

TITLE 18. FRANCHISE TAX BOARD
PROPOSED REGULATION SECTION 25128.5,
RELATING TO SINGLE-SALES FACTOR METHOD ELECTION

A hearing was held on March 29, 2011, by Laurie J. McElhatton of the Franchise Tax Board Legal Division, the "hearing officer," on proposed new Regulation section 25128.5, which was noticed in the California Regulatory Notice Register on January 20, 2011. Revenue and Taxation Code section 25128.5 was enacted in 2009. It allows apportioning trades or businesses to elect to apportion their business income to California based solely on the sales factor. Revenue and Taxation Code section 25128.5, subdivision (c), allows the Franchise Tax Board to issue regulations necessary or appropriate regarding the election. The proposed regulation, if adopted, would provide guidance on how the election is made.

Department staff reviewed the proposed regulations and considered the comments submitted before and after the hearing. The hearing officer recommends that certain amendments to the proposed regulation be made to clarify the different forms that an apportioning trade or business can take and that (1) partnerships and disregarded entities that are not unitary with their owners may use the single-sales factor formula to determine California source income for the nonunitary owner, because they are treated as separate trades or businesses of the owners, (2) sole proprietorships owned by nonresidents may use the single-sales factor formula, and (3) partnerships may use the single-sales factor formula to the extent they are owned by nonresident individuals.

The hearing officer also recommends that there be certain deletions for redundant or unnecessary subsections. All of the amendments recommended by the hearing officer are reflected in the attachment hereto and meet the standards to be treated as either nonsubstantial or sufficiently related changes (within the meaning of Govt. Code section 11346.8). Deletions to the indicated regulation are reflected by ~~strikeout~~, and additions to the regulation are reflected by underscore. The proposed changes are summarized below:

1. Subsection (a)(1), the definition of "affiliated corporations," is revised to delete the words "without regard to unity." The definition of "affiliated corporations" is needed so that the term may be used to describe the situation where corporations that have common ownership, are not in one apportioning trade or business, but are in fact in separate apportioning trades or businesses. In this scenario the affiliated corporations may make separate elections for each separate apportioning trade or business. The term "affiliated corporations" only addresses the common ownership between the corporations. It is not necessary to include the language "without regard to unity" and including that phrase may lead to confusion, hence it was deleted.

Affiliated corporations. "Affiliated corporations" are corporations related by common ownership. ~~without regard to unity.~~

2. Subsection (a)(2), the definition of "apportioning trade or business," is revised to clarify the different forms an apportioning trade or business can take. The prior version was not explicit in addressing whether the election may be made by an apportioning trade or business that operates as a nonunitary division of a corporation, a partnership that

is not unitary with a corporate partner and therefore is a separate apportioning trade or business, a sole proprietorship owned by a nonresident, or a partnership to the extent owned by an individual nonresident:

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors. An apportioning trade or business includes at least one taxpayer member because it has income derived from sources within this state and from sources outside this state. An apportioning trade or business can be conducted in many forms, including, but not limited to, the following:

(A) A corporation.

(B) A corporation that is a member of a combined reporting group.

(C) A division of a corporation engaged in a separate trade or business not unitary with the other trades or businesses of the corporation.

(D) A partnership to the extent owned by a corporate partner that is not unitary with the partnership, whether the corporation stands alone or is a member of a combined reporting group.

(E) A partnership to the extent owned by a partner who is an individual who is not a resident of California.

(F) A sole proprietorship that that is operated by an individual who is not a resident of California.

3. Subsection (a)(3), the definition of "apportionment" is modified to delete a reference to "group" business income of a "combined report" which does not address situations where the apportioning trade or business is operated within one corporation so that no combined report is necessary. Accordingly, the language is revised to delete "group" with no replacement term and to delete "combined report" and replace it with "apportioning trade or business."

(3) Apportionment. "Apportionment" is the means by which the total ~~group~~ business income of an apportioning trade or business ~~combined report~~ is assigned to this state under Revenue and Taxation Code sections 25128 through 25137 and section 25141.

4. The word "Subchapter" is capitalized at subsection (a)(10) for the definition of corporation to be consistent with capitalization in existing sections of the Revenue and Taxation Code and to be consistent herein with capitalization for "qualified Subchapter S subsidiaries."

