

INITIAL STATEMENT OF REASONS FOR THE
ADOPTION OF AMENDMENTS TO
CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25137-2

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

When a multistate taxpayer that manufactures or fabricates tangible personal property elects one of the methods of long-term contract accounting provided by Treasury Regulation 1.451-3 or Internal Revenue Code section 460 (as incorporated into the Revenue and Taxation Code by section 24673.2) the standard apportionment formula provided by Revenue and Taxation Code section 25128 will not fairly represent the business activity of the taxpayer in California relative to the income generated under the contract because, under the long term contract methods of accounting, income, is generally recognized in a year other than the year in which the performance required to earn that income occurred. Thus there will be a mismatch between the factors used to apportion the income and the income being apportioned.

Revenue and Taxation Code section 25137 provides for the use of an alternative apportionment formula when the standard formula does not fairly represent the extent of the taxpayer's business in California. The existing regulation at Title 18, California Code of Regulations section 25137-2 provides for the use of an alternative formula when construction is performed under a long-term contract and the taxpayer has elected one of the long-term contract methods of accounting provided by Treasury Regulation 1.451-3 or Internal Revenue Code section 460. However, the regulation does not cover situations in which tangible personal property is manufactured or fabricated under a long-term contract.

Additionally, the proposed amendments will remove from the regulation the specific descriptions of the completed contract and percentage of completion method of long-term contract accounting methods provided by the Treasury Regulation. It proposes to replace the descriptions with references to the appropriate subsections of the Treasury Regulation. The proposed amendments also modify the language of the regulation to conform it to the fact that Revenue and Taxation Code section 25128 now provides for a double weighted sales factor.

SPECIFIC PURPOSE OF THE REGULATION

This proposed amendment to the regulation will apply the special apportionment formula already provided for long-term construction contracts to long-term contracts for the manufacture or fabrication of tangible personal property. It will provide that income recognized under such a contract will be apportioned using factors representative of the years during which work was performed under the contract. It will also provide for exclusion from the property factor of the apportionment formula of work in process inventory for which the taxpayer has received payment.

NECESSITY

Under the decision of the State Board of Equalization in *Appeal of Fluor Corporation*, 95-SBE-009, August 31, 1995, if it is asserted that the apportionment formula provided by Revenue and Taxation Code section 25128 does not fairly reflect the business done by the taxpayer in California, the party seeking to deviate from the standard formula must demonstrate that the effect of the standard formula is unfair (that it results in "distortion") and that, in the case at bar, it results in that degree of "distortion" that has been recognized as permitting the application of an alternative formula under Revenue and Taxation Code section 25137. If, however, the facts of the case fit the facts set forth in one of the regulations adopted under the authority of section 25137, then, under *Appeal of Fluor*, the formula set forth in the regulation becomes the standard formula and it is not necessary to show that the statutory formula results in any particular degree of "distortion". Thus, if a fabricator or manufacturer of tangible personal property were to elect a long-term method of contract accounting it would be necessary for the taxpayer or the Franchise Tax Board to demonstrate that the "distortion" resulting from the application of the statutory formula exceeded the 36 percent test set forth by the Board of Equalization in *Appeal of Merrill, Lynch, Pierce, Fenner, & Smith, Inc.*, 89-SBE-017, June 2, 1989. However, if a construction contractor with the same financial facts elected to account for a long-term construction contract in the same manner, the special formula provided by the regulation at 25137-2 would apply and it would not be necessary to demonstrate that the *Merrill, Lynch* standard had been met.

There is no logical reason for treating receipts from long term construction contracts differently from receipts generated by long-term contracts for the fabrication or manufacture of tangible personal property.

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

In drafting the proposed regulation, the Franchise Tax Board relied upon Revenue and Taxation Code section 25137, and California Code of Regulations, Title 18, Section 25137-2.

Other than the items described in the preceding paragraph, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing adoption of the proposed amendments to the regulation.

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

In accordance with Government Code section 11346.5, subdivision (a)(12), the Franchise Tax Board has determined that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be a effective and less burdensome to affected private persons than the proposed regulatory action. In addition, the proposed regulation pertains to corporate taxpayers with

operations in multiple states. As a result it does not affect private persons or most small businesses.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The proposed regulatory action will not have a significant adverse economic impact on business. In some cases the proposed amendment to the existing regulation will make it easier for a taxpayer to secure relief under Revenue and Taxation Code section 25137. In others, the proposed amendment will make it easier for the Franchise Tax Board to apply section 25137.