

**STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
REGARDING THE PROPOSED AMENDMENTS TO REGULATION SECTION 25106.5**

A. Oral comments from Barry Weissman representing Chevron during the February 6, 2013 hearing.

Comment #1.

The proposed amendments to Regulation section 25106.5 do not appear to reflect the passage of Prop 39, the new mandatory single sales factor that starts in taxable years beginning on or after January 1, 2013. The question is: is there a plan by staff to update the regulations to reflect the new law change? If so, will they be able to do it under the existing rulemaking item that is in the 2013 calendar, or will this be something that would have to wait until the 2014 calendar as a new item before proceeding?

Response:

Staff currently has no plan to update the proposed amendments to Regulation section 25106.5 to reflect the new law change but will evaluate the need for doing so on a later date.

Recommendation:

No change to the proposed amendments is required.

Comment #2.

Proposed Regulation section 25106.5(c)(7)(A)1.a. describes, for taxable years beginning on and after January 1, 2011, the three methods that currently exist before 2013 under Revenue and Taxation Code sections 25128 and 25128.5. Revenue and Taxation Code section 25137 is not considered when applying the more-than-50-percent gross business receipts test under Revenue and Taxation Code section 25128. The language of the proposed regulation, however, appears to cause an unintended conflict when it states in section 25106.5(c)(7)(A)1.b. that "[i]n the application of subsection (c)(7)(A) of this regulation, except as modified under Section 25137 of the Revenue and Taxation Code:..." Such wording gives the impression that the Section 25137 distortion somehow comes into to play in applying the more-than-50-percent gross business receipts test. (Chevron)

Response:

Subsection (c)(7)(A)1.a. of the proposed amendments provides guidance for determining a combined reporting group's California apportionment percentage under the different apportionment formulas – single-sales factor, double-weighted sales factor, and single weighted sales factor – based on the "gross business receipts" test prescribed in Revenue and Taxation Code section 25128. Revenue and Taxation Code section 25137 is not considered in applying the "gross business receipts" test under Revenue and Taxation Code section 25128. After the appropriate apportionment formula is determined for the combined

reporting group, subsection (c)(7)(A)1.b. of the proposed amendments provides guidance in computing the California property factor, payroll factor, and sales factor of the group. The apportionment factors are determined under Revenue and Taxation Code sections 25129 through 25136, including modifications authorized by Revenue and Taxation Code section 25137.

Recommendation:

To provide clarity, revise the language of the proposed amendments to Regulation section 25106.5(c)(7)(A)1.b. to read "In the application of this subsection (c)(7)(A)1.b. of this regulation, except as modified under Section 25137 of the Revenue and Taxation Code:"

B. Written comments from Reed Smith dated February 6, 2013.

Comment #1.

The sales into California from an entity subject to the protections of Public Law 86-272 should not be included in a California Combined Report.

Public Law 86-272, 15 U.S.C. 381-384 ("PL 86-272") prohibits states and political subdivisions from imposing a net income tax on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property.

It is well settled law that state legislation will not work to override federal legislation.

Amendments to Section 25135, effective 2011, should not override or impose a net income tax on the entity protected under PL 86-272.

The Draft Regulation provides that the California sales of the entity which is protected under PL 86-272 are allocated to the taxpayer members based on the intra-state apportionment percentage. Draft Regulation section 25106.5(c)(7). In summary, this method is an indirect taxation of the entity which is protected under PL 86-272.

The FTB has previously declined to shift the burden of tax from a tax exempt entity to other members of the unitary group. For example, the FTB excluded an insurance company from the combined report for formulary apportionment from unitary income "since it is exempted from franchise, preference income, and corporate income taxes by the California Constitution." 1975 WL 3290 (Cal. Fran. Tax. Bd.) ("Legal Ruling 385").

