



STATE OF CALIFORNIA
FRANCHISE TAX BOARD - Legal Department
PO Box 1720
Rancho Cordova CA 95741-1720
(916) 845-5245 Fax (916) 845-3648

STEVE WESTLY
Chair

CAROLE MIGDEN
Member

DONNA ARDUIN
Member

August 6, 2004

FTB NOTICE 2004-5

SUBJECT: Asserting a Revenue and Taxation Code Section 25137 Variation in an Original Return Filing: Accuracy-Related Penalties

The Franchise Tax Board (FTB) has become aware that some taxpayers that are subject to the apportionment and allocation provisions under Chapter 17 of the Corporation Tax Law (part 11, div. 2, Revenue and Taxation Code (hereinafter "RTC")) have filed original returns in a manner inconsistent with rules provided in RTC sections 25120 through 25136, and the regulations thereunder, or in a manner inconsistent with rules provided by regulations adopted under RTC section 25137. When these returns are examined, those taxpayers often assert that they have taken that filing position pursuant to the authority of the general provisions of RTC section 25137, despite not having obtained prior approval from the FTB to so file. Absent such approval, that filing position will be considered erroneous, and may result in the assertion of an accuracy-related penalty under RTC section 19164 (incorporating by reference certain provisions of Internal Revenue Code (hereinafter "IRC") §§ 6662 through 6665).

In general, RTC section 19164 and IRC section 6662 authorize the imposition of an accuracy-related penalty equal to 20% of an underpayment of tax caused by negligence or disregard of rules or regulations, or any substantial understatement of income or franchise tax. The amount of the penalty imposed on the grounds of negligence is reduced to the extent that the taxpayer establishes a "reasonable basis" for its return position (Treas. Reg. § 1.6662-3(b)(1) & -3(b)(3)). The amount of the penalty imposed on the grounds of substantial understatement of tax is reduced to the extent that the taxpayer either a) shows substantial authority for the position taken or b) adequately disclosed the relevant facts affecting the position taken and there was a "reasonable basis" for the tax treatment of such item by the taxpayer (IRC § 6662(d)(2)(B)).

RTC sections 25120 through 25136, and the regulations thereunder, provide rules regarding the apportionment and allocation of business and nonbusiness income, respectively. RTC section 25137 provides that alternative methods of apportionment and allocation of income can be required in circumstances where those rules do not fairly reflect taxpayer business activity in California. The FTB has adopted special apportionment and allocation rules by regulation under RTC section 25137 that apply to all taxpayers whose specific circumstances are described therein. If a taxpayer, item, or transaction is described in those regulations, then the regulation applies without requiring either the taxpayer or the FTB to make a showing specific to an individual taxpayer that the rules of RTC sections 25120 through 25136, and the regulations thereunder, do not fairly reflect the taxpayer's business activity in this state. (*Appeal of Fluor Corporation*, 95-SBE-016 (December 12, 1995).) For purposes of this notice, the provisions of RTC sections 25120 through 25136, the regulations thereunder, as well as

regulations adopted under section RTC 25137, are collectively referred to herein as the "standard apportionment and allocation rules."

If a taxpayer seeks a variation from the standard apportionment and allocation rules, RTC section 25137 authorizes a taxpayer to petition for an alternative method of apportionment or allocation. By definition, a petition is "a formal written request made to an official person or organized body." (Merriam-Webster's Collegiate Dictionary (10th ed. 1998), p. 869.) Thus, RTC section 25137 merely authorizes the taxpayer to request a variation. The act of seeking a variation does not grant it, conditionally or otherwise.

California enacted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1966, effective for years beginning on or after January 1, 1967. UDITPA is a model statute adopted by the National Conference of Commissioners on Uniform State Laws. Section 25137 is the California counterpart of section 18 of UDITPA. The official Comment to UDITPA section 18 issued by those Commissioners provides, in part:

Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the *tax administrator* to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. (Emphasis added.)

Thus, the authority to exercise discretion to grant a variation under RTC section 25137 lies with the FTB. Accordingly, only after the FTB acts pursuant to a specific request for a variation is the taxpayer authorized to file in a manner consistent with that request. Because RTC section 25137 requires the department to act for a variation to be effective, that section by itself does not provide authority for an original return filing position inconsistent with the standard apportionment and allocation rules, absent a prior approval for that filing position.

Accordingly, if an audit examination determines that the taxpayer has filed its original return in a manner inconsistent with the standard apportionment and allocation rules, and the taxpayer has not obtained prior approval for that filing position, the return is erroneous. As a result, the taxpayer may be subject to the accuracy-related penalty provided in RTC section 19164 (which incorporates by reference the provisions of IRC §§ 6662 through 6665).

For purposes of determining whether the filing position constitutes negligence, assertion of RTC section 25137 in a self-assessed filing position will not be considered as having a reasonable basis under Treasury Regulation section 1.6662-3(b). If the erroneous filing results in a substantial understatement of income, a taxpayer's reliance on RTC section 25137 for such filing will not be considered as having substantial authority under IRC section 6662(d)(2)(B)(ii), and such a position will not be considered as having a reasonable basis under IRC section 6662(d)(2)(B)(ii)(II).

In the course of an audit examination, or in the course of a protest proceeding, if the taxpayer objects to an adjustment that applies the standard apportionment and

allocation rules and cites RTC section 25137, that objection will be considered an original RTC section 25137 petition at that time.

Prior approval to file an original return in a manner inconsistent with the standard apportionment and allocation rules will only be deemed to have been provided if (and only if) the treatment 1) is an RTC section 25137 variation permitted in an audit manual that was operative during the taxable year, or which is currently operative, and the taxpayer's facts are substantially the same as those described in the manual, 2) is the same variant specifically permitted under authority of section 25137 (for a year in which that section was operative) in a published opinion of the Board of Equalization, a California Court of Appeal, or the California Supreme Court, and the taxpayer's facts are substantially the same as those described in those opinions, 3) has been approved in writing in a prior year petition under section 25137 that specifically provides that the variation also applies to the year in question, or 4) has been approved in a closing agreement issued under authority of RTC section 19441 or 19442 for an earlier year that by its terms also applies to the taxable year of the return. In all other cases, taxpayers must obtain prior approval for a RTC section 25137 variation before filing an original return on that basis.

The foregoing portion of this notice applies to all returns the due date for which (determined without regard to extensions) is on or after October 15, 2004.

For returns whose due date (determined without regard to extensions) is before October 15, 2004, if a statement in or attached to the return adequately discloses that the taxpayer has filed its return in a manner other than that provided under the standard apportionment and allocation rules, or specifically states that the taxpayer has relied upon RTC section 25137 in its filing position, such a statement will be considered adequate disclosure under RTC section 19164. Merely entering data in California Schedule R ("Apportionment and Allocation of Income") using a variant means of apportionment or allocation will not by itself be considered adequate disclosure, because that cannot reasonably be expected to apprise the FTB of the nature of the potential controversy concerning the use of a variation under RTC section 25137. (See *Little v Commissioner* (9th Cir. 1997) 106 F.3d 1445.) If the taxpayer's position is adequately disclosed, the FTB will not assert a penalty under RTC section 19164 if the taxpayer's self-assessed position is one that would have a realistic possibility of being granted by the FTB if it had been requested as fairly representing the extent of the taxpayer's business activity in this state. (See Treas. Reg. §1.6694-2(b) for a description of the realistic possibility standard.)

The principal author of this notice is Michael E. Brownell of the Franchise Tax Board, Legal Department. For further information regarding this notice, contact Mr. Brownell at the Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720.