

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 October 30, 1998, in Room 1040 at 9645 Butterfield Way, Sacramento, California, to consider adoption of new sections under Title 18 of the California Code of Regulations, authorized under Section 25106.5 of the California Revenue and Taxation Code, pertaining to the mechanics of combined reporting. Said hearing will also consider the renumbering of Section 25106.5-3 of Title 18 of the California Code of Regulations (pertaining to combined reports including foreign country operations) to Section 25106.5-10 of Title 18 of the California Code of Regulations. Regulations to be considered at this hearing are as follows:

25106.5-0 (table of contents)

25106.5 (pertaining to general rules for combined reporting)

25106.5-1 (reserved)

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

25106.5-3 (pertaining to accounting methods and elections in a combined report)

25106.5-4 (pertaining to fiscalization of income to a principal member's accounting period in a combined report)

25106.5-5 (pertaining to interest offset in a combined report)

25106.5-6 (reserved)

25106.5-7 (reserved)

25106.5-8 (reserved)

25106.5-9 (pertaining to partial period combined reporting)

25106.5-10 (renumbering from Section 25106.5-3)

25106.5-11 (reserved)

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. The three-member Board will consider the proposed regulations and

comments submitted with respect to the proposed regulations prior to acting upon them at one of its meetings.

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., October 30, 1998. 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 which are required to file a combined report. 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, combined reporting procedures are reflected only in FTB Publication 1061 and in the case law. The regulations proposed to be adopted would provide detailed guidance regarding the steps involved in combined reporting.

Under Section 19503 of the California Revenue and Taxation Code, regulations apply with retroactive effect unless prescribed by regulation to the contrary. The regulations below will apply with retroactive effect except as otherwise indicated.

Proposed Section 25106.5-0.

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.

Proposed Section 25106.5

Proposed Section 25106.5 of the California Code of Regulations provides the general rules for combined reporting which will apply to all unitary groups. The regulation sets 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 which is business income of the unitary 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 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 unitary 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's California apportionment percentage. This is the taxpayer member's California source combined income.
- 7) Each taxpayer member then adds any other California source income or loss to its intrastate apportioned income. The California interest offset, net operating loss, etc. is then applied. This results in its California source income which 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 and 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 and fifth step described above, adopts the method required by the California State Board of Equalization in the Appeal of Joyce, Inc., decided November 23, 1966. 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 which 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) 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 25106.5-1. (Reserved).

Proposed Section 25106.5-2. Capital, Section 1231 Internal Revenue Code (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 (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 corporations. 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.

Proposed 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. In the first step of combined reporting, the separate income of each member is determined under the Revenue and Taxation Code independently of the other members. Thus, absent this proposed regulation, if a member experienced an overall capital loss, that loss would not be recognized under the Revenue and Taxation Code except to the extent that member experienced a corresponding gain in a succeeding year.

Proposed regulation Section 25106.5-2 allows capital, Section 1231 (IRC), and involuntary conversion gains and losses which are business income under Section 25120(a) to be applied against each other in combined reporting, after apportionment. 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 each of the taxpayer members using their respective California apportionment percentage (see above).
- 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 a loss results, the taxpayer has a California source short term capital loss carryforward. That loss can be applied to California source capital gains in later years.

Pursuant to Section 19503 of the Revenue and Taxation Code, the provisions of this proposed regulation would apply to all income years that are not closed under applicable statutes of limitation. However, because the Appeal of Finnigan, supra, applies to years ending before January 1, 1999, special rules may be needed to apply that holding to the transactions described by this proposed regulation entered into before that date.

Proposed Section 25106.5-3. Accounting Methods and Elections.

In the first step of combined reporting in Proposed Section 25106.5, California Code of Regulations, the separate net income of each member of the group is determined under the Revenue and Taxation Code independently of the other members. That means that each member may select their own accounting methods, and make their own tax elections. Proposed Section 25106.5-3 of the California Code of Regulations provides the rules for accounting methods and elections in a combined report.

Generally, each taxpayer member selects an available accounting method or election as provided under the Revenue and Taxation Code for its own income. In addition, the taxpayer members select an available accounting method or election for the other members of the unitary group.

Once selected, then the member's income must be consistently determined if that member's income is included in more than one combined report calculation. This might happen, for example, if the taxpayers in the group file separate returns and do their own combined report calculations. If that occurs, the Franchise Tax Board has the discretion to resolve the inconsistency as it determines appropriate.

Sometimes taxpayers exclude a corporation from the unitary group in error. If the Franchise Tax Board adds the corporation to the group, in some cases the taxpayer members may make accounting elections on behalf of the erroneously excluded entity. This can be done even if the election would otherwise have to be made on a timely filed return. The proposed regulation provides rules for making an application for such an election. However, this election does not apply if the excluded entity filed a California or U.S. tax return, and made an election in one of those returns.

Proposed Section 25106.5-4. Fiscalization.

Proposed Section 25106.5-4 of the California Code of Regulations provides rules for combined reporting when some of the members of the unitary group have different accounting periods. Business income must be apportioned using a common accounting period and common apportionment factors for that accounting period. To do that, the business income and apportionment data of the members of the unitary group must be adjusted to the accounting period of the principal member. The “principal member” is a designated corporation, usually a parent corporation, which serves as a reference point for the other members. This process is called “fiscalization.”

