

TITLE 18
FRANCHISE TAX BOARD
PROPOSED AMENDMENT TO
REGULATION SECTION 17951-4 AND PROPOSED
ADOPTION OF REGULATION SECTION 17951-6

A hearing was held on January 19, 2001, by Richard Gould of the Franchise Tax Board Legal Staff (hearing officer) on the proposed amendment to Regulation section 17951-4, relating to the taxation of nonresident individuals with income from a multistate trade or business, and the proposed adoption of Regulation section 17951-6, relating to the taxation of nonresident individuals with income from a covenant not to compete executed in connection with the sale of a business. Both the proposed amendment and the proposed adoption were noticed in the California Regulatory Notice Register on December 1, 2000. Section 17954 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations apportioning and allocating income of nonresident individuals to sources within and without California.

As a result of comments received during the hearing process and the State Board of Equalization's decision in *Appeal of Milhous*, 2000-SBE-003, Nov. 2, 2000, the hearing officer recommends that certain changes be made to the proposed amendment to Regulation section 17951-4 and the proposed adoption of Regulation section 17951-6. These changes constitute sufficiently related changes within the meaning of Government Code section 11346.8 and nonsubstantial changes within the meaning of Government Code section 11346.8. The changes provided by this notice are reflected by double strikeout or by double underscore. (The amendments to Regulation section 17951-4 as initially proposed are reflected by single strikeout or by single underscore.) The proposed sufficiently related changes are summarized below.

Subsection (j) of Regulation section 17951-4 is amended to provide that the provisions of the regulation which represent a change in the law be applied in the computation of taxes and penalties for taxable years beginning on or after January 1, 2001. These provisions are: (1) those requiring Personal Income Tax rules be applied in assigning nonbusiness income of a multistate trade or business in computing California source income of a nonresident owner, and (2) those stating that unitary combination will not generally be required if a nonresident individual owns less than a 20 percent interest in an entity.

Subsection (a)(1) of Regulation section 17951-6 is amended to refer to section 25128 of the Revenue and Taxation Code rather than refer to a specific apportionment factor formula, consistent with *Appeal of Milhous, supra*.

Subsection (a) of Regulation section 17951-6 is amended to delete the provision that states that the assignment of income provisions for a covenant not to compete will be applied only to the extent the taxation of the income is not prohibited by federal statutes or by the federal or California Constitution. There is no constitutional bar on the power of a state to tax income from property located within its borders. (*Shaffer v. Carter* (1920) 252 U.S. 37 [40 S.Ct. 221, 64 L.Ed. 445].) Pursuant to federal and California law,

income from a covenant not to compete is income from property having a situs where competition is prohibited. (*Korfund v. Commissioner* (1943) 1 T. C. 1180; *Appeal of Pesiri*, 89-SBE-027, Sept. 26, 1989; *Appeal of Milhous, supra.*) Thus, the proposed language regarding the prohibition is unnecessary.

Subsection (a)(4) of Regulation section 17951-6 is amended to include examples of indirect covenants not to compete that are included within the general definition so as to provide guidance.

Subsection (a)(6) of Regulation section 17951-6 is amended to make clear that a limitation exists on the provision that permits either the taxpayer to petition for or the Franchise Tax Board to require the use of another apportionment method to assign income from a covenant not to compete if the use of the prescribed formula results in a gross distortion of income. The limitation is that the use of another method must always assign income within the legally enforceable area of prohibition. Business and Professions Code section 16600 et seq. voids any covenant not to compete executed in connection with the sale of a business to the extent that the geographic area of prohibition is greater than the area in which the business conducted activity. Accordingly, it is not proper to assign income from such a covenant beyond that area, and any method of assigning income must recognize the geographic limits imposed by law.

Subsection (a)(6) of Regulation 17951-6 is amended to make clear that the general apportionment rule for covenants not to compete will be applied in all but unusual circumstances and that gross distortion must be measured only by the relationship between the factors of the business for the year of sale, the degree of recent historical business activity conducted by the business within the enforceable area of prohibition and the nature of activities prohibited by the terms of the covenant. Staff experience and State Board of Equalization decisions confirm that the application of the general rule will produce a proper apportionment of income to locations within the enforceable area of abstinence in the vast majority of circumstances. Unless this regulation makes clear that the general rule will be applied in all but unusual situations, it will not provide guidance either to the taxpaying public or to Franchise Tax Board staff. Rather it will lead to frequent and continuing disputes as to the proper apportionment methodology to be used.

Subsection (b) is added to Regulation section 17951-6 to specify that the provisions of the regulation are to apply to all taxable years for which the Franchise Tax Board may propose a deficiency or the taxpayer may claim a refund. The apportionment methodology prescribed in this regulation generally follows the decision in *Appeal of Milhous, supra.* That decision addressed the taxability of a covenant not to compete executed in 1993. Unpublished decisions of the State Board of Equalization applying the same general methodology addressed covenants not to compete executed as early as 1987. If this amendment were to be prospective in operation, an inference could be drawn that the Franchise Tax Board will not require the use of the factor apportionment method for covenants not to compete executed in years before the adoption of this regulation. Such is not the case.

All other changes are nonsubstantial changes (within the meaning of Government Code section 11346.8, subdivision (c)). The nonsubstantial and sufficiently related changes are being made available to the public for the 15-day period required by Government Code section 11346.8, subdivision (c), and section 44 of title 1 of the California Code of Regulations. Written comments regarding these changes will be accepted until 5:00 p.m. on August 25, 2001.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes as well as those who attended the hearing and those who commented orally or in writing and will be available to other persons upon request. All inquiries and written comments concerning this notice should be directed to Colleen Berwick (916) 845-3306, FAX (916) 845-3648, E-Mail (colleen.berwick@ftb.ca.gov), or by mail to the Legal Branch, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. This notice and the proposed amendment and adoption will also be made available at the Franchise Tax Board's website at www.ftb.ca.gov.