DISCUSSION TOPICS

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

October 18, 2013

Possible revisions to Regulation section 25137-1 were first discussed by staff of the Franchise Tax Board at an Interested Parties Meeting held August 21, 2008. At that meeting, staff discussed various issues that were under review and solicited input from the public. Unfortunately, the regulatory effort did not proceed to a conclusion following that meeting. Staff is now revisiting the regulatory effort in a more streamlined manner, with the hope that addressing fewer issues may lead to a more productive regulatory effort.

Of the fourteen issues that were identified by staff for discussion at the 2008 interested parties meeting, staff is pursuing the following eight issues:

- Clarify the treatment of distributive share items from non-unitary partnerships
- Address indirect ownership of business assets
- Address intercompany sales between partners and partnerships
- Address special allocations vs. allocations consistent with partnership interests
- Address variations in taxable years between partners and partnerships
- Eliminate duplicate long-term contract provisions
- Integrate personal and corporate income tax rules
- Clarify the application of safe harbor rules in Regulation section 17951-4

A. Background

When a taxpayer subject to the Corporation Tax Law is a partner in a partnership as defined in Revenue and Taxation Code[1] 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"),[2] 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regulation has generally functioned well over the years but the passage of time has rendered some of its provisions out of date and new business models have arisen that the regulation does not address.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

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[1] For the sake of brevity, further references to Revenue and Taxation Code provisions will be made only by section number, i.e., "section 25128."
[2] Further references to California Code of Regulations, title 18, will be made by "Regulation" followed by a section number, i.e., "Regulation 25137-1."

and identified several issues that it believes should give rise to consideration of amending the regulation.

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.

B. ISSUES IDENTIFIED BY STAFF

1. *Clarify the Treatment of Items of Distributive Share from Non-Unitary Partnerships*

Under the existing partnership regulation, the appropriate treatment of distributive share items from a non-unitary partnership is to treat such items as income from a separate, non-unitary trade or business. However, some taxpayers have attempted to characterize such distributive share items 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 in section 23040 for the sourcing of distributive share items. Should subsections (a) and (g) of the existing regulation be amended to make clear that a distributive share item 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?

2. *Indirect Ownership of Business Assets*

The existing 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 owned 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 owned directly by Corporation A. Should subsection (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 owned the asset directly?

3. *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.”

It has been argued that these rules do not lead to the elimination of sales that are made, instead of directly to the partner, to another member of the partner's unitary combined reporting group. While staff of the Franchise Tax Board believes that the term "taxpayer" should be viewed broadly to include any member of the partner's combined reporting group, staff would like to clarify the regulation to provide specifically that sales by a partnership to any member of the unitary partner's unitary combined reporting group should be eliminated.[3]

In addition, there are detailed rules in Regulation 25106.5-1 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.

4. *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 losses and the partner’s share of the partnership’s assets in liquidation. Thus, in any given year a partner's percentage share of distributive share items 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 percentage of distributive share items for the taxable year?

5. *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.

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[3] Franchise Tax Board staff has also identified certain facts patterns concerning this issue as a California listed transaction. See FTB Notice 2011-01.

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 the federal law which California incorporates, 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 existing regulation, the partnership's taxable year would end at a different time for federal purposes than for state purposes, and thus the taxable year that the partner's distributive share items are taken into account may be different for state purposes than for federal purposes.

Consideration should be given to deleting the rules of existing 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 the partnership in which it has an interest has resulted in distortion, may in turn apply for relief under the general provisions of section 25137.

6. *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).

7. *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).

8. *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 when 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 a less than 20 percent partnership interest was 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?

9*. 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 that merit certainty or necessary rules 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 of any amendment to the existing regulations is to promulgate clear and straightforward rules that may be easily applied by taxpayers and administered by the Franchise Tax Board.