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tax audit issues
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Discussion of Common Tax Audit Issues Affecting California Corporate Taxpayers¹

By E. Scott Ewing, Benjamin Elliott & Natasha Ng²

In its April 2014 issue of *Tax News*, the California Franchise Tax Board (“FTB”) identified the most common franchise/income tax audit issues currently affecting corporations.³ In this article we restate the common audit issues identified by the FTB, summarize the technical aspects of each issue and provide general insight regarding the potential prevalence of such issues in future FTB audits, including a discussion of some of the recent and contemplated changes in the California Revenue and Taxation Code and California Code of Regulations, title 18 adopted thereunder that may affect these issues.⁴

The FTB identified the following four areas as some of the most common audit issues affecting corporations: (1) Cost of Performance and Sourcing of Intangible Sales; (2) Sales Factor and Gross Receipts; (3) Abusive Tax Shelters; and (4) Credits.

I. COST OF PERFORMANCE AND SOURCING INTANGIBLE SALE

A. The FTB’s Observations

For tax years beginning before January 1, 2011, sales from intangible sales and services are assigned based on the cost of performance. The complex rules of identifying income-producing activities and documentation necessary to do a cost-of-performance analysis may result in incorrect assignment of sales from intangibles and services. For tax years beginning on or after January 1, 2011, taxpayers who elect a single sales factor for apportioning business income to California will use market rules for assigning sales from intangibles and services instead of cost of performance rules.⁵

B. Practitioner Observations

While California law currently requires taxpayers to source the sales from intangibles and services under the market-based sourcing rules,⁶ many corporate taxpayers are under audit for tax years in which the cost-of-performance rules (“COP Rules”) apply to such sales.⁷ Section 25136(a) sets forth the manner in which sales, other than sales of tangible personal property (i.e., intangible sales and services), are included in the numerator of the sales factor for corporate franchise tax apportionment purposes.⁸ Under this statute, sales are assigned to California if the income-producing activity is performed in California.⁹ If the income-producing activity is performed both

in and outside California, the sale is assigned to California if the greater proportion of the income-producing activity is performed in California than in any other state, based on costs of performance (“COP”).¹⁰ The initial step when analyzing a COP issue is to identify the income-producing activity or activities related to each separate item of income. The income-producing activity is defined as “the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing an item of income.”¹¹ Income-producing activity may include the rendering of personal services; the utilization of tangible or intangible personal property; or the sale, rental, leasing, licensing or other use of real, tangible, or intangible personal property.¹² A taxpayer may engage in multiple income-producing activities as part of its business. For taxable years ended January 1, 2008, and thereafter, a taxpayer’s income-producing activity also includes transactions and activities performed on behalf of a taxpayer, such as by an agent or independent contractor.¹³ COP are direct costs incurred by the taxpayer in performing the income-producing activity that gave rise to the particular item of income.¹⁴

In applying California’s COP Rules, the FTB and taxpayers often have different views on: (1) the transactions and activities that should be tested for the purposes of applying the COP Rules (e.g., identification of a separate income-producing activity, or identification of the COP incurred in order to perform the income-producing activity); and (2) the level of documentation that is required to substantiate the taxpayer’s income-producing activities and COP.

First, the FTB and taxpayers often differ on defining a specific income-producing activity or activities that are subject to the COP Rules, which may significantly affect the sales that are sourced to the California sales factor numerator. A major cause of this difference is that Regulation 25136 does not provide specific rules on how taxpayers are to define income-producing activities. This lack of specific guidance is compounded by the differing levels of analysis when auditing the income-producing activity that generated the sales. In some cases the parties may take a narrow view when identifying the income-producing activities (i.e., a transaction-based analysis), while in other instances, the parties may take a more broad view (i.e., an operational analysis).

Second, some taxpayers appear to devote a substantial amount of time during an audit of a COP issue to assembling and providing documentation in order to substantiate: (1) the underlying transactions and activities in which the taxpayer engages in the regular course of its trade or business, and (2) the costs incurred to support such transactions and activities that generate the income. This is likely caused by an inconsistency between the level of analysis used by either party to define the income-producing activities and the taxpayer's organization of its operating business units or divisions, which, in many cases, is ultimately how the taxpayer originally identified its income-producing activities when conducting its COP analysis. As a result, when an FTB auditor requests information on the income-producing activities that is inconsistent with the methodology in which the taxpayer has structured and operates its business units and divisions (and used to determine its separate income-producing activities), taxpayers are often unable to meet the FTB auditor's request.

