taxnotes®

state

Volume 107, Number 3 ■ January 23, 2023

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Reprinted from *Tax Notes State*, January 23, 2023, p. 329

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In this article, Tourian describes what procedural rights are attached with requesting a variance under Cal. Rev. & Tax Code section 25137 and examines California FTB Legal Ruling 2019-01 contradictions.

The opinions expressed here are solely the author's and do not reflect the opinion of BDO USA LLP.

In Legal Ruling 2019-01 California's Franchise Tax Board sets out rules for determining appropriate subject matters to be considered in a request for variance from the standard apportionment and allocation formula. However, by limiting what taxpayers are allowed to bring forth, and in essence, redefining what is considered a variance under the statute, LR 2019-01 effectively tries to self-censor taxpayers.

Cal. Rev. & Tax. Code (RTC) section 25137 defines the standard apportionment and allocation formula. LR 2019-01, which the FTB released June 7, 2019, describes four scenarios the FTB deems to be appropriate subject matters for considering — but not necessarily granting — variance from that standard. By providing these examples, the FTB has signaled it wants to severely limit the application of section 25137 by limiting a taxpayer's recourse for equitable relief when the facts and circumstances might warrant it.

This article first describes what procedural rights are attached with requesting variance under section 25137. It then describes how the four examples in LR 2019-01 contradict either: the Revenue and Taxation Code, established jurisprudence, the original intent of Uniform Division of Income for Tax Purposes Act section 18, or a logical reading and application of the relevant statutes.

Procedural Rights Associated With Section 25137

Section 25137, which mirrors UDITPA section 18, allows for relief in unusual circumstances in which the standard apportionment formula does not result in a fair representation of a taxpayer's business activity in California. Petitions may be reviewed and decided by FTB staff (including review by an auditor, protest hearing officer, or a special 25137 committee) or may be decided by the three FTB board members after a decision denied by FTB staff. These reviews typically take place in an informal setting.[1] Cal. Code Regs. section 25137(d) provides that only "cases deemed appropriate by the Franchise Tax Board" will be considered by the FTB for purposes of granting variance.[2]

[1] California FTB, "Guidelines to Implement Resolution 2017-01" (June 18, 2018).

[2] Reg. section 25137 is being amended. However, the proposed amendments do not affect the subject of this article.

LR 2019-01 tries to limit the cases deemed appropriate by redefining the subject matter for purposes of RTC section 25137. It is the FTB's right to not pursue RTC section 25137 as a sword; however, it is precluded from interpreting regulations outside the scope of the statute.[3] Further, LR 2019-01 has the potential to unduly influence the recently established Office of Tax Appeals. For example, the OTA recently ruled in favor of the FTB under reg. section 25137(c)(1)(A) in two decisions, written one month apart, in which the reasoning differed significantly.

In *Appeal of Faries*,[4] the OTA relied on the fact that the property and payroll factors reflected the appreciation of intangible values. However, in *Appeals of Amarr Co. and Amarr Co. (C SGNF)*,[5] the OTA ruled that the appreciation of intangibles did not need any other factor representation besides the sales factor, although the issue was not fully briefed by either the FTB or taxpayers.[6] Compounding *Amarr* is that the OTA decided to make it precedential.[7] As such, LR 2019-01 is the first step in trying to change the traditional understandings of when RTC section 25137 is warranted, and redefining what distortion is.

Situation 1: Despite What the Statute Says

LR 2019-01's holding that decombination is not an appropriate subject matter to be considered in a request for variance does not follow precedent, and explicitly contradicts both the plain language of RTC section 25137 and an original construction of RTC section 25101.

Under Situation 1, Company A filed a variance requesting to decombine itself from its subsidiary, effectively using separate accounting. LR 2019-01 provides that this scenario does not warrant a request for decombination as "R&TC section 25137 does not address issues such as unitary combinations (R&TC section 25101)."

