

## **TITLE 18. FRANCHISE TAX BOARD**

As required by Government Code section 11346.4, this is notice of intention to adopt amendments to California Code of Regulations, title 18, section 25137-2, subsection, pertaining to the apportionment formula to be used when a taxpayer has elected to recognize income under one of the long-term contract methods of accounting authorized by Treasury Regulation 1.451-3 or Internal Revenue Code section 460. There will not be a public hearing unless requested by an interested person at least 15 days before the close of the written comment period. Any request for a public hearing should be submitted to the agency officer named below.

### **WRITTEN COMMENT PERIOD**

Written comments will be accepted until 5:00 p.m., November 8, 2002. 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**

Revenue and Taxation Code section 19503 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 interprets, implements, and makes specific Revenue and Taxation Code section 25137.

### **INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW**

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 may 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.

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 was sufficient under the relevant decisions of the courts and the Board of Equalization to permit the use of an alternative formula. This process requires legal research and analysis and the results are open to dispute. 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 standard formula did not fairly represent the business of the taxpayer in California.

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.

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.

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.

## **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 that 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.

The Board has made an initial determination that there will be no significant statewide adverse economic impact directly affecting businesses including the ability of California businesses to compete with businesses in other states.

Cost impacts on representative private persons or businesses: The 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.

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

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

Effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: None. The proposed amendment only applies to multistate corporate taxpayers that are not typically small businesses and because the regulation affects small businesses in the same manner as it affects other 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 reasonable alternative it considered or that has otherwise been identified and brought to its attention 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.

## **AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS**

The express terms of the proposed regulatory action, as well as the initial statement of reasons and all information upon which the proposed regulatory action is based, are available upon request from the agency officer named below. 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 at <http://www.ftb.ca.gov/>.

## **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 regulations should be sent to the attention of the agency officer named below.

## **ADDITIONAL COMMENTS**

If a hearing is held, the hearing room will be accessible to persons with physical disabilities. Also, any person who is in need of a language interpreter, including sign language, should contact the agency 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; Tel.: (916) 845-3306; Fax: (916) 845-3648; E-Mail: [colleen.berwick@ftb.ca.gov](mailto:colleen.berwick@ftb.ca.gov), or the designated backup, Doug Powers; Tel.: (916) 845-4962; Fax: (916) 845-3648; E-Mail: [doug.powers@ftb.ca.gov](mailto:doug.powers@ftb.ca.gov). In addition, all questions on the substance of the proposed regulation can be directed to Karl Grossenbacher; Tel.: (916) 845-6822. This notice, the initial statement of reasons, and the express terms of the proposed regulation are also available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.