

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 10:00 a.m., on January 19, 2001, at 9645 Butterfield Way, Sacramento, California, to consider the amendment of section 17951-4 and the adoption of section 17951-6 in Title 18 of the California Code of Regulations. The proposed amendments to section 17951-4 specify the formula to be used in determining the California source income of a nonresident sole proprietor, a nonresident partner of a partnership, a nonresident shareholder of an S corporation or a nonresident member of a limited liability company which conducts business within California. Proposed section 17951-6 specifies the formula to be used by nonresidents to determine California source income from a covenant not to compete executed in connection with the sale of a business conducted in whole or in part within California. An employee of the Franchise Tax Board will conduct the hearing, and a report will be submitted to the three-member Franchise Tax Board for its consideration, along with a recommendation as to whether the three-member Board should hold a hearing on the proposed regulatory action. Government Code section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action, if any person makes such a request. If a request is received, the three-member Board will hold a hearing.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., January 19, 2001. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY AND REFERENCE

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001 of the Revenue and Taxation Code). Section 17954 authorizes the Franchise Tax Board to prescribe regulations for apportioning and allocating income to sources within and without this state for the purpose of determining the gross income of nonresidents. The proposed regulatory action interprets, implements, and makes specific section 17951 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/ PLAIN ENGLISH OVERVIEW

Under existing law, a nonresident sole proprietor, partner, S corporation shareholder or limited liability member of a multistate business that has operations in California must compute income and pay tax to California on the individual's share of income from the entity derived from California sources. The amount of income from California sources is generally computed by using corporate rules for assigning income. Business income is assigned to California by applying a formula that takes into account the relative amounts of California property, payroll and sales to total property, payroll and sales of the business entity. Nonbusiness income is assigned to locations by the use of corporate rules for allocating particular types of income.

A nonresident sole proprietor, partner, S corporation shareholder or limited liability member of a business entity that is so closely connected with another business activity owned (in whole or in part) by the same individual so as to constitute a single trade or business using unitary business principles, must combine his or her income from the separate activities and compute California source income by reference to the entire unitary activity, rather than by reference to the individual components.

Nonresidents who receive income from a covenant not to compete associated with the sale of a business or the sale of an entire interest in a business must pay tax to California on the portion of the covenant income assigned to California. That portion is computed by multiplying the covenant income by the same apportionment formula for determining the amount of business income from California sources used by the business that was sold in the year of the sale.

Existing section 17951-4 was adopted in 1976, prior to the time that California conformed to the federal S corporation provisions and prior to the time that limited liability companies came into existence. While the regulation addresses how California source income of a nonresident sole proprietor and partner is computed, it does not directly address S corporation shareholders or limited liability company members. In addition, the regulation requires that nonbusiness income of a partner be assigned to locations using corporate rules applied at the partnership level. This requirement is contrary to the rule applied to sole proprietors and the rule for assigning nonbusiness income of a partnership that conducts business in one state only. In these cases, such income is assigned by using personal income tax sourcing rules applied at the individual level. The regulation was also adopted before the State Board of Equalization decided that covenant income associated with the sale of a business should be assigned to California using the same formula for apportioning business income of the business entity sold for the year in which the sale occurs.

The proposed amendment continues to require the use of corporate rules applied at the entity level for assigning business income of a sole proprietor and partner to California sources, but requires the use of personal income tax rules applied at the individual level for assigning nonbusiness income to California. The proposed amendment expressly

applies the same rules to S corporation shareholders and limited liability members as it does for partners and sole proprietors.

To ease the compliance burden, the proposed amendment requires a nonresident individual to combine unitary interests in a sole proprietorship, partnership, S corporation and limited liability company only if the individual holds a 20 percent or more ownership interest in the entity. If the nonresident holds less than a 20 percent interest, he or she will not be required or allowed to combine unitary interests unless the Franchise Tax Board determines that combination is necessary to properly reflect income and then, only after conducting a comparable uncontrolled price examination.

The proposed amendment adopts the decisional rule that income from a covenant not to compete associated with the sale of a business must be assigned to California by reference to the formula for apportioning business income of the business that was sold for the year in which the sale occurs, but only if the taxation of the assigned income is not prohibited by federal statutes or the U.S. or California Constitution. The proposed amendment also provides that the Franchise Tax Board may require or the taxpayer may petition for the modification of the formula or the use of another formula if it results in a gross distortion of income being assigned to California.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Adverse Economic Impact on business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: None

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: The effect on small businesses will be minimal because these regulations apply only to multijurisdictional businesses.

The express terms of the proposed action written in plain English are available from the agency contact person named in this notice.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5(a)(12), the Board must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

The proposed regulatory action pertains to corporate taxpayers and therefore does not affect private persons.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The Franchise Tax Board has determined that it is not feasible to draft the text of the proposed regulations in plain English due to the technical nature of the regulations. However, a noncontrolling plain English summary of the text of the proposed regulations, as well as the initial statement of reasons and all information upon which the proposed regulatory action is based, and the express terms of the proposed action, are available upon request from the agency officer named below.

CHANGE OR MODIFICATION OF ACTIONS

The three-member Franchise Tax Board may adopt the proposed regulatory action after consideration of any comments received during the comment period. Government Code section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action, if any person makes such a request. If a request is received, the three-member Board will hold a hearing.

The regulations and amendments may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the

date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing, who is in need of a language interpreter, including sign language should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen_berwick@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.