DISCUSSION TOPICS

Franchise Tax Board Interested Parties Meeting
Regulation Section 25137-1[1]
Apportionment and Allocation of Partnership Income

August 21, 2008 and August 22, 2008

A. BACKGROUND

When a taxpayer subject to the Corporation Tax Law is a partner in a partnership as defined in Revenue and Taxation Code[2] section 17008, the computation of its distributive share of partnership items is determined in accordance with Chapter 10 of Part 10 of Division 2 of the Revenue and Taxation Code. The portion of such distributive share (constituting business and nonbusiness income) that has its source in this state, or that is included in the taxpayer's business income, is determined in accordance with California Code of Regulations, title 18, section 25137-1 ("the partnership regulation"),[3] which was promulgated in 1972 and last amended in 1985.

The partnership regulation has generally functioned well over the years but the passage of time has rendered some of its provisions out of date and new business models have arisen that the regulation does not address. For these reasons, FTB staff has studied the regulation and identified several issues that it believes should give rise to consideration of amending the regulation. Because of the size and scope of the regulation and the number of issues identified for discussion, as well as additional issues that might be identified by members of the public, the initial interested parties meeting on the partnership regulation will take place in two sessions, on August 21, 2008 at 1:00 p.m. and on August 22, 2008 at 9:30 a.m. Staff anticipates discussing Issues 1 through 5 and 7 through 9 at the first session and Issues 6 and 10 through 15 at the second session. Each session is expected to last approximately two hours.

The issues identified by staff are not intended to limit the topics that may be discussed at the meeting. Staff invites members of the public to raise for discussion any other issues respecting the partnership and related regulations that they may deem appropriate.

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[1] Potential amendment to associated provisions of Cal. Code of Regs., tit. 18, §§ 17951-4, 25106.5, 25122, and 25137-2, will also be discussed.
[2] For the sake of brevity, further references to Revenue and Taxation Code provisions will be made only by section number, i.e., "section 25128."
[3] Further references to California Code of Regulations, title 18, will be made by "Regulation" followed by a section number, i.e., "Regulation 25137-1."

B. ISSUES IDENTIFIED BY STAFF

1. *The Partnership Regulation does not Reflect the Double-Weighted Sales Factor*

The partnership regulation references the provisions of section 25128 before section 25128 was amended to double weight the sales factor for taxable years beginning on or after January 1, 1994. For example, the Regulation provides for apportionment of income from partnerships using a "three-factor" apportionment percentage. As amended, section 25128 provides for a double-weighted sales factor with certain exceptions for taxpayers whose gross business receipts from certain activities exceed 50 percent of their total gross business receipts. Staff recommends that subdivisions (a), (f), and (g) of the regulation be amended to reflect the double-weighted apportionment factor and to clarify the application of the gross business receipts test in the context of partnerships.

2. *Clarify the Treatment of Partnership Distributions from Non-Unitary Partnerships*

Under the partnership regulation, the appropriate treatment of partnership distributions from a non-unitary partnership is to treat that distribution as income from a separate, nonunitary trade or business. However, some taxpayers have attempted to characterize distributions of income from a non-unitary partnership as nonbusiness income to the partner. In addition, some cases predating enactment of the Uniform Division of Income for Tax Purposes Act (UDITPA), sections 25120-25139,relied on section 23040 for the sourcing of distributive income of partnerships. Should subdivisions (a) and (g) of the regulation be amended to make clear that a distribution of business income from a non-unitary partnership is properly considered income from a separate trade or business and is not properly considered nonbusiness income to the partner unless it is properly considered nonbusiness income to the partnership itself, and the income from the partnership is not considered properly sourced under section 23040?

3. *Tiered Partnerships*

The partnership regulation contains no rules dealing with the treatment of distributive share items in the case of tiered partnerships, i.e., partnerships that own other partnerships or chains of partnerships, and more particularly, issues that may arise when the business operations of the partner are unitary with some partnerships but not others in the ownership tier. Staff would like to discuss the possible addition of new regulatory language to deal with these issues.

