2002-SBE-004

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 34424
Crisa Corporation	)	
	)	

Representing the Parties:

For Appellant:	Steven Toscher, Attorney
For Respondent:	William Hays Weissman, Tax Counsel

Counsel for Board of Equalization:	Donald L. Fillman, Tax Counsel Ian C. Foster, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Crisa Corporation against proposed assessments of additional franchise tax in the amounts of $116,378, $227,597, and $278,825 for the years ended December 31, 1987, December 31, 1988, and, December 31, 1989, respectively.[2]

---

[1] Unless otherwise specified, all section references are to sections of the California Revenue and Taxation Code as in effect for the years in issue.

[2] The audit also included 1986. However, a Notice of Action was not issued for 1986 because the proposed adjustment only changed the reported operating loss. The appeal does not include 1986.

The topic of this appeal is the effect of hyperinflation in Mexico on the determination and apportionment of income subject to California franchise tax. The issues are (1) whether appellant has established that respondent used the incorrect "functional" currency and translation rates in calculating both income and the property factor of the three-factor UDITPA[3] apportionment formula; and, in the alternative, (2) whether the UDITPA three-factor apportionment formula does not fairly represent appellant's business activity in California due to Mexican inflation.

Facts: General

Crisa Corporation (hereinafter appellant) is a distributor of glassware that was incorporated in Texas and qualified to do business in California (since 1984). Appellant filed California franchise tax returns for each appeal year using the three-factor formula of section 25128 to apportion its domestic income (only) between California and other states. It did not include income from related entities in other countries. During the audit, respondent determined and appellant agreed that it was a part of a worldwide unitary business that included Vitro, S.A. (Vitro), a Mexican limited liability (holding) company that owned 100 percent of appellant.

The total net income of the unitary business for each year, as reported by appellant on its consolidated income statements in millions of Mexican pesos, was as follows: 355,122; 479,955; and 568,953.[4] These consolidated income statements, using Mexican pesos, were prepared for reporting to appellant's shareholders, and were subject to review by an independent auditor.[5] Respondent used appellant's consolidated statements to prepare combined reports for the unitary business (prepared by respondent in 1994). The combined reports made accounting adjustments to calculate income according to California's requirements. The income and apportionment factors were computed in Mexican pesos (the parent corporation's functional and reporting currency), and income was apportioned to California using the standard UDITPA apportionment formula of section 25128 (property, payroll, and sales). Apportioned income was translated into dollars and California taxes calculated.[6]

---

3 Uniform Division of Income for Tax Purposes Act. (Rev. & Tax. Code, §§ 25120–25137.)

4 When three figures are listed in sequence they refer, respectively, to 1987, 1988, and 1989.

5 Appellant also provided a portion of its Form F-1 filed with the Securities and Exchange Commission on September 30, 1991. Appellant stated that this statement showed the income of Vitro, S.A. and its subsidiaries in "constant pesos" to "modify the income of prior reporting periods in order to restate them in terms of equivalent purchasing power when compared to the current reporting period—June 30, 1991." As so modified, back from June 30, 1991, the net income for each appeal year under U.S. generally accepted accounting principles (US GAAP) was shown as 1,134,000; 740,000; and 717,000 (million pesos).

6 The exchange rates used, in pesos per dollar, were 1,566.6; 2,245; and 2,461 pesos, respectively, an average of the exchange rates throughout each year.

Summary of Applicable Law

First Issue. Regulation 25106.5–10[7] provides the detailed rules that must be followed in preparing a combined report for a unitary business which has operations in foreign countries. Subdivision (b) provides the manner in which income shall be computed; subdivision (c) provides the rules for computing the three factors of the unitary formula (property, payroll, and receipts (sales)); subdivision (d) provides the sources for the translation exchange rates; and subdivision (e) provides that in computing both the income and any of the three unitary factors, consideration must be given to the effort and expense required to obtain the necessary information—in appropriate cases, reasonable approximations are acceptable. Specific subdivisions of Regulation 25106.5–10 are cited as they are discussed below.

Second Issue. Section 25137 provides that if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in California, the taxpayer may petition for, or respondent may require, another method to equitably allocate and apportion the taxpayer's income.

