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 10:00 a.m., on November 19, 1999, Room 1040, at 9645 Butterfield Way, Sacramento, California, to consider amendments to Title 18 of the California Code of Regulations, adopted under Section 25106.5 of the California Revenue and Taxation Code, pertaining to the mechanics of combined reporting. Regulation amendments to be considered at this hearing are as follows:

25106.5-0 (amended table of contents)

25106.5 (pertaining to general rules for combined reporting)

25106.5-2 (pertaining to capital, Section 1231 (Internal Revenue Code), and involuntary conversion gains and losses in a combined report)

All proposed regulations would be in Title 18 of the California Code of Regulations.

An employee of the Franchise Tax Board will conduct the hearing. Thereafter, a report will be made to the three-member Franchise Tax Board for its consideration. Government Code Section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request. If a request is received, a hearing will be held by the three-member 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., November 19, 1999. 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. In addition, Section 25106.5 of the Revenue and Taxation Code provides specific authority to adopt regulations relating to combined reporting. The proposed regulatory action interprets, implements, and makes specific Section 25106.5 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW:

Section 25106.5 of the Revenue and Taxation Code authorizes the Franchise Tax Board to adopt regulations relating to corporations that are required to file a combined report. Corporations that are required to file a combined report are hereafter described as members of a combined reporting group. In general, a combined report refers to the schedules that must be attached to a corporation's tax return if that corporation is a member of a unitary group.

A unitary group is a group of corporations that is treated as conducting a single trade or business under Section 25101 of the Revenue and Taxation Code. If a unitary group conducts part of its business in California, it is required to apportion part of its combined business income to this state. The apportionment rules are provided in Sections 25120 through 25141 of the Revenue and Taxation Code, and related regulations.

Combined reporting schedules present the data necessary to apportion the unitary group's business income to California. Presently, some combined reporting procedures are reflected in 18 Cal. Code of Reg. Sections 25106.5, 25106.5-2, 25106.5-3, 25106.5-4, 25106.5-5, 25106.5-9, and 25105.5-10. The regulations proposed to be adopted would provide detailed guidance regarding the steps involved in combined reporting.

Proposed Section 25106.5-0. Table of Contents.

Proposed Section 25106.5-0 is the table of contents for all regulations that have been or are proposed to be adopted under Section 25106.5. The table of contents are proposed to be amended to reflect proposed amendments to Proposed Section 25106.5 and 25106.5-2.

Proposed Section 25106.5. General Rules of Combined Reporting.

Proposed amendments to Section 25106.5 of the California Code of Regulations would provide the general rules for combined reporting which will apply to all unitary groups. The proposed amendments to the regulation set forth a series of steps in the apportionment process. In general, these steps are:

1) The members of the group determine their separate net income under the California Revenue and Taxation Code. Unless provided differently in another regulation, the determination of separate net income of a member is to be made without regard to the fact that the member is in a combined reporting group.

2) The members determine the part of their separate net income that is business income of the combined reporting group (Section 25120(a) Revenue and Taxation Code). Business income is then combined.

3) A portion of interest expense, known as the interest offset (Section 24344(b), Revenue and Taxation Code), is removed. A portion of that interest expense is be applied to California nonbusiness interest and dividends, if applicable (see below).

4) The members gather their property, payroll, and sales factor data relating to the unitary business. That information is used to compute the California property, payroll, and sales factor for each taxpayer member of the combined reporting group. For example, the California sales factor for a taxpayer is the ratio of California sales of the taxpayer to the total sales of the group everywhere. If a member is exempt from taxation in this state, its California destination sales are not considered in the California numerator of any member.

5) A California apportionment percentage for each taxpayer member is then determined. Most taxpayers will have an apportionment percentage based on the sum of the taxpayer's California property factor, payroll factor, and double weighted sales factor, with that sum divided by four. However, for certain industry groups (extractive, agricultural, banks and financials), the taxpayers will have an apportionment percentage based on evenly weighted property, payroll and sales factors.

6) The combined income is multiplied by the taxpayer member's California apportionment percentage. The result is the taxpayer member's California source combined income.

7) Each taxpayer member then adds (or nets) any other California source income or loss to its California source combined income. The California interest offset, net operating loss, etc. is then applied. This results in that member's California source income that is subject to tax.