(10) Corporation. References to "corporation" include a Subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation pursuant to Revenue and Taxation Code sections 23038 or 23038.5.

5. A definition of a "disregarded entity" is added at subsection (a)(11) because single member disregarded limited liability companies and qualified Subchapter S subsidiaries have been included in the examples at subsection (b)(6) in response to comments received by the hearing officer requesting clarification of treatment of entities operating as nonunitary divisions of a taxpayer. The definition is taken from California Code of Regulations section 23038(b)-2, subsection (a).

(11) Disregarded Entity. A "disregarded entity" is an entity described in California Code of Regulations, section 23038(b)-2, subsection (a).

6. A definition of a "limited liability company" is added at subsection (a)(15) because references to limited liability companies are added to the proposed regulation in subsections (b) and (c).

(15) Limited liability company. A "limited liability company" is as defined at Revenue and Taxation Code section 17941, subdivision (d).

7. A definition of "member" is added at subsection (a)(16) for guidance because the term is used in the proposed regulation. There is a distinction to be made between a member of a combined reporting group that is a California taxpayer ("taxpayer member") and a member of a combined reporting group that is not a California taxpayer ("member").

(16) Member. "Member" is as defined by California Code of Regulations, section 25106.5, subsection (b)(10).

8. A definition of "nonresident" is added at subsection (a)(19). Nonresident sole proprietorships and nonresident individual owners of partnerships may operate apportioning trades or businesses. Subsection (c)(2) is added to provide instructions indicating that California source income of the sole proprietor and the individual partner may be determined using the single-sales factor formula. Since the term "nonresident" is used in subsection (c)(2), a definition is added.

(19) Nonresident. A "nonresident" is as defined in California Code of Regulations section 17014.

9. A definition of "partnership" is added at subsection (a)(21) because the term is used at subsections (a), (b), and (c). The definition was partially taken from California Code of Regulations section 25137-1, subsection (a), with an added reference to California Code of Regulations section 23038(b)-3 for clarity because eligible entities with two or more owners may elect to be treated as a partnership or be treated as a partnership by default.

(21) Partnership. A "partnership" is as defined in Revenue and Taxation Code section 17008 and includes entities treated as partnerships as set forth in California Code of Regulations section 23038(b)-3.

10. A definition of "qualified Subchapter S subsidiary" is added at subsection (a)(23) because this term is used in an example in subsection (b).

(23) Qualified Subchapter S subsidiary: A "qualified Subchapter S subsidiary" is as defined in Internal Revenue Code section 1361, subsection (b)(3), as incorporated by Revenue and Taxation Code section 23800 and as modified by Revenue and Taxation Code section 23800.5.

11. A definition of "resident" is added at subsection (a)(24) because the term "resident" is used in subsection (c) and hence a definition was warranted for purposes of clarity.

(24) Resident. A "resident" is as defined in Revenue and Taxation Code section 17014, subdivision (a), and California Code of Regulations section 17014, subsection (a).

12. A definition of "S corporation" is added at subsection (a)(25) because the term is used in subsections (a) and (b). The definition refers directly to Internal Revenue Code sections 1361 and 1362 as modified by Revenue and Taxation Code sections 23800.5 and 23801. Revenue and Taxation Code section 23801 recognizes S corporations when a federal election to be an S corporation has been made and all requirements are met. Including a definition of "S corporation" allows use of that term when discussing the qualified Subchapter S subsidiaries that are disregarded entities and treated as a division of the S corporation, and also for examples involving an S corporation. This provides clarity because an apportioning trade or business might be operated within a qualified Subchapter S subsidiary that is not unitary with the parent S corporation, but is treated as a division of the S corporation.

(25) S corporation. "S corporation" is as defined in Internal Revenue Code sections 1361 and 1362, as modified by Revenue and Taxation Code sections 23800.5 and 23801.

13. A definition of "sole proprietorship" is added at subsection (a)(26) because the term is used in the newly added subsection (c)(2)(A) that clarifies that a sole proprietorship operating an apportioning trade or business may determine California source income of the owner using the single-sales factor formula.

(26) Sole Proprietorship. A "sole proprietorship" is an unincorporated trade or business that is operated by one individual.

