

THE GENETELLI CONSULTING GROUP
State and Local Tax Services
431 FIFTH AVENUE
NEW YORK, NY 10016

(212) 684-4111
FACSIMILE: (212) 213-1020
EMAIL: rgetelli@genetelli.com

Subject: California – Alternative Apportionment Methods

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To Our Clients and Friends:

California has memorialized a new policy with respect to the use of alternative apportionment methods by corporate taxpayers. By way of background, Cal. Rev. & Tax Code §25137 permits taxpayers to petition the Franchise Tax Board to use alternative methods if the standard allocation and apportionment provisions do not reflect business activity in California. Such methods include: (1) separate accounting; (2) the exclusion of any one or more factors; (3) the inclusion of one or more additional factors; or (4) the employment of any other method to equitably allocate and apportion income. Many taxpayers in the past have taken alternative apportionment filing positions based on §25137 without obtaining prior approval from the Franchise Tax Board.

Under the new policy, a return with an unextended due date on or after October 15, 2004 that contains an alternative apportionment method will be deemed erroneous if submitted without prior approval by the Franchise Tax Board. Such return may be subject to the 20% accuracy-related penalty, and an assertion of reliance on §25137 will not be considered "reasonable cause" for penalty abatement purposes. If during the course of an audit exam or a protest proceeding a taxpayer cites §25137 to assert alternative apportionment, such action will be considered an original §25137 petition at that time.

There are exceptions to the new policy. A taxpayer may file a return containing an alternative apportionment method without prior consent of the Franchise Tax Board in the following circumstances: (1) an audit manual now in effect, or in effect during the tax year in question, allows the type of §25137 alternative method the taxpayer wants to use, and the taxpayer's fact situation is substantially the same as in the manual; (2) the taxpayer wants to use the same type of §25137 alternative method (for a year in which that section was operative) as permitted in a published opinion of the State Board of Equalization, California Supreme Court or California Court of Appeal, and the taxpayer's fact situation is substantially the same as described in such opinion; or (3) the alternative method in question was approved in writing in a prior year §25137 petition or a closing agreement that specifically provides that it applies to the tax year now in question.

A return with an unextended due date before October 15, 2004 that contains an alternative apportionment method without Franchise Tax Board approval will not be subject to the 20% accuracy-related penalty if there is adequate disclosure and the alternative method would have had a realistic possibility of gaining approval had prior Franchise Tax Board approval been sought. Adequate disclosure includes a statement in or attached to the return disclosing that the

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standard apportionment methods are not being used, or that the filing position relies on §25137. Merely entering data in the apportionment schedule using an alternative method does not constitute adequate disclosure.

If you have any questions, please do not hesitate to contact me.

Richard W. Genetelli
The Genetelli Consulting Group
State and Local Tax Consultants
431 Fifth Avenue, 3rd Floor
New York, NY 10016
Tel: (212)684-4111
Fax: (212)213-1020
Website: www.genetelli.com