

**INITIAL STATEMENT OF REASONS FOR
THE AMENDMENT OF CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25106.5**

**PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION
OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS**

Revenue & Taxation Code (RTC) section 25135 provides the sales factor numerator assignment rules for sales of tangible personal property. During 2009, the Legislature amended RTC section 25135, operative for taxable years beginning on or after January 1, 2011.

Prior to the 2009 amendments, RTC section 25135 generally provided that sales receipts from sales of tangible personal property are assigned to the California sales factor numerator if (a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; and (b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

While the language of RTC section 25135 had remained substantially unchanged since its first enactment in 1966, the interpretation of this statute by the State Board of Equalization (SBE) vacillated several times.

In *Appeal of Joyce, Inc.*, 66-SBE-070, November 23, 1966, the SBE held that a unitary group's California sales factor numerator must exclude the group's sales receipts from sales of tangible personal property made to California purchasers, if the individual member making the sales was not itself subject to tax in California (the *Joyce* rule).

In *Appeal of Finnigan Corporation*, 88-SBE-022, decided on August 25, 1988 (*Finnigan I*), *Appeal of Finnigan Corporation*, 88-SBE-22A, Opinion on Petition for Rehearing, decided on January 24, 1990 (*Finnigan II*), and *Appeal of The NutraSweet Co.*, 92-SBE-024, decided on October 29, 1992 (*NutraSweet*), the SBE abandoned the *Joyce* rule and required sales receipts from sales of tangible personal property to be assigned to the sales factor numerator of the destination state if any member of the group had taxable nexus with that destination state (the *Finnigan/NutraSweet* rule).

However, in the *Appeal of Huff Corporation*, 99-SBE-005, decided on April 22, 1999, the SBE reversed course and reinstated the *Joyce* rule prospectively for taxable years beginning on or after April 22, 1999.

Consequently, for taxable years beginning on or after April 22, 1999, the Franchise Tax Board has applied the *Joyce* rule and required sales receipts from sales of tangible personal property to be assigned to the sales factor numerator of a jurisdiction only when the member of a combined reporting group making the sales has established nexus with that jurisdiction. The existing California Code of Regulations, title 18 (Regulation), section 25106.5(c), adopted in 2000, reflects the *Joyce* rule.

In 2009, the California Legislature amended RTC section 25135 to adopt and codify the *Finnigan/NutraSweet* rule rather than the *Joyce* rule. As amended, for taxable years beginning on or after January 1, 2011, RTC section 25135 requires that sales receipts from sales of tangible personal property delivered or shipped to a purchaser in California be assigned to the California sales factor numerator if the seller or any member of the seller's combined reporting group is taxable in California. In addition, all sales receipts from sales of tangible personal property delivered to a state other than California are not assigned (thrown back) to the California sales factor numerator of the seller if any member of the seller's combined reporting group is taxable in the destination state. While RTC section 25135 has clearly adopted the *Finnigan/NutraSweet* rule, the regulations for combined report mechanics, contained in Regulation section 25106.5, have not been amended to reflect this change in law. This regulatory effort will remedy that discrepancy and provide that the same rule is included in the combined report mechanics provisions contained in Regulation section 25106.5, which currently instructs use of the *Joyce* rule.

RTC section 25106.5(a) specifically authorizes the Franchise Tax Board to adopt regulations necessary to ensure that the tax liability or net income of any taxpayer whose income derived from or attributable to sources within California which is required to be determined by a combined report pursuant to RTC section 25101 or 25110 is properly reported, determined, computed, assessed, collected, or adjusted.

SPECIFIC PURPOSE FOR THE MODIFICATION OF THE REGULATION

The purpose of the proposed amendments is to revise the regulation to reflect the 2009 legislative amendments and to instruct multistate taxpayers on when and how to assign sales receipts from sales of tangible personal property to the California sales factor to properly apportion income among different jurisdictions. The regulation amendments will achieve that purpose by providing definitions, guidelines, and examples that include information beyond that provided by the underlying code section.

NECESSITY

Existing Regulation section 25106.5(c)(7), which was adopted in 2000, applies the *Joyce* rule in assigning the sales receipts from sales of tangible personal property. Under the *Joyce* rule, a seller's sales receipts from sales of tangible personal property delivered to a purchaser in California are assigned to the seller's California sales factor numerator only if the seller itself is taxable in California, without regard to whether other members of the seller's combined reporting group are taxable in California. Therefore, under current Regulation section 25106.5(c)(7), a taxpayer member of a combined reporting group determines its share of California source total group combined report business income based on its own California property, payroll, and sales factors, without regard to the total group California property, payroll, and sales factors.

