

**Request for Permission to Proceed with the Formal Regulatory Process
to Adopt Proposed Regulation section 17942, Relating to Limited Liability Company Fees**

California Revenue and Taxation Code (RTC) section 17942 requires a limited liability company (LLC) to pay an annual fee to the Franchise Tax Board, determined by the amount of "total income" attributable to California during the taxable year. In light of litigation challenging the constitutionality of the LLC fee, the Legislature amended RTC section 17942 in 2008, effective September 30, 2008 and operative for taxable years beginning on or after January 1, 2009, by amending subdivision (a) (1) through (a)(4) to state that the fee is based upon "total income from all sources derived from or attributable to this state" rather than "total income from all sources reportable to this state". Subdivision (b) was also amended to provide a definition for "total income from all sources derived or attributable to this state", specifying in subdivision (b)(1)(B) that the sourcing rules contained in RTC sections 25135 and 25136 and the regulations thereunder, as modified by regulations under Section 25137, with certain exceptions, should be used to determine "total income from all sources derived from or attributable to this state" and providing specific LLC fee due dates and penalties in subdivision (d). Prior to this amendment, RTC section 17942 described the LLC fee as determined by "total income" and established a due date for payments.

This regulation is authorized by RTC section 19503, which provides in subdivision (a) that "[t]he Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with Section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), and this part and may prescribe the extent to which any ruling (including any judicial decision or any administrative determination other than by regulation) shall be applied without retroactive effect."

An Interested Parties Meeting was held on June 17, 2008, allowing the public an opportunity to raise issues to be addressed in the proposed regulation. The Discussion Topics from the June 17, 2008 Interested Parties Meeting provided a general background of the purpose behind the proposed Regulation, and potential issues that may arise with regard to the proposed Regulation. After this first Interested Parties Meeting, language for the proposed regulation was drafted based upon the amendments to RTC section 17942. A second Interested Parties Meeting was held on November 19, 2010, in which a draft of the proposed language was discussed with the public. The meeting was successful and the proposed regulation language was generally found acceptable.

Much of the public response concerned the treatment of nonbusiness income in determining total income from all sources derived from or attributable to California. Staff explained that the distinction between business and nonbusiness income was not an issue, as all income is being allocated, rather than apportioned, through the rules contained in subdivision (b) of Section 17942. Each item of income is directly assigned, either to California or to a location other than California for purposes of RTC section 17942. Another public concern involved the application of fees when there is a tiered ownership structure to multiple LLCs. This concern was addressed at the second Interested Parties Meeting and the public was satisfied with the response.

A third Interested Parties Meeting was held on October 4, 2011, allowing the public a final opportunity to raise issues to be addressed in the proposed regulation, and to discuss two issues raised subsequent to the second Interested Parties Meeting. One issue concerned whether the cost of goods sold includes the tax basis of real property. The other issue concerned whether an LLC can make a single sales factor election while a member of a unitary group.

After the meeting, department staff considered the public comments and determined that, with regard to the tax basis of real property, the LLC Income Worksheet (FTB Form 568) should be amended to specifically exclude the basis of real property from the cost of goods sold, for purposes of calculating the LLC fee. This change would occur starting with the 2012 tax year. With regard to the single sales factor election concern, staff determined that allowing the LLC an independent election is beyond the authority of RTC section 25128.5.

Staff believes that the regulation as proposed provides appropriate guidance regarding the LLC fees provided in RTC section 17942, and requests permission to commence the formal regulatory process under the Administrative Procedure Act.

Summary and Explanation of Proposed Regulation

The purpose of proposed California Code of Regulations (CCR) section 17942 is to instruct taxpayers on how to properly calculate the California LLC fee. The regulation will achieve that purpose by providing definitions, guidelines and examples that go beyond the information found in the underlying code section.

Subsection (a) of the regulation states the general rule that every LLC subject to California taxation must pay an annual fee determined by the "total income from all sources derived from or attributable to this state." "Total income" is defined as gross income, without the application of any exclusion from gross income, plus the cost of goods sold. This fee is in addition to the tax imposed on LLCs pursuant to RTC section 17941.