Finally, it is important to note that for tax years beginning on or after January 1, 2011, California introduced market-based sourcing rules.¹⁵ For tax years beginning on after January 1, 2011 and ending December 31, 2012, all taxpayers who elected under Section 25128.5 to file their California return using a single-sales-factor apportionment method were required to source their sales from intangibles and services using the market-based sourcing rules. For tax years beginning on or after January 1, 2013, all taxpayers are required use the market-based sourcing rules for sourcing such sales. In its Tax News article, the FTB did not identify any audit issues with respect to applying the market-based sourcing rules. Because these rules apply to years that are likely not under current FTB audit, practitioners can only speculate as to the potential audit issues that may arise in the future with respect to an audit of a taxpayer's application of the market-based sourcing rules.¹⁶ However, given the complexity of this area, as evidenced by the multiple Interested Parties Meetings noticed during the initial regulatory process for Regulation 25136-2 and the current regulatory amendment process, it is likely that audit issues related to market-based sourcing may naturally arise in the future.¹⁷

II. SALES FACTOR AND GROSS RECEIPTS

A. The FTB's Observations

We continue to see items in the sales factor denominator that do not meet the definition of "gross receipts" or that result in distortion.¹⁸

B. Practitioner Observations

Under Section 25120(e), "sales" are generally defined as all gross receipts of the taxpayer not allocated, including all gross receipts derived from a taxpayer's business activities, even if the

income is not from usual business sources. In 2009, the statutory definition for "gross receipts" was amended.¹⁹ This amendment was defined as "clarifying, nonsubstantive changes" and provided that for taxable years beginning on or after January 1, 2011, "gross receipts" is defined as "the gross amount realized . . . on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized under the Internal Revenue Code" ²⁰ Certain types of receipts are specifically excluded from the definition of gross receipts (e.g., receipts from a taxpayer's treasury function, and amounts received from hedging transactions).²¹

The FTB's observations with respect to the audit issues relating to the inclusion of certain "gross receipts" in the sales factor are consistent with what practitioners encounter when advising corporate taxpayers. The ongoing audit issues between the FTB and taxpayers are commonly related to the taxpayer's inclusion of receipts from treasury function activities and hedging transactions.

Since many taxpayers currently have audits open in years prior to the statutory amendment of the definition of "gross receipts" applicable to taxable years after January 1, 2011, whether the receipts generated from a taxpayer's treasury function activities are includible in the sales factor continues to remain a significant issue for many corporate taxpayers. One of the most common disagreements between the FTB auditors and taxpayers relates to inclusion of receipts from treasury function activities and the application of a number of California court cases and California State Board of Equalization ("SBE") decisions opining on the inclusion of gross receipts from a taxpayer's treasury function in the sales factor denominator.²² California court cases and the SBE have held that a number of types of receipts from treasury function activities are includible in the taxpayer's sales factor denominator under Section 25120(e) as in effect prior to January 1, 2011.²³ However, the FTB auditors continue to assert the position that such receipts are excluded, arguing that such inclusion results in impermissible distortion.²⁴

Along these same lines, FTB auditors and taxpayers also commonly disagree on whether receipts generated from a taxpayer's hedging transactions should be included in the sales factor. Similar to the FTB's position with respect to gross receipts from a taxpayer's treasury function activities, the FTB auditors have continued to assert that receipts from hedging transactions are excluded based on impermissible distortion, notwithstanding that a California appellate court has held that gross receipts from hedging transactions are included in the sales factor under Section 25120(e) as in effect prior to January 1, 2011.²⁵

III. ABUSIVE TAX SHELTERS

A. The FTB's Observations

We continue to see abusive tax shelters in a variety of situations to avoid state or federal tax. These types of transactions often involve the creation of entities or deductions without economic substance or a business purpose.²⁶