4. *Indirect Ownership of Business Assets*

The partnership regulation does not deal with situations where a partnership holds an asset that is a nonbusiness asset with respect to the business activity of the partnership but the asset would have been a business asset of the partner if the partner had held the asset directly. For example, assume that Corporation A is a farm implement manufacturer and it invests in a partnership that engages in mineral exploration. The partnership buys stock in a steel fabricator from which the partner buys steel used to manufacture farm implements. Dividends from the stock are nonbusiness income to the partnership. The stock is a nonbusiness asset with respect to the activities of the partnership but it would be a business asset if held by Corporation A. Should subdivision (b) of the regulation be amended to clarify that income that is nonbusiness income with respect to the activities of a partnership should be reclassified as business income with respect to a partner if the income would have been business income had the partner held the asset directly?

5. *Mixed Unitary and Nonunitary Partners*

Regulation 25137-1(f) is based on a model involving a partner and partnership that are unitary. However, in some cases one partner might be unitary with a partnership while another is not. Should the regulation be amended to provide that if a partnership has both unitary and nonunitary partners, the unitary partner's distributive share of partnership income and apportionment factors is combined with the unitary partner, but not the nonunitary partner; and with respect to the nonunitary partner, that apportionment is appropriately determined at the partnership level with the result that the nonunitary partner receives partnership distributions of income that have already been apportioned at the partnership level?

6. *Intercompany Sales Between Partner and Partnership*

Regulation 25137-1(f)(3) addresses the sales factor treatment of intercompany sales between a partner and its unitary partnership. In general, a partner's sales to such a partnership are included in the partner's sales factor subject to a portion of those sales being eliminated under Regulation 25137-1(f)(3)(A)(i), to the extent of the partner's interest in the partnership.

Under Regulation 25137-1(f)(3)(A), a partner generally includes a portion of a partnership's sales in its sales factor to the extent of the partner's interest in the partnership. However, Regulation 25137-1(f)(3)(A)(ii) eliminates those sales, "not to exceed the taxpayer's interest in all partnership sales." In some cases, this elimination rule appears to produce unusual results and may fail to reflect the effect of the other partners' economic interest in such sales.

To illustrate, assume Corporation A and Corporation B are partners in a partnership and Corporation A's share of the partnership's income is 20 percent. A is unitary with the partnership and is the purchaser of 20 percent of the partnership's sales. If the partnership has $2 million in sales to Corporation A and $8 million in sales to unrelated customers, the regulation assumes that Corporation A's 20 percent share of the total sales of $10 million ($2 million) is attributable entirely to indirect sales by Corporation A to itself. Thus, all of Corporation A's share of sales attributable to the partnership's selling activity is disregarded in the determination of Corporation A's sales factor.

This rule appears to disregard the fact that Corporation A's capital and risk in the partnership should be applied to all of Partnership P's selling activity, and thus Corporation A's sales factor should reflect the portion of the partnership's total selling activity, including sales to unrelated customers. Similarly, Corporation B's capital and risk are also directed to sales by the partnership to Corporation A. Should Corporation A's 20 percent share of partnership sales be eliminated only to the extent that Corporation A is properly treated as a sale to itself?

In addition, there are detailed rules in Regulation 25106.5-2 relating to intercompany sales between members of a combined reporting group. In general, these rules not only eliminate intercompany company sales from the sales factor, but also defer any intercompany income resulting from such sales. Staff would like to discuss whether clarification is needed on the issue of whether income from intercompany sales between a partner and a partnership should likewise be deferred. Current Regulation 25137-1(f)(3) deals only with the effect of intercompany sales on the sales factor, and contains no rule providing for deferral of income from such sales.

