and Taxation Code section 25114.