B. Practitioner Observations

The FTB has defined an abusive tax avoidance transaction ("ATAT") as any of the following: (1) Tax shelter as defined in Internal Revenue Code of 1986, as amended ("IRC") section 6662(d)(2)(C); (2) Reportable transaction, as defined in IRC section 6707A(c)(1), with respect to which the requirements of IRC section 6664(d)(2)(A) are not met; (3) Listed transaction as defined in IRC section 6707A(c)(2); (4) Gross misstatement with the meaning of IRC section 6404(g)(2)(D); or (5) Any transaction to which Section 19774 applies.²⁷

The FTB may initially assert that a tax position taken on a corporate franchise tax return is an ATAT because, for example, certain structural attributes tend to give rise to the existence of an ATAT. However, in some instances the suspected ATAT does not, in fact, meet the definition of an ATAT.

IV. CREDITS

A. The FTB's Observations

We verify that credits, such as Enterprise Zone and Research and Development Credits, are reported correctly. In addition, we verify that the assignment of credits is properly reported by the assignor and the assignee.²⁸

B. Practitioner Observations

California's Enterprise Zone ("EZ") tax credit program was an incentive program offered to businesses operating within designated geographic zones. The EZ tax credit program contained two separate credits: (1) a hiring credit against franchise/income tax based on the amount of "qualified wages" paid to "qualified employees;"²⁹ and (2) a credit against franchise/income tax for sales or use tax paid or incurred in connection with the purchase of "qualified property" used exclusively in an EZ.³⁰

To be a "qualified employee" for purposes of the hiring credit, an employee must fit into a specific category (e.g., a qualified displaced worker, an ex-offender, etc.).³¹ Among other requirements, a taxpayer must obtain vouchers from certain government agencies that provide that the "qualified employee" meets one of the requisite categories and must retain a copy of the certification and provide it to the FTB upon request. In order to claim the credit for sales and use tax paid, taxpayers must purchase "qualified property" and must use the property exclusively in the EZ.

California's EZ tax credit program expired on December 31, 2013.³² As the program winds down, auditors have continued to verify the accuracy of taxpayer EZ hiring credit vouchers and the documentation necessary to support the vouchering decision. Additionally, the FTB regularly audits the credit for sales/use tax with respect to whether the property is "qualified property," whether such property is being exclusively used within the EZ, and whether the sales or use tax was paid.

As to the California Research and Development ("R&D") tax credit against franchise/income tax paid, taxpayers have found that the FTB has generally followed the IRS' determinations with respect to the credit.³³ However, in some instances the FTB has conducted its own independent audit of the taxpayer's California R&D credit. In such instances, the FTB will request additional information to determine how to apply the federal analysis to the California research activities. Additionally, FTB auditors will often examine the taxpayer's computation of R&D credit and request information on computational or state issues where California does not conform.

Section 23663 permits the irrevocable assignment of credits among affiliated members of the same combined reporting group. As the FTB identifies in its Tax News article, a common audit procedure is to verify whether a taxpayer has properly assigned its credits. The FTB has highlighted that in some situations taxpayers have made defective elections, such as when the total credits available to be assigned are less than the assignor contemplated when the original tax return was filed, or an assignee was not a member of the same combined reporting group on the required dates.³⁴ Because the assignment election is irrevocable, taxpayers are left with no clear recourse to fix such defective elections, and the FTB has not yet established any standards to apply in adjusting such defective elections.³⁵ Therefore, the FTB is currently in the process of promulgating a new regulation to establish standards to apply to apply in adjusting defective assignment of credits.³⁶

ENDNOTES

1. This proposal was principally prepared E. Scott Ewing, member of the State Bar of California Taxation Section as part of the annual Washington, D.C. delegation co-sponsored by the State Bar of California and the Los Angeles County Bar Association Taxation sections. The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association. Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