7. *Special Allocations and Partnership Interests*

The partnership regulation assigns a proportionate amount of a partnership's property, payroll, and sales to a unitary partner based on the partner's *"partnership interest"* in the partnership. In many cases, however, a partner's "interest" under the current regulation is difficult to determine. For example, a partnership agreement might provide that a partner's share of current income is different than the partner's share of current loses and the partner's share of the partnership's assets in liquidation. Thus, in any given year a partner's percentage share of distributed income may be different than the partner's "partnership interest percentage." Should Regulation 25137-1(f) be amended to assign property, payroll, and sales to a unitary partner based on the partner's share of distributive income?

8. *Variation of a Partnership Accounting Period to Alleviate Distortion if a Partnership's Taxable Year is Different Than the Taxable Year of a Partner*

Regulation 25137-1(f)(5) provides that if a partner and partnership are unitary and have different accounting periods, the income and apportionment factors of the partnership may be placed on the accounting period of the partner in order to avoid distortion. However, Internal Revenue Code ("IRC") section 706(b), applicable in California through section 24271(b) and the partnership provisions of Part 10 of the Revenue and Taxation Code, provide that if all of the partners have the same taxable year, then the partnership's taxable year must conform to that of the partners. Thus, only if the partners have different taxable years from each other will the situation described in the regulation occur.

Under IRC section 706(b), if partners have different taxable years, the partnership's taxable year is based on the single taxable year (if one exists) of those partners whose aggregate interest in profits or capital of the partnership exceeds 50 percent. If no such year exists, then the partnership taxable year is determined by reference to the taxable year of all of the principal partners (i.e., those having an interest of 5% or more of the partnership's profits or capital). If no principal partners exist, or if the principal partners have different taxable years, the partnership is required to use a calendar taxable year.

The provisions of Regulation 25137-1(f)(5) may result in an accounting period different than that prescribed by statute, and in any event, cannot be consistently applied from one partner to the next because there will always be one partner for which a potentially new accounting period would itself provide a premise to invoke the rule. In addition, because the accounting period for state purposes would be different than that required for federal purposes, there potentially could be significant federal/state differences in timing of income as well as tax accounting for the partnership itself. Moreover, taxpayers would be required to maintain two sets of accounting period data. Under federal law, income from a partnership is included in the taxable year within which the taxable year of the partnership ends. If the partnership taxable year is changed under this regulation, the partnership's tax year ends at a different time for federal purposes than for state purposes, and thus the taxable year that distributive partnership income is taken into account may be different for state purposes than for federal purposes.

Consideration should be given to deleting Regulation 25137-1(f)(5), which would allow the federal scheme to operate. Any taxpayer that believed the effects of having a different taxable year from its partnership resulted in distortion may apply for relief under the general provisions of section 25137.

9. *Sales Factor Treatment of Sales of Partnership Interests*

For sales factor purposes, the treatment of sales other than sales of tangible personal property is governed by section 25136. Those sales are assigned to the state where the income-producing activity occurs based on the greater cost of performance. However, the cost of performance rule in section 25136 does not properly reflect the pass-through nature of a partnership with respect to the sale of partnership interests.

In addition, the rule is inconsistent with the look-through treatment of nonbusiness income from the sale of a non-unitary partnership interest. Section 25125(d) generally provides that the gain or loss from the sale of a partnership interest is allocable to the state by reference to the property factor of the partnership at the time of sale, approximating the effect that would occur if the underlying property of the partnership were sold. That section also provides the gain or loss from the sale of a partnership interest is allocable to the state by reference to the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the interest was sold in cases where more than 50 percent of the value of the partnership's assets consist of intangibles.

Consideration should be given to regulatory provisions that assign the gain or loss resulting from the sale of a partnership interest to the states in which the partnership has property as if the property were sold, in cases where a partnership interest constitutes a business asset to the partner. Rules to require the application of a similar rule in cases of tiered partnerships should also be discussed.

If the location of partnership property cannot be determined, a simple average of the partnership's payroll factor, property factor, and sales factor to distribute the value of the partnership interest for purposes of determining the selling partner's sales factor with respect to the sale of the partnership interest could be utilized. In cases where a partner sells a partnership interest that constitutes a nonbusiness asset to the partner, the regulation could simply incorporate the nonbusiness rule contained in section 25125(d).

