

Request for Permission to Proceed with Formal Hearing for Proposed Regulation 25106.5-11, Relating to the Filing of a Group Return By California Taxpayer Members of a Combined Reporting Group

Each taxpayer that is subject to the California Corporation Tax Law has an obligation to file a return. If a taxpayer conducts business within and without California, it must attach to its return a copy of a combined report, which shows how its business income is apportioned amongst the various states. In many instances, many California corporate taxpayers are members of the same combined reporting group. This means that the same combined report relates to each of them. Therefore, each must file its own return, attaching a copy of the same combined report to each return. This creates administrative difficulties and burdens, both for taxpayers and the Franchise Tax Board.

As a matter of administrative convenience, it has been the Franchise Tax Board's long-standing practice to allow taxpayers that are members of the same combined reporting group to file a single "group return," thereby satisfying each taxpayer's return-filing obligation. Attached to this return is a copy of the combined report, which shows how the business income of the group is apportioned amongst the various states. To qualify for filing a group return, the Franchise Tax Board has required that one of the affiliated taxpayers agree to be designated as the "key corporation" for the combined reporting group. The key corporation agreed to act as agent and surety for the remaining taxpayers included in the combined report. This allowed affiliated taxpayers to avoid the burden of filing duplicative combined reports, while allowing the Franchise Tax Board to coordinate with only one taxpayer as opposed to many. The designation of the key corporation and the identification of the remaining taxpayer members included in the single group return was effectuated by attaching a completed Schedule R, Schedule R-7, to the Form 100 that was filed by the designated key corporation.

The taxpayer community has generally followed this existing practice, so staff does not anticipate that the proposed regulation will be controversial. This new proposed regulation will generally codify the department's long-standing administrative practice described above.

A symposium to discuss the proposed regulation was held on August 30, 2004. A report on the symposium is included in the materials prepared for the Board. As a result of the symposium, a number of changes were made to the language in staff's original discussion draft proposal. A copy of the revised proposed regulation, with changes made as a result of the symposium shown in strike-out and underline, is also included in the Board's materials. Staff requests permission to proceed to the formal public hearing process under the Administrative Procedure Act.

**SUMMARY OF SYMPOSIUM
DISCUSSION DRAFT REGULATION SECTION 25106.5-11,
FILING OF SINGLE GROUP RETURNS**

I. Background

On June 10, 2004, staff received authorization from the Franchise Tax Board to proceed with a symposium on proposed regulation section 25106.5-11, which sets forth the rules that must be followed in order for California corporate franchise taxpayers that are members of a unitary combined reporting group to file a single group return which would satisfy each taxpayer's return-filing obligation. The proposed regulation generally codifies existing administrative policies that are set forth in Schedule R-7 and FTB Publication 1061.

The Symposium was held at 10:00 a.m. on August 30, 2004, at the Franchise Tax Board's central offices in Sacramento, California. The facilitator was Craig Swieso, Tax Counsel III for the Franchise Tax Board. On July 2, 2004, staff issued a notice advising the public of the scheduling of the symposium for August 31, 2004. On July 12, 2004, a new notice was issued advising the public that the symposium had been rescheduled for August 30, 2004. Both notices had been sent to all individuals who had previously expressed an interest in the proposed regulations. Copies of the proposed regulation were attached to the initial notice. Furthermore, the notice and the proposed regulations were posted on the department's website.

Prior to the symposium, staff received written comments and suggestions for changes from Michele Chang, who is with the Los Angeles office of the accounting firm of Ernst and Young, and Jeff Vesely, who is with the San Francisco office of the law firm of Pillsbury Winthrop. On the day of the symposium, comments were received by FAX from Jennifer Boe, who is the state and local tax director of CNF Service Co.

The only outside on-site attendee of the symposium was Eric Coffill, who is with the Sacramento office of the law firm of Morrison & Forester. Jennifer Boe, and Robert Garvey, of the San Diego office of the accounting firm PriceWaterhouseCoopers, participated via teleconference. The comments and suggestions will be discussed below.

II. Pre-Symposium Written Comments

A. Michele Chang's Comments

1. Proposed regulation subsection (b)(1) references Regulation section 25106.5(a)(14). It should actually reference Regulation section 25106.5(b)(14).

Response – She is correct. Subsection (b)(1) has been revised accordingly.

