

AMENDED REVISED STATEMENT OF REASONS FOR THE
AMENDMENT OF REGULATION
SECTIONS 25106.5-0, 25106.5 AND 25106.5-2,
TITLE 18, CALIFORNIA CODE OF REGULATIONS

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

Section 25106.5 of the Revenue and Taxation Code was enacted in 1987 to provide specific authority to promulgate regulations dealing with combined reporting. Before the enactment of that section, combined reporting procedures were generally reflected in FTB Publication 1061 (Guidelines for Corporations Filing a Combined Report) and case law. Regulations were adopted under Section 25106.5 of the Code on June 13, 1999, but a number of provisions in those regulations were reserved for later amendment.

SPECIFIC PURPOSE OF THE REGULATIONS

The proposed amendments would provide detailed rules relating to the steps of combined reporting. In general, the proposed amendments to Section 25106.5 of the California Code of Regulations provide rules for aggregation of business income of a combined reporting group, collection of apportionment factor data, apportionment of business income to the taxpayer members of the group, and application of the taxpayer member's nonbusiness income and other California source income. The proposed amendment to Regulation Section 25106.5-2 would prescribe rules for the treatment of capital loss carryforwards.

NECESSITY

Proposed Amendments to 18 California Code of Regulations Section 25106.5. Under Section 25101 of the Revenue and Taxation Code, California law imposes tax on a corporation only with respect to its income from sources within the state. If a taxpayer does business within and outside of the state, its income from sources within the state is generally determined by apportionment of business income (defined in Section 25120(a) of the Revenue and Taxation Code) and allocation of nonbusiness income (described in Section 25123-25137 of the Revenue and Taxation Code). Corporations which are members of a unitary group (i.e., conduct a single business enterprise through one or more corporations) generally must apportion the combined business income of all of the members of the unitary group in order to determine the California source income of those members which are taxable in California (*Edison California Stores v. McColgan* (1947) 30 Cal.2d 472). The data necessary to do that apportionment is collected in what is known as a combined report. There are a number of steps involved in identifying business income and apportioning that income to the respective taxpayer members of the unitary group.

Over the years, combined reporting procedures have been developed by informal practices, generally accepted by the corporate taxpayer community, reflected in various versions of FTB

Publication 1061, Guidelines for Corporations Filing a Combined Report. Many of the principles of combined reporting reflected in that publication are illustrated by example, but are not particularized by rule, even informally.

Existing 18 California Code of Regulations¹ Section 25106.5 provides definitions that are needed to describe the elements of the combined reporting procedure. Other regulations promulgated under Section 25106.5, Revenue and Taxation Code, including 18 CCR Sections 25106.5-2, 25106.5-3, 25106.5-4, 25106.5-9, and 25106.5-10 provide rules for combined reporting in certain specific situations. The proposed amendments to 18 CCR Section 25106.5 would place the informal practices in FTB Publication 1061 into regulatory form and integrate the special rules described above into a single regulatory structure that details the mechanics of combined reporting.

The proposed amendments sequence and describe 1) the accounting rules which apply to the determination of the separate income of the members of a combined reporting group, 2) the process of separating combined report business and nonbusiness income, 3) the assignment of combined report business income to the common accounting period of the principal member (as defined), if applicable, 4) the aggregation of combined report business income of the members of the group, 5) the determination of the apportionment percentage of each taxpayer member of the group, including detailed rules relating to the composition and weighting of the payroll, property and sales factors which are component parts of that percentage, 6) the application of the apportionment percentage to combined report business income, 7) the reassignment of each taxpayer member's apportioned share of business income to the appropriate income year of that member, if applicable, and 8) for each taxpayer member of the group, the aggregation of that member's apportioned share of combined report business income with its other California source business income, or California source nonbusiness income, if applicable, to arrive at that member's California source income which is subject to taxation.

With respect to the above steps of apportionment of combined income, the regulations are needed for the reason stated below:

- 1) In the past, there has been some argument that a unitary combined reporting group must compute its income as if the unitary group were a single legal entity. This would mean that accounting methods and elections would be done for the group as a whole. If that were applied as a rule however, that approach would create serious administrative problems, because the process of reconciling accounting methods to a common method, would require substantial taxpayer resources to prepare and substantial resources for the department to audit because taxpayers' normal book and tax records are not kept that manner. Creating a common method of accounting would not have significant revenue impact to the state, except for timing of income. For that reason, it is considered far more efficient to allow taxpayers to compute income and retain accounting methods and elections on an entity, rather than group, basis. The rules that allow each member to adopt their own accounting methods and elections, is currently contained in 18 CCR Section

¹ Hereafter "18 CCR."