10. *Tax Nexus and Public Law 86-272*

The partnership regulation does not deal with the impact of tax nexus and Public Law 86-272, 15 U.S.C. section 381 et seq., on the apportionment of partnership income. In particular, the regulation does not reflect the fact that a partner might have tax nexus even though the partnership itself might not if it were considered alone without regard to its partners. In addition, the regulation does not reflect the fact that a partner might have tax nexus by virtue of owning an interest in a partnership, which will cause it to have nexus with respect to its other activities directed to the state. In this respect, the regulation does not reflect the decision of the State Board of Equalization in *Appeal of Kelsey-Hayes,* 78-SBE-196, October 18, 1978, which stands for the proposition that once the taxpayer establishes tax nexus with respect to any one particular activity it acquires tax nexus with respect to any other business activity in which it engages, even if the activities are not unitary.

Staff would like to discuss whether a provision should be added to Regulation 25137-1(k) to adopt a rule providing that if a taxpayer has acquired tax nexus in California by any means, whether by conducting a trade or business directly on its own or conducting a trade or business through a partnership, it acquires tax nexus for all purposes. Thus, if a taxpayer conducts a business activity in California that would have been protected by P.L. 86-272 if considered alone, but the taxpayer has independently acquired tax nexus through a partnership doing business in California, the taxpayer loses the protection of Public Law 86-272 with respect to its own trade or business activity even if that activity is not unitary with the activity of the partnership. Similarly, if a taxpayer has tax nexus in California by virtue of conducting a trade or business activity in this state and is a partner in a partnership, which if considered alone would be protected from taxation under P.L. 86-272; the partner cannot assert the protections of P.L. 86-272 with respect to its distributive share of the income and other items from the partnership.

In addition, staff would like to discuss amending Regulation 25122 to remove the inconsistency between *Kelsey Hayes* and the rule in the regulation, and adding an example to Regulation 25122(b)(1)(B) to illustrate "taxability in another state." In addition, that regulation might need to be clarified to illustrate that a taxpayer that is subject to a flat minimum franchise tax in a particular state, but cannot be subjected to a tax on or measured by income in that state because of the operation of P.L. 86-272, is not considered "taxable" in that state for purposes of the operation of the throwback rule.

11. *Indirect Unitary Relationships in a Commonly Controlled Group*

The partnership regulation does not address situations in which a partnership is unitary with a member of the partner's commonly controlled group (within the meaning of section 25105) without the partner itself being a member of the unitary group; it deals only with situations involving a unitary relationship between a partner and its partnership. Some taxpayers have argued that the regulation does not apply if a nonunitary corporation holds the partnership interest even if another corporation in the commonly controlled group is in a unitary relationship with the partnership held by the nonunitary partner. Consideration should be given to adding provisions that require combination of the business income of a partnership and the business income of any member of the partner's commonly controlled group if the respective businesses are unitary, even if the immediate partner is not unitary. Such provisions might properly appear under the appropriate regulation under section 25106.5, rather than section 25137, on the basis that such situations deal with aspects of combined reporting of two or more corporations rather than the relationship between a partner and its partnership.

12. *Redundancy of Provisions Relating to Long-Term Contracts*

Regulation 25137-1(h) contains a lengthy rule regarding the treatment of long-term contracts held by a partnership. For the most part, these rules are redundant with the long-term contract rules contained in Regulation 25137-2. Because long-term contracts are relatively rare, to the extent that special rules are necessary with respect to long-term contracts of partnerships, they are more appropriately addressed in Regulation 25137-2 itself. Therefore, staff recommends deleting substantial provisions of Regulation 25137-1(h) dealing with long-term contracts. Special partnership rules might be added to Reg. §25137-2 to reflect the unique circumstances of partnerships engaged in long-term contracts. A cross-reference to new abbreviated partnership rules in Regulation 25137-2 could be added to Regulation 25137-1(l).