2. Ms. Chang suggests revising proposed regulation subsection (b)(1) to read: "In order to be eligible to make the election provided under this section, *the electing key corporation must meet the definition of a "key corporation" as defined in Regulation section 25106.5 (b)(14), in addition*

to meeting the following requirements, by either ---" (Emphasized portions are additions to original proposed regulation.)

Response – By revising the proposed regulation, taxpayers will know that they must satisfy both the requirements of Regulation section 25106.5 (b)(14) as well as the new regulatory provisions. This is an editorial change that has been accepted.

3. Proposed regulation subsection (b)(1)(A) indicates that a "key corporation" should be a "parent corporation". Subsection (A) should reference the definition of a "parent corporation" that is contained at Regulation section 25106.5(b)(12)(A)(1).

Response – This editorial change has been accepted.

4. Proposed regulation subsection (b)(1)(B) provides that if the "parent corporation" is not a taxpayer member, then the taxpayer member with the largest property factor numerator should be the key corporation. Ms. Chang suggests that this section should be revised to state that a "lower tier" parent should be the key corporation. The "lower tier" parent will be defined as the corporation that would be the other taxpayer member's parent corporation, if the actual parent corporation were disregarded. If there is no taxpayer member that would qualify as a "lower tier" parent, then the taxpayer member of the combined reporting group that, on a recurring basis, has the largest amount, by value of real and tangible personal property in the state, would be treated as the key corporation. The stated purpose of this suggestion is to ensure that the key corporation does not have to be changed on a year-to-year basis just because the taxpayer member who is the existing key corporation has a lower property factor numerator than some other taxpayer member.

Response - This revision is not necessary. Proposed regulation section (g)(1) provides that the FTB can treat a key corporation as being valid even though not all the regulation's conditions are met. Therefore, even if an existing key corporation has less of a property factor numerator, the FTB will not automatically require that another taxpayer member with the greater property factor numerator take its place.

5. Proposed regulation subsection (b)(1)(C) states that the key corporation's powers, rights and privileges must not be forfeited or suspended nor can it have a pending petition with the U.S. Bankruptcy Court. Ms. Chang suggested that the subsection be revised to specify that the key corporation must not be forfeited or suspended with the California Secretary of State. Therefore, if a key corporation was suspended or forfeited in another jurisdiction, it could still be a key corporation for California purposes. Furthermore, she could not understand why having a petition pending with the U.S. Bankruptcy Court would be relevant.

Response - Revising the subsection (b)(1)(C) to reference the California Secretary of State has been accepted. However, the reference to the bankruptcy status of the key corporation should remain. The bankruptcy status of the key corporation is relevant because the key corporation is a surety for the tax liability of the electing taxpayer members. If it has a bankruptcy petition pending, the FTB's ability to collect the tax liability from the electing taxpayer members might be adversely impacted.

6. Proposed regulation section (c) requires that each taxpayer member's California corporation number be listed on the Schedule R-7. In many instances a corporation doing business in California will not have a California corporation number assigned to them by the time a return must be filed. Ms. Chang suggests that proposed regulation section (c) be revised to state that the California corporation number must be listed *if one has been assigned and provided to the taxpayer*.

Response – This editorial change has been accepted.

7. Proposed regulation subsection (d)(7) provides that notwithstanding the fact that if any of the taxpayer members included in the election to file the single group return are subsequently determined not be members of the key corporation's combined reporting group, the key corporation and that taxpayer agree that any subsequent adjustment may be assessed to, billed to or paid by the key corporation. Ms. Chang suggests that the key corporation also be authorized to receive refunds. In addition, she suggests that the term "assessed" is ambiguous and that the following phrase be included at the end of the regulation: "in the case of assessments and refunded to the key corporation in the case of overpayments."

Response – As agent, the key corporation would have the authority to receive refunds. However, the regulation should be amended to clearly specify as much. Furthermore, her suggestion about clarifying the term "assessed" has also been accepted.

8. Proposed regulation section (e) provides that a key corporation election will remain in effect for 30 days after the taxpayer member has notified the FTB in writing that they wish to terminate the election. Ms. Chang suggests that the regulation should be revised to indicate that the election would terminate 30 days after the taxpayer member has mailed the written termination notice. She said this is necessary because taxpayers would not know the definitive date a written notice has been received by the FTB. Also Ms. Chang mentions that a taxpayer that was previously included in a single group return, but has since been disaffiliated from the group, may not be aware of an ongoing FTB audit. She suggests that the proposed regulation include information as to how such a taxpayer could contact the FTB to determine if there is an ongoing audit relating to any relevant single group returns.