The California Legislature's 2009 amendment to RTC section 25135 returning to the *Finnigan/NutraSweet* rule makes it necessary to amend the existing regulations promulgated under RTC section 25106.5 that contain the *Joyce* rule to implement the *Finnigan/NutraSweet* rule. Under *Finnigan/NutraSweet*, a combined reporting group's sales receipts from sales of tangible personal property delivered to a purchaser in

California are assigned to California and are included in the group's California sales factor numerator if *any* member of the seller's combined reporting group is taxable in California, regardless of whether the member making the sale itself is taxable in California. Therefore, existing Regulation section 25106.5 needs to be amended to reflect the new combined report mechanics resulting from the 2009 amendments to RTC section 25135 that California source total group combined report business income must be determined first based on the group's California apportionment percentage derived from the group's California factor(s). The resulting California source total group combined report business income is then assigned to each taxpayer member through the intrastate apportionment process based on each taxpayer member's relative California factor(s).

Subsection (b) of existing Regulation section 25106.5 defines terms used in all regulations adopted under RTC section 25106.5. The following definitions must be added so that terms used in the proposed amendments are defined: "California Apportionment Percentage," subsection (b)(20); "Intrastate Apportionment," subsection (b)(21); and "Intrastate Apportionment Percentage," subsection (b)(22). All three of these definitions are derived from a never adopted 2000 discussion draft created by the Franchise Tax Board during the prior regulatory process.

The term "California Apportionment Percentage" in proposed subsection (b)(20) is added to refer to the percentage, determined under RTC section 25128 or 25128.5, used to apportion the total group combined report business income to California.

The term "Intrastate Apportionment" in proposed subsection (b)(21) is added to define the method by which the total group combined report business income, after it has been apportioned to California, is assigned to each of the taxpayer members of the combined reporting group.

The term "Intrastate Apportionment Percentage" in proposed subsection (b)(22) is added to define the percentage a specific taxpayer member applies to the total group combined report business income, after apportionment to this state, to determine that member's share of the group's California source apportioned income.

Subsection (c) of existing Regulation section 25106.5 sets forth the steps in determining California source income or loss from the business income of a combined reporting group.

Subsection (c)(1) sets forth the method to determine the separate net income of each member of a combined reporting group.

Subsection (c)(2) sets forth the accounting methods the taxpayer members of the combined reporting group may elect to determine the net income of a member of the group and other elections as authorized by Division 2, Part 11 of the RTC.

Subsection (c)(3) requires the removal of nonbusiness income from the resulting total separate income of each member of the combined reporting group.

Subsection (c)(4) is reserved for the future adoption of the assignment of expenses to business and nonbusiness income rules.

Subsection (c)(5) requires the business income and apportionment data of those combined report group members with an accounting period different from that of the principal member be fiscalized to the principal member's accounting period.

Subsection (c)(6) requires the combined report business income of all members be aligned to the accounting period of the principal member and aggregated to arrive at the total group combined report business income.

Subsection (c)(7) provides the detailed guidance on how to compute a taxpayer member's California source total group combined report business income.

Subsection (c)(8) provides the methodology to fiscalize a taxpayer member's California source combined report business income to its own taxable year, if the taxpayer member's accounting period differs from that of the principal member of the combined reporting group.

Subsection (c)(7) of existing Regulation section 25106.5 applies the *Joyce* rule to assign sales receipts from sales of tangible personal property for California sales factor purposes. The 2009 amendment to RTC section 25135 dictates that the *Joyce* rule only applies to taxable years beginning on or after April 22, 1999 and before January 1, 2011. Since there are some open taxable years to which the *Joyce* rule still applies, the existing subsection (c)(7) needs to remain in the regulation. As a result, existing subsection (c)(7) is being renumbered to Regulation section 25106.5(c)(7)(B), so that the *Finnigan/NutraSweet* rule can be inserted at Regulation section 25106.5(c)(7)(A).

Amendments are proposed to add a new Regulation section 25106.5(c)(7)(A) to the existing Regulation section 25106.5(c)(7) to reflect the Legislature's 2009 codification of the *Finnigan/NutraSweet* rule in assigning sales receipts from sales of tangible personal property to this state, which will apply to taxable years beginning on or after January 1, 2011.

Unlike the *Joyce* approach where a taxpayer member applies its own California apportionment percentage to compute its share of California source total group combined report business income, the *Finnigan/NutraSweet* approach first applies the group's California apportionment percentage to compute the California source total group combined report business income. The resulting amount is then assigned to each taxpayer member through the intrastate apportionment process based on each taxpayer member's intrastate apportionment percentage.

Subsection (c)(7)(A)1. provides that a group's California source combined report business income is computed by multiplying the total group combined report business income for the accounting period of the principal member by the California apportionment percentage of the combined reporting group.

Subsection (c)(7)(A)1.a. provides guidance for determining the California apportionment percentage of the combined reporting group under the different apportionment formulas of single-sales factor, double-weighted sales factor, and single-weighted sales factor.

Subsection (c)(7)(A)1.b. provides further guidance regarding the California property factor, payroll factor, and sales factor of the combined reporting group for the application of subsection (c)(7)(A). The *Finnigan/NutraSweet* rule is implemented at subsection (c)(7)(A)1.b.iii.

Subsection (c)(7)(A)2. provides the intrastate apportionment method to assign the California source total group combined report business income between the taxpayer members of the group. The group's California source combined report business income is multiplied by a taxpayer member's intrastate apportionment percentage to arrive at that taxpayer member's California source combined report business income.