Summary of Contentions

Appellant. Appellant's primary contention is that respondent misapplied Regulation 25106.5–10. Appellant contends this error occurred when respondent used the peso as the functional currency rather than the dollar. Appellant also contends that respondent abused its discretion in two respects: (a) by not allowing appellant to recalculate its cost of goods sold using monthly exchange rates on the dates of acquisition rather than the average annual exchange rates, and (b) by not allowing appellant to use the dollar rather than the peso in calculating the property factor. Alternatively, appellant contends that if this Board finds respondent not in error with respect to applying Regulation 25106.5–10, appellant is entitled to an equitable adjustment to the standard apportionment provisions, under Section 25137, to fairly account for the distortive effects of Mexican hyperinflation.

Respondent. Respondent contends that appellant's audited financial statements already report cost of goods sold, depreciation, and fixed assets at historical cost as required by Regulation 25106.5–10, subdivisions (b)(4)(A), and (c)(1)(A) and (E). Respondent's use of the parent company's functional and reporting currency (the Mexican peso) allowed the income and expense results from multiple sources to be stated in a common currency. Respondent's use of appellant's audited financial statements for cost of goods sold and ending inventory obviated the

---

[7] Unless otherwise specified, all regulation references are to sections of title 18 of the California Code of Regulations as in effect for the years in issue.

need for historical-rate currency translation.[8] Respondent argues that appellant's contentions are requests for deviation from the express terms of Regulation 25106.5–10. Respondent further contends that appellant wants to use separate accounting on a geographic basis, which would be inconsistent with the standard UDIPTA apportionment formula, and which respondent urges should be rejected as a change in appellant's accounting methods made without respondent's consent. (See Rev. & Tax. Code, § 24651.)

Facts: Detailed

Table 1 compares taxable income of the unitary business as separately calculated by respondent and appellant:

Table 1
(Taxable Income in Dollars)

	1987	1988	1989	Totals
Respondent	113,942,200	235,039,121	270,204,772	619,186,093
Appellant	(94,514,659)	140,986,436	168,473,746	214,945,523

Table 2 compares California tax on California-source income of the unitary business as separately calculated by respondent and appellant:

Table 2
(California Tax in Dollars)

	1987	1988	1989	Totals
Respondent	116,978	229,931	283,506	630,415
Appellant	-0-	-0-	92,687	92,687

Although only the property factor is in dispute, Table 3 shows the combined (average) three-factor California apportionment percentage calculated by the parties, and their differences:

[8] Respondent notes that appellant's Annual Report states that it records transactions in foreign currency at a fixed rate close to the transaction date and makes monthly adjustments for material variances. Thus, respondent argues, the figures used already reflect such variances. Further, the Annual Report indicates that cost of sales was computed using four different accounting methods.

Table 3
(Combined Apportionment Percentages)

	1987	1988	1989
Respondent	1.2639	1.0519	1.1282
Appellant	0.7280	0.6009	0.7193
Difference	0.5359	0.4510	0.4089
Percentage Differences[9]	42%	43%	36%

However, as discussed below, no numerical formula or numerically calculated "difference" is a reliable gauge in determining whether the standard unitary formula fails to fairly represent the extent of a taxpayer's business activity in California.

Appellant provided a chart of exchange rates for the period from 1900 through 1990, showing the rate for each month. Table 4 shows the exchange rates (in pesos per dollar) for each December from 1985 through 1989 together with the resulting annual change:

Table 4
(Pesos per Dollar)

	December Exchange Rate	Annual Change	Annual Percentage Change	Respondent's Yearly average Exchange Rate
1986	925			
1987	2,204	1,279	138%	1,566.60
1988	2,273	69	3%	2,245.35
1989	2,650	377	17%	2,461.00

The cumulative three-year change (from December 1986 to December 1989) was 1725 pesos per dollar, for a compounded three-year rate change of 186 percent (1725 ÷ 925).

