



June 07, 2019

LEGAL RULING 2019 - 01

SUBJECT: Requests for variances initiated pursuant to California Revenue and Taxation Code (R&TC) section 25137 by taxpayers and Franchise Tax Board (FTB) staff seeking an alternative apportionment methodology.

ISSUE

What are appropriate subject matters to be considered for a request for variance from the standard formula pursuant to R&TC section 25137?

SITUATION ONE

Company A files a variance request claiming that Subsidiary and Company A were not unitary during the tax years at issue because the Three Unities Test was not met. Company A claims that the inclusion of Subsidiary in its unitary group would be distortive, such that Company A and Subsidiary should be decombined and apportioned separately.

SITUATION TWO

Company B receives dividends from a non-affiliated supplier. Company B asserts that including the dividends in its business income does not fairly reflect its business activities in California.

SITUATION THREE

Company C files on a water's-edge basis. Company C receives royalty income from a unitary, foreign affiliate that is excluded from Company C's water's-edge combined reporting group due to the water's-edge election. Company C asserts that, since the royalty income is included in its business income, the exclusion of the apportionment factors from the royalty-paying affiliate from its water's-edge combined report would not fairly reflect its business activities in California.

SITUATION FOUR

Company D derives more than 50 percent of its gross business receipts from the conduct of its extractive business activity. Per R&TC section 25128(b), Company D apportions its business income to California using a three-factor apportionment formula, consisting of a single-weighted sales factor, a property factor, and a payroll factor. Company D has property

and payroll in California but it has no California sales and no everywhere sales. Company D asserts that the inclusion of a sales factor with a zero numerator and a zero denominator, resulting in a ratio of 0/0, would not fairly reflect its business activities in California. As a result, Company D asserts that a two-factor formula should be the basis for determining its apportionable income.

LAW AND ANALYSIS

R&TC section 25137 provides:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

In addition, Title 18, California Code of Regulations (CCR) section 25137(d) provides:

In cases deemed appropriate by the Franchise Tax Board it may elect to hear and decide petitions filed pursuant to Section 25137 instead of having this function performed by the staff. As a condition to having such petition considered by the Board, the petitioning taxpayer shall waive in writing the confidentiality provisions of Section 19542 with respect to such petition and to any other facts which may be deemed relevant in making a determination. Consideration of said petitions by the Board shall be in open session at a regularly scheduled meeting.

Taxpayers that have business activities within and without California are required to determine the amount of income properly attributed to activities in California by use of the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC § 25120 - 25141).¹ Under the appropriate methodology, a taxpayer's income is divided into business and nonbusiness income. (R&TC § 25120(a), (d).) Business income is apportionable to each state by use of an apportionment formula, while nonbusiness income is allocable "to this state" by statute. (R&TC §§ 25123 - 25127.)

UDITPA only addresses issues relating to the allocation and apportionment of income. Consequently, UDITPA does not address, and therefore requests for variance should not be

¹ These statutes are located in Article 2 of Chapter 17 in Division 2, Part 11, of the Revenue and Taxation Code.

utilized to pursue, issues such as: (1) unitary combinations (R&TC § 25101); (2) combined report mechanics (R&TC § 25106.5); (3) issues relating to tax rates (R&TC, div. 2, pt. 11, ch. 2, art. 2, 3; div. 2, pt. 11, ch. 3, art. 1), tax credits (R&TC, div. 2, pt. 11, ch. 3.5), or tax procedures (R&TC, div. 2, pt. 10.2); (4) the determination of income (see *Appeal of CTI Holdings, Inc.*, 96-SBE-003, Feb. 22, 1996); (5) water's-edge mechanics (R&TC §§ 25110, 25113); or (6) other issues addressed by appropriate California authority outside of UDITPA. Strictly speaking, R&TC section 25137 only expressly grants statutory authority to provide variances to the apportionment formula and the allocation provisions. It does not expressly grant authority to provide variances to items unrelated to the apportionment formula and the allocation provisions.

Under UDITPA, a taxpayer determines its total business income and uses an apportionment formula to determine the portion of such business income that will be subject to California taxation. (R&TC §§ 25120, 25128, 25128.7.) For taxable years beginning before January 1, 2011, unitary businesses are generally apportioned by multiplying their business income by an apportionment formula consisting of three factors: the property factor, the payroll factor, and the sales factor.² (R&TC § 25128.) For taxable years beginning on after January 1, 2011, and before January 1, 2013, a taxpayer could elect to apportion its business income using a single-weighted sales factor.³ If no election was made, a taxpayer's business income was apportioned using the standard three factor formula, with double-weighted sales factor, as set forth under R&TC section 25128. For taxable years beginning on or after January 1, 2013, unitary businesses are generally apportioned by multiplying their business income by the sales factor. (R&TC § 25128.7.⁴) When combined, apportionment factors establish a fraction (i.e., an apportionment percentage) of the unitary business' total business income that is subject to California taxation.