First, in *Hyundai Motor America*,[8] the Board of Equalization, in an unpublished decision, granted alternative apportionment to the taxpayer when the taxpayer met its burden of proving that the statutory apportionment provisions did not fairly represent the extent of its business activity in this state, and that separate accounting was a reasonable alternative. Further, *Colgate-Palmolive Co.*[9] considered decombination and separate accounting under section 25137 but ruled that the taxpayer had not met its burden of proof for variance to be granted.

Second, section 25137(a) provides that taxpayers can request alternative apportionment based on separate accounting. Historically, FTB's UDITPA manual, "Other Apportionment Methods," provided a situation like Situation 1.[10] However, in that manual, the FTB provided this was the fact pattern — based on the lack of unitary factors — that warranted variance for separate accounting and decombination purposes. The current audit manual does not include this example, nor does it provide any examples illustrating separate accounting.

Finally, the FTB has no basis in its interpretation that section 25101 precludes section 25137 from allowing either a taxpayer, or

[3] *Yamaha Corp. of America v. BOE*, 19 Cal. 4th 1 (1998).

[4] *Appeal of T. Faries and Estate of D. Faries Jr.*, 2022-OTA–068 (Jan. 5, 2022).

[5] *Amarr Co. and Amarr Co. (C SGNF)*, 2022-OTA-41P (Dec. 9, 2021).

[6] Whether the decision-making in *Amarr* is considered *sua sponte* is outside the scope of this article. However, the six-document briefing file does not discuss the intrinsic value between goodwill and the marketplace. The Opening Brief for Respondent, Amarr (Apr. 13, 2020) makes a cursory attempt to discuss why the reasoning under reg. section 25137(c)(1)(A) should not apply. And the Opening Brief for Respondent, FTB (July 2, 2020) argues that the taxpayer agreed that 25137(c)(1)(A) should apply on page 4. It further discusses why the assets are business income under the functional test on pages 5-8.

[7] The case was recommended for precedential consideration during the review process, by a panel member or the presiding administrative law judge. It was not anyone outside of OTA who made the request. The precedential committee concluded that it met the standards under reg. section 30502.

[8] *Appeal of Hyundai Motor America*, 97A-0310 (Cal. BOE June 25, 1998).

[9] *Colgate-Palmolive Co. v. FTB*, 10 Cal. App. 4th 1768 (1992).

[10] California FTB, "The UDITPA Manual — FTB" (Sept. 1984), provides when separate accounting may be used, and provides an example similar to the example provided in LR 2019-01:

> 1020 SEPARATE ACCOUNTING
> Whenever the trade or business of the taxpayer within the state is separate and distinct from the business conducted outside the state, separate accounting is used to compute the income derived from sources within this state. . . .
> 1040 SEPARATE ACCOUNTING AND FORMULA APPORTIONMENT
> . . . For example, in a previous example, a corporation was engaged in farming activities in California and retail store operations outside the state. If the corporation had operated stores in this state as well, it would be proper to use separate accounting for the farm operations and to use formula apportionment for determining the portion of the retail store business attributable to this state. The total of the two, plus any nonbusiness income allocable to this state, would be the measure of tax.

the FTB, from seeking decombination. Rather, sections 25101 and 25137 work together to determine what falls under the discretionary authority purview. Section 25101 provides that taxpayers who are subject to RTC part 11 shall apportion their income as provided by part 11, chapter 17, article 2.[11] Section 25101 is found under part 11, chapter 17, article 1, titled "General Provisions." Section 5 provides that the "General Provisions" article generally defines how the code should be constructed unless the context requires a different reading.[12]

Historically, section 25101 provided rules for apportionment.[13] This is further illustrated by section 25101.3, which reg. section 25137-7 cross-references for purposes of determining the apportionment formula for the airline industry, and reg. section 25101(b), which provides the rules for apportioning for sea transportation companies.[14]

Situations 2 and 3: Which Came First, the Chicken or the Egg?