Response –With respect to making the termination effective on the date that it was mailed, FTB will be relying on the existing key corporation election to take various actions until it receives notice that the election is terminated. The 30-day period reflects the time needed to process notices and refunds. Making the 30-day period start before FTB receives the notification could result in situations where FTB will have started the process to issue notices on a combined basis, and may be unable to reissue valid notices on a separate basis. Changing the rule from a "received" standard to a "mailed" standard would create difficulties that would not be offset by any purported benefits. With respect to providing contact information in the regulation, the FTB currently provides this information through its established taxpayer services. The contact information is generally publicized in all of the FTB notices and return packages. It would be redundant to include it in a regulation, and if included in the regulation, opening a new regulation project would be required to change that information, which could be cumbersome. Therefore, this suggestion was not accepted.

B. Jeff Vesely's Comments

1. As mentioned above, proposed regulation subsection (b)(1)(B) puts forward that if the parent corporation is not a taxpayer member and, therefore, can't be the key corporation, then the key corporation should be the taxpayer member with the largest California property factor numerator. Mr. Vesely inquired as to the rationale for this requirement.

Response – As the surety for the other taxpayer members, the FTB can collect from the key corporation for the other taxpayer members' outstanding liabilities. By requiring that the key corporation have the largest California property factor numerator, the FTB receives greater assurance that it will be able to lien property in California to protect any outstanding collectible liabilities.

2. Similar to Ms. Chang's comment about proposed regulation subsection (d)(7), as the regulation is currently written, it does not mention how refunds will be paid.

Response – By incorporating Ms. Chang's suggested revision regarding this subsection, we have rectified the issue.

3. Proposed regulation section (e) addresses terminating the key corporation election. However, as Mr. Vesely points out, it does not require the terminating taxpayer member to notify any of the other taxpayer members. He suggests that written notice of the termination should be provided the other taxpayer members.

Response - Since the termination does not necessarily impact all of the taxpayer members, there isn't a good reason to force the terminating member to notify all of them. In any case, the terminating member may not have the necessary information to allow it to contact the other members. However, the termination does impact the key corporation. Therefore it is appropriate that the terminating taxpayer member should also be required to notify the existing key corporation that the election is being terminated. Additionally, if the key corporation is terminating the election it must notify all of the taxpayer members. We have incorporated this suggestion.

4. Proposed regulation section (e) does not address whether the termination of the key corporation election has any retroactive impact. Mr. Vesely points out that applying the termination retroactively can cause problems, especially with respect to applying estimated tax payments. He suggests that the termination should only be applied prospectively.

Response – The key corporation election is made on an annual basis when the single group return is filed. Generally, by that time all estimated tax payments have been made and applied. Therefore, the termination generally operates to terminate the key corporation's position as agent and surety for the taxpayer member. However, specifically stating that the termination is only to be prospectively effective is arguably unnecessary and redundant, but staff has nonetheless incorporated this suggestion.

C. Jennifer Boe's Comments

1. Proposed regulation section (c) states that the election to file a group return is made by the key corporation filing a Schedule R-7 that identifies all of the taxpayer members. Ms. Boe's concern involves situations when a single group return has been filed but no key corporation has been designated. She suggests that proposed regulation section (c) be revised to state that filing a single group return does not necessarily confer "key corporation" status on the parent corporation.

Response - According to proposed regulation section (c), a single group return cannot be filed unless a key corporation has been designated. Therefore, Ms. Boe's concern is actually a nullity: There can't be a single group return without a designated key corporation.

2. Proposed regulation subsection (d)(2)(B) provides that by not filing its own return, the taxpayer member is in effect acknowledging that the key corporation has the authority to fulfill the taxpayer member's filing obligations. Proposed regulation subsection (d)(2)(C) provides that if a taxpayer member asserts that it should not have been included in a single group return, then that taxpayer member must file its own return. Ms. Boe suggests that these sections should be collapsed into one section.

Response – Proposed regulation subsection (d)(2)(B) establishes the presumption that if a taxpayer member does not file its own return, it acquiesces to being included in the single group return. To overcome this presumption, the taxpayer member must file its own return, as provided for in proposed regulation section (d)(2)(C). Since it will only be an exceptional situation when a taxpayer member will assert that it should not have been included in the single group return, staff believes it is better to discuss this situation separately rather than include it as a clause in the general section.