When the application of the standard UDITPA apportionment formula fails to fairly reflect the extent of a taxpayer's business in this state, an alternate method may be utilized. (R&TC § 25137.) (*Microsoft Corp. v. Franchise Tax Board (Microsoft)* (2006) 39 Cal.4th 750, 757 ["The UDITPA contains a relief provision"].)

In utilizing R&TC section 25137, a taxpayer or the FTB may request a variance from the standard formula which only addresses issues relating to the allocation and apportionment of income.⁵ William J. Pierce, the principal author of UDITPA, stated:

² In 1993, the Legislature changed the formula to double-weight the sales factor.

³ Former R&TC 25128.5. Former R&TC section 25128.5 was repealed by its own terms effective December 1, 2013.

⁴ Proposition 39, approved by the voters during the November 6, 2012 general election, and effective November 7, 2012, was applicable to taxable years beginning on or after January 1, 2013. R&TC section 25128(b) provides an exception for industries (i.e., engaged in a "qualified business activity") to single-sales factor apportionment.

⁵ If a petition is filed, it may be filed with the three-member Franchise Tax Board or with the 25137 Committee composed of FTB staff. As delineated above, CCR section 25137(d) provides that FTB staff may consider R&TC section 25137 petitions.

[T]he uniform act assumes that the existing state legislation *has defined the base of the tax* and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense.

(William J. Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747 [emphasis in original].) As such, R&TC section 25137 does not operate with respect to other alleged issues created by the application of other California authority.

In the *Appeal of Crisa Corporation (Appeal of Crisa)*, 2002-SBE-004, Jun. 20, 2002, the State Board of Equalization (SBE) identified five examples⁶ in which Section 25137 relief may be warranted:

- (1) A corporation does substantial business in California, but the standard formula does not apportion any income to California. For example, the employees of a professional sports franchise render services in California while playing "away" games, but the standard formula apportions all income to the team's home state.
- (2) The factors in the standard formula are mismatched to the time during which the income is generated. For example, a construction contractor reports income when long-term contracts are completed, but the standard formula requires income to be reported currently.
- (3) The standard formula creates "nowhere income" that does not fall under the taxing authority of any jurisdiction. For example, a company owns equipment, the value of which is attributed to the high seas or to outer space, where it cannot be taxed by any jurisdiction.
- (4) One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, a taxpayer continuously reinvests a large pool of "working capital," generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services that the taxpayer provides as its primary business.
- (5) A particular factor does not have material representation in either the numerator or the denominator, rendering that factor useless as a means of reflecting business activity. For example, because a company does not own or rent any tangible or real property, the numerator and denominator of the property factor are zero.

⁶ The examples below included citations which have been omitted.

As to these five examples, the SBE observed that R&TC section 25137 was found to apply, or not apply, based on whether an analysis revealed some manner in which the standard apportionment formula did not fairly reflect the taxpayer's business activities in California.

The California Supreme Court in *Microsoft, supra*, further analyzed R&TC section 25137. In *Microsoft*, the Supreme Court found that, while R&TC section 25137 ordinarily applies to nonrecurring situations, the statute does not apply only to such situations. The Court held that "the statutory touchstone remains an inquiry into whether the formula 'fairly represent[s]' a unitary business's activities in a given state, and when it does not, the relief provision may apply." *Microsoft, supra*, 750, 770.

Requests for variance from the standard formula must, therefore, specifically address an issue relating to an allocation or apportionment methodology and seek relief through the use of an alternative apportionment methodology pursuant to R&TC section 25137.

HOLDING – SITUATION ONE

Company A's request for decombination is not an appropriate subject matter to be considered in a request for variance. R&TC section 25137 only addresses issues relating to the allocation and apportionment of income. R&TC section 25137 does not address issues such as unitary combinations (R&TC § 25101).

HOLDING – SITUATION TWO

Company B's request for treating dividends as nonbusiness income is not an appropriate subject matter to be considered in a request for variance. Although UDITPA may address the division of a taxpayer's income into business and nonbusiness income (R&TC § 25120(a), (d)), R&TC section 25137 only addresses issues relating to the allocation and apportionment of income.

HOLDING – SITUATION THREE

Company C's request to have the apportionment factors of its unitary, foreign affiliate included in the combined report is not an appropriate subject matter to be considered in a request for variance. Company C has elected to file on a water's-edge basis; the result is that its foreign affiliate's apportionment factors are not reflected in Company C's water's-edge combined report unless subject to an inclusion ratio. R&TC section 25137 does not apply to water's-edge mechanics.

HOLDING – SITUATION FOUR

Similar to Example 5 in the *Appeal of Crisa, supra*, Company D does not have any material representation in its sales factor in either the numerator or the denominator, as the company has not begun making any sales. In this situation, relief under R&TC section 25137 would be appropriate, to exclude the sales factor from Company D's formula.

DRAFTING INFORMATION

The principal author of this Legal Ruling is Anthony Epolite of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Epolite at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.