Subsection (b) defines "total income from all sources derived from or attributable to this state" and is a restatement of the rule contained in RTC section 17942(b)(1)(A).

(b) "Total income from all sources derived from or attributable to this state" means gross income, as defined in Revenue and Taxation Code section 24271, plus the cost of goods sold that is paid in or incurred in connection with the trade or business of the taxpayer. This amount does not include, however, any allocation or attribution of income or gain or distributions made to the limited liability company in its capacity as a member or holder of an economic interest in another limited liability company, so long as the income of the limited liability company that earned the income was itself subject to the fee described in Revenue and Taxation Code section 17942.

Subsection (b) also provides an example of the application of the definition. The example illustrates the meaning of being "subject to" an LLC fee. In this case, the LLC-taxpayer (LLC A) owns an interest in another LLC (LLC B), which has \$200,000 of total income from all sources derived from or attributable to California. Because the LLC B has income below \$250,000, it is not required to pay a fee. Furthermore, in determining the fee owed by LLC A, LLC A's distributive share of LLC B's income will not be included in LLC A's total income from all sources attributable to this state because LLC B's income was "subject to" the LLC fee.

Subsection (c) explains that income and distributions received from pass-through entities, other than LLCs that are also subject to the fee, must be included in calculating the LLC fee. This includes the LLC's distributive share of the pass-through entity's cost of goods sold. Subsection (c) further provides that items of income received from pass-through entities not subject to the LLC fee must be computed and assigned for purposes of the LLC fee, just like any item if income derived directly by the LLC. The subsection provides:

(c) Items of total income from all sources derived from or attributable to this state that a limited liability company receives from pass-through entities, other than other limited liability companies that are themselves subject to the fee, must be computed and assigned for purposes of the limited liability company fee calculation. This means that a limited liability company's distributive share of items allocated to it by another pass-through entity that is not itself a limited liability company must be adjusted to include cost of goods

sold, if applicable, in order to compute the correct amount of total income for fee purposes.

The example in subsection (c) illustrates how an LLC with a 50 percent interest in a partnership will be allocated not only 50 percent of the partnership's total income, but for LLC fee purposes, will also be allocated 50 percent of the partnership's cost of goods sold.

Subsection (d) explains that to determine total income from all sources derived from or attributable to this state, the assignment rules of RTC sections 25135 and 25136, and the regulations thereunder, as modified by regulations under RTC section 25137, other than those provisions that exclude receipts from the sales factor, are to be utilized. Subsection (d)(1) explains that income derived from the passive holding of intangible property must be assigned for fee purposes to the location where the intangible property is managed. The example in subsection (d)(1) posits an Indiana LLC that holds a portfolio of bonds, and employs a portfolio manager who is located in Nevada. The interest income from the bonds will be assigned to Nevada for LLC fee purposes. This subsection is necessary because the rules contained in Regulation section 25137(c)(1)(C) may exclude these receipts and not assign them to a location, but in the context of the LLC fee, these receipts must be assigned to a location pursuant to RTC section 17942(b)(1)(B). By providing a clear rule, the fee calculation is made more certain, in line with a comment made during the Interested Parties Meeting process.

Subsection (d)(2) provides that while an occasional sale may be excluded from the sales factor of the apportionment formula pursuant to Regulation section 25137, for LLC fee purposes RTC sections 25135 and 25136 apply, and the occasional sale will be assigned pursuant to the rules contained therein. In addition, this subsection clarifies by example that if the taxpayer elects the single-factor sales apportionment methodology pursuant to RTC section 25128.5, then the taxpayer must apply the same assignment rules for purposes of calculating the LLC fee. This subsection is also necessary because of RTC section 17942(b)(1)(B).

Subsection (d)(3) provides a rule that total income received from a pass-through entity, other than as provided in subsection (b) of this regulation, shall be assigned to the state where the partnership assigns the income on the Schedule K-1 provided to the LLC. This provides a catch-all provision for the assignment of receipts from pass-through entities that is easy to apply because it relies on information already provided to the holder of the interest, the Schedule K-1.

Subsection (e) explains that if an LLC conducts all of its business in California, then it can calculate its total income without regard to the above rules, as the same amount will be reached in either case.

