

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 Revenue and Taxation 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 Regulation 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 25123-25127 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 Regulation 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 Regulation 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 Regulation 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.

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 affiliated corporations. While the informal practices reflected 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 Regulation Section 25106.5-2. The provisions of existing Regulation 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 California Code of Regulations Section 25106.5 and 25106.5-2, including notices, statements of reasons, public hearing documents, written comments and responses thereto (Reg. File No. 99-0528-01S), 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 Huffy, 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 or are incorporated by reference 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 the proposed amendments to Section 25106.5 and Section 25106.5-2 of Title 18 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 by 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.