

REVISED FINAL STATEMENT OF REASONS
FOR PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25106.5

The proposed regulations do not impose any mandate on local agencies or school districts.

UPDATE OF INITIAL STATEMENT OF REASONS

The public notice required by section 11346.4 of the Government Code was mailed and published in the California Notice Register on December 7, 2012. The hearing was held, as noticed, on February 6, 2013, to consider the amendment of Regulation section 25106.5, pertaining to the assignment of sales of tangible personal property for sales factor numerator purposes. There were nine attendees at the hearing and oral testimony was received from one individual. One written comment was received during the comment period, which ended at 5:00 p.m. on February 6, 2013. A summary of and responses to the comments received was prepared and is included in the rulemaking file as Tab 9.

As a result of comments received, non-substantial, sufficiently related changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on July 10, 2013. No comment was received regarding the 15-day changes. No further changes were made.

The oral comment received during the February 6, 2013 hearing suggested that the language of the proposed amendment to Regulation section 25106.5, subsection (c)(7)(A)1.b., as drafted, may be construed to mean that Revenue and Taxation Code section 25137 distortion plays a role in applying the more-than-50-percent gross business receipts test under Revenue and Taxation Code section 25128, causing a conflict with Revenue and Taxation Code section 25128, subdivision (d)(1). To avoid such a potential perception of conflict, as provided in the 15-day notice, staff recommended a change to the proposed regulation language to assure clarity.

The written comments object to the inclusion in a California Combined Report of the sales into California from an entity entitled to the protections of Public Law 86-272. The objection alleges that such method under amended Revenue and Taxation Code section 25135 and the proposed amendment to Regulation section 25106.5 constitutes an indirect taxation of the entity which is protected under Public Law 86-272.

The staff disagrees. The proposed amendments to Regulation section 25106.5 change the method of constructing the sales factor of the apportionment formula from the *Joyce* rule to the *Finnigan* rule in order to implement the amendment to Revenue and Taxation Code section 25135, which is applicable to taxable years beginning on or after January 1, 2011. Case law is clear that this change does not alter in any way the existing rules concerning a state's jurisdiction to tax a particular corporation. In other words, the application of the *Finnigan* approach does not result in the taxation of a corporation protected by Public Law 86-272, either directly or indirectly.

Including the California destination sales of a corporation protected by Public Law 86-272 in the numerator of the sales factor of a combined reporting group does not constitute imposition of an income-based tax on that corporation, but is merely a different method of measuring a combined reporting group's activities in California. The Court of Appeal upheld the FTB's use of the *Finnigan* approach against a similar challenge in *Citicorp North America Inc., et al., v. Franchise Tax Board* (2000) 83 Cal. App.4th 1403.

Changes were made to the proposed regulation for clarity as part of the 15-day changes. The proposed modifications constitute sufficiently related changes (within the meaning of Govt. Code section 11346.8). These modifications are described below:

1. Subsection (c)(7)(A)1.b., describing how to arrive at the California property factor, payroll factor, and sales factor of a combined reporting group, is revised to specify the scope of clause 1.b. of subsection (c)(7)(A). Such specificity is necessary to clarify that Revenue and Taxation Code section 25137 may modify the computation of a combined reporting group's California apportionment factors, but is not considered in determining the applicable apportionment formula for that apportioning trade or business as described in subsection (c)(7)(A)1.a:

In the application of subsection (c)(7)(A)1.b. of this regulation, except as modified under Section 25137 of the Revenue and Taxation Code:

2. Subsection (c)(7)(A)2, describing the intrastate apportionment methodology, is revised to clarify that the intrastate apportionment methodology assigns the total group combined report business income only to taxpayer members whose tax is measured by net income. For purposes of subsection (c)(7)(A)2, the definition of "taxpayer member" is modified to include only taxpayer members whose tax is measured by net income. The modification of the definition clarifies that the total business income of the combined reporting group is not assigned to corporations protected by Public Law 86-272, even though such corporate taxpayer members must file a tax return in this state because they are subject to the minimum franchise tax:

Intrastate Apportionment of Taxpayer Member Income, In General. The resulting California source total group combined report business income, determined under the preceding subsection (c)(7)(A)1, is intrastate apportioned between the taxpayer members of the group, to arrive at each taxpayer member's California source combined report business income. That value is determined by multiplying the group's California source combined report business income by that member's intrastate apportionment percentage to arrive at the taxpayer member's California source combined report business income. For purposes of this clause, "taxpayer member" means a taxpayer member, as defined in subsection (b)(11) of this regulation, whose tax is measured by net income. The steps of intrastate apportionment are as follows:

No other major concerns or objections were raised, and technical changes made through a 15-day notice received no comments.

ALTERNATIVES DETERMINED

The Franchise Tax Board has determined that no alternatives to the proposed amendments to the regulation it considered would be more effective in carrying out the purpose of the proposed amendments to the regulation or would be as effective and less burdensome to affected private persons than the adopted amendments to the regulation, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law, in accordance with Government Code section 11346.9, subdivision (a).