

Summary of Interested Parties Meeting Regulation §25128.5, Alternate Method Election

- I. **Administration:** On January 28, 2010 at 10:00 a.m., members of the public attended an interested parties meeting at the Franchise Tax Board office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was tape recorded for reference but there will be no attribution of comments and no transcript.

The Hearing Officer, Laurie McElhatton, listed the four documents available as handouts: the notice of the meeting, the list of discussion topics, a copy of CCR §25113 to be used as a model, and the list of discussion points, recently posted online. Parties were told they had until February 15, 2010 to submit written comments, and that a summary of the interested parties meeting would be posted online.

The hearing officer explained that the purpose of the meeting was to provide the public with an opportunity to discuss and provide comments on the regulation to implement the single sales factor election.

- II. **Discussion:** The discussion was organized topically, following the areas covered by the most recent water's edge regulation CCR §25113 (May, 2009).

A. **Definitions:** (subdivision (b) of CCR §25113)

It was discussed that the single sales factor (SSF) regulation may not need all of the definitions listed in CCR §25113, and some additional ones may need to be added. This will be a work in progress and we can add definitions as we draft the regulation. Two definitions that may not be needed are the ones for "good cause" and "water's edge group." Others that may need to be added include those for "corporation", "unitary business", "combined reporting group", "apportionment", and "standard method." The attendees had no comments to add regarding definitions.

B. **Execution of the Election:** (subdivision (c) of CCR §25113)

It was discussed that the water's edge regulation requires a timely filed original return and that every member of the combined reporting group must make the election. At this point there was considerable input from the attendees regarding where and when to make the SSF election, who makes the election, what happens when the membership of the group changes at audit, what happens when a taxpayer is engaged in more than one trade or business, when is an election valid, what is the timing of the election, what happens when there is more than one timely return. Comments included the following:

- Wouldn't it be simpler to simply have the key corporation make the election?
- Is it necessary for the election to be made by every member of the combined reporting group? If each taxpayer doesn't make the election on their own return, might it be stated that no election was made them due to inadvertent omission?

- What about using the list of entities on the R-7 and simply saying that the election was made for all of those entities.
- Should the election be binding on all members just as the Sch. R-7 is binding on everyone in the group?
- Could the statute be interpreted to mean that the members of a combined report elect differently, and if not, then why is it necessary to address this in the regulation?
- Each member still has its own tax liability so in order to avoid the situation where a particular member claims that they did not want to elect the SSF, the language addressing this may be necessary.
- Because this is an annual election, it may be able to be simpler.
- At the end of the tax year the taxpayer should know who is in the group. Since the taxpayer files at the end of the year, all changes in ownership will be known for the year at the time of filing, there won't be any changes that occur later that have to be taken into account since this happens every year at the end of each year. For water's edge, it is an 84 month period where the election is in the first year, etc. Once made it continues on until the taxpayer decides to go off. Here taxpayer will be acting every year.
- Is it possible to simply do a rollover election. This alleviates the problem of inadvertent omission and would be consistent with a water's edge election.
- FTB can use the Schedule R-1 and allow taxpayers to make the election. Possible ways to use the Schedule R-1 include the following: (1) taxpayer fills out only the sales factor portion of the Schedule R-1 or (2) taxpayer chooses between a Part I and a Part II of the Schedule R-1 with Part I for those making the SSF election and Part II for those using the standard three factor formula.
- What about Form 2416 and partially included entities with sub part F income? Does the SSF election apply to partially included CFCs? When computing the factors from a partially included CFC, will the election also apply to those CFCs? For purposes of computing the factors, will the SSF election also be binding on partially included CFCs? Would the CFCs use sales only for their apportionment if they were an electing entity and payroll and property were left off? Are these entities deemed to be part of the group? Discussion was that the CFCs are included consistent with the rest of the group. So, if the rest of the group is on SSF, then that is what would be done for these partially included entities. If the rest are on a 3 factor formula, then that is what the partially included entities would be on. In this situation, it is the income that is being included and then that income is apportioned with the chosen method and the inclusion ratio is used.
- One of the rules for determining 100 percent inclusion on the water's edge return uses an apportionment factor of 20 percent or more, how will the SSF election affect this? The question then is whether you determine that 20 percent using the SSF or the 3 factors. If

taxpayers are to use the SSF because they are an electing entity, then that is a change that may need to be made to the water's edge regulation.

- Discussed that water's edge rules provide for a deemed election when a corporation becomes subject to franchise/income tax mid-year, when an entity is combined at audit, and that water's edge allows separate elections for separate trade or businesses of a taxpayer.
- What happens when a corporation is decombined at audit? This happens years later and that corporation will have lost the opportunity to make a SSF election on its own for the years after the decombination, which seems unfair as that corporation was not aware that it would be decombined. Discussion about whether to allow a retroactive election in cases of decombination at audit. The years subsequent to decombination would already have their original timely returns filed without a SSF election. Discussion that FTB already allows this for the accounting method elections that can be made during the 60 day window after combination at audit under CCR§25106.5-3. Comment was that since the purpose of the election is to allow the taxpayer to elect the best possible method, allowing retroactive election in that circumstance would be consistent with the purpose.
- Comment was made that this retroactive election scenario could affect net operating loss carrybacks.
- Comment was made that there may be a non-apportioning corporation that should actually be apportioning and this is corrected at audit. Would that now apportioning entity be allowed to make the SSF election retroactively?
- Comment was again made that Schedule R-1 is where the election should be made, have it highlighted and in bold type. The general consensus was that two sets of Schedule R-1 would be preferred to effectuate the election and this would alleviate the rollover issue because by definition, entities making the SSF election would have to fill out the Sch. R-1 and the election would thus be made annually.
- Question was whether there would be a conflict between the SSF and the water's edge election because once the water's edge election is made, it continues simply by filing a return. Thus, the taxpayer is rolling over the election as there is no water's edge contract required. Concern was if there is a check the box requirement for SSF and if taxpayer forgets to check the box, what then? Response was that if the payroll and property were left off, then that could be objective evidence of an election.
- Question was raised of what result if both the SSF and the 3-factor portions are filled out? What result? A comment was that one result might be that since the SSF election is an affirmative election, if there is not sufficient evidence of an election, then one simply was not made and the default 3-factor formula would be used.
- A suggestion was to use the Schedule R-1 but to have different names for each section so the SSF would be Schedule R-1X and the 3-factor would be Schedule R-1Y or something similar. This would be similar to water's edge which has its own forms.