25106.5-3. Proposed subsection (c)(1) and (2) shows the sequencing of determination of the separate net income of the members of the combined reporting group and of 18 CCR Section 25106.5-3 (accounting methods and elections used in determining that income) in the combined reporting process. The amount of net income that is subject to apportionment and/or allocation must be determined first before the process of apportionment and allocation can commence, because the universe of income that is potentially subject to the respective apportionment and allocation rules must be identified. [Reference: Publication 1061, Guidelines for Corporations Filing a Combined Report (hereafter Publ. 1061): “The Use of a Combined Report” (pp. 4-5).] Proposed subsection (c)(1)(B) reflects the sequencing of adjustments of separate net income to remove capital gains and losses from such income, so that the special rules of 18 CCR Section 25106.5-2 can be given effect. [Reference: Publ. 1061: “Capital Loss Limitation” (pp. 7-8).] Proposed subsection (c)(1)(C), is added to clarify that special net operating loss rules apply elsewhere in the regulation sequencing (proposed subsection (e)), and should not be included in separate net income.

- 2) As noted, California law provides that business income is subject to apportionment (Section 25128, Revenue and Taxation Code) and nonbusiness income is subject to allocation (Sections 25123-25127, Revenue and Taxation Code). In a combined reporting setting, it is common for one or members to have both business and nonbusiness income. In general, nonbusiness income is specifically allocable to the member which earns it (see, *Appeal of VSI, Inc.*, (cite) Cal. St. Bd. of Equal), whereas business income of the entire unitary group is subject to apportionment using the apportionment factors of the entire group (see 18 CCR Section 25101). Proposed subsection (c)(3) shows the necessary removal of business income from the member’s respective separate net income (before apportionment) and is needed to show when in the sequencing of determining income subject to apportionment the separation of income between business and nonbusiness components occurs. [Reference: Publ. 1061: “The Unitary Method” (pp. 3-4); “Example of Combined Report Computations and Schedules” (p. 9; Schedules 1-A and 1-B, pp. 10-11).]
- 3) If taxpayers in a combined reporting group have different accounting periods, their combined report business income is earned in their respective different accounting time periods. Yet, the business income of the respective members must be apportioned using a common apportionment percentage, reflecting the apportionment factors of each of the members. Combined report business income must be aligned to a common accounting period, as there is no mathematical way, without fiscalization, that income can be combined with regard to the combined income and apportionment factors of the other members. Existing 18 CCR Section 25106.5-4 contain rules to align income and apportionment factors to a common accounting period, which is determined by reference to a common entity in the group, called the “principal member.” Proposed subsection (c)(5) is needed to show the sequencing of the process of “fiscalization” of income to the accounting period in the rest of the steps of combined reporting. For example, fiscalization generally is appropriate only with respect to business income, and not nonbusiness income, as nonbusiness income is specific to each respective member (see

paragraph above). [Reference: Publ. 1061: “Corporations with Different Accounting Periods” (p. 5); “Example of Combined Report Computations and Schedules” (p. 9; Schedule 2, p. 12).]

- 4) Once the process of “fiscalization” is complete (if required), business income of each of the members of the combined reporting group is then added together, and resulting value is then subject to apportionment. Proposed subsection (c)(6), is needed to show the sequencing when process of aggregation of “fiscalized” income occurs. Aggregation of business income cannot occur at any other step in the process, because of the need to place income on a common accounting period before the aggregation occurs. [Reference: Publ. 1061: “Example of Combined Report Computations and Schedules,” (p. 9; Schedule 1-B, p. 11).]
- 5) Once business income of the combined reporting group is aggregated, it must then be apportioned. Proposed subsection (c)(7) provides the detail with respect to the process of determining and gathering apportionment data of all of the members of the combined reporting group and the process of apportioning combined report business income to the respective taxpayer members. There has been a controversy in the past regarding the proper method of apportioning income for combined reporting groups in situations where one of the members is taxable in a state and another member, otherwise exempt from taxation there, sells tangible personal property into that state. *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal., Nov. 23, 1966, held that merely because one member of the group was taxable in the destination state did not mean that sales of an otherwise exempt member should be assigned and subject to tax to that state. *Appeal of Finnigan Corp* , Cal. St. Bd. of Equal., 88-SBE-002, Aug. 25, 1988, opin. on pet. for reh. 99-SBE-002A, Jan. 24, 1990, overruled *Appeal of Joyce, Inc.*, *supra*, and held that if one member of a combined reporting group is taxable in a state sales of an exempt member should nevertheless be assigned to the destination state, and income apportioned to the destination should be assigned to the member or members that are taxable there. *Appeal of Huffy, Inc.*, Cal. St. Bd. of Equal., 99-SBE-005, April 22, 1999, prospectively overruled *Appeal of Finnigan, supra*, (effective for years beginning on or after April 22, 1999). This subsection adopts the method prescribed in *Appeal of Huffy, Inc., supra*, with the same effective date. (For further information see *Appeal of Huffy, Inc., supra*, at Tab 1D of this regulation file). [Reference: Publ. 1061: “The Use of a Combined Report” (p. 4); “Example of Combined Report Computations and Schedules” (p. 9, Schedule 1-B; p. 12; Schedule 2; p. 14; Schedule 4-C, p. 16; Schedule 4-D, p. 17), which reflect the former *Finnigan* rule.] In the process of apportionment, each taxpayer member has its own California apportionment percentage, which is applied against the business income of the combined reporting group to arrive at that member’s California source combined report business income. That member’s apportionment percentage (see proposed subsection (c)(7)(D)), as applied, is also referred to in proposed subdivision (b)(9), as an added definition (formerly reserved), to complete the operative definitions of the regulation.
- 6) Once income is apportioned to each taxpayer member, fiscalizing taxpayers must realign their income to the accounting period of the taxpayer member in order to impose tax on