14. A definition of "taxpayer" is added at subsection (a)(28) because the term is used in subsection (b)(5) where "business assets" is defined, subsection (b) where electing the single-sales factor formula is explained, and subsection (c)(3) where changes in

affiliation are discussed. The definition is taken from California Code of Regulations section 25113, subsection (b)(11).

(28) Taxpayer. "Taxpayer" means an individual, corporation, or partnership with a requirement to file a California franchise or income tax return.

15. A definition of "unitary" is added at subsection (a)(31) because the term is used at subsections (a), (b), and (c), and hence a definition is needed for clarity. The definition of "unitary business" is already included in the proposed regulation and is referenced.

(31) Unitary. One corporation or partnership is "unitary" with another corporation or partnership if they are engaged in a unitary business.

16. Minor modifications are made to subsection (b)(1) to provide clarity. The reference to "combined reporting group" is deleted and moved and a reference to "for purposes of apportioning business income" is added. When the apportioning trade or business is operated within a combined reporting group, then all taxpayer members must elect.

(b) Electing the Single-Sales Factor Formula.

(1) To make a single-sales factor formula election permitted by Revenue and Taxation Code section 25128.5 a taxpayer must make an election on a timely filed, original return for the year of the election. ~~In order~~For an election ~~by a combined reporting group~~ to be effective for purposes of apportioning the business income of a combined reporting group, each taxpayer member of the combined reporting group that is subject to taxation under Part 11 of the Revenue and Taxation Code must ~~affirmatively make this the~~ election.

17. Subsection (b)(3) is modified in response to comments received from the public. The modification deletes references to "combined reporting group" and inserts references to "apportioning trade or business" to clarify that an apportioning trade or business may operate in a form other than a combined reporting group. This is necessary because an apportioning trade or business may operate as a single business entity, as a nonunitary division of a business entity, or as a business entity owned by an individual. Rather than limit this regulation to apportioning trades or businesses that operate within a combined reporting group, deleting these references to "combined reporting group" and replacing them with "apportioning trade or business" removes that limitation and provides clarity.

(3) An apportioning trade or business~~Combined reporting groups~~ that includes one or more qualified business activities may make the single-sales factor election provided the apportioning trade or business ~~combined reporting group~~ does not derive more than 50 percent of its gross business receipts from qualified business activities.

Revenue and Taxation Code section 25128.5, subdivision (a), states in pertinent part that "for taxable years beginning on or after January 1, 2011, any apportioning trade or

business, *other than an apportioning trade or business described in subdivision (b) of Section 25128*, may make an irrevocable annual election on an original timely filed return" (Emphasis added.) Revenue and Taxation Code section 25128, subdivision (b), states,

(b) If an apportioning trade or business derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities, all business income of the apportioning trade or business shall be apportioned to this state by multiplying business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Subsection (b)(3) explains in the first two examples when a corporation and when a combined reporting group may make the single-sales factor formula election when some of the gross business receipts are from qualified activities. Further guidance is provided in a third example added to explain under what circumstances an apportioning trade or business operating as a partnership partially engaged in qualified business activities may use the single-sales factor formula. The further guidance is necessary because, in response to comments received, the regulation now encompasses elections made by entities other than corporate combined reporting groups, and an example of the application of the rules to entities other than corporations provides added clarity.

The example involves an apportioning trade or business operating as a partnership. The partnership derives less than 50 percent of its gross business receipts from qualified business activities and is owned by two nonunitary corporations. Because 50 percent or less of the gross business receipts are from qualified business activities, the apportioning trade or business operating in the partnership may use the single-sales factor formula to determine the California source income for the nonunitary partners.

Example 3: Partnership P conducts an apportioning trade or business and is owned 65 percent by Corporation W and 35 percent by Corporation T. Partnership P derives less than 50 percent of its gross business receipts from an extractive business activity. Partnership P, Corporation T, and Corporation W are not unitary with each other. As a result, Corporation W and Corporation T may not independently decide whether to make a single-sales factor method election for their distributive share items of income from the nonunitary Partnership P. However, Partnership P may use the single-sales factor formula to determine California source income for Corporation W and Corporation T on Part B of schedule R-1 of form 565 using the Partnership P factor(s) because Partnership P's separate apportioning trade or business derives less than 50 percent of its gross business receipts from a qualified business activity.