In most cases, the taxpayers in the group may choose one of two available methods, the interim closing method and the pro rata method. The pro rata method may be used if it does not produce a material misstatement of income. If it does, the interim closing method must be used.

The first method, the interim closing method, is the more exact. Each member determines its actual income and apportionment data for the principal member’s accounting period. This will require an interim closing of the member’s books and records.

The other method, the pro rata method, is an approximation. Each member determines its income and apportionment data for its own accounting period. The member then prorates its income and data based on the number of months in common with the principal member.

For example, assume that the principal member's income year ends on December 31, 1997. A member whose accounting year ends on March 31 will reflect 3/12ths of its business income and 3/12ths of its payroll and sales for its income year ended March 31, 1997 in the December 31, 1997 income year of the principal member. That member will then reflect 9/12ths of its adjusted separate combined report business income and its payroll and sales for its income year ended March 31, 1998 in the December 31, 1997 income year of the principal member. Similar rules apply for the property factor.

After business income and apportionment factors are aligned to the accounting period of the principal member, that income is apportioned to California in accordance with the rules provided in Proposed Section 25106.5.

After apportionment, an additional adjustment is necessary to realign that member’s California source combined income to the taxpayer member’s income year. To do that, the income is prorated based on the number of months in common with the principal member’s accounting period.

Proposed Section 25106.5-5. Interest Offset.

Under Section 24344 of the Revenue and Taxation Code, interest expense is a deduction to arrive at net income. Contained within the rules for interest expenses is Section 24344(b) of the Revenue and Taxation Code, known as the interest offset. Generally, the interest offset rules require otherwise deductible interest expense to be first specifically applied as a deduction against certain classes of income. Before interest expense is deductible against any other income, it is first deductible against business interest income. If any interest expense remains, it is then deductible

against nonbusiness interest and dividends. Thereafter it is deductible subject to the provisions of Section 25120(d) of the California Code of Regulations.

As indicated above, under proposed Section 25106.5, California Code of Regulations, the separate net income of each member of the group is determined under the Revenue and Taxation Code independently of the other members. If no other rule were provided, the interest offset might be applied to the specific member's business interest income and nonbusiness interest and dividends.

That result, however, is contrary to the holding of Pacific Telephone and Telegraph v. Franchise Tax Board (1972) 7 Cal.3d 544, which held that the interest offset rules required that interest expense of one member of a unitary group be offset against the nonbusiness dividends of another member. Proposed Section 25106.5-5 of the California Code of Regulations preserves the existing judicial interpretations that relate to the interest offset in a unitary setting.

Proposed Section 25106.5-6. (Reserved).

Proposed Section 25106.5-7. (Reserved).

Proposed Section 25106.5-8. (Reserved).

Proposed Section 25106.5-9.

Proposed Section 25106.5-9 of the California Code of Regulations provides rules for when a corporation leaves or enters the unitary group in the middle of the principal member's accounting period. When that happens, the general rule requires the preparation of a combined report for just the part of that period in which unity for all the corporations exists. That way, income and apportionment factors are excluded if they do not relate to the time the corporations are unitary. This will require each member to determine the actual income and apportionment factors of the unitary business for the partial period. This will usually require an interim closing of the books. The income from the partial period is then intrastate apportioned to each taxpayer member of the group under the regular rules (proposed Section 25106.5 of the California Code of Regulations). If a short period return is not required, the member adds that income to its other California source income from the rest of its income year. Tax is computed on the sum (or net) of those amounts.

In some cases, these procedures can require a lot of computational steps. Proposed Section 25106.5-9 also allows taxpayers to use a simplified alternative method in some cases. However, that method cannot be used if it produces a material misstatement of income.

Under the simplified alternative method, the income and apportionment data is determined for the leaving or entering member only for the period it is unitary. That income and data is added to the full accounting period of the principal member (usually 12 months). However, the property factor data for the leaving or entering member has to be adjusted (by weighted average) to reflect that the property was not used by the group for the whole time. A combined report calculation is made as if the partly unitary member were unitary for the principal member's entire accounting period. The income is then intrastate apportioned to each taxpayer member of the group under the regular rules (proposed Section 25106.5 of the California Code of Regulations). If the new or leaving member is a taxpayer, that income is treated as earned only during the part of the year that unity exists. If a

short period return is not required, the member adds that income to its other California source income from the rest of its income year. Tax is computed on the sum (or net) of those amounts.

Proposed Section 25106.5-10. (Renumbers existing 25106.5-3).

Proposed Section 25106.5-10 contains the rules relating to combination of corporations that are members of a unitary group part of whose activity is conducted in a foreign country. This section is the same as the existing Regulation Section 25106.5-3, and is simply being renumbered.

Proposed Section 25106.5-11 (Reserved)

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 which has no federal counterpart. Proposed Section 25106.5-2, which deals with those kinds of gains and losses, preserves the federal classifications and methodology relating to this type of gain and loss. However proposed Section 25106.5-2 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.

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 businesses. In addition, most of the provisions of the proposed regulations reflect existing administrative practices.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES:

In accordance with Government Code Section 11346.5(a)(12), the Board must determine 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 Beverly Moore at Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; telephone (916) 845-3354; Fax (916) 845-3648; E-Mail:bev_moore@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.