- Comment was made to consider doing Part I and Part II of Sch. R-1 so that Part I is the new SSF election and Part II is the standard 3-factor method.
- Comment was made that even if there is no check-the-box portion, if a taxpayer fills out both sections, the SSF election and the 3-factor method, then what? Response was that we could see what numbers were carried into the rest of the return and then that would be objective evidence of whether an election was made or not. FTB can list out possible objective evidence of a SSF election.
- Comment was made that the software companies should take care of this so that the forms are filled out correctly.
- Discussion about later timely filings and what the water's edge rule provides. There was no comment against following water's edge rules for later timely filings.
- Discussion about whether it should be required to have a copy of the SSF election attached to all subsequent returns in a taxable year. If the election is made on the Schedule R-1, might this happen automatically?

C. **Termination and Re-election:** These are subdivisions (d) and (e) of CCR §25113 and the consensus was that these are not needed for the SSF election regulation.

D. **Election, those affected:** (subdivision (f) of CCR §25113)

It was discussed that water's edge requires that all members of the group elect before the election is considered effective and that the status of the SSF election after changes in affiliation is governed by which members (electing or non-electing) have the greater value of total business assets. There were a number of subsections from the water's edge regulation that possibly may not apply because the SSF election is made at the end of every year. Those subsections may include the following: what to do when members leave the group, what to do when corporations have different commencement dates, what to do when there are both electing and non-electing taxpayers in one group, what to do when there are two non-electing corporations added to a group with different commencement dates. Discussion included the following comments:

- There is a question of what to do when taxpayers are filing with different fiscal years and when there are short period return issues. For example, which election controls when a non-electing unitary group member with a fiscal year-end files its return earlier than the electing combined group? Should the SSF election be binding on an annual basis or on a per tax return basis (for short period filers)?
- FTB will provide examples of different scenarios to address the end-of-year issues at the next interested parties meeting.
- Question was raised whether we really need these rules for the SSF election since the election will be made at the end of the tax year. Do other rules already take care of these problems?

- Question: What if there are two periods, a period before an entity comes into the group and a period after that entity comes into the group. Discussion was that there may not be separate returns necessarily, but there would be different apportionment methods for the two time periods. Comment was that when the entity was separate, it would have its own return with its prior group where it filed with the election of that earlier group in a different return associated with that group. Then, when that entity joins the second group, it would be included and be electing or non-electing according to the second group in that group's return.
- Comment was made that a cross reference to the combined reporting rules may be effective here as it addresses what to do with partial year returns. Another comment was that combined reporting rules only deal with sourcing, not with actual procedure on filing of forms.
- Question was made about what "annual" election means and if that means that an entity can still be a part of two different elections in one taxable year, since it was part of two different groups. Consensus was that there need to be two elections allowed if an entity moves between two groups and that this might be taken care of in the regular combined reporting rules.
- Discussion regarding "timely filed original return": A comment was made stating that where there is an entity moving between two groups mid-tax year, then there would necessarily be two returns and two elections for that entity. Another comment was that there is different income on each return so there is no overlap there. There was a comment that this would be a deviation from water's edge so that there is a part year apportionment schedule same as where there is an added entity and instant unity so that this entity's factors are included after joining, but there is a different return for the time before the entity joined and group two is not a part of that return. Is one election required for the whole year or would entities be able to move in and out of the election?
- Question whether the election is made by virtue of filling out a Schedule R-1 correctly or is it really made by virtue of filing a return?
- Discussion regarding a series of acquisitions that are really steps in a single transaction and how that would be treated and whether to include language from RTC §25113(c)(7) which states that the steps would be aggregated into a single change of membership. Also question of whether to include the language from the water's edge statute regarding mergers and consolidations at RTC §25113(c)(8).

E. Miscellaneous Comments:

- Question about CCR §25137-10 (generals and financials in one combined reporting group) and how would the SSF election apply there?
- Question about exempt corporations. Would their sales be included in the factor? Discussion that the return to the Finnigan rule may dictate the result on those facts and that factors and income of exempt entities would be included.
- Question whether FTB will use RTC §25137 to revoke the election? The response was no.

- Question about combined report mechanics and non-residents with income from a trade or business partially carried on in California. Discussion that those activities would be picked up by virtue of Regulation 17951-4 and the cross reference in that regulation to RTC §25120-25139.
- Discussion regarding fiscal year taxpayers. What if the entity has a period that is less than the taxable year of the key corporation? Discussion regarding CCR §25106.5-11(b)(2) that requires a taxpayer to have the same taxable year as the key corporation or a taxable year that is wholly within the taxable year of the key corporation before it can be considered a "taxpayer member."