3. Proposed regulation subsection (g)(1) addresses how an invalid key corporation election can be cured. It states that if one or more conditions of the regulation aren't met, the FTB, upon request by the taxpayer, may exercise its discretion to treat the election as being valid. Ms. Boe suggests that rather than require the consent of both the FTB and the taxpayer, the subsection be revised to provide "the Franchise Tax Board may, at the request of the taxpayer, treat the election as being valid. The Franchise Tax Board, may at its own discretion, decline to treat the election as valid."

Response – There are two parts to Ms. Boe's suggestion. The first part would require that in order for a possibly invalid election to be considered valid, a taxpayer must affirmatively request as much. Apparently, the default position created by this requirement is that if the taxpayer member does not affirmatively make such a request, the election is automatically considered invalid. This could be a hardship for many taxpayer members. This suggestion implies that the taxpayer member would be aware that the election is possibly invalid, which is not always the case. In many instances the designated key corporation's tax department files the single group return. An affected taxpayer member might never be aware that a problem exists. Without being aware of the problem, they most likely would not affirmatively request that the election be considered valid. On the other hand, if the FTB becomes aware of a problem with the election,

and determines that the problem isn't necessarily fatal, the FTB can exercise its discretion and choose to treat the election as valid. Presumably all of the taxpayer members would have consented to the election; otherwise they would have filed their own return. Consequently, the first part of Ms. Boe's suggestion has not been accepted.

The second part of Ms. Boe's suggestion is that the FTB can decline to treat the election as valid. The rules that require a taxpayer to file a return and to pay its tax liability are statutory. If a taxpayer member has not satisfied these obligations, either through its participation in a single group return, or by filing its own returns, the FTB is required to pursue that taxpayer. If an election to file a single group return is irredeemably invalid, the FTB would have no choice but to treat the election as invalid and, accordingly, pursue the taxpayer if it has not satisfied its return filing and payment obligations. (For instance, if the key corporation had filed multiple single group returns over the years, but had forgotten to include one of the taxpayer member's information and had not made any payments for that taxpayer member, the FTB would have to treat that taxpayer member as if it had never filed a tax return). The second part of Ms. Boe's suggestion does not add anything that doesn't already exist under the statutory scheme. Therefore, staff believes it is unnecessary.

III. Comments Received During the Symposium

Because there weren't very many people in attendance at the symposium, the discussion was very informal. As a result of what was discussed, all of the parties agreed that the regulation should not be retroactive, but should only be prospective. This is because there might be some outstanding cases involving this issue and the taxpayer community would not want the regulation to be used to leverage the FTB's position in those cases.

Furthermore, during the discussion, it was determined that there may exist certain possible fact patterns involving a single group return filing position and the designation of a key corporation that might have been treated differently than the proposed regulation requires. This would mean that the proposed regulation was not necessarily only a codification of existing administrative policies. Therefore, when the proposed regulation is noticed and distributed for the formal regulation hearing, it was suggested that the accompanying explanation of the proposed regulation state that it *generally* codifies existing administrative policies. Both of these suggestions have been incorporated.

The proposed regulation has been revised to reflect the changes mentioned in this report.

Section 25106.5-11 is adopted to read:

§ 25106.5-11. Election to File a Group Return.

(a) General. Every taxpayer subject to the California Corporation Tax Law is required to file its own tax return, including taxpayers that are members of a combined reporting group. Taxpayers subject to the California Corporation Tax Law that are members of a combined reporting group are required to attach a combined report to their tax returns. Notwithstanding these requirements, taxpayers subject to the California Corporation Tax Law that are members of a combined reporting group that includes another taxpayer that is also subject to the California Corporation Tax Law may annually elect to be included in a "group return" as provided for in this regulation. (See Regulation section 25106.5, subsections (b)(1), (3) and (13)).

(b) Requirements.

(1) In order to be eligible to make the election provided under this section, the electing key corporation must meet the definition of a "key corporation" as defined in Regulation section 25106.5, subsection (b)(14) in addition to meeting the following requirements, by either being---

(A) the parent corporation of the combined reporting group as defined in Regulation section 25106.5(b)(12)(A)(1), or

(B) if the parent corporation of the combined reporting group is not a taxpayer member, the taxpayer member with the largest California property factor numerator, and

(C) the key corporation's powers, rights and privileges must not be forfeited or suspended by the California Secretary of State and it must not have a petition with the United States Bankruptcy Court pending on the last day of the taxable year.