Subsection (f) provides an alternative method for assigning total income from all sources derived from or attributable to this state. This alternative method is provided in response to comments made during the Interested Parties Meeting process that there should be an easier way to calculate the fee that does not require looking at each item of income individually, especially when it is clear that the LLC will easily exceed the \$5,000,000 threshold for the imposition of the maximum fee of \$11,790.

Subsection (f)(1) provides that if the LLC reports to its members a sales factor numerator over five million dollars (\$5,000,000), the Franchise Tax Board will accept that amount as a proxy for "total income from all sources derived from or attributable to this state" for fee purposes, as reporting a larger amount cannot result in a larger LLC fee. The use of the sales factor numerator is reasonable because similar rules are used to assign each item of income for fee purposes to those used for apportionment purposes in calculating the sales factor numerator for California.

Subsection (f)(2) provides that if the LLC reports a sales factor numerator below five million dollars (\$5,000,000), it may still choose to use the alternative method. However, it must adjust that numerator amount first by assigning all items of total income that were previously assigned as nonbusiness income for apportionment purposes (subsection (f)(2)(A)), second by assigning all items of total income that were not included in the sales factor numerator pursuant to regulations under RTC section 25137 that excluded the sales from the sales factor entirely (numerator and denominator)(subsection (f)(2)(B)), and third by removing all items of total income received from other LLCs that were also subject to the LLC fee (subsection (f)(2)(C)), consistent with subsection (b) of this regulation.

These additions and subtractions are necessary to approximate the differences between the apportionment scheme contained in RTC section 25120-25137 and the LLC fee rules contained in RTC section 17942.

Nonbusiness determinations are relevant in determining whether an item of income is apportioned through the apportionment formula or allocated directly to a state outside of the apportionment scheme in calculating the income or franchise tax. Such distinctions are not necessary in the LLC fee context as the entire scheme is direct allocation and not apportionment. Therefore, receipts allocated using the nonbusiness rules of RTC sections 25124–25127 need to be reassigned using the rules contained in RTC sections 25135, 25136 and, if applicable, 25137 in accordance with RTC section 17942(b)(1)(B).

Similarly, items that are not assigned to a state's numerator but are removed entirely by operation of regulations promulgated under RTC section 25137 must also be assigned under RTC section 17942(b)(1)(B).

Receipts that are included in the sales factor numerator but are derived from or attributable to other limited liability companies that were subject to the limited liability company fee must be removed, consistent with subsection (b) of the proposed regulation and in accordance with RTC section 17942(b)(1)(A).

Subsection (f)(3) lastly provides that if the sales factor numerator is over five million dollars (\$5,000,000), but included in this amount was income received from another LLC such that removal of the income will result in the sales factor numerator falling below five million dollars (\$5,000,000), then the LLC may remove that amount and then make the adjustments described in subsections (f)(2)(A) and (B).

Summary of Third Interested Parties Meeting
Proposed Regulation section 17942, Limited Liability Company Fees

- I. Administration: On October 4, 2011 at 1:00 p.m., members of the public attended an Interested Parties Meeting at the Franchise Tax Board's offices in Sacramento, California. Parties attended in person and by telephone. Those physically present were asked to register at the entrance. The session was to be tape recorded for reference but there would be no attribution of comments and no transcript.

The hearing officer, Douglas Barish, listed the documents available as handouts: a notice of the meeting and discussion topics, all of which were posted online. A summary of the interested parties meeting was also posted online.

- II. Discussion: The discussion was focused on comments received during or subsequent to the second Interested Parties Meeting.

A concern regarding whether the tax basis of real property should be included in the cost of goods sold was addressed. It was determined that the LLC fee worksheet already removed the tax basis of real property from the costs of goods sold. It was agreed that clarification that the tax basis of real property is not included in the cost of goods sold should be added to the LLC fee worksheet. Such changes will take effect starting with the 2012 tax year.

A second concern was raised regarding whether a single sales factor election could be made by an LLC that is a member of a unitary group. There was a concern about the disparate treatment of LLCs that are unitary as compared with LLCs that are not unitary. The hearing officer advised that, notwithstanding such disparity, RTC section 25128.5, which only allows elections based on an apportioning trade or business and only for purposes of the franchise tax, would not permit such an election. No provision exists in the RTC allowing an additional, independent election for purposes of calculating the LLC fee. The public was advised that no action would be taken on this concern.