18. Subsection (b)(4)(A) is deleted as unnecessary. Whether a member of the combined reporting group is subject to taxation under Part 11 of the Revenue and Taxation Code during the taxable year will be known at the time of the annual election at the end of the taxable year, so a member of the combined reporting group that becomes subject

to taxation under Part 11 of the Revenue and Taxation Code during the taxable year may be included in the return at that time and will automatically be subject to any single-sales factor formula election made by members of the combined reporting group. No deemed election is necessary

~~(A) — If a corporation that is a member of a combined reporting group is not itself subject to taxation under Part 11 of the Revenue and Taxation Code in the year for which the single-sales factor formula election is made, but subsequently becomes subject to taxation under Part 11 of the Revenue and Taxation Code, that corporation shall be deemed to have elected with the other taxpayer members of the combined reporting group.~~

19. An example (Example 4) is added to subsection (b)(5), "Election following forced de-combination." This example is needed to provide guidance regarding when the single-sales factor formula may be used in the context of a partnership with a corporate partner determined at audit to not be unitary with the partnership. The example explains that the same period of time is available for the single-sales factor formula to be used to determine the California source income of the nonunitary corporate partner as is allowed in a fact pattern involving all corporations.

Example 4: Partnership X operates an apportioning trade or business during Years 1 through 5 and is owned 25 percent by Corporation A and 75 percent by Corporation B. Corporation B determines that it is unitary with Partnership X and properly makes a single-sales factor formula election on Part B of schedule R-1 on its timely filed original forms 100 for Years 1 through 4. Corporation A determines that its apportioning trade or business is not unitary with Partnership X. Partnership X determines the California source income of Corporation A using the single-sales factor formula as properly indicated on Part B of schedule R-1 of forms 565 for Years 1 through 4. Corporation A makes no election for its separate apportioning trade or business and uses the standard three-factor formula for Years 1 through 4. During Year 6, the Franchise Tax Board audits Corporation B for Years 1 and 2 and determines that it was not unitary with Partnership X during Years 1 and 2, with a determination dated July 15 of Year 6. Corporation B and Partnership X may file amended returns for Years 1 through 4 by no later than September 15 of Year 6 to determine Corporation B's California source income from Partnership X using the single-sales factor formula and Partnership X's factors. Corporation B must file forms 100X and Partnership X must file amended information returns and indicate that it is determining the California source income of Corporation B using the single-sales factor formula on Part B of schedule R-1 of forms 565. Partnership X may file its information return for Year 5 by the extended due date of October 15, 2006 and may use the single-sales factor formula to determine the California source income of Corporation B on a timely filed original Part B of schedule R-1 of form 565 for that year.

20. Subsection (b)(6) is modified to delete the reference to Revenue and Taxation Code section 25128, subdivision (d)(6).

(6) A taxpayer that is engaged in more than one apportioning trade or business as defined in Revenue and Taxation Code section 25128, subdivision (d)(6), may make a separate election for each apportioning trade or business.

Revenue and Taxation Code section 25128, subdivision (d)(6), states,

(6) "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

The reference to Revenue and Taxation Code section 25128, subdivision (d)(6), is deleted because it includes references to Section 25101, which includes the language, "When the income of a taxpayer subject to the tax imposed under this part" Apportioning trade or businesses that operate in partnerships, sole proprietorships, limited liability companies treated as partnerships, and qualified Subchapter S subsidiaries are not subject to tax imposed under Part 11 of the Revenue and Taxation Code and are not required to file a form 100 with the state of California. Accordingly, the reference to Revenue and Taxation Code section 25128, subdivision (d)(6), is deleted so that the single-sales factor formula may be used by all apportioning trades or businesses.

An example (Example 1) is moved from subsection (c)(1) to subsection (b)(6) because subsection (c)(1) is deleted as redundant with subsection (b)(6). The text of the example is provided below with modifications indicated by double underlining. The term "apportioning trade or business" is used instead of "unitary business" to be consistent with Revenue and Taxation Code section 25128.5. The term "combined reporting group" is used instead of "unitary group" to be more precise. A "combined reporting group" is the group after any water's-edge election. It is important to use this term because a foreign corporation that is not a member of a combined reporting group due to a water's-edge election may be unitary with the other members of the combined reporting group. Changing the term from "unitary group" to "combined reporting group" eliminates that ambiguity. Other words are added for clarification.

