

**STATEMENT OF REASONS FOR FORM 100 CHANGE TO TITLE 18
OF THE CALIFORNIA CODE OF REGULATIONS**

The recently-enacted Proposition 39 (approved by the voters on November 6, 2012, and specifically operative for taxable years beginning on or after January 1, 2013) made several changes to how an apportioning business must apportion its business income to this state. Under Proposition 39, the applicable apportionment formula depends on the taxable year at issue and on whether a given apportioning business is engaged in a qualifying business activity as defined in subdivision (b) of Section 25128, Revenue and Taxation Code.

Pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, a "qualifying business activity" means (1) an agricultural business activity, (2) an extractive business activity, (3) a savings and loan activity, and/or (4) a banking or financial business activity. An apportioning business engaged in a qualified business activity apportions its business income to this state by multiplying the business income by a three-factor apportionment formula, consisting of payroll, property, and sales factor. Proposition 39 does not change the apportionment methodology for such apportioning businesses.

Prior to Proposition 39 taking effect, for taxable years beginning before January 1, 2011, an apportioning business, other than one engaged in a qualifying business activity, had to apportion its income to this state by multiplying its business income by a four-factor apportionment formula, consisting of payroll, property, and double-weighted sales factor, pursuant to subdivision (a) of Section 25128, Revenue and Taxation Code (hereinafter referred to as "the four-factor formula"). In contrast, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, the four-factor formula no longer applies.

Also prior to Proposition 39 becoming operative, for taxable years beginning on or after January 1, 2011, an apportioning business not engaged in a qualifying business activity had an option of apportioning its business income to this state by multiplying its business income either by the four-factor formula or by a single sales factor apportionment formula if the taxpayer made an irrevocable annual election on its original return pursuant to Section 25128.5, Revenue and Taxation Code. In contrast, under Proposition 39, the single sales factor apportionment formula annual election is no longer available for taxable years beginning on or after January 1, 2013. As a consequence, taxpayers could make an election under Revenue and Taxation Code section 25128.5 only for taxable years beginning on or after January 1, 2011 and before January 1, 2013.

For taxable years beginning on or after January 1, 2013, Proposition 39, codified in relevant part in newly added Section 25128.7, Revenue and Taxation Code, mandates that all businesses, other than those engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code,

apportion their business income to this state using a single sales factor apportionment formula. Effectively, therefore, for taxable years beginning on or after January 1, 2013, only businesses engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, apportion their business income to this state pursuant to a three-factor formula consisting of property, payroll, sales factors, while all other apportioning businesses must apportion their business income pursuant to the single sales factor apportionment formula.

Because Title 18 of the California Code of Regulations contains a number of Franchise Tax Board regulations that reference the four-factor formula, such regulations must be updated to reflect the above changes in the law mandated by Proposition 39. The proposed changes, which are identified below, are all "changes without regulatory effect" that may properly be adopted under Section 100 of Title 1 of the California Code of Regulations.

The following list, with explanations, describes each of the proposed Form 100 changes to California Title 18 of the California Code of Regulations:

Section 17951-4, Income from a Business, Trade or Profession:

- Subsection (d)(5)(A) has been revised to provide notice that the property and payroll factors might not be relevant in determining California apportioned business income, depending upon whether the taxpayer is engaged in a qualifying business activity, with most taxpayers using the now mandatory single factor, sales only, apportionment formula. The insertion of the phrase "whichever is applicable" indicates that, if the single sales factor apportionment formula applies, only the sales factor reference in the preceding phrase of "payroll, property, and sales" is relevant.
- Subsection (g) has been revised to specify that, unless an apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, must be used for taxable years beginning on or after January 1, 2013.
- Subsection (g) also has been revised to highlight that the payroll factor provisions are not relevant in situations where the apportioning business uses the single sales factor apportionment formula to apportion its business income to this state.

Section 17951-6, Income from a Covenant Not to Compete:

- Subsection (a)(1) has been revised to clarify that, depending on the taxable year at issue, the four-factor formula referenced in subdivision (a) of Section 25128, Revenue and Taxation Code, may not be applicable. For example, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code,

applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) of Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election made under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.

Section 25101, Allocation of Income:

- As a result of Proposition 39, which mandates the use of a single sales factor apportionment formula for many apportioning businesses, the applicable apportionment formula will no longer include all three factors. For that reason, subsection (a) of this regulation was revised to delete references to the property, payroll and sales factors in favor of a general "apportionment formula" phrase. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include the property and payroll factors.

- Subsection (b) was similarly revised with additional language clarifying that, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, only the receipts factor references in that subsection should apply. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25106.5-9, Partial Combined Reporting Periods:

- Subsection (d) was revised to clarify that all references to the property factor in this regulation should be considered only if neither Section 25128.5 (single sales factor apportionment formula election), Revenue and Taxation Code, nor Section 25128.7 (mandatory single sales factor apportionment formula), Revenue and Taxation Code, applies. For example, for taxable years beginning on or after January 1, 2013, the property factor is irrelevant unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. And, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, the property factor is also irrelevant, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, or the apportioning business elected to apportion its business income to this state by multiplying the business income by the four-factor formula, which includes a property factor and a payroll factor.

