

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 10:30 a.m., on September 16, 1997, at 9645 Butterfield Way, Sacramento, California, to consider the amendment of Section 23038(a), the repeal of Section 23038(b), and the adoption of Regulations 23038(b)-1, 23038(b)-2, and 23038(b)-3 in Title 18 of the California Code of Regulations pertaining to the classification of business entities for tax purposes. The hearing will be conducted by an employee of the Franchise Tax Board and a report will be made to the Franchise Tax Board. 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., September 16, 1997. 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 & 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. The proposed regulatory action interprets, implements, and makes specific Section 23038 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW:

Regulation 23038(a) is amended by revising the terms to reflect that banks are corporations, by deleting redundant provisions related to the classification of a business trust as a business entity, and by adding provisions that parallel Treas. Reg. 301.7701-4 regarding the classification of trusts. Although California law is comparable to federal law related to the

definition of a trust, federal regulations regarding the classification of trusts are not applicable for California tax purposes unless these amendments are adopted.

Regulation 23038(b) is repealed in its entirety and replaced with Regulation 23038(b)-1 to 23038(b)-3. These regulations are modeled after Treas. Reg. Sec. 301.7701-1 to 301.7701-3. Under the federal regulations, whether or not an organization is an entity for federal tax purposes is a matter of federal tax law. A business entity is an entity that is or may be recognized for federal tax purposes that is not classified as a trust. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. If a business entity is disregarded, its activities are treated like a sole proprietorship, branch, or division of the owner.

Under the federal regulations, a business entity organized under a federal or State law that describes or refers to the entity as a corporation is always a corporation. In addition, specifically identified entities created under the laws of various foreign countries are always classified as a corporation.

Other business entities, defined as eligible business entities, may elect their classification for federal tax purposes. Eligible business entities with more than one member may be classified as a partnership or as a corporation. An eligible business entity with one owner may be classified as a corporation or may be disregarded.

In the absence of an election to be classified as a corporation, an eligible business entity created after January 1, 1997, with more than one member will be classified as a partnership and an eligible business entity with a single owner will be disregarded. Unless the entity elects otherwise, an eligible business entity existing before January 1, 1997, will have the same classification that the entity claimed under federal regulations in effect prior to January 1, 1997; however, an eligible business entity classified as an association taxable as a corporation under California law in effect prior to January 1, 1997, will continue to be classified as an association taxable as a corporation unless the entity elects irrevocably to be classified the same as it is classified for federal purposes. If an

eligible entity elects to change its classification, the entity may not change its classification for a sixty-month period.

Under proposed Regulations 23038(b)-1 to 23038(b)-3, the rules for the classification of business entities under federal regulations Treas. Reg. Secs. 301.7701-1 to 301.7701-3 are made applicable for California tax purposes except that the classification of an eligible business entity for federal tax purposes shall be applicable for California tax purposes. No separate election is allowed. In addition, if an eligible business entity is disregarded for federal tax purposes it will be disregarded taxes imposed under the Bank and Corporation Tax Law and the Personal Income Tax Law other than the requirement for a limited liability company to pay a tax and a fee, to file a return, and certain limitation on tax credits..

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: Recently adopted federal regulations permit eligible business entities, including small business entities, to elect to have the business entity classified as a corporation or as a partnership for federal tax purposes or to have the separate existence of the entity disregarded for federal tax purposes. This regulation makes the federal classification applicable for purposes of the Bank and Corporation Tax Law. Consequently, tax administration for small business will be simplified.

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. In addition, the proposed regulatory action pertains directly to business entities 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 regulation in plain English due to the technical nature of the regulation. However, a noncontrolling plain English summary of the text of the proposed regulation, 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 proposed regulatory action may be adopted after consideration of any comments received during the comment period.

The amendment may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation 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 Beverly Moore at (916) 845-3354 or by mail to the Legal Division, Attn: Beverly Moore, P.O. Box 1720, Rancho Cordova, CA 95741-1720.