(2) A "taxpayer member" (see Regulation section 25106.5, subsection (b)(11)) is a corporation that---

(A) is required to file a return in this state under Revenue and Taxation Code section 18601,

(B) is a member of a combined reporting group, which includes the key corporation,

(C) has the same taxable year as the key corporation or has a taxable year wholly within the key corporation's taxable year, and

(D) has the same statutory return filing due date as the key corporation for the taxable year.

(c) Manner for Making the Election. An election to file a group return is made by the key corporation filing a California Form 100, Schedule R-7 of Schedule R , which identifies the name, California corporate number (if one has been assigned and provided to the taxpayer), federal employer identification number and total self-assessed tax liability of the affiliated taxpayer members of a combined reporting group that are intended to be included in the group return.

(d) Consequences of Making an Election.

(1) The election is binding on all the taxpayer members and the key corporation for all matters for the taxable year of the election.

(2) The key corporation shall file the group return. The group return satisfies the requirement for filing a California Form 100 for each taxpayer member listed on the key corporation's Schedule R-7.

(A) By signing the California Form 100, an officer of the key corporation is attesting that he has the legal authority to bind the key corporation to all of its duties.

(B) Failure of a taxpayer member to file its own return shall be deemed to be an acknowledgement that the officer of the key corporation possesses the authority to fulfill the taxpayer member's return filing obligation.

(C) A taxpayer member asserting that it is not properly included in a group return must independently satisfy its obligation to file a return.

(3) The key corporation is a surety for each taxpayer member for payments owed under the California Corporation Tax Law.

(4) The key corporation is an agent for each taxpayer member.

(5) Extensions or waivers of the statute of limitations shall be executed by the key corporation and shall be effective for all taxpayer members.

(6) All notices regarding the liability of a taxpayer member may be sent to the key corporation and additional amounts due with respect to any taxpayer member may be assessed and billed to the key corporation and it shall be liable for payment of such amounts. Any refund or credit due to a taxpayer member may be made to the key corporation.

(7) If some or all of the corporations included in the election to file a group return are subsequently determined not to be members of the combined reporting group of the key corporation, then the key corporation and the electing taxpayer members shall be deemed to agree that any subsequent adjustment for any and all members included in the original group return may still be billed to or paid by the key corporation in the case of assessments and refunded to the key corporation in the case of overpayments.

(e) Duration of election to file group return. The election to file a group return for all matters for the taxable year of the election will remain in effect until 30 days following the receipt by the Franchise Tax Board of a written notice of termination of the election by any of the taxpayer members. The taxpayer member that is terminating the election must also notify the previously designated key corporation that the election is being terminated. The termination will only be applied prospectively. If the key corporation is terminating the election it must notify all of the taxpayer members. If an employee, agent or representative of the Franchise Tax Board is conducting an examination of a single group return at the time when any of the taxpayer members or a key corporation sends a written notice of termination to the Franchise Tax Board, the terminating taxpayer member or terminating key corporation must provide the employee, agent or representative of the Franchise Tax Board that is conducting the examination with a copy of the written notification of termination of the election.

(f) Failure or Inability of Key Corporation to Perform Its Duties. If the key corporation does not fulfill its obligation to pay any tax liability or to act on behalf of the taxpayer members, or if its powers, rights and privileges are forfeited or suspended at any time with respect to that taxable year, each taxpayer member may be independently assessed or billed for its own tax liability. In that event, each taxpayer member will be credited with taxes previously paid in accordance with the taxpayer member's self-assessed tax liability as indicated in the return data as filed. In the event that the self-assessed liabilities of the taxpayer members cannot be derived from the return data as filed, the individual liabilities of the each of the respective members may be determined by the Franchise Tax Board from data obtained during audit or supplied by the taxpayer members, using the best available information. If insufficient information is available to determine individual liabilities, the Franchise Tax Board, may, in its discretion, credit taxes paid in a manner that is reasonable under the circumstances.

(g) Curing an Invalid Election.

(1) In the event that a taxpayer fails to satisfy one or more of the conditions of this regulation, the Franchise Tax Board may, at the request of the taxpayer and at its own discretion, treat the election as being valid.

(2) In lieu of disallowing an election, the Franchise Tax Board may, at its own discretion, allow the taxpayer members to designate another taxpayer member in substitution for the key corporation originally designated in the election.

(h) Application. This regulation will only be applied prospective from the date of adoption.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25106.5, Revenue and Taxation Code.