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3. See “FTB Audit Issues,” *Tax News* (April 2014) at <https://www.ftb.ca.gov/professionals/taxnews/2014/April/>.
4. Except as otherwise provided, all references herein to “Section” are to the California Revenue and Taxation Code, and all reference herein to “Regulation” are to title 18 of the California Code of Regulations.
5. See “FTB Audit Issues,” *Tax News* (April 2014) at <https://www.ftb.ca.gov/professionals/taxnews/2014/April/>.
6. The market-based sourcing rules are contained in Section 25136 and Regulation 25136-2. California also has a provision excluding 50% of the sales sourced to California under the market-based sourcing rules for taxpayers in the cable network business that make a minimum investment in California of \$250 million for the taxable year. See Rev. & Tax. Code § 25136.1(a).
7. The COP rules are found in Regulation 25136.
8. Rev. & Tax. Code § 25136(a) (as in effect for tax years beginning prior to January 1, 2011 and for tax years beginning on or after January 1, 2011 and before January 1, 2013 for taxpayers who did not elect under Section 25128.5 to file their California franchise tax return using a single sales factor apportionment method).
9. Rev. & Tax. Code § 25136(a)(1).
10. Rev. & Tax. Code § 25136(a)(2).
11. Cal. Code Regs., tit.18, § 25136(b).
12. *Id.*
13. *Id.*
14. Cal. Code Regs., tit.18, § 25136(c).
15. Rev. & Tax. Code § 25136; Cal. Code Regs., tit. 18, § 25136-2.
16. See generally Cal. Code Regs., tit. 18, § 25136-2.
17. During the initial drafting stages Regulation 25136-2, the FTB noticed three Interested Parties Meetings. Currently, the FTB is in the process of amending Regulation 25136-2 and has noticed three Interested Parties Meetings. See https://www.ftb.ca.gov/law/Regulatory_Activity.shtml.
18. See “FTB Audit Issues,” *Tax News* (April 2014) at <https://www.ftb.ca.gov/professionals/taxnews/2014/April/>.
19. See Ch. 17 (S.B. 15), Laws 2009, 3rd Ex. Sess.
20. Rev. & Tax. Code § 25120(f)(2), (f)(4).
21. Rev. & Tax. Code § 25120(f)(2)(A) – (L).
22. See, e.g., *General Motors Corp. v. FTB*, 39 Cal. 4th 773 (2006) (holding that with the exception of receipts from repurchase agreements, gross proceeds from the sale of marketable securities as a treasury function activities were includible in the sales factor); *Microsoft v. FTB*, 39 Cal. 4th 750 (2006) (holding that gross proceeds from the sale of marketable securities, including redemptions on maturity, are includible in the sales factor); *Appeal of Home Depot USA, Inc.*, Letter Decision Case No. 298683, (Cal. St. Bd. of Equal. Dec. 18, 2008).
23. *Id.*
24. See Rev. & Tax Code § 25137. Under Section 25137 a taxpayer may petition the FTB for permission, or the FTB may require a taxpayer, to use a method for apportioning income between states that differs from the standard apportionment formula otherwise prescribed by law. The crux of a distortion claim is that the allocation and apportionment provisions under the standard apportionment formula does not fairly represent the taxpayer’s activities within California. Cal. Code Regs., tit. 18, § 25137(a).
25. *General Mills Inc. & Subsidiaries v. FTB*, 172 Cal.App.4th 1535 (2009).
26. See “FTB Audit Issues,” *Tax News* (April 2014) at <https://www.ftb.ca.gov/professionals/taxnews/2014/April/>.
27. See Penalties: Abusive Tax Shelters and Transactions, Franchise Tax Board, available at: https://www.ftb.ca.gov/law/tax_shelter/penalties.shtml.
28. See “FTB Audit Issues,” *Tax News* (April 2014) at <https://www.ftb.ca.gov/professionals/taxnews/2014/April/>.
29. See Rev. & Tax. Code § 23622.7.
30. See Rev. & Tax. Code § 23612.2.
31. See Rev. & Tax. Code § 23622.7.
32. See Rev. & Tax. Code § 17053.73(a).
33. See Recent Developments in California Research Credit Audits, FTB Tax News, December 2013, available at: https://www.ftb.ca.gov/professionals/taxnews/2013/December/Article_3.shtml.
34. Meeting Notice, Third Interested Parties Meeting, available at: https://www.ftb.ca.gov/law/regs/23663/06122014_Third_Notice_and_Information.pdf.
35. *Id.*
36. *Id.*