Subsection (c)(7)(A)2.a. provides guidance regarding each taxpayer member's California property factor, payroll factor, and sales factor.

Subsection (c)(7)(A)2.b. provides guidance on how to determine each taxpayer member's California apportionment percentage under the different apportionment formulas of single-sales factor, double-weighted sales factor, and single-weighted sales factor.

Subsection (c)(7)(A)2.c. explains how to determine the taxpayer member's intrastate apportionment percentage.

Subsection (c)(7)(A)2.d. explains how a taxpayer member computes its California source combined report business income by multiplying the group's California source combined report business income by its intrastate apportionment percentage.

Subsection (c)(7)(A)3. provides detailed examples to illustrate the rules set forth in subsection (c)(7)(A).

Existing Regulation section 25106.5(g) is deleted because subparagraphs (A) and (B) of Regulation section 25106.5(c)(7), as proposed, set forth the applicable taxable years to which the amendments (*Finnigan/NutraSweet* rule) and the existing regulation provisions (*Joyce* rule) will apply, respectively.

BENEFITS OF THE REGULATION

Multistate taxpayers will benefit from having direction on when and how to assign sales receipts from sales of tangible personal property to the California sales factor to properly apportion income among different jurisdictions in compliance with recently amended statute. There are no benefits of the proposed regulation to the health and welfare of California residents, worker safety, and the state's environment.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting proposed Regulation section 25106.5, the Franchise Tax Board relied on a prior discussion draft that the Franchise Tax Board prepared but did not adopt during the 2000 regulation amendment, FTB Notice 90-3, and two interested parties meetings held in May and October of 2011. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

Government Code section 11346.2, subdivision (b)(5), requires the Franchise Tax Board to consider alternatives to the proposed regulatory action that would lessen any adverse impact on affected private persons or small business. The proposed regulation amendment seeks to implement RTC section 25135, as amended in 2009. The amended RTC section 25135 requires the implementation as proposed in the regulation amendment. Therefore, the Franchise Tax Board did not consider alternatives.

ECONOMIC IMPACT ANALYSIS

For taxable years beginning on or after January 1, 2011, the California Legislature codified the *Finnigan/NutraSweet* rule that assigns sales of tangible personal property to California sales factor numerator if the seller or any member of the seller's combined reporting group is taxable in California. The proposed Regulation section 25106.5 amends existing regulations to implement this new *Finnigan/NutraSweet* legislation. The new *Finnigan/NutraSweet* legislation would raise California tax liabilities for some corporations and lower tax liabilities for others. Generally, corporations with domiciles within California would have higher tax liabilities, while other corporations with domiciles outside of California would have lower tax liabilities. During the legislative process, it was estimated that the new *Finnigan/NutraSweet* rule, in combination with two other provisions of the same legislation, would result in a net corporate tax increase of between \$30 and \$70 million annually. Franchise Tax Board estimates the revenue from the *Finnigan/NutraSweet* portion of this legislation to raise revenue by about \$12 million annually. The new *Finnigan/NutraSweet* regulation would not create any private-sector costs beyond those resulting from the legislative process.

Taxpayers impacted by the proposed Regulation section 25106.5 are C and S corporations that apportion their multi-jurisdictional income to California. In 2009, there were about 70,000 apportioning corporations. Franchise Tax Board estimates that about 80 percent of these businesses qualify as small businesses.

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has made the following assessments regarding the proposed amendments to the existing regulation:

Creation or Elimination of Jobs Within the State

Since the new *Finnigan/NutraSweet* legislation is estimated to raise net private-sector costs, it is expected to result in net job losses in the long run. However, the proposed Regulation section 25106.5 to implement this legislation would not have any additional impact on the number of jobs created or eliminated.

Creation of New or Elimination of Existing Businesses Within the State

The new *Finnigan/NutraSweet* legislation may encourage the formation of businesses whose taxes will be lower under the *Finnigan/NutraSweet* rule and discourage businesses whose taxes will be increased. The number of business formed and eliminated is not known, but the net effect on business formation may be slightly negative since the rule raises business taxes in the aggregate. The proposed Regulation section 25106.5 to implement this legislation would not have any additional impact on the number of businesses created or eliminated beyond those envisioned at the time the legislation was passed.

Expansion of Businesses or Elimination of Existing Businesses Within the State

The proposed Regulation section 25106.5 merely amends existing regulations to implement the new California legislation that adopts the *Finnigan/NutraSweet* rule. The original legislation itself would have economic impact. The proposed Regulation section 25106.5 would not have any additional economic impact. Specifically, the proposed Regulation section 25106.5 would not itself have any additional impact beyond the changes resulting from the associated statutory changes on the expansion of businesses currently doing businesses within the state of California.

ADVERSE ECONOMIC IMPACT ON BUSINESS

Since the proposed Regulation section 25106.5 merely amends existing regulations to implement the new California legislation that adopts the *Finnigan/NutraSweet* rule, the Franchise Tax Board has determined that the proposed Regulation section 25106.5 would not itself have any additional adverse economic impact on business beyond that arising from the *Finnigan/NutraSweet* legislation.