Legal Discussion

At the outset, we must recognize that combined reports that include data from more than one country will of necessity be affected by varying economic conditions—the economy of every country is somewhat different than that of any other. Some countries have

[9] Using respondent's average factor as a base (which followed the standard unitary formula).

low wages, low costs of materials, and low transportation costs that allow products to be produced inexpensively. Other countries have high production costs but support much higher retail prices. As a result, many products are manufactured in countries of lower cost and transported to countries that support a higher sales price. Some countries have periods of high inflation—as Mexico experienced during a portion of the 1980's. As appellant acknowledged having done, a business must factor anticipated inflation into the prices it contracts to use in the future. California tax accounting does not attempt to provide adjustments for the myriad of possible economic changes that occur daily. In applying the three-factor apportionment formula, California attempts to reach a rough approximation of the portion of the total income of a unitary business that has a California source. With this recognition, we explore the complex issues and contentions raised in this appeal.

I. Functional Currency

Regulation 25106.5–10 governs the preparation of combined reports that include operations in foreign countries. This regulation uses the "profit and loss method" for determining income. It excludes unrealized exchange rate gains and losses resulting from the restatement of assets or liabilities, while including exchange rate gains and losses attributable to income transactions. (Cal. Code Regs., tit. 18, § 25106.5–10, subd. (a)(2).) Subdivision (b)(1) sets forth the usual method for determining income, wherein separate profit and loss statements are prepared for each member of the unitary business and then translated into the currency of the parent company according to special translation rules. (*Id.*, subd. (b)(1)(D).) The regulation then directs separation of business and nonbusiness income and apportionment of business income to California. (*Id.*, subd. (b)(1)(E)-(G).) The income apportioned to California is translated into dollars so the California tax can be computed in dollars. (*Id.*, subd. (b)(1)H).)

Subdivision (b)(2) provides an alternative method for determining income, subject to respondent's discretion. It begins with a consolidated profit and loss statement that covers all members of the unitary business, rather than separate statements. The consolidated statement must either be prepared for filing with the Securities and Exchange Commission or prepared for reporting to shareholders and subject to independent audit. The consolidated statement is then adjusted, if necessary, to conform to accounting principles generally accepted in the United States (except as modified by the regulations) and California tax accounting standards, as well as to eliminate unrealized exchange rate gains and losses. (*Id.*, subd. (b)(2)(A).) After those adjustments, subdivision (b)(2) proceeds like the usual method under subdivisions (b)(1) (E)-(H). (*Id.*, subd. (b)(2) (B)-(E).)

The present case proceeded under subdivision (b)(2) when respondent relied on Vitro's independently–audited consolidated profit and loss statements. Appellant has not objected to this method. Vitro's statements were prepared in Mexican pesos, the currency in which it did business. Respondent used pesos as the functional currency in both the determination of income and the calculation of the apportionment factors. Finally, respondent translated the apportioned income from pesos into dollars using translation rates for the tax years at issue, and calculated the tax owed.[10]

Appellant argues that hyperinflation in the Mexican economy caused instability in the peso such that use of the peso does not accurately reflect appellant's business activity in California. As such, appellant's primary contention is that respondent misapplied Regulation 25106.5–10 when it used the peso as the functional currency in the determination of income. Appellant argues that subdivision (b)(2)(A) mandates use of the dollar as the functional currency because it requires conformity with US GAAP—which includes Financial Accounting Standards Board statement 52 (FAS 52). Appellant contends that FAS 52 requires use of the dollar as the functional currency. Respondent does not dispute that there was hyperinflation in the Mexican economy or that the dollar was a more stable currency than the peso. However, respondent argues that conformity with US GAAP under subdivision (b)(2)(A) is not required, and even if it were required, respondent's determination was correct because even FAS 52 requires use of the peso as the functional currency under the present facts.

On the issue of "functional currency" we must agree with respondent. The determination of income in this case began with respondent's use of Vitro's consolidated profit and loss statements, which were prepared in pesos. Respondent's continued use of the peso as the functional currency was correct for the following reasons. Subdivision <u>(b)(1)</u> of the regulation <u>begins with separate profit and loss statements</u> of the individual unitary units and requires that the statements be translated into the parent's currency, which in this case is the peso. Determining income under subdivision <u>(b)(2)</u> (as was done in this case) differs only in that it <u>begins with a consolidated statement</u>. A consolidated statement, by its nature, has already translated any differing currencies of the unitary business units into the common currency of the parent. Thus, there is no reason for a further translation (to the functional currency of the parent) under subdivision (b)(2).