As drafted, the Draft Regulation requires taxpayer members to intrastate-apportion income generated from all members of the combined group regardless of PL 86-272 protection. No distinction can be made between a tax exempt insurance company and an entity not subject to state income tax per PL 86-272.

Inclusion in the sales factor of sales generated by a unitary group member protected by PL 86-272 would be in effect an imposition of an income tax on the protected entity. It appears that the Draft Regulation attempts to circumvent PL 86-272 by shifting sales generated by a PL 86-272 protected entity to a California taxpayer member. This would circumvent the intent of Congress in connection with PL 86-272.

FTB Publication 1050 mentions California's adoption of Appeal of Finnigan (Cal. St. Bd. of Equal. (Aug. 25, 1988) and refers to the use of the "revised method" currently authorized by Legal Ruling 234.

Legal Ruling 234 was issued on October 27, 1959, approximately a month after the enactment of PL 86-272 on September 14, 1959, but refers to the Appeal of Kaiser-Frazer Sales Corporation. Cal. St. Bd. of Equal. (Nov. 7, 1958). The Kaiser-Frazer case, which was decided on November 7, 1958, did not address the situation whereby a corporation is exempted from state taxation under PL 86-272.

As discussed above, it is well settled law that Federal legislation will pre-empt State legislation. Therefore, neither Legal Ruling 234 nor any state statute or regulation has authority to override PL 86-272.

Response:

The proposed amendments to Regulation 25106.5 change the method of constructing the sales factor of the apportionment formula from the *Joyce* rule to the *Finnigan* rule in order to implement the amendment to Revenue and Taxation Code section 25135 applicable to taxable years beginning on or after January 1, 2011. This change does not alter in any way the existing rules concerning a state's jurisdiction to tax a particular corporation. In other words, the application of the *Finnigan* approach does not result in the taxation of a corporation protected by PL 86-272, either directly or indirectly.

Including the California destination sales of a corporation protected by PL 86-272 in the numerator of the sales factor of a combined reporting group does not constitute imposition of an income-based tax on that corporation, but is merely a different method of measuring a combined reporting group's activities in California. The Court of Appeal upheld the FTB's use of the *Finnigan* approach against a similar challenge in *Citicorp North America Inc., et al., v. Franchise Tax Board* (2000) 83 Cal. App.4th 1403 (*Citicorp*). In doing so, the *Citicorp* court noted that the FTB, in applying the *Finnigan* approach,

"... is not taxing, but is apportioning income attributable to California. Taxes are actually imposed only on the corporations that are subject to California taxing jurisdiction. [The California] Supreme Court has approved apportionment formulas as an appropriate method of determining the California income of a unitary group of corporations. The United States Supreme Court held that computing income of a unitary business that is allocable to one state by use of a reasonable formula does not result in an impermissible tax on extraterritorial values." (Bracketed material added for clarification, citations omitted.)

Citing *Edison California Stores v. McColgan* (1947) 30 Cal. 2d 472, the *Citicorp* court went on to state "[t]he ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication. Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business..." (*Citicorp, supra*, at p. 1415.) Accord, *Disney Enterprises, Inc., v. Tax Appeals Tribunal of the State of New York* (2008) 10 N.Y. 3d 392 [888 N.E.2d 1029] (concluding that inclusion of an out-of-state affiliate's sales in the numerator of the receipts factor is necessary to arrive at the appropriate business allocation percentage and does not amount to a tax on that affiliate in violation of PL 86-272).

Recommendation:

No change to the proposed amendments is required.

Comment #2.

The current Draft Regulation does not address the application or treatment for the following situations. Examples are used for illustration purposes.

Example A. Taxpayer Subject to the Income Tax

Corporation A is a taxpayer which is subject to the income tax, not franchise tax, because it is incorporated outside California, is not doing business in California under Section 23101, and has California source income (i.e. California source income from a partnership investment). Corporation A has unitary affiliates Corporation B and Corporation C. Corporation B conducts business in California and is subject to the franchise tax. Corporation C is incorporated outside California, has business activities solely outside California, and has sales to California customers which are protected under PL 86-272.