Example 1: Corporations A and B are taxpayers and are affiliated with each other, and are also affiliated with non-taxpayer Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one apportioning trade or unitary business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate apportioning trade or unitary-business and form a combined reporting group, Group Y. Since both Corporations A and B are members of a combined reporting group that includes at least one California taxpayers, either each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of with their respective unitary-combined reporting groups. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return

for Group X, may make a single-sales factor formula election for Group X. Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.

Four examples are added (Examples 2, 3, 4, 5) to subsection (b)(6) to provide clarity for how the single-sales factor formula election operates when there is a partnership owned by a nonunitary corporate partner, when there are disregarded entities operating separate apportioning trade or businesses as divisions of a nonunitary corporate owner, when there are disregarded entities that are owned by a unitary corporate owner operating within a combined reporting group, and when there are qualified Subchapter S subsidiaries with some unitary and some not unitary with the S corporation parent. The examples provide guidance on whether an independent single-sales factor election may be made in each fact pattern. All of these examples are necessary to provide guidance on how to apply the regulation to these entities.

Example 2 provides guidance for when a corporation owns two separate apportioning trade or businesses that operate within two partnerships where the corporation is not unitary with either of the partnerships and the partnerships are not unitary with each other. The single-sales factor formula may be used at the partnership level to determine the California source income of the nonunitary partner. Since the two partnerships owned by the nonunitary partner operate independent apportioning trades or businesses not unitary with each other, each partnership may make independent single-sales factor formula elections to determine the California source income of the nonunitary corporate partner.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trades or businesses, Partnership J and Partnership K, but is not unitary with either partnership. Partnership J determines the California source income of Corporation W using the single-sales factor method on a timely filed original return on Part B of schedule R-1 of form 565. Partnership K makes no election and uses the standard three-factor formula to determine the California source income of Corporation W. Corporation W makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula.

Example 3 provides guidance for when a corporation owns disregarded entities that operate distinct apportioning trades or businesses that are not unitary with each other, are not unitary with the corporate owner, and operate as divisions of the corporate owner. The example illustrates that each independent apportioning trade or business operating in each of the disregarded entities may determine the California source income of the corporate owner using the single-sales factor formula. It is not required that all of the disregarded entities make the same single-sales factor formula election because they are not unitary with each other and therefore do not comprise one apportioning trade or business.

Example 3: Corporation P is a taxpayer that is the single owner of three limited liability companies, Q, R, and S that are each disregarded entities for tax

purposes and operate three distinct apportioning trades or businesses. P, Q, R, and S are not unitary with one another. Q and R determine the California source income of Corporation P using the single-sales factor formula on timely filed original information returns on Part B of schedule R-1 of form 568. S makes no election and determines the California source income of Corporation P using the standard three-factor formula on Part A of schedule R-1 of form 568. Corporation P makes no election and apportions its business income from its separate apportioning trade or business using the standard three-factor formula on Part A of schedule R-1 of form 100.

Example 4 provides guidance for when a corporation owns disregarded entities that are unitary with the corporate owner. In that situation the income and factors of the disregarded entities are added to those of the corporate owner and a single-sales factor formula election may be made by the corporation to apportion the income of the corporate owner's unitary business. No separate election by the disregarded entity is possible because it is not a separate apportioning trade or business, but rather is a unitary division of the trade or business of the corporation.

Example 4: Same facts as Example 3 except that Corporation P and the disregarded limited liability companies Q, R, and S are unitary. The combined reporting group includes Corporation P (Q, R, and S), Corporation A and Corporation B filing a group return for Group P. Group P makes a single-sales factor formula election on its timely filed original group return. Since Q, R, and S are disregarded entities operating as divisions of Corporation P and are unitary with each other and Corporations P, A, and B, the income and factors of Q, R, and S are added to those of Corporations P, A, and B, and the single-sales factor formula is used to apportion the income of Group P.

Example 5 provides guidance for when a corporation has elected to be treated as an S corporation and owns qualified Subchapter S subsidiaries that are disregarded entities not unitary with each other or with the S corporation owner. The S corporation may elect to use the single-sales factor formula for its own apportioning trade or business that includes the income and factors of a unitary Subchapter S subsidiary. Each of the qualified Subchapter S subsidiaries that is not unitary with the S corporation owner may use the single-sales factor formula to determine the California source income of the S corporation owner. The S corporation and the nonunitary qualified Subchapter S subsidiary are not required to make the same election because they do not comprise a single apportioning trade or business.