Appellant misread FAS 52. Appellant cites the following provision from FAS 52:

> "The financial statements of a foreign entity in a highly inflationary economy shall be <u>remeasured</u> as if the functional currency were the reporting currency."

[10] The record is somewhat unclear as to the exact order in which final apportionment and translation took place. The parties indicate that respondent used the net income and apportionment factors (both calculated in pesos) to apportion income to California, then translated the apportioned income from pesos into dollars (this would be consistent with the regulation). However, a report of respondent's audit appears to show that respondent translated the net income from pesos into dollars, then apportioned it to California. We need not make a finding as to which calculation actually took place because, mathematically, the distinction is immaterial.

(Financial Accounting Standards Board, General Standards, vol. 1, § F60.116; emphasis added.) Appellant asserts that its reporting currency is the dollar, and thus the dollar should be treated as the functional currency in this case. However, appellant appears to misapply the terms "foreign entity" and "reporting currency."

First, with respect to the term "foreign entity," the entity whose statements are at issue is not appellant (Crisa), but appellant's parent (Vitro). From Vitro's perspective, Crisa is the "foreign entity" (*Id.*, § F60.412) that used a "foreign currency"—the dollar (*Id.*, § F60.408). However, that entity (Crisa) was not in a highly inflationary economy (the United States), and, thus, under FAS 52, it did not need to have its financial statements "remeasured" to account for hyperinflation. (*Id.*, § F60.116.)

Second, the term "reporting currency" has a particular meaning under FAS 52. The "reporting currency" is not simply the currency in which a company "reports" its income for California tax purposes; rather, it is the currency "in which an enterprise prepares its financial statements." (*Id.*, § F60.417.)[11] Thus, Vitro's "reporting currency" is the peso. By contrast, the "functional currency" is the currency "of the primary economic environment in which the entity operates." (*Id.*, § F60.415) Because Vitro operates in Mexico, its "functional currency" is also the peso. There is no need to translate from the functional currency (pesos) to the reporting currency (also pesos). For these reasons, we find that appellant's reliance on FAS 52 is misplaced.

Appellant also argues that the dollar is the proper functional currency for use in calculating the property factor. Regulation 25106.5–10, subdivision (c)(1)(E), states:

> "The property factor shall be computed in the currency of the parent company unless the taxpayer requests and the Franchise Tax Board determines that computing the factor in dollars or any other currency fairly reflects the taxpayer's activities in California."

Respondent followed the general directive of the regulation by using pesos, the currency of the parent company, to compute the property factor (as well as the payroll and sales factors, which are not in dispute). Respondent clearly had discretion to calculate the property factor in dollars if it determined that such would fairly reflect appellant's activities in California. Respondent did not do so, and appellant asserts that respondent abused it's discretion.

[11] FAS 52 specifically assumes the enterprise uses the U.S. dollar as its reporting currency. See footnote 1 to section F60.103, which states: "For convenience, this section assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency. However, a currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with United States generally accepted accounting principles."

A state board or agency has abused its discretion where its finding has no reasonable basis (*Rible v. Hughes* (1944) 24 Cal.2d 437, 445); or is unsupported by the evidence. (*McDonald's Systems of California, Inc. v. Board of Permit Appeals* (1975) 44 Cal.App.3d 525, 548.) A state board or agency also has abused its discretion where its finding is contrary to uncontradicted evidence (*Naughton v. Retirement Board of San Francisco* (1941) 43 Cal.App.2d 254, 260); or is otherwise arbitrary, capricious, or fraudulent. (*McDonough v. Goodcell* (1939) 13 Cal.2d 741, 748-749.) However, there is no abuse of discretion where the finding has a "sufficient factual basis." (*McDonough v. Goodcell, supra*, p. 749.) Considering these authorities, we do not find any abuse of discretion. Appellant has failed to show that respondent's use of the peso was arbitrary and without rational basis.