- III. Written Comments: The Franchise Tax Board received two written comments, as mentioned above. The first comment concerned the exclusion of the tax basis of real property from the cost of goods sold. The second comment concerned the single sales factor election available to members of a unitary group.

There will be no further Interested Parties Meetings, as there appears to be no additional public comments or concerns.

Section 17942 is adopted to read:

§ 17942. LLC Fees.

(a) In addition to the tax imposed under Revenue and Taxation Code section 17941, every limited liability company subject to tax under Revenue and Taxation Code section 17941 shall pay annually to the state a fee determined by the amount of total income from all sources derived from or attributable to this state for the taxable year. "Total income" means gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer. For purposes of the LLC fee, gross income would be determined without the application of any exclusion from gross income, such as Internal Revenue Code sections 103, 104 or 108, as applicable for California purposes.

Example: Assume A, a limited liability company organized in California that is taxed as a partnership, has income from the discharge of indebtedness during the taxable year. For purposes of the LLC fee, A will include the income from the discharge of indebtedness, whether or not A is insolvent, as the exclusion under Internal Revenue Code section 108 does not apply in determining total income for purposes of the LLC fee.

(b) "Total income from all sources derived from or attributable to this state" means gross income, as defined in Revenue and Taxation Code section 24271, plus the cost of goods sold that is paid in or incurred in connection with the trade or business of the taxpayer. This amount does not include, however, any allocation or attribution of income or gain or distributions made to the limited liability company in its capacity as a member or holder of an economic interest in another limited liability company, so long as the income of the limited liability company that earned the income was itself subject to the fee described in Revenue and Taxation Code section 17942.

Example: Assume AB, a limited liability company organized in Georgia that is taxed as a partnership, has total income from all sources derived from or attributable to this state from its own business activities in the amount of \$400,000. AB also owns an interest in BC, a limited liability company organized in Ohio that is also taxed as a partnership. BC has total income from all sources derived from or attributable to this state from its business activities in the amount of \$200,000. AB's distributive share of BC's total income from all sources attributable to this state is \$150,000. In calculating its total income from all sources derived from or attributable to this state, AB will not include its \$150,000 distributive share of income from BC, even though BC did not actually pay any limited liability company fee itself (under these facts, BC's total income is below the \$250,000 minimum threshold for the imposition of the fee), because the \$200,000 earned by BC was "subject to" the fee. As a result, AB will pay a fee based on its total income from all sources derived from or attributable to this state of \$400,000.

(c) Items of total income from all sources derived from or attributable to this state that a limited liability company receives from pass-through entities, other than other limited liability companies that are themselves subject to the fee, must be computed and assigned for purposes of the limited liability company fee calculation. This means that a limited liability

company's distributive share of items allocated to it by another pass-through entity that is not itself a limited liability company must be adjusted to include cost of goods sold, if applicable, in order to compute the correct amount of total income for fee purposes.

Example: Assume GD, a limited liability company organized in Oregon that is taxed as a partnership, has a 50% interest in Partnership X. During the year, Partnership X sells widgets for \$10,000 with a related cost of goods sold of \$5,000. GD is allocated a 50% distributive share of X's gross income from Partnership X in the amount of \$2,500 at the end of the year. For limited liability company fee purposes, in addition to any total income from its own activities, GD has an item of total income of \$5,000, comprised of GD's \$2,500 distributive share of gross income from X, plus the associated \$2,500 of cost of goods sold from X representing GD's distributive share of X's cost of goods sold.

(d) To determine total income from all sources derived from or attributable to this state, the assignment rules of Revenue and Taxation Code sections 25135 and 25136, and the regulations thereunder, as modified by regulations under Revenue and Taxation Code section 25137, other than those provisions that exclude receipts from the sales factor, are to be utilized. These rules are the sales factor numerator assignment rules of the apportionment formula for entities paying the corporate franchise or income tax. Sales shall be assigned under Revenue and Taxation Code section 25136 for fee purposes using the same method as that elected under Revenue and Taxation Code section 25128.5 to assign sales for apportionment purposes.