Example 5: Corporation T has elected to be an S corporation. It wholly owns Corporations U, V, and W, each of which satisfies the requirements to be a qualified Subchapter S subsidiary and, pursuant to an election by T, are treated as disregarded entities. T is unitary with W, while T, U and V are not unitary with one another and each operates a separate apportioning trade or businesses. U and V determine the California source income of Corporation T using the single-sales factor formula on a timely filed original return, form 100S filed by Corporation T, with the election indicated on Part B of schedule R-1 attached to

schedule QS. Corporation T makes no single-sales factor formula election. Because W is unitary with T and T made no election, W may not determine Corporation T's California source income using the single-sales factor formula. Corporation T does the following: (1) apportions the business income from its separate apportioning trade or business using the standard three-factor formula, (2) adds the income and factors of unitary W to its own income and factors, and (3) adds the California source income from the separate apportioning trades or businesses of U and V as determined using the single-sales factor formula with U and V's sales factors.

21. Subsection (b)(7) is modified to add references to the forms that partnerships, limited liability companies, qualified Subchapter S subsidiaries, individuals, and nonresident individuals must use to make a single-sales factor formula election to determine California source income for nonunitary partners, nonunitary owners, individuals, or nonresident individuals. In addition, the word "of" is changed to "attached to."

(7) Validity of Election. An election under this regulation will be considered valid if the following conditions are satisfied:

(A) The tax is computed in a manner consistent with the single-sales factor formula election, and

(B) A written notification of election is filed with the return on Part B of schedule R-1 ~~of~~ attached to form 100 (S Corporations file a form 100S, and water's edge corporations file a form 100W), form 565 (for nonunitary partnerships), form 568 (for nonunitary limited liability companies), schedule QS (for nonunitary qualified Subchapter S subsidiaries), form 540 (for individuals), or form 540NR (for nonresident individuals).

22. Subsection (c)(1) is deleted as redundant with subsection (b)(6) and the example is moved to subsection (b)(6) at Example 1. The example is modified as indicated under number 20 above.

~~(1) Affiliated corporations not engaged in the same unitary business. A group of affiliated corporations that are engaged in more than one unitary business may make a single-sales factor formula election with respect to one or more of the businesses, but need not elect for all of its businesses.~~

~~Example: Corporations A and B are California taxpayers and are affiliated with each other and with Corporations C, D, E, F, G, H, and I. Corporations A, C, D, and G are engaged in one unitary business, Group X. Corporations B, E, F, H, and I are engaged in another separate unitary business, Group Y. Since both Corporations A and B are California taxpayers, either may elect to file on a single-sales factor formula basis with their respective unitary group. It is not necessary for both Corporations A and B to make the same election, even though they are members of the same group of affiliated corporations. Corporation A, filing a group return for Group X, may make a single-sales factor formula election for Group X.~~

~~Corporation B, filing a group return for Group Y, is not required to make a single-sales factor formula election.~~

23. Subsection (c)(2) is renumbered to be subsection (c)(1) and is modified. The phrase "to the extent owned by corporations" is added to clarify that this subsection does not address partnerships to the extent owned by individuals. A sentence is added to clarify that a partnership may use the single-sales factor formula to determine the California source income of nonunitary partners. This section is necessary to provide further guidance regarding partnerships owned by nonunitary partners, as an apportioning trade or business may operate within a partnership owned by a nonunitary corporate partner and this was not addressed in the earlier version of the regulation. A sentence was added to subsection (c)(1) in response to comments received by the public. This sentence allows the single-sales factor formula election to be made at the partnership level to determine the California source income of the nonunitary corporate partner.

(1) Partnerships to the extent owned by corporations. Corporations that elect single-sales factor formula apportionment must use the single-sales factor formula for distributive share items of income and factors from unitary partnerships. A partnership may make a single-sales factor formula election on Part B of schedule R-1 of form 565 or form 568 to determine California source income for its nonunitary partners.

Three new examples are added and two examples are deleted. The following two examples are deleted so that the new examples can clarify that nonunitary partnerships may use the single-sales factor formula at the partnership level.