II. Exchange Rates

Regulation 25106.5-10 sets forth the proper exchange rates to use when currency translation is necessary. In the determination of income under subsections (b)(1) and (b)(2), depreciation, depletion, and amortization are translated at the exchange rate for the period in which the historical cost of the underlying asset was incurred. (Cal. Code Regs., tit. 18, § 25106.5-10, subs. (b)(4)(A).) All other items are translated at either the end-of-year exchange rate or the simple average exchange rate for the translation period, except when respondent exercises its discretion to allow different exchange rates. (*Id.*, subs. (b)(4)(B).) For purposes of determining the property factor, fixed assets and inventories are to be valued at original cost and translated at the exchange rate in effect on the date of acquisition. (*Id.*, subs. (c)(1)(A) & (C).)

Appellant contends that respondent used the incorrect exchange rates under Regulation 25106.5-10, subsections (b)(4) and (c)(1). Specifically, appellant argues that by merely converting apportioned income from pesos to dollars for each tax year at issue, respondent effectively translated depreciation and fixed assets using "current" exchange rates rather than "historical" exchange rates as required by the regulation. Appellant also argues that respondent erred by translating cost of goods sold with yearly average exchange rates rather than monthly average exchange rates. Appellant argues that translating with monthly average exchange rates would partially ameliorate the effects of hyperinflation.

Once again, we disagree with appellant and find that respondent properly applied the regulation. Appellant's first argument centers around the requirement that certain items be translated at historical exchange rates, while its second argument is predicated on respondent's discretion to allow a change from yearly average exchange rates to monthly averages. We believe that appellant has confused the translation of items for purposes of determining net income and apportionment factors with the final translation of apportioned income for the purpose of computing taxes owed.

Appellant is correct when it first argues that depreciation and fixed assets must be translated at historical exchange rates—if any translation is necessary. But it fails to recognize that such a translation was not necessary in this case. Had there been a need to translate separate profit and loss statements into pesos, or had the peso not been the functional currency, a translation of depreciation and fixed assets at historical exchange rates may have been required. However, in this case respondent used Vitro's consolidated profit and loss statement, which had already valued the assets at their historical cost in pesos. Also, as discussed above, the peso was the proper functional currency for the determination of net income, as well as for calculating each of the apportionment factors. Accordingly, there was no need for any further translation to meet the regulatory mandate that historical exchange rates be used. In other words, one cannot "translate" historical cost in pesos to historical cost in pesos.

Appellant's second argument, that cost of goods sold would be better translated with monthly average exchange rates rather than yearly averages, must fail for the same reason. That is, there was no need for translation of such items during the determination of net income because the amounts were already shown in pesos. Although respondent would have discretion to use monthly as opposed to yearly-average exchange rates when translating cost of goods sold, respondent cannot exercise that discretion when no translation is necessary.

The only translation made by respondent was during the final step in the process, that is, translating apportioned income from pesos into dollars using current exchange rates for the tax years at issue. Appellant's contention that this "effectively translated" the historic depreciation, fixed assets, and cost of goods sold (as calculated by appellant for the consolidated statements) at current exchange rates is inconsistent with the regulation; appellant is really asking this Board to unravel the calculations of net income and apportionment factors and recalculate them in dollars. However, we have already held that the peso was the proper functional currency for these calculations and, therefore, no translations were necessary prior to the final translation of apportioned income (so that the California tax could be determined in dollars).

III. Distortion and Section 25137

Section 25137 provides that, if the standard UDITPA allocation and apportionment provisions "do not fairly represent the extent of the taxpayer's business activity" in California, the parties may modify the standard provisions so as to "effectuate an equitable allocation and apportionment of the taxpayer's income." This Board has stated that section 25137 applies when the standard UDITPA provisions "produce inequitable results when applied to unusual factual situations." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989.) Likewise, the relevant regulations state that section 25137 only applies "where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results." (Cal. Code Regs., tit. 18, § 25137, subd. (a).) It is well settled that the party invoking section 25137, which in this case is appellant, bears the burden of proof. (*Appeal of Merrill, Lynch, supra*; *Appeal of New York Football Giants, Inc.*, 77-SBE-014, Feb. 3, 1977.)

Appellant contends that, if respondent properly applied regulation 25106.5–10, then it is entitled to relief under section 25137. In this regard appellant argues that the standard UDITPA formula does not fairly represent the extent of its business activity in California because Mexican hyperinflation has caused distortion in the calculation of both net income and the property factor of the apportionment formula.

