Explanation of the Discussion Draft for California Code of Regulations, title 18, section 25137-2, special apportionment rules to be used in cases of long-term contracts for the manufacture or fabrication of tangible personal property.

Attached is a discussion draft of a proposed addition to the existing regulation addressing special apportionment rules that apply when a taxpayer elects the federal tax law rules under Internal Revenue Code section 460, relating to long-term contracts, that are incorporated by reference for state purposes under Revenue and Taxation Code section 24673.2.

When a contractor constructs a fixture or fabricates a piece of tangible personal property under a multi-year contract and elects one of the methods of long-term contract accounting permitted by Internal Revenue Code section 460 and Revenue and Taxation Code section 24673.2, the standard apportionment rules may result in a mismatching of income with apportionment factors, because income will not be recognized in the years during which the taxpayer made the related payroll expenditures or used property to earn the income. The existing regulation, California Code of Regulations, title 18, section 25137-2, provides rules to ensure the proper matching of income and expenses in the case of long-term construction contracts.

The current California regulation was adopted in 1974 when federal regulations only allowed the long-term method of accounting to be used for construction contracts. Thus, the current California apportionment regulation only applies to construction contracts. It does not apply to long-term contracts for the manufacture or fabrication of tangible personal property, which the proposed changes would extend the regulation to cover.

In addition, there are five changes of a clean up nature that will be made at this time:

- To avoid any unintended conflict with federal regulatory language, the language in the existing regulation describing the percentage of completion method of long-term contract accounting will be stricken and will be replaced with a reference to the relevant federal regulation. (Treas. Reg. § 1.451-3.)

- References to the three-factor apportionment formula will be modified in recognition of the fact Revenue and Taxation Code section 25128 now provides for the use of a double-weighted sales factor (and thus a four-factor formula) in most cases.

- A mathematical error in one of the examples will be corrected.

- Dates in the existing examples will be updated.

- Generic references to income year will be replaced with taxable year to reflect statutory changes eliminating income year. (Stats. 2000, Ch. 862 (AB 1843))

The draft reflects staff's position that the rationale that applies to the current regulation's treatment of long-term construction contracts should apply with equal force to long-term contracts for the fabrication or manufacture of tangible personal property. Fair apportionment requires that income be apportioned by the use of factors that reflect the effort and investment that generated the income. When income is apportioned by a formula that does not reflect the effort that generated the income, distortion will inevitably result.