The proposed regulation adopts a method different than that required by the California State Board of Equalization in the Appeal of Finnigan Corporation, decided August 25, 1988, (Opinion on Rehearing decided January 24, 1990), and the Appeal of Nutrasweet Company, decided October 29, 1992. The proposed regulation, and in particular the fourth through sixth steps described above, adopts the method required by the California State Board of Equalization in the Appeal of Joyce, Inc., decided November 23, 1966, and Appeal of Huffy, Inc., decided April 22, 1999. Section 19503, Revenue and Taxation Code, authorizes the Franchise Tax Board "to prescribe the extent to which any regulation shall be applied without retroactive effect." The proposed regulation adopts a method that is different than the current administrative practice established by the Appeal of Finnigan Corporation, supra. and the Appeal of NutraSweet Company, supra. Therefore, it is proposed that the adoption of subsection (c)(6) of Regulation 25106.5 will apply prospectively only. However, if the Finnigan and NutraSweet cases are retroactively overruled, subsection (c)(6) may also be applied retroactively.

Proposed Section 25106.5-2. Capital, Section 1231 (IRC), and involuntary conversion gains and losses.

The Revenue and Taxation Code incorporates a number of Internal Revenue Code provisions, including some of the rules for gains and losses relating to capital assets, Section 1231 (Internal Revenue Code (IRC)) assets, and assets involved in an involuntary conversion. These rules are complex. There are specific rules under which income and losses in each category can be offset. If an overall capital loss results, federal and California laws do not allow recognition of the loss. For federal purposes, the loss must be carried back for three years or forward for five years. California does not conform to the federal carryback provisions. In addition, California does not provide preferential treatment for capital gains for corporations. Thus, for corporations, the California effect of these rules is limited to deferral of capital losses.

Section 25106.5-2 of the California Code of Regulations sets forth special rules for the treatment of capital, Section 1231(IRC), and involuntary conversion gains and losses in a combined report.

The steps for the treatment of such gains and losses are as follows:

1) All capital, Section 1231 (IRC) and involuntary conversion gains and losses are removed from business income.

2) Business gains and losses are netted within each category without netting across categories. For example, short-term business capital gains can be netted with short-term business losses. However, at this point, business long-term losses cannot be netted with business short term gains.

3) Each category of gain or loss is apportioned to the taxpayer members using the apportionment percentage for each of those members.

4) The taxpayer member then applies the federal netting rules to all of its California source capital, Section 1231 (IRC), and involuntary gains and losses (including its nonbusiness items in those classes).

If an overall loss results, the taxpayer has a California source short-term capital loss carryforward. The treatment of that carryforward was reserved in the original Regulation Section 25106.5-4 in subsection (g). As proposed to be amended, subsection (g) will provide that the resulting loss is carried forward by the taxpayer member and can be applied to that member's California source capital gains in later years.

COORDINATION WITH FEDERAL REGULATIONS

Except for the treatment of capital, Section 1231 (IRC), and involuntary conversion gains and losses, the regulations proposed under Section 25106.5 of the California Code of Regulations

deal with combined reporting which is specific California law that has no federal counterpart. Section 25106.5-2 of the California Code of Regulations, which deals with those kinds of gains and losses, preserves the federal classifications and methodology relating to this type of gain and loss. However, the regulation also provides particular rules to deal with the fact that California law requires additional classifications of income as business or nonbusiness for purposes of apportionment and allocation. Proposed amendments to that regulation will provide a specific rule for carryforward of capital losses.

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: The effect on small businesses will be minimal because the regulation applies only to multijurisdictional business. In addition, most of the provisions of the proposed regulations reflect existing practices.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES:

In accordance with Government Code Section 11346.5(a)(12), the Board has determined 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.

The proposed regulatory action pertains to corporate taxpayers 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 regulations in plain English due to the technical nature of the regulations. However, a noncontrolling plain English summary of the text of the proposed regulations, as well as the initial statement of reasons and all information upon which the proposed regulatory action is based, as well as 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 by the three-member Franchise Tax Board after consideration of any comments received during the comment period.

The regulations may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are 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 regulations 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 regulations 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 or sign language assistance, 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 Colleen Berwick at the Franchise Tax Board Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone: (916) 845-3306; Fax: (916) 845-3648; E-Mail: colleen_berwick@ftb.ca.gov. The regulation and initial statement of reasons are also available at the Franchise Tax Board's website at www.ftb.ca.gov.