

DISCUSSION TOPICS

FRANCHISE TAX BOARD INTERESTED PARTIES MEETING -- AIR TRANSPORTATION AND BLENDED AIR/TRUCKING INDUSTRY REGULATIONS

SEPTEMBER 6, 2007

1. BACKGROUND

Due to the mobile nature of the air transportation industry, it is generally difficult to isolate and properly measure the level of California activity in comparison to the level of activity everywhere. The Franchise Tax Board (FTB) looks to Revenue and Taxation Code (RTC) section 25101.3 to calculate the property factor, and to California Code of Regulations (CCR), title 18, section 25137-7, to calculate the payroll and sales factors. Each relevant section provides its own formula for each factor. The rules for determining the apportionment factors for the air transport industry, pursuant to RTC section 25101.3, and CCR section 25137-7, have generally been derived from, and are parallel to, the State Board of Equalization's (SBE) property tax allocation laws and guidelines.

The formula found in RTC section 25101.3, originally enacted to reflect the property tax allocation laws, compares business activity for certificated aircraft in California to the business activity of certificated aircraft everywhere. The formula found in CCR section 25137-7 calculates the payroll and sales factors based on the type of aircraft in California compared to the type of aircraft everywhere. Historically, under either of these rules, information based on make and model of aircraft was used in the formula apportionment of income.

In the recent Appeal of Alaska Airlines, Inc. (Alaska Airlines), the SBE upheld, in an unpublished opinion, the position of Alaska Airlines that a 1973 amendment to RTC section 25101.3 severed the relationship between the apportionment formula laws for franchise tax purposes and the property tax allocation laws. The SBE went on to decide that an air transportation company could look at its entire fleet of aircraft, instead of individual aircraft, to calculate its property factor pursuant to RTC section 25101.3.

The SBE also upheld Alaska Airlines' argument that the reference to "type of aircraft" found in CCR section 25137-7 is specifically defined in subsection (e) of that same regulation. Therefore, the FTB could not require the taxpayer to consider make and model of aircraft in computing the payroll and sales apportionment factors.

The SBE's decision in Alaska Airlines that the property tax allocation laws have no bearing on formula apportionment for franchise tax purposes could potentially impact other airlines that were not parties to the appeal. At the very least, that holding has created uncertainty as to the proper means of apportioning the income of companies involved in air transport. It should be noted that Alaska Airlines' methodology appears to benefit regional carriers, while at the same time adversely affecting airlines with business operations primarily outside of California, including international carriers.

For airlines engaged in hauling cargo, there have also been concerns raised regarding the use of the airline formula to apportion the entire income of the business, when a significant amount of the operations involve the use of trucks to complete the delivery of packages. To address

this concern, interested parties should be prepared to discuss the use of a formula to determine what portion of the factors should be assigned to air transportation activities, as opposed to trucking transportation activities, to properly reflect overall business activities. The regulatory scheme might also need to address the factor contribution of both the trucking and air activities if this is technically feasible.

2. STAFF'S EXPECTATIONS FOR THE MEETING

In response to the decision in Alaska Airlines, the department is currently allowing the air transportation industry to apply either the Alaska Airlines formula or the traditional formula. The department is now seeking to update its existing air transportation regulations so that a uniform formula can be applied industry wide. Additionally, the department needs to clarify the factor representation issue for blended air/trucking transportation activities.

Staff believes core principles that provide an objective basis upon which to evaluate proposed solutions should guide any solution. Among these principles are:

- 1) Equity: Are all taxpayers being treated similarly?
- 2) Administrability: Is the rule clear and simple? Can taxpayers and the department apply the new rule?
- 3) Elimination of potential disputes: Does the new rule raise new concerns that could lead to new disputes?
- 4) Recordkeeping: Does the new rule use existing records as much as possible to minimize taxpayer recordkeeping burdens?

At a minimum, it appears to staff that any regulatory changes should:

- 1) Clearly identify the relationship, if any, between the property tax allocation laws and formula apportionment of income laws.
- 2) Clearly identify the relationship between the apportionment factor laws.
- 3) Clearly identify what, if any, documents should be incorporated into the regulations by reference. For example, the department originally looked to the SBE's Handbook for interpreting its apportionment formula laws.
- 4) Incorporate relevant aspects of the 1972 FTB guidelines.
- 5) Provide definitions for aircraft type, certificated aircraft, and statistical data.
- 6) Remove any unclear or outdated instructions, such as the itemized listing of aircraft type in CCR section 25137-7(e).
- 7) Clarify the factor representation for trucking and air activities and reference the trucking company regulation, CCR section 25137-11.
- 8) If possible, address other industry concerns that may exist.

3. POSSIBLE SOLUTIONS

The amended regulations could be updated to reflect the original approach to formula apportionment developed in 1968 by the Legislature at the request of the air transportation industry. This approach would allow the department to look to SBE laws and regulations.

An alternative approach would be to separate the formula apportionment laws from the

property tax laws, as the SBE found in Alaska Airlines.

Either of these alternatives has the potential for providing one industry wide formula that provides clarity and consistency for both taxpayers and the department.

For blended industries, staff is considering including a statement referencing the trucking company regulation, CCR section 25137-11, and devising a formula for assigning factor representation between trucking and air activities.

The department anticipates having an open discussion to address these and other concerns that may be present in the industry. FTB will discuss possible approaches to administering the apportionment factors laws at the interested parties meeting, keeping in mind that the underlying objective should be to replace the current dual formulas with simple, straight forward rules that are easily complied with by taxpayers and easily administered by the department, with all taxpayers being treated equally.