13. *Integration of Personal Income Tax and Corporation Tax Rules for Pass-Through Entities*

Regulation 17951-4(d)(1) provides that, "the total business income of a partnership shall be apportioned *at the partnership level* in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, ... and the regulations thereunder," except as otherwise provided in that regulation. (Italics added.) Thus, regulations adopted under section 25137, including Regulation 25137-1, are incorporated by reference into the personal income tax partnership apportionment rules, except to the extent that special rules contained in Regulation 17951-4 (dealing mostly with cases where the owner of a pass-through entity is unitary with a pass-through entity itself) supersede them.

The phrase "at the partnership level" reflects the rule that applies in cases where a partner and partnership are not unitary. In that case, apportionment is done at the partnership level and the resulting apportioned income is distributed to the nonunitary partner. However, some taxpayers have argued that the phrase "at the partnership level" might be interpreted to permit the application of the regulations adopted under section 25137 (including the partnership apportionment rules of Reg. §25137-1) only in cases involving nonunitary partnerships because there is no express incorporation of UDITPA regulations in cases where unity exists between a partner and his or her partnership, where combination and apportionment occurs at the *partner* level.

Staff recommends that Regulation 17951-4(d)(1) be amended to clarify that all of the rules of the partnership regulation are applicable to Personal Income Taxpayers except to the extent specifically overridden by Reg. §17951-4(d)(2)-(5).

14. *Clarification of the Applicability of the Safe-Harbor Rule in Regulation 17951-4*

When Regulation 17951-4 was amended in 2002, subsections (d)(4) and (5) were added to require mandatory unitary combination of the business activity of the partnership is unitary with another business activity of the partner and the partner has a 20 percent-or-more interest in the partnership. Mandatory combination does not apply to partners holding less than a 20 percent partnership interest. The less-than-20-percent safe-harbor provision was added to reduce the compliance burden for taxpayers and their representatives on the assumption that partners that owned less than 20 percent of partnership interests were less likely to be unitary.

Some taxpayers have argued that the safe-harbor rule should apply for the benefit of more-than-20 percent partners through the use of intervening partnerships. Should Regulation 17951-4 be amended to clarify the application of the 20-percent rule to aggregate interests in the cases of indirect interests in partnerships held through multiple tiers?

15. *Technical Amendment*

Staff would like to obtain public input on whether the term "taxpayer" should be replaced by the term “partner” in appropriate contexts throughout the regulation. A partnership can itself be a partner in another partnership despite not being a taxpaying entity; and in such situations, the regulation should apply to the partner that is itself a partnership as if it were a corporation, i.e., a taxpayer. Second, a partnership may be considered a "taxpayer" for tax accounting purposes, so using the term "partner" removes any potential ambiguities.

C. STAFF'S EXPECTATIONS FOR THE MEETINGS

FTB staff believes that Regulation 25137-1 and associated regulations should be updated and clarified. In addition, other situations not currently contained within the regulation should be addressed. In addressing these issues, the following core principles should provide an objective basis upon which to evaluate any proposed solutions and should guide any amendments to the regulation. These principles are:

Equity:	Are all similarly situated taxpayers treated similarly?
Administration:	Is the rule as clear and concise as possible? Can taxpayers and the FTB apply the rule?
Elimination of disputes:	Does the rule clarify current areas of dispute, or raise other concerns that might lead to new disputes?
Recordkeeping:	Does the rule utilize existing records as much as possible to minimize taxpayers' recordkeeping burdens?

The FTB will host open discussions to address these and other concerns that may be presented by the public regarding the partnership and related regulations. Interested parties should be prepared to discuss possible approaches to addressing the issues outlined above and any other issues brought up in the discussions, keeping in mind that the underlying objective is of any amendment to the regulations is to promulgate clear and straightforward rules that may be easily applied by taxpayers and administered by the Franchise Tax Board.

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