At the outset, we note that section 25137 is a part of UDITPA, which deals only with allocation and apportionment of income, and not with the determination of income itself. (*Appeal of CTI Holdings, Inc.*, 96-SBE-003, Feb. 22, 1996.) William J. Pierce, principal author of UDITPA, stated that:

> "[UDITPA] 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."

(William J. Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747 [emphasis in original].) Accordingly, this Board has held that relief under section 25137 is not available to correct alleged distortion in the amount of income to be apportioned. (*Appeal of CTI Holdings, Inc., supra*.) Therefore, section 25137 provides no relief in this case to the extent of any alleged distortion in the determination of income.

Section 25137 may still apply, however, if appellant demonstrates that distortion in the property factor has resulted in an unfair reflection of business activity in California. (As indicated above, the payroll and sales factors are not in dispute.) Yet a simple comparison of the property factors as calculated by each party does not help us ascertain whether there is sufficient distortion to invoke section 25137.[12] In the *Appeal of Merrill Lynch, supra*, we held that what matters is the "ultimate distortive effect that occurs when all three factors are considered in combination." *Merrill Lynch* reasoned that distortion in one factor does not necessarily result in distortion in the whole formula because UDITPA's three factors are intended to balance each other; thus, "the other two factors may well mitigate the distortive effect of the third." (See also *Appeal of The Babcock and Wilcox Company*, 78-SBE-001, Jan. 11, 1978.) Respondent now criticizes this analysis, arguing that there are a number of circumstances in which two factors will not mitigate the third. We agree with respondent's concern, but disagree with its reading of *Merrill Lynch*. *Merrill Lynch* acknowledged that one factor might be so distortive as to

---

[12] Appellant calculated the property factor to be 0.4604, 0.3275, and 0.4035 percent for the respective appeal years. Respondent calculated the standard property factor as 2.0683, 1.6805, and 1.6302 percent, respectively.

invalidate the entire formula, and stated that "whether distortion must be shown in all or just one of the factors" depends upon a consideration of the formula as a whole.

In attempting to show that the standard formula, as a whole, does not fairly reflect its business activity, appellant cites to several numerical comparisons, some of which are derived from an economist's report that appellant commissioned. For example, appellant asserts that on a separate accounting basis, its operating margin averaged 3.8 percent during the appeal years, while the standard formula results in an operating margin of 30.3 percent. Also based on separate accounting, appellant asserts that its total apportioned income over the appeal years results in a net loss of $273,911, while the standard formula apportioned net gain of $6,596,364. In addition, appellant states that the median return on assets of other glass distribution companies during the appeal years was 7.7 percent, while the standard formula attributes a return on appellant's assets of 47.2 percent. For the reasons set forth below, we do not find that any of appellant's quantitative comparisons uphold appellant's burden of proving distortion in this case.

First of all, showing distortion in the standard formula is a difficult hurdle to overcome. The three-factor formula "has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, at fn. 2 (quoting from *Container Corp. v. Franchise Tax Board* (1983) 463 U.S. 159, 183).) The attempted use of separate geographical accounting alone to impeach apportionment by the three-factor formula has been rejected by the United States Supreme Court because it is exactly the theoretical weaknesses of separate geographical accounting that justified resort to formula apportionment in the first place. (*Container Corp. v. Franchise Tax Board*, *supra*, 463 U.S. at p. 181; see also *Appeal of Dart Container Corporation of California*, 92-SBE-021, July 30, 1992.) After considering *Container Corp.* and other United States Supreme Court cases, we indicated in *Merrill Lynch* that we would not consider an argument that the standard apportionment formula could be proven inadequate solely by comparing it with internal accounting records using separate geographical accounting methods. Because most of appellant's quantitative comparisons are based solely on internal accounting records using separate geographical accounting methods, we give them limited weight in the present case as a method of impeaching the standard apportionment formula.

We acknowledge that, in some of the cases cited above, quantitative comparisons based upon separate geographical accounting were discussed in the context of attempting to impeach the standard apportionment formula. Unfortunately, a discussion of percentage comparisons in distortion cases is often wrongly interpreted as having greater significance than it actually has and acts as a distraction from the primary task of determining whether the standard apportionment formula fairly represents the extent of the taxpayer's business activity in California.