In Situation 2 of LR 2019-01, the FTB deems a request for treating dividends as nonbusiness income as an inappropriate subject matter to be considered in a request for variance. Situation 3 proclaims that any taxpayer making a water's-edge election is precluded from requesting variance.

Regarding Situation 2, LR 2019-01 first relies on a general passage from William Pierce's article "The Uniform Division of Income for State Tax Purposes," which provides that UDITPA's application assumes that the tax base has been defined.[15] The FTB's reading of this passage is misguided. The scope of that passage pertained to income determined at the federal level.

Pierce writes in the same article that the application of UDITPA section 18 (the equivalent of section 25137) applies to all aspects of what is in UDITPA.[16] This includes the determination of what is, or is not, business income. Further, section 25137 states that it applies to where "the *allocation and apportionment* provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state" (emphasis added). As such, section 25137 can recharacterize an income stream as business or nonbusiness income (in this case, dividends), which are the fundamental tenets of determining which

[11] Section 25101 provides:
When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

[12] Section 5 provides: "Unless the context otherwise requires, the general provisions hereinafter set forth govern the construction of this code."

[13] *Standard Register Co. v. FTB*, 259 Cal. App. 2d 125 (1968), provides that when determining what income is attributable to California, "Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, value and situs of tangible property or by reference to pay of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State."

[14] California FTB, Title 18, Cal. Code Regs. section 25101, Office of Administrative Law Matter Number 90-10250-015, Exhibit B, "Notice for 10/15/90 Hearing (Comment Period 10/15/90)," at 2, provides how historic rules for apportionment were repealed, except the sea transportation companies, because taxpayers were now subject to UDITPA: "Section 25101 of the Rev. & Tax. Code states that any apportionment method shall take into account income derived from or attributable to transportation by sea. The inadvertent withdrawal of the regulation could be interpreted as a significant change in the manner in which sea transportation companies are taxed. No such change has been proposed or was intended by the inadvertent withdrawal of subsection (b) of Subsection 25101. The amendment at issue is needed to specify how the income of sea companies will be apportioned."

[15] William J. Pierce, "The Uniform Division of Income for State Tax Purposes" 35 *Taxes* 747 (1957), provides: "The 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."

[16] *Id.*, provides:
Section 18 is a general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some altitude for showing that the particular business activity, some more equitable method of allocation and apportionment could be achieved. . . . Nonetheless, some alternative method must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.

streams of income are allocable or apportionable.

LR 2019-01 further relies on *CTI Holdings Inc.*[17] for the proposition that variance should not be used for income determination.[18] However, *CTI Holdings* made no such determination. In its opinion, the BOE held that foreign taxes paid on eliminated income items were nondeductible despite the elimination of the underlying income. California law generally prohibits deductions of state, federal, or foreign taxes "on or according to or measured by income or profits," including taxes imposed on intercompany dividends paid by one member of a unitary group to another member of the unitary group and eliminated from the income of the recipient, as per section 24345(b).

The taxpayer also made a side argument, claiming that the application of section 24345(b) amounted to distortion. Although the BOE did provide as a general rule that "UDITPA only deals with the allocation and apportionment of income, not with the determination of what constitutes income," the crux of the BOE's determination for why section 25137 did not apply in the taxpayer's context was that the taxpayer failed to substantiate its contentions.[19] Thus, the holding in *CTI* for purposes of evaluating RTC section 25137 should be limited to its facts, especially given the lack of factual development in the case. Making a blank assertion that the treatment of dividends can never be subject to a section 25137 variance defeats the purpose of what Pierce envisioned in his UDITPA section 18 analysis.

The above analysis applies to LR 2019-01, Situation 3, in which the FTB precludes a taxpayer's section 25137 variance request for taxpayers making a water's-edge election. The FTB's rationale was that variance requests do not apply to "water's edge mechanics." However, such an overarching rule defeats the purpose of section 25137, especially in unusual situations that could affect a water's-edge taxpayer. For example, although California has still not conformed to the Tax Cuts and Jobs Act of 2017, the issue of how to treat and apportion global intangible low-taxed income has arisen and is treated differently by New York state and New York City.