Section 25105.5-10, Foreign Combination:

- Subsection (c)(3) was added to clarify that, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, only the receipts factor references in subsection (c) of the regulation applies. This is necessary because, pursuant to Proposition 39, for taxable

years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25128, Apportionment of Business Income:

- The first sentence of subsection (a) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. For example, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.
- The second sentence of subsection (a) was revised to change verbs from the present tense to the past tense because the sentence references the rules set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, which do not apply to taxable years beginning on or after January 1, 2013.
- Subsection (a) was also revised to include two additional paragraphs. The first added paragraph summarizes Section 25128.5, Revenue and Taxation Code, relating to the annual single sales factor apportionment formula election that was available to apportioning businesses not engaged in a

qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. That paragraph further clarifies that this election was only available during taxable years beginning on or after January 1, 2011 and before January 1, 2013. The second added paragraph summarizes the mandatory single sales factor apportionment formula, as set forth in new Section 25128.7, Revenue and Taxation Code, meant for all apportioning businesses not engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Both proposed paragraphs are patterned after the existing language in the regulation that similarly summarizes provisions of Section 25128, Revenue and Taxation Code.

- Subsection (c) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. The subsection was revised and expanded to clarify that, for taxable years beginning before January 1, 2011, groups that failed the 50 percent gross business receipts test were required to use the double-weighted sales, four-factor formula; for taxable years beginning after January 1, 2011, and before January 1, 2013, these groups should also be using the four-factor formula unless the group made an annual single sales factor apportionment formula election pursuant to Section 25128.5, Revenue and Taxation Code; and, for taxable years beginning on or after January 1, 2013, these groups are now required to use the single sales factor apportionment formula pursuant to new Section 25128.7, Revenue and Taxation Code.
- In addition, the example in subsection (c) was revised to clarify that, depending on the taxable years at issue and on whether the taxpayer made an annual election pursuant to Section 25128.5, Revenue and Taxation Code, the taxpayer's apportionment formula is not limited to the four-factor formula. For example, for taxable years beginning on or after January 1, 2013, if the group fails to meet the 50 percent test as described in subsection (c) of the regulation, the group will be required to apportion its business income to this state by multiplying its business income by the single sales apportionment factor. Similarly, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, assuming the group does meet the 50 percent test as described in subsection (c) of the regulation, the group could elect on its original return to use the single sales factor apportionment formula. If this election was made,

then the group was required to apportion its business income to this state by multiplying its business income by the single sales apportionment factor.

Section 25137-1, Apportionment and Allocation of Partnership Income:

- Subsection (f) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. For example, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election made under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.
- As a result of Proposition 39, which mandates the use of a single sales factor apportionment formula for many apportioning businesses, the applicable apportionment formula may not include all three factors. For that reason, subsection (g)(1) was revised to delete references to the three factor formula in favor of a general "apportionment formula" phrase. This is necessary because, depending on the taxable year at issue, the single sales factor apportionment formula may be the applicable apportionment formula.
- Subsection (g)(1) was further revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. For example, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the

apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election made under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.

- Subsection (h)(2) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. Please see explanation directly above.

Section 25137-2, Contractors – Apportionment of Income, Long-Term Contracts:

- Subsection (d)(1) was revised to clarify that the applicable apportionment formula depends on the taxable year at issue, and, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, on whether the taxpayer made an election under Section 25128.5, Revenue and Taxation Code. To clarify, the new language summarizing Revenue and Taxation Code Sections 25128.5 and 25128.7 was added, patterned after the existing language that summarizes Revenue and Taxation Code Section 25128. Again, the revision makes it clear that, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue

and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.

- Subsection (d)(3) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. Again, the revision makes it clear that, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code, applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.
- Subsection (d)(7) was revised to clarify that the applicable apportionment formula may depend on the taxable year at issue. For clarification purposes, the new language was added, summarizing Revenue and Taxation Code Sections 25128.5 and 25128.7, patterned after the existing language that summarizes Revenue and Taxation Code Section 25128. Again, the revision makes it clear that, for taxable years beginning on or after January 1, 2013, the single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, shall be applied unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. In contrast, for taxable years beginning before January 1, 2011, the four-factor formula set forth in subdivision (a) of Section 25128, Revenue and Taxation Code,

applied unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code. Finally, for taxable years beginning on or after January 1, 2011 and before January 1, 2013, an apportioning business could have used either a four-factor formula under subdivision (a) Section 25128, Revenue and Taxation Code, or a single sales factor apportionment formula pursuant to an annual election under Section 25128.5, Revenue and Taxation Code, unless the apportioning business was engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code.

- Subsection (e) was revised to delete a reference to the number of factors in an apportionment formula in favor of the general "apportionment formula" phrase because, depending on the taxable year at issue, the single sales factor apportionment formula may be the applicable apportionment formula.

Section 25127-4.2, Banks and Financial Corporations – Allocation and Apportionment of Income:

- Subsection (e) has been added to the regulation to clarify that, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-7, Air Transportation Companies – Allocation and Apportionment of Income:

- Subsection (f) has been added to clarify that, unless Section 25128(b), Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because,

pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-8.2, Motion Picture and Television Film Producers, Distributors, and Television Networks – Apportionment of Income:

- Subsection (d) has been revised to add new language that clarifies, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-9, Railroads – Allocation and Apportionment of Income:

- Subsection (b) has been added to clarify that, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-10, Combination of General (Non-Financial) and Financial Corporations:

- Subsection (g) has been added to clarify that, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-11, Allocation and Apportionment of Income of Trucking Companies:

- Subsection (c)(5) has been added to clarify that, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.

Section 25137-14, Mutual Fund Service Providers and Asset Management Service Provider:

- Subsection (c) has been revised to add new language that clarifies, unless subdivision (b) of Section 25128, Revenue and Taxation Code, applies, all references to the property and payroll factors in that regulation are not relevant for taxable years beginning on or after January 1, 2013. This is necessary because, pursuant to Proposition 39, for taxable years beginning on or after January 1, 2013, unless the apportioning business is engaged in a qualifying business activity pursuant to subdivision (b) of Section 25128, Revenue and Taxation

Code, the mandatory single sales factor apportionment formula set forth in new Section 25128.7, Revenue and Taxation Code, applies and does not include property and payroll factors.