Additionally, we find appellant's quantitative comparisons lacking because they rely upon figures that are derived in large part from appellant's calculation of net income, not merely its calculation of the property factor. Because the relative difference between the parties' calculations of net income is larger than the relative difference in their calculations of the property factor, the quantitative comparisons are heavily weighted by appellant's income calculations. As we have already discussed, respondent correctly calculated net income under regulation 25106.5–10, and section 25137 provides no relief from this calculation. Therefore, quantitative comparisons that are derived from a recalculation of net income are not useful in the context of section 25137.

The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. (See *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, *supra*.) The answer to this question lies in an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then section 25137 may apply. Section 25137 must be analyzed on a case-by-case basis; there is no bright line rule that determines when the standard formula does not adequately deal with a particular situation. However, our prior opinions reveal five examples of unusual fact situations that may trigger section 25137:[13]

(1) A corporation does substantial business in California, but the standard formula does not apportion any income to California. For example, the employees of a professional sports franchise render services in California while playing "away" games, but the standard formula apportions all income to the team's home state. (See *Appeal of New York Football Giants, supra*; *Appeal of Milwaukee Professional Sports and Services, Inc.*, 79-SBE-093, June 28, 1979.)

(2) The factors in the standard formula are mismatched to the time during which the income is generated. For example, a construction contractor reports income when long-term contracts are completed, but the standard formula requires income to be reported currently. (See *Appeal of Donald M. Drake Company*, 77-SBE-012, Feb. 3, 1977.)

(3) The standard formula creates "nowhere income" that does not fall under the taxing authority of any jurisdiction. For example, a company owns equipment, the value of which is attributed to the high seas or outer space, where it cannot be taxed by any jurisdiction. (See *Appeal of American Telephone and Telegraph Company*, 82-SBE-093, June 29, 1982.)

(4) One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, the taxpayer continuously

[13] This is not intended to be an exclusive list of examples.

reinvests a large pool of "working capital," generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business. (See *Appeal of Pacific Telephone and Telegraph Company*, 78-SBE-028, May 4, 1978.)

(5) A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity. For example, because a company does not own or rent any tangible or real personal property, the numerator and denominator of the property factor are zero. (See *Appeal of Oscar Enterprises, LTD*, 87-SBE-069, Oct. 6, 1987.)

We observe that numerical comparisons did not play a significant role in any of the cases cited in support of the five listed examples. Rather, the cases analyzed the relationship between the structure and function of the standard apportionment formula and the circumstances of the particular taxpayer at issue. Section 25137 was found to apply (or not to apply) based on whether the analysis revealed some manner in which the standard formula could not adequately deal with the taxpayer's circumstances.

In this case, appellant has failed to prove that the standard apportionment formula does not fairly represent the extent of its business activities in California. An analysis of the relationship between the structure and function of the standard formula and appellant's circumstances does not reveal any manner in which the standard formula cannot adequately deal with the hyperinflation of a foreign currency. This leaves appellant's numerical comparisons standing alone, and for the reasons outlined above, they are not sufficient to prove distortion.

Conclusion

We conclude that respondent properly applied regulation 25106.5–10 in its determination of income and the property factor. We further conclude that appellant has failed to demonstrate that the standard apportionment formula does not fairly reflect the extent of its business activities in this state, and we deny appellant's request for relief under section 25137. Therefore, respondent's actions are sustained.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Crisa Corporation against proposed assessments of additional franchise tax in the amounts of $116,378, $227,597, and $278,825 for the income years ended December 31, 1987, December 31, 1988, and, December 31, 1989, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 20th day of June, 2002, by the State Board of Equalization, with Board Members Mr. Chiang, Mr. Klehs, Mr. Andal, Mr. Parrish, and Ms. Marcy Jo Mandel present.

Mr. John Chiang, Chairman

Mr. Johan Klehs, Member

Mr. Dean Andal, Member

Mr. Claude Parrish, Member

*Ms. Marcy Jo Mandel, Member

* For Kathleen Connell per Government Code section 7.9.