

FINAL STATEMENT OF REASONS FOR  
THE AMENDMENT OF 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

The proposed regulation does not impose any mandate on local agencies or school districts.

UPDATE OF INITIAL STATEMENT OF REASONS

The public notice required by Section 11346.4 of the Government Code was mailed on July 31, 1997 and published in the *California Regulatory Notice Register* on August 1, 1997.

The first hearing was held, as scheduled, September 16, 1997. Six members of the public attended and one person gave oral testimony. One written comment was received.

After further review of the regulations, changes were made to Regulations Sections 23038(a), 23038(b)-1, 23038(b)-2 and 23038(b)-3 that were nonsubstantial and sufficiently related to the text as published on August 1, 1997. These changes were mailed to the public on November 10, 1997 and the close of the comment period was November 25, 1997 as required by Section 44, Title 1, of the California Code of Regulations. No comments were received during this comment period.

SUMMARY AND RESPONSE TO COMMENTS RECEIVED DURING THE ORIGINAL NOTICE PERIOD OF AUGUST 1, 1997 THROUGH SEPTEMBER 16, 1997.

COMMENT NO. 1: The comment criticized the Franchise Tax Board for failing to issue proposed regulations when the Internal Revenue Service issued proposed regulations and recommended that the Franchise Tax Board should immediately adopt federal regulations dealing with laws that have comparable provisions under California law. (Comment 1, Paul Gordon Hoffman, August 4, 1997).

RESPONSE: Reject. Under current California law (RTC §§17024.5(d) and 23051.5(d)), regulations issued by the Treasury Department under provisions of the Internal Revenue Code applicable for California tax purposes are applicable as regulations issued under the Revenue and Taxation Code, unless they conflict with or are inconsistent with a provision of the Revenue and Taxation Code or a regulation issued by the Franchise Tax Board. California law regarding the classification of business entities was not the same as federal law. Consequently, federal regulations issued in December 1996 were not applicable for California tax purposes. The

enactment of Chapter 608, Statutes of 1997 (SB 1234) provided the authority to issue regulations substantially similar to federal regulations.

COMMENT NO. 2: The comment recommended that the effective date of the proposed regulations should be retroactive to the effective date of the federal regulations (December, 1996), unless a taxpayer affirmatively made an election under the federal regulations, in which case the taxpayer should have the right to elect whether to have the California regulations apply retroactively. (Comment 2, Paul Gordon Hoffman, August 4, 1997).

RESPONSE: Accept and reject. Pursuant to the Ch. 608, Stat. 1997 (SB 1234), the regulations are retroactive to the effective date of the federal regulations; however, the effective date of the federal regulations is January 1, 1997. Pursuant to subparagraphs (ii) and (iii) of Section 23038(b)(2)(B), as added by Ch. 608, Stat. 1997, the classification of an eligible business entity for California tax purposes shall be the same as the classification of the entity for federal tax purposes.

COMMENT NO. 3: The regulations (§23038(b)-2(b)(8)) contain a list of certain foreign entities that are always classified as a corporation (per se corporations) and, consequently, not eligible to elect a different classification for California tax purposes. This list is identical to the list contained in the Treasury regulations (Treas. Regs. §301.7701-2(b)(8)) that identifies certain foreign entities that are always classified as a corporation for federal tax purposes. The comment questioned the drafting choice of duplicating the listing of entities, as reflected in the federal regulations, that are always classified as corporations rather than referring to the list contained in the federal regulations. (Tax Section, State Bar of California, Mr. Phil Jelsma, Transcript of Oral Hearing, September 16, 1997, page 9.)

RESPONSE: Reject. While it's true that most taxpayers are expected to have very little difficulty obtaining a copy of the federal regulations promulgated in December 1996, it may be difficult for some taxpayers. More important, if the federal regulations are modified, a copy of the federal regulations as promulgated in December 1996 may not be readily available. Duplication of the list of per se corporations avoids these problems.

COMMENT NO. 4: The regulations, like the federal regulations promulgated in December, establish different default classification rules for a domestic entity and a foreign entity. These regulations, also like the federal regulations, provide that for purposes of these regulations, an entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any State; an entity is a foreign entity if it is not a domestic entity.

The Taxpayer Relief Act of 1997 (Section 1151(a), Taxpayer Relief Act of 1997 [P.L. 105-34]) amended section 7701(a)(4) of the Internal Revenue Code, related to the

definition of a domestic partnership, to provide that the existing definition of a domestic partnership (a partnership created or organized in the United States or under the laws of the United States or a State) won't apply if Treasury regulations provide otherwise. The comment questioned the extent to which the regulations should accommodate this new federal authority. (Tax Section, State Bar of California, Mr. Phil Jelsma, Transcript of Oral Hearing, September 16, 1997, pages 9 and 10.)

RESPONSE: Reject. While the definition of "partnership" as contained in section 7701(a)(2) of the Internal Revenue Code is comparable to the definition of "partnership" as contained in Section 17008 of the Revenue and Taxation Code, the definition of "domestic" as contained in Section 7701(a)(4) of the Internal Revenue Code, as modified by the Taxpayer Relief Act of 1997, is not applicable for California tax purposes.

#### ALTERNATIVES DETERMINED

Franchise Tax Board has determined that no alternative would be more effective in carrying out the purpose for which the regulation is proposed or would be as effective and less burdensome to affected private persons than the proposed regulation.