

TITLE 18. FRANCHISE TAX BOARD
PROPOSED AMENDMENTS REGULATION SECTIONS 23038(a),
23038(b)-1, 23038(b)-2, AND 23038(b)-3

Proposed amendments to Regulation Section 23038(a), repeal of Regulation Section 23038(b), and adoption of Regulation Sections 23038(b)-1, 23038(b)-2, and 23038(b)-3 in Title 18 of the California Code of Regulations were noticed in the California Regulatory Notice Register on August 1, 1997, in anticipation of the enactment of legislation (Senate Bill 1234, 1997 Regular Session) directing the Franchise Tax Board to issue regulations substantially similar to federal regulations regarding the classification of business entities for tax purposes.

In general, under Section 23038 of the Revenue and Taxation Code and these regulations, effective January 1, 1997, an eligible business entity may be classified as a partnership or an association taxable as a corporation or disregarded for tax purposes by election. An eligible business entity with more than one owner is classified as a partnership unless the entity makes an election to be classified as an association taxable as a corporation. The separate existence of an eligible business entity with a single owner is disregarded for tax purposes unless the entity elects to be classified as an association taxable as a corporation.

The adoption of the federal regulations did not alter the classification of an eligible business entity in existence prior to the effective date of the federal regulations. Unless an eligible business entity elects otherwise, an eligible business entity in existence prior to January 1, 1997, will have the same classification that the entity claimed under regulations in effect prior to January 1, 1997. However, an eligible business entity with a single owner that claimed to be a partnership under federal regulations in effect prior to January 1, 1997, is disregarded for federal tax purposes.

Under Section 23038 of the Revenue and Taxation Code and regulations in effect for periods prior to January 1, 1997, a Massachusetts or business trust was classified as a corporation for purposes of the corporate income tax imposed by Chapter 3 (commencing with Section 23501) of Part 11 of

Division 2 of the Revenue and Taxation Code. In addition, under California regulations in effect prior to January 1, 1997, a single owner organization engaged in business for profit was either a sole proprietorship or a "so-called one man corporation". However, under federal regulations in effect prior to January 1, 1997, a Massachusetts or business trust could be classified as a partnership or as an association taxable as a corporation.

Under Section 23038 of the Revenue and Taxation Code and these regulations, an eligible business entity shall be classified or disregarded for California tax purposes the same as the entity is classified or disregarded for federal tax purposes. However, if an eligible business entity in existence prior to the effective date of this regulation was properly classified for California tax purposes as an association taxable as a corporation under Section 23038 of the Revenue and Taxation Code and the regulations thereunder, as in effect prior to January 1, 1997, and, under federal regulations effective January 1, 1997, was properly classified for federal tax purposes without election as a partnership or disregarded for federal tax purposes, the eligible business entity shall continue to be classified, for California income and franchise tax purposes, as an association taxable as a corporation, notwithstanding the classification as a partnership or the disregard of the entity for federal tax purposes, unless the entity makes an election to be classified or disregarded the same as the entity is classified or disregarded for federal tax purposes.

Proposed Regulation Section 23038(b)-3, as noticed on August 1, 1997, permits these eligible entities in existence before January 1, 1997, to make an irrevocable election to be classified the same as the entity is classified or disregarded for federal tax purposes. The effective date specified in the election can be no more than 75 days prior to the date on which the election is filed; however, an election filed within 90 days following "the date of enactment of SB 1234 (1997 Regular session)" may specify an effective date of January 1, 1997.

A hearing was held on September 16, 1997, to consider these revisions. SB 1234 (1997 Regular Session) was enacted on October 3, 1997 (Ch. 608, Stat. 1997).

After further review the following changes are being made to the proposed regulations as published in the California Regulatory Notice Register on August 1, 1997.

Add language to clarify that, pursuant to Section 23038 of Revenue and Taxation Code, as amended by Ch. 608, Stat. 1997, and these regulations, an eligible business entity is classified or disregarded under these regulations only for purposes of California income and franchise tax under the Revenue and Taxation Code.

Add language to clarify that, pursuant to Section 23038 and other provisions of the Revenue and Taxation Code, as amended by Ch. 608, Stat. 1997, and these regulations, a single owner organization that is disregarded for federal tax purposes and for California income and franchise tax purposes will be recognized for purposes of the return filing requirements of a limited liability company under Section 18633.5 of the Revenue and Taxation Code and the credit limitations of a disregarded entity under Sections 17039 and 23036 of the Revenue and Taxation Code.

Revise the date by which certain eligible business entities may elect to be classified or disregarded the same as the entity is classified or disregarded for federal purposes with an effective date of January 1, 1997. Under the proposed regulations noticed on August 1, 1997, the election of an existing eligible entity to be classified or disregarded for California income and franchise tax purposes the same as the entity is classified or disregarded for federal tax purposes with an effective date of January 1, 1997, must be filed within 90 days following the date of enactment of SB 1234 (1997 Regular Session). The proposed regulations are revised to reflect that this election must be filed with the Franchise Tax Board within 90 days following the date this regulation is filed with the Secretary of State.

Delete awkward and redundant language related to the description of an ordinary trust and restore and update inadvertently deleted language regarding the effective date of proposed Regulation 23038(a).

Correct nonsubstantive errors in style, spelling, and formatting. In this regard, incorrectly labeled subdivision (f) of Regulation Section 23038(b)-2 is redesignated subdivision (e).

The proposed changes are shown in double underscoring of the new text and bold strikeout of the original text as published on August 1, 1997. These nonsubstantive and sufficiently related changes are being made available to the public for the 15-day period required by Government Code Section 11346.8 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 November 25, 1997.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes as well as those individuals who attended the hearing and those who commented orally or in writing and will be available to all other persons upon request from the agency officer named below. In addition, a copy of the proposed amendments will be available via the internet at <http://www.ftb.ca.gov>.

All inquiries and written comments concerning this notice should be directed to Beverly Moore (916) 845-3354, FAX (916) 845-3648 or by mail to Legal Branch, Attn: Beverly Moore, P.O. Box 1720, Rancho Cordova, CA 95741-1720