~~Example 1. Corporation A is a taxpayer. Corporation A and B are members of a combined reporting group. Corporation A owns 50 percent of the unitary Partnership Y. Accordingly, 50 percent of Partnership Y's income and factors are included in Corporation A and Corporation B's combined report. Corporation A makes a single-sales factor formula election. Corporation A's sales factor will include the California sales of Partnership Y to the extent of its ownership interest. Partnership Y's payroll and property will be disregarded for apportionment purposes consistent with Corporation A's election.~~

~~Example 2. Same facts as Example 1 except that Corporation A owns 50 percent of the nonunitary Partnership Z instead of a 50 percent interest in unitary Partnership Y. Pursuant to California Code of Regulations section 25137-1, subsection (g), Corporation A's distributive share of Partnership Z's income is treated as income from a separate trade or business and Corporation A's single sales factor election does not apply to determining Partnership Z's California sourced income. Partnership Z's California source income is separately determined utilizing the rules contained in California Code of Regulations, section 25137-1, subsection (g).~~

Example 1 is added to illustrate when and where a single-sales factor formula election may be made when there is a partnership owned by two corporate partners, one

unitary and one not unitary with the partnership. For the unitary corporate partner, the election is made at the partner level with the distributive share items of income and factors from the partnership combined with those of the corporate partner. For the nonunitary corporate partner, the election is made at the partnership level to determine the California source income of the nonunitary partner.

Example 1: Partnership Y is owned 50 percent by Corporation A, which is a member of a combined reporting group, Group A, and 50 percent by Corporation B, which is a member of a combined reporting group, Group B. Partnership Y is unitary with Group A but not with Group B. If Group A makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from Partnership Y, adding 50 percent of the sales factor numerator and denominator of Partnership Y to those of Group A and adding 50 percent of total business income of Partnership Y to that of Group A. Partnership Y may make a single-sales factor formula election or may choose to not elect and remain on the three-factor formula to determine the California source income for Corporation B.

Example 2 is added to illustrate when and where a single-sales factor formula election may be made when there is a limited liability company treated as a partnership that has several owners, each operating independent apportioning trades or businesses, some unitary and some not unitary with the limited liability company. The corporate partner that is unitary with the limited liability company may make a single-sales factor formula election and, if it does so, must use the single-sales factor formula for its distributive share of items of income and factors from the limited liability company. The limited liability company may use the single-sales factor formula to determine the California source income for each of the nonunitary corporate partners. Since the two nonunitary corporate partners are not unitary with each other, they are instead in separate apportioning trades or businesses and may make separate elections to apportion their own income.

Example 2: A limited liability company M has three owners and has made no election for its classification for tax purposes so by default M is treated as a partnership. Each of the three owners of M operate an apportioning trade or business in addition to that operated by M. M is owned 25 percent by Corporation A, 25 percent by Corporation B, and 50 percent by Corporation C. M is unitary with Corporation C, but not with Corporations A or B. If Corporation C makes a single-sales factor formula election, it must use the same single-sales factor formula for its distributive share items of income and factors from M, adding 50 percent of the sales factor numerator and denominator of M to its own and adding 50 percent of total business income to its own total business income. M may make a single-sales factor method election to determine the California source income for Corporations A or B. Corporations A and B may independently make single-sales factor formula elections for their own separate apportioning trades or businesses that do not include M.

Example 3 illustrates when and where a single-sales factor formula election may be made when there are tiered pass-through entities, with some unitary and some not unitary. As a general rule, when there is a pass-through entity, the ability to make a single-sales factor formula election moves to the next ownership level if the pass-through is unitary with the next-level owner and the next-level owner is not itself a pass-through entity. If the next-level owner is itself a pass-through entity, the election moves up to further levels of unitary owners until reaching a unitary corporate owner where the election may be made, including the distributive share items of income and factors from all the preceding pass-through entities. If the pass-through entity is not unitary with its owner (whether the owner is a corporation or a pass-through entity), then the election may be made at the pass-through entity level to determine the California source income for the nonunitary owner using the income and factors of the pass-through entity which includes the distributive share items of income and factors from all the preceding unitary pass-through entities.

