

**INITIAL STATEMENT OF REASONS
FOR THE ADOPTION OF AMENDMENTS TO
CALIFORNIA CODE OR REGULATIONS,
TITLE 18, SECTION 25110(d)(2)(F)**

**PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENTS, OR OTHER CONDITION
OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS**

On August 22, 2006, the Organization For International Investment ("OFII"), pursuant to Government Code section 11340.6, filed a petition with the Franchise Tax Board to amend title 18, section 25110, and specifically subsection (d)(2)(F)(1), to exclude from the definition of "United States source income" certain types of "not effectively connected income" ("NECI").

Existing California Code of Regulations, title 18, section 25110, subsection (d)(2)(F)(1), defines United States income to mean the income of a foreign corporation that is effectively connected, or treated as effectively connected under the provisions of the Internal Revenue Code, with a United States trade or business (ECI) and the United States source income which is NECI if such income is considered business income under Revenue and Taxation Code section 25120 and the regulations thereunder. After a review, the Franchise Tax Board concluded that treating NECI as United States source income for water's-edge purposes was inconsistent with the legislative history of Revenue and Taxation Code section 25110.

In addition, a technical amendment is proposed to reference a Treasury regulation that details how expenses related to effectively connected income are to be determined.

Accordingly, at the September 20, 2006, meeting of the Franchise Tax Board it was determined that proposed amendments to California Code of Regulations, title 18, section 25110, consistent with those proposed in the petition filed by OFII, should be noticed for public hearing pursuant to the Administrative Procedures Act.

SPECIFIC PURPOSE OF THE REGULATION

The proposed amendments to the existing regulation, California Code of Regulations, title 18, section 25110, subsection (d)(2)(F), will prescribe the extent to which United States income of a foreign corporation is to be included in a water's-edge combined report in a manner that is consistent with the legislative intent of the underlying statute.

NECESSITY

The proposed amendments to the regulations are needed to clarify the original legislative intent and provide guidance on the proper application of Revenue and Taxation Code, section 25110, subdivision (a)(4).

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting the proposed amendments to the existing regulation, the Franchise Tax Board reviewed and considered the legislative history of Revenue and Taxation Code section 25110, and the comments contained in the petition filed with the Franchise Tax Board on August 22, 2006, by the Organization For International Investment (OFII).

Other than the items described in the preceding paragraph, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing adoption of the proposed amendments to the existing regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON PRIVATE PERSONS OR SMALL BUSINESS

In accordance with Government Code section 11346.5, subdivision (a)(13), 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 with operations in multiple jurisdictions. As a result, it does not affect private persons or most small businesses.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The proposed regulatory action will not have a significant adverse economic impact on business.