Explanation of Discussion Draft for Proposed Amendments to
Regulations §§ 23038(b)-1, 23038(b)-2, 23038(b)-3, 23038(b)-4, and 23038(b)-5
(13 Jun 16)

On January 1, 1997, the Internal Revenue Service issued regulations designated 26 C.F.R. §§ 301.7701-1 through 301.7701-3, commonly called the "check-the-box" regulations. These regulations provided rules for the classification of business entities for federal tax purposes.

In 1997, California Revenue and Taxation Code section 23038, subdivision (b)(2)(B), was amended to state in part as follows: ". . . , the classification of a business entity . . . shall be determined under regulations of the Franchise Tax Board, which shall be consistent with federal regulations as in effect *January 1, 1997*, that classify a business entity as a partnership or an association taxable as a corporation or disregard the separate existence of certain business entities for tax purposes." (Emphasis added.)

The Franchise Tax Board (FTB) adopted regulations implementing the legislation which were designated California Code of Regulations, title 18, sections 23038(b)-1 through 23038(b)-3.

On September 15, 2014, the Governor approved Assembly Bill No. 1143 which stated in part that the regulations issued by the FTB related to the classification of a business entity shall be consistent with federal regulations as in effect May 1, 2014.

California Revenue & Taxation Code, Section 23038, subdivision (b)(2)(B), currently states in part as follows: "For purposes of the preceding subparagraph, the classification of a business entity . . . shall be determined under regulations of the Franchise Tax Board, that shall be consistent with federal regulations as in effect *May 1, 2014*, that classify a business entity as a partnership or an association taxable as a corporation or disregard the separate existence of certain business entities for tax purposes." (Emphasis added.)

In order to make California's regulations consistent with the federal check-the-box regulations, the FTB is proposing amendments to the California regulations.

On January 11, 2016, the FTB held an Interested Parties Meeting (IPM) to elicit public input regarding possible amendments to the regulations at California Code of Regulations, Title 18, sections 23038(b)-1, 23038(b)-2 and 23038(b)-3. During and after the first IPM, the FTB received suggestions and comments regarding the proposed amendments.

A second IPM is scheduled for August 3, 2016. This Explanation of Discussion Draft provides the FTB's comments with regard to the proposed amendments and the comments received at the first meeting.

A discussion draft of the proposed amendments is provided with this Explanation. The draft attempts to take into account the comments and concerns of various interested parties raised during and subsequent to the IPM held in January 2016. Not all of the parties' recommendations were adopted.

Comments Regarding Section 23038(b)-1:

A commenter suggested that the phrase "or income" should be deleted from subsection (f) in section 23038(b)-1. After consideration of the issue and further review of the materials, staff determined that the phrase should not be deleted because no changes were made to the Federal regulations which would require the deletion and the phrase "income years" has continuing viability for the measurement period prior to 2000.

Comments Regarding Section 23038(b)-2:

A commenter suggested that the language "For purposes of the tax imposed under [Chapter 2 and] Chapter 3 of the Revenue and Taxation Code (commencing with Revenue and Taxation Code section 23501), the term corporation includes—" should be deleted from subsection (b) in section 23038(b)-2, and replaced with the phrase "For California income and franchise tax purposes, the term corporation means –". After further consideration of the issue, staff determined that the first sentence in subsection (b) should not be amended. The proposed addition of the phrase "Chapter 2 and" will not be added because no changes were made to the Federal regulations which would require the proposed additions and, under the check-the-box regulations the definition of "corporation" only applies for corporate income tax purposes.

In regard to the proposed addition of the phrase "An insurance company," in subsection (b)(4) of section 23038(b)-2, a commenter noted that some insurance companies are subject to the premium tax, not the income and franchise tax. After consideration of the issue and further review of the materials, staff determined that subsection (b)(4) should not be amended because no changes were made to the Federal regulations which would require the proposed additions. The phrase "An insurance company" will not be included.

A commenter suggested that Example 1 under subsection (c) of section 23038(b)-2, should be revised by replacing the word "consolidated" with the word "combined" and by replacing the phrase "Internal Revenue Service (IRS)" with the phrase "Franchise Tax Board (FTB)." After consideration, staff determined that the word "consolidated" should be replaced with the phrase "combined reporting." Staff determined the rest of the suggestion should be accepted.

A commenter suggested that the word "or" should be deleted from subparagraph 2 of subsection (d)(3)(A) in section 23038(b)-2, and added at the end of subparagraph 3. After consideration of the issue, staff determined that this change should be made.

During the course of review, staff determined that the sentence "For rules that apply before September 14, 2009, see 26 CFR part 301, revised as of April 1, 2009" at subsection (e)(2) in section 23038(b)-2 should not be included in the California regulation because California does not have an equivalent to 26 C.F.R. part 301.

Comments Regarding Section 23038(b)-3:

A commenter suggested that the word "original" should be inserted before the phrase "effective date" throughout subsections (b)(3)(A), (b)(3)(B), (b)(4)(A), and (b)(4)(A)1 of section 23038(b)-3, in order to ensure that the provisions addressing "existing eligible entities" is only applicable to those eligible entities that were in existence when the regulation was first effective, and not any subsequently formed eligible entities. After consideration of the issue, staff determined that the phrase "the effective date of this regulation" should be replaced with "January 9, 1998" throughout subsections (b)(3)(A), (b)(3)(B), (b)(4)(A), and (b)(4)(A)1 of section 23038(b)-3.

A commenter suggested that the phrase "(including any changes in the classification)" should be added to subsection (c) of section 23038(b)-3 in order to clarify that original classification elections and subsequent federal elections will be the same for California. After consideration of the issue, staff determined that the regulation is clear and, therefore, the additional language does not need to be added.

Comments Regarding Section 23038(b)-4:

A commenter suggested that the new regulation designated 23038(b)-4 should be designated 23038(b)-5 in order to make it match the equivalent federal regulation which is 301.7701-5. After consideration of the issue, FTB staff determined that 23038(b)-4 should be reserved and the proposed new regulation should be designated 23038(b)-5 as suggested.

A commenter suggested that the definition of "foreign corporation" in 23038(b)-4 (now designated 23028-5) may conflict with other provisions of the tax code because California uses a different definition of "foreign corporation" (a corporation outside of California) than the definition stated in 23038(b)-4 (a corporation outside of the United States). After consideration of the issue, FTB staff determined that the phrase "For purposes of Regs. §§ 23038(b)-1, 23038(b)-2, and 23038(b)-3," should be added to 23038(b)-4(a) (now designated 23028-5(a)) in order to clarify that the definition is limited to the check-the-box regulations.