

California Releases Legal Ruling Addressing Requests for Variance from Standard Apportionment Formulas

Overview

Recently, the California Franchise Tax Board (“FTB”) published Legal Ruling 2019-01 (“LR 2019-01” or “Ruling”) addressing the appropriate subject matter for a taxpayer request to use an alternative apportionment, or allocation, methodology pursuant to California Revenue and Tax Code (“CRTC”) section 25137.¹ In the Ruling the FTB presents four hypothetical situations, and provides its view on whether each situation would represent appropriate (or inappropriate) subject matter to request a variance from the standard apportionment formula.² The Ruling situations are not intended to be all-inclusive, and instead provide guidance for taxpayers when filing a request to use an alternative apportionment formula.

The Ruling ultimately states, in part, that “[r]equests for variance from the standard formula must, therefore, specifically address an issue relating to an allocation or apportionment methodology.”³ Specifically, through the situations provided, LR 2019-01 concludes that issues of unity/decombination, business vs. nonbusiness income, and water’s-edge mechanics are not appropriate subject matters for alternative apportionment because these issues relate to the determination of income. However, a taxpayer with no sales factor may be an appropriate instance to request variance from the standard formula because this situation does relate to apportionment.

This Tax Alert summarizes LR 2019-01 and provides certain taxpayer considerations.

Background

Generally, CRTC section 25137 provides taxpayers with an option to petition the FTB to use an alternative apportionment methodology on the grounds the standard allocation and apportionment provisions do not fairly represent the extent of the taxpayer’s business activity in California in certain situations.⁴ Additionally, the FTB can utilize the provision to require a taxpayer to use an alternative apportionment methodology, if it determines the result of the standard formula does not fairly represent the extent of the taxpayer’s business in California.⁵

In order to qualify to use the alternative apportionment in CRTC section 25137, the taxpayer or FTB must demonstrate the standard apportionment formula does not fairly and accurately represent taxpayer’s business activity in the state and is therefore distortive. Various distortion cases can be used as guidance to determine whether distortion may exist.

A taxpayer may request a variance from the standard apportionment formula by filing a petition either with the three-member Franchise Tax Board or with a Section 25137 Committee composed of FTB staff.⁶ FTB staff has been granted the power to hear CRTC section 25137 petitions via California Code of Regulations (“CCR”) Title 18, section 25137(d).⁷ If a taxpayer presents a petition to the Section 25137

¹ FTB Legal Ruling 2019-01 (June 07, 2019), available [here](#).

² *Id.*

³ *Id.* at pg. 5.

⁴ CRTC § 25137.

⁵ CRTC § 25137.

⁶ See FTB Legal Ruling 2019-01. n.5 (June 07, 2019).

⁷ *Id.*; CCR § 25137(d).

Committee and is denied, the taxpayer may appeal that determination to the three-member Franchise Tax Board.⁸

Legal Ruling 2019-01

LR 2019-01 offers guidance reflecting FTB's interpretation of situations where a CRTC section 25137 variance request may be appropriate. It also identifies specific situations that would not qualify, such as decombination. The Ruling details a total of four hypothetical situations. Three of the situations the FTB concluded were inappropriate for a request involved scenarios the FTB viewed to be non-apportionment related issues:⁹

- Scenario 1: An increase in apportionment due to a unitary determination was concluded to not be an apportionment issue, and thus an inappropriate issue for a CRTC section 25137 request.
- Situation 2: Categorization of a dividend as business income as opposed to non-business income was concluded to not be an issue of allocation and apportionment, and thus an inappropriate issue for a CRTC section 25137 request.
- Scenario 3: The FTB asserted that inclusion of royalties from a foreign affiliate in the income base is not an appropriate scenario to warrant a request for variance, as "25137 does not apply to water's edge mechanics."

LR 2019-01 includes a single example of an appropriate variance in Situation 4:

- A hypothetical taxpayer's CRTC section 25137 request to use a 2-factor apportionment formula, rather than a 3-factor formula (pursuant to CRTC section 25128(b)), was considered by the FTB to be appropriate where the company had no sales and therefore was unable to compute a sales factor.

The example in Situation 4 is specific to a taxpayer required to use a three-factor formula and did not specifically address a situation where a taxpayer required to use a single sales factor formula had no sales, such as a startup company. However, the FTB has previously provided informal guidance in a Tax News article addressing the situation where a company using a single sales factor formula had no sales whatsoever and advised that the FTB might apply alternative apportionment under CRTC section 25137.¹⁰ However, it is important to note that although the FTB views alternative apportionment to be appropriate where a taxpayer has no sales factor, the FTB's asserts that a petition to use such an alternative apportionment methodology would still be required to avoid potential exposure to the accuracy related penalty.¹¹ Likewise, receiving FTB permission to apply alternative apportionment may be necessary to avoid California's large corporate underpayment penalty.

In LR 2019-01, the FTB identified five examples in which CRTC section 25137 relief may be warranted.¹² The FTB has included these examples by reference in the Ruling.

Considerations

The FTB has worked to formalize and standardize the process under CRTC section 25137 for requesting a variance from the standard apportionment methodologies in recent years. With the change to a single-weighted apportionment formula based on sales for most taxpayers, and the complexities associated with market-based sourcing, taxpayers should continue to monitor whether use of the required apportionment formula clearly reflects their activities in California. Important takeaways from the Ruling include:

⁸ A waiver of confidentiality is required to appeal to the three-member Franchise Tax Board as appeals are heard in open session. Guidelines to Implement Resolution 2017-01; see Franchise Tax Board Resolution 2017-01 (December 7, 2017).

⁹ *Id.*

¹⁰ California Franchise Tax Board, Tax News – All About Business, (October 2016). Informal guidance is not binding on the FTB.

¹¹ Franchise Tax Board Notice 2004-5 (August 6, 2004).

¹² *Id.*

- Legal rulings represent the FTB’s official interpretation of current law. As an interpretation of existing law, rather than “law-making,” the FTB’s interpretation can be applied retroactively.
- The examples provided in the Ruling are not intended to be all-inclusive, thus there may be other situations where the FTB would choose not to grant CRTC section 25137 relief.
- A taxpayer’s specific circumstances should always be considered, and the Ruling should not prevent issues from being raised or discussed with the FTB as part of any dispute, including circumstances seemingly identical to LR 2019-01’s enumerated examples.
- A taxpayer that files a petition for alternate apportionment should be prepared to represent how the standard apportionment formula caused the distortion and discuss an alternative theory, or theories, to apportion income to fairly reflect income from sources within California.

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