California source income, part of which includes that member's share of combined report business income. Existing 18 CCR Section 25106.5-4 provides the mechanism for that realignment process. Proposed subsection (c)(8) shows the sequencing where the process of that realignment occurs. Income cannot be realigned to the taxpayer's income year until apportionment has occurred. [Reference: Publ. 1061: "Corporations with Different Accounting Periods" (p. 5); "Example of Combined Report Computations and Schedules" (p. 9; Schedule 4-E, page 18).]

- 7) A California taxpayer is taxed on all of its California source income, including its share of combined report business income, its nonbusiness income, and any other income with a California source (e.g., income from a separate trade or business, see 18 CCR Section 25101 and 18 CCR Section 25120(b)). Proposed subsection (c)(d) shows the sequence of accumulating other items of California source income to arrive at total California source income subject to tax. [Reference: Publ. 1061: "The Unitary Method—Tests for Determining Unity" (p. 3-4); "Example of Combined Report Computations and Schedules" (p. 9; Schedule 4-E, p. 18).] This regulation provides more needed specificity regarding the process of aggregation of various items of income from California sources than that currently provided in 18 CCR Section 25101. Section 25108 of the Revenue and Taxation Code provides that net operating loss of an apportioning taxpayer is the sum (or net) of loss from the process of apportionment of business income or loss and allocation of nonbusiness income or loss. However, Section 25108 of the Revenue and Taxation Code does not provide detail regarding the application of the net operating loss in a combined reporting environment when many members may participate in the generation of a combined report business loss. Proposed subsection (d)(3) and (e) also provide needed specificity in the operation of the California net operating loss (both with respect to its creation, and with respect to its application as a deduction in a subsequent year) in that environment. The rules provided in those proposed subsections are the substantially same as reflected in Publ. 1061, "Net Operating Losses (NOLs)" (p. 7); see also, the deduction of a net operating loss in "Example of Combined Report Computations and Schedules" (p. 9; Schedule 4-E, page 18).]

These rules would apply to virtually every corporation that does business within and outside California, if it conducts its business in conjunction with one or more additional corporations. While the informal practices reflecting in FTB Publication 1061 are generally accepted by the taxpayer community, the Franchise Tax Board is obliged to reduce those practices to regulation.

Proposed Amendments to 18 California Code of Regulations Section 25106.5-2. The provisions of existing 18 California Code of Regulations Section 25106.5-2 describe, in detail, the process of collecting, apportioning, and allocating items described as capital gains or losses, Section 1231 (Internal Revenue Code) gains or losses, and involuntary conversion gains or losses. There are specific federal rules, adopted for California purposes, which deal with these items. The existing regulation explains how those rules are applied in a combined reporting context. Federal law (Section 1212, Internal Revenue Code), adopted with modifications for California purposes, provides that capital losses may not be deducted in the year incurred. Instead, those rules (as

modified) provide for a carryover deduction of capital losses, to be applied against capital gain in subsequent years. The existing regulation does not describe how a capital loss carryover applies in a combined reporting context (that portion of the existing regulation has been reserved). It is fairly common for corporations that are members of a combined reporting group to have a capital loss in any given year. This regulation provides needed guidance to show how those capital losses, which are apportioned to California under the existing regulation, are to be applied as a deduction in succeeding income years. Under the proposed amendment, California source capital losses incurred in one year are treated as a California source short-term capital gain in the succeeding income years.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS.

The Franchise Tax Board examined and considered the regulatory history of 18 Cal. Code of Reg. Section 25106.5 and 25106.5-2, including notices, statements of reasons, public hearing documents, written comments and responses thereto, records of the proceedings of the Franchise Tax Board, Publication 1061 (Guidelines for Corporations Filing a Combined Report), and the decision of the Board of Equalization in Appeal of Huff, Inc., decided April 22, 1999. Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation. These items are included in the rulemaking file for this proposed regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS.

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that proposed amendments to Section 25106.5 and Section 25106.5-2 of the California Code of Regulations will not have a significant overall economic impact on business. Some taxpayers will be adversely affected by the application of the apportionment rules of the proposed regulations, because they represent a significant departure from existing practices. However, other taxpayers are favorably affected those same rules when compared to existing practices. For the most part, the remainder of the proposed amendments reflect existing practices.

Some taxpayers may be adversely affected by the capital loss carryover rules of proposed Subsection 25106.5-2(g), while others may be benefited by them.