Assuming the current Draft Regulation's intrastate apportionment of California sales of the corporation exempt under PL 86-272 to the taxpayer members based on the intrastate apportionment percentage stands, would the California sales of Corporation C be intrastate apportioned to Corporation A which does not conduct business in California but has California source income?

Example B. Taxpayer Subject to Allocation but not Apportionment

The facts are the same as above except that Corporation A has only nonbusiness income subject to allocation, does not have any business income subject to apportionment, and has no apportionment factors.

Assuming the current Draft Regulation's intrastate apportionment of California sales of the corporation exempt under PL 86-272 to the taxpayer members based on the intrastate apportionment percentage stands, would the California sales of Corporation C

be intrastate apportioned to Corporation A which does not have business income and no apportionment factors?

Example C. Taxpayer with Non-unitary Separate Trade or Business

The facts are the same as above except that Corporation A, Corporation B, and Corporation C are affiliates which file a federal consolidated return but Corporation A engages in a separate trade or business which is not unitary with Corporation B and Corporation C which engage in another separate trade or business.

Assuming the current Draft Regulation's intrastate apportionment of California sales of the corporation exempt under PL 86-272 to the taxpayer members based on the intrastate apportionment percentage stands, would the California sales of Corporation C be intrastate apportioned to Corporation A which engages in a separate trade or business which is not unitary with Corporation B and Corporation C?

Responses: See below.

Comment #2, Example A.: No.

(1) Under the Draft Regulation, "intrastate apportionment" assigns the *total group combined report business income* that has been apportioned to California, only to taxpayer members of the combined reporting group. Intrastate apportionment does not assign the sales of one member to another member of a combined reporting group.¹

(2) The California-source total group combined report business income is apportioned – assigned through intrastate apportionment – to the taxpayer members of the combined reporting group based on each taxpayer member's intrastate apportionment percentage.² Each taxpayer member's intrastate apportionment percentage is determined based on that taxpayer member's California property, payroll and sales factors.³ Under the facts in this example, as a California taxpayer subject to income tax, not franchise tax, with California source income from a partnership investment, Corporation A's California property, payroll and sales factors pertaining to the combined reporting group of corporations A, B, and C would be zero percent (0%). Accordingly, applying the mechanics of the Draft Regulation, none of the California-source total group combined report business income would be intrastate apportioned to Corporation A in the example cited in the comment.

Comment #2, Example B.: No.

This fact pattern is essentially the same as that provided in Example A.

(1) See paragraph (1) in response to Comment #2, Example A. above.

¹ Draft Regulation section 25106.5(b)(21).

² Draft Regulation section 25106.5(b)(22).

³ Draft Regulation section 25106.5(c)(7)(A)2.

(2) As stated in the facts of the example, Corporation A has only nonbusiness income (with respect to the combined reporting group of corporations A, B, and C) subject to allocation; it does not have any business income subject to apportionment and has no [California] apportionment factors. See paragraph (2) in response to Comment #2, Example A. above.

Comment #2, Example C.: No.

(1) See paragraph (1) in response to Comment #2, Example A. above.

(2) Under the provisions of the Draft Regulation, "intrastate apportionment" assigns the total group combined report business income, which has been apportioned to California, only to *taxpayer members of the combined reporting group*. Intrastate apportionment does not assign income to a unitary affiliate that is not a California taxpayer.⁴ Because Corporation A is not unitary with the combined reporting group of Corporations B and C, it is not a taxpayer member of the B and C combined reporting group. Therefore, "intrastate apportionment" under the Draft Regulation does not operate to assign any income of the B and C combined reporting group to Corporation A.

Recommendation:

No change to the proposed amendments is required.

⁴ Draft Regulation section 25106.5(b)(21). Also, see Regulation section 25106.5(c)(3).