(1) Items of total income from all sources derived from or attributable to this state that are derived from the passive holding of intangible personal property, an activity that may not have been assigned to a location due to Regulation section 25137, subsection (c)(1)(C), must be assigned to a location for purposes of computing the limited liability company fee. Income derived from such property shall be assigned for limited liability company fee purposes to the location from which the intangible personal property is managed by the limited liability company.

Example: Assume DE, a limited liability company organized in Indiana that is taxed as a partnership, holds a portfolio of bonds that generates interest income. Assume an individual bond portfolio manager located in Nevada monitors these bond investments and makes decisions regarding the portfolio. In assigning the interest income from the bonds for limited liability company fee purposes under this regulation, the income will be assigned to Nevada, the state where the individual bond portfolio manager is located.

(2) Occasional sales of assets may also be disregarded for sales factor purposes under the rules of Regulation section 25137, subsection (c)(1)(A), however, total income from all sources derived from or attributable to this state from such transactions must be assigned to a location for purposes of computing the limited liability company fee. Therefore, the apportionment methodology election made by the taxpayer pursuant to Revenue and Taxation Code section 25128.5 shall apply and total income from all sources derived from or attributable to this state shall be

assigned under Revenue and Taxation Code section 25136 in accordance with such election.

Example: Assume EF, a limited liability company organized in California that is taxed as a partnership, elects single-factor sales pursuant to Revenue and Taxation Code section 25128.5. Therefore, for purposes of calculating the LLC fee, total income from all sources derived from or attributable to this state will be assigned based on the market-rules for sales contained in Revenue and Taxation Code section 25136, subdivision (b).

(3) All items of total income from all sources received by the limited liability company from other pass-through entities, other than as specifically provided by subsection (b) of this regulation, shall be assigned to the state where the partnership assigned the income on the Schedule K-1 provided to the limited liability company.

(e) If a limited liability company conducts all of its business activities in California, then the limited liability company may simply calculate its total income and may disregard the assignment rules set forth above, since the application of the rules would result in the same amount of income being assigned to this state.

(f) Alternative method for assigning total income from all sources derived from or attributable to this state. Under Regulation section 17951-4, a limited liability company that is classified as a partnership under Revenue and Taxation Code section 23038 and conducts its business within and without this state shall apportion its income at the partnership level in accordance with Revenue and Taxation Code sections 25120 through 25139. The limited liability company shall determine its California sales factor numerator pursuant to Revenue and Taxation Code sections 25135, 25136, and, if applicable, 25137. As an alternative, multistate limited liability companies may utilize this apportionment information to calculate the limited liability company fee in the following manner:

(1) If the sales factor numerator amount is over five million dollars (\$5,000,000) for the taxable year, the limited liability company may report the sales factor numerator amount as the correct amount for purposes of calculating the fee since the sales factor amount exceeds the top bracket for calculating the fee amount.

(2) If the sales factor numerator is less than five million dollars (\$5,000,000) for the taxable year, then the limited liability company may use the sales factor numerator amount as the starting point for the calculation of the fee and then make the following adjustments:

(A) Assign all items of total income from all sources that were previously assigned as nonbusiness income for apportionment purposes, using the assignment rules of this regulation.

(B) Assign, pursuant to this regulation, all items of total income from all sources that were not included in the sales factor numerator by operation of the

provisions of regulations under Revenue and Taxation Code section 25137 that exclude sales from the sales factor.

(C) Remove all items of total income that were derived from or attributable to other limited liability companies that were subject to the limited liability company fee, consistent with the methodology described in subsection (b) of this regulation.

(3) If the sales factor numerator amount is over five million dollars (\$5,000,000) for the taxable year, but the limited liability company has included an amount received from another limited liability company in the numerator amount such that the removal of that amount will result in the remaining sales factor numerator falling below five million dollars (\$5,000,000), the limited liability company may remove the amount and then make the other adjustments pursuant to subsections (2)(A) and (2)(B).

Note: Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 17942, Revenue and Taxation Code.