In New York City, net GILTI amounts used for calculating entire net income are included in both the tax base and denominator of the business allocation percentage.[20] New York state took a different approach, under which it effectively used separate accounting, as 95 percent of net GILTI is excluded from the tax base, and only 5 percent is included in the denominator of the business allocation percentage.[21]

How New York state and New York City treat GILTI income is an example of an extraordinary event warranting a section 25137 variance, even when a taxpayer has made a water's-edge election. The reason is that it is expected that the rules for allocation and apportionment have been set once a water's-edge election is made, knowing exactly what will be included in the tax base. The TCJA, which created GILTI, is an example where something unexpected happens that might impact water's-edge mechanics, or something similar. The examples from New York state and New York City are only meant to convey that there are different ways to solve an apportionment issue created by an unforeseen federal change affecting the tax base.

[17] *In the Matter of the Appeal of CTI Holdings Inc.*, 96-SBE-003 (Feb. 22, 1996).

[18] Legal Ruling 2019-01 states that UDITPA does not address issues such as "the determination of income (see *Appeal of CTI Holdings Inc.*, 96-SBE-003, Feb. 22, 1996)."

[19] *CTI Holdings* provides:

> UDITPA only deals with the allocation and apportionment of income, not with the determination of what constitutes income. Moreover, section 25137 cannot be invoked unless appellant proves that application of the general provisions of UDITPA would lead to an unfair representation of the extent of its activities in this state. . . . A rough approximation under the general UDITPA standards is all that is required. . . . Since appellant has failed to provide any substantive evidence to validate its bald contention that the standard UDITPA formula distorts its income to such an extent that an alternate method must be used, this part of its argument must also fall. (Footnotes and citations omitted.)

[20] New York City Finance Memoranda 18-9 (rev. Feb. 11, 2021) and 18-10 (rev. Feb. 2, 2021).

[21] N.Y. Tax Law section 208.6-a(b)(iii).

Situation 4: Square Peg in a Round Hole

LR 2019-01's Situation 4 presents numerous problems. In Situation 4, 50 percent of the taxpayer's gross business receipts from the conduct of its extractive business activity made that taxpayer an extractive company, subject to the equally weighted apportionment formula under section 25128(b). The taxpayer provided that it had zero business receipts and thus requested variance where it could use only the payroll and property factors.

Situation 4 raises a couple questions. How did the taxpayer know it was an extractive company subject to the rules under section 25128(b) when it had no business receipts to make that determination? Did the FTB determine that the taxpayer's business activities, evidenced by its payroll and property factors, qualified the taxpayer to be an extractive business activity?

And more importantly, in a normal situation in which a taxpayer did not have any gross receipts (and a 0/0 factor would be a mathematical impossibility, like a start-up company), and would normally be subject to the single-weighted sales factor, should factors outside the scope of payroll and property be used to determine a given taxpayer's apportionment formula?

This makes sense, because historically, the FTB had used other factors such as purchases and expenses of manufacturing.[22] Further, Pierce referred to the allocation and apportionment sections of UDITPA as "a formula designed for manufacturing and merchandising businesses."[23] With the U.S. economy no longer focused on manufacturing and merchandising, other factors should be used to determine a taxpayer's business activity.

Conclusions

Taxpayers should not be afraid to request variance when any aspect of UDITPA does not adequately reflect their business activities in California and when the standard formula produces unreasonable results.

The standard formula was not meant to be limited, and applied dogmatically, especially when it was written when most businesses were brick-and-mortar. Businesses do not stay stagnant so that taxing jurisdictions can administer their taxes easily. Rather, it is the tax administration that needs to be flexible, especially on a provision specifically designed for flexibility. ■

[22] *Standard Register*, 259 Cal. App. 2d 125.

[23] Pierce, *supra* note 15.