Example 3: Partnership X operates an apportioning trade or business and is owned 50 percent by a limited liability company (R) taxed as a partnership and 50 percent by a limited liability company (T) that has elected to be taxed as a corporation. All three business entities X, R, and T, are unitary. R is owned 5 percent by nonunitary Corporation A, 85 percent by unitary Corporation B, and 10 percent by nonunitary limited liability company S taxed as a partnership. The combined reporting group of X, R, T, and Corporation B is Group Y. The 50 percent distributive share of income and factors from X flows through to R and T. To determine the California source income for the 5 percent distributive share items of income for nonunitary Corporation A, the single-sales factor formula may be used at the R level by R on Part B of schedule R-1 of form 568 using R's factors. The single-sales factor formula may also be used by unitary Corporation B which may elect to use the single-sales factor formula on Part B of schedule R-1 of form 100 if the same election is made by all members of Group Y. Corporation B would add to its own income and factors its 85 percent distributive share of income and factors from R (which would include R's 50 percent distributive share of income and factors from X) and the combined factors and income would be used on Corporation B's schedule R-1 of form 100 or Group Y's group return. To determine the California source income for the 10 percent distributive share items of income for nonunitary S, the single-sales factor formula may be used at the R level on Part B of schedule R-1 of form 568 using R's factors.

24. Subsection (c)(2) is added to reflect comments received from the public regarding the application of the regulation to non-corporate apportioning trades or businesses. The subsection is necessary to explain that the single-sales factor formula may be used by sole proprietorships and partnerships to the extent owned by nonresident individuals. Examples are provided.

(2) Nonresidents.

(A) Sole Proprietorships. A nonresident individual who is a sole proprietor of a business that engages in activities partly within and partly without the

state, as provided in California Code of Regulations section 17951-4, subsection (c)(2), may determine California source income using the single-sales factor formula.

Example 1: Beth Johnson is a nonresident and is the single owner of a sole proprietorship that operates an apportioning trade or business engaged in activities within and without California. Beth Johnson may use the single-sales factor formula on Part B of schedule R-1 for purposes of sourcing her income from the sole proprietorship.

Example 2: John Smith is a nonresident and is the single owner of a limited liability company that operates an apportioning trade or business engaged in activities within and without California. The limited liability company is treated as a disregarded entity for tax purposes. John Smith may make the single-sales factor formula election on Part B of schedule R-1 of form 568 for purposes of sourcing the limited liability company's income.

(B) Partnerships to the extent owned by individuals. A nonresident individual who is a partner in a partnership that engages in activities partly within and partly without the state may determine California source income, as provided in California Code of Regulations section 17951-4, subsection (d)(1), using the single-sales factor formula on Part B of schedule R-1 of form 565, but if the partnership does elect to use the single factor formula, the partnership must use the single-sales factor formula to determine California source income for all nonresident partners.

Example: Janet Jones and Bruce Johnson are nonresidents and are partners in an apportioning trade or business that operates as Partnership X. Each of the partners owns 50 percent of the partnership. Partnership X may elect to use the single-sales factor formula on Part B of schedule R-1 of form 565 to determine the California source income of the partners, but if Partnership X uses the single-sales factor formula, it must do so for both Janet Jones and for Bruce Johnson.

25. There are minor modifications made to the language that can be reviewed in the full proposed draft. These include consistently referring to Revenue and Taxation Code sub-parts as "subdivisions" and California Code of Regulation sub-parts as "subsections," deleting references to "paragraph" after "subsection," changing "who" to "which" when the reference is to a corporation, changing the language for a series of years to be more concise, deleting unnecessary words, changes in punctuation for uniformity, and changes to numbering to accommodate added paragraphs,

These nonsubstantial or sufficiently related changes are being made available to the public for the 15-day period required by Government Code section 11346.8, subdivision (c), and Section 44 of Title 1 of the California Code of Regulations. Written comments regarding these changes will be accepted until 5:00 p.m. on May 31, 2011.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes, as well as those who attended the hearing and those who commented orally or in writing, and will be available to other persons upon request. All inquiries and written comments concerning this notice should be directed to Colleen Berwick (916) 845-3306, FAX (916) 845-3648, E-Mail: colleen.berwick@ftb.ca.gov, or by mail to the Legal Division, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. This notice and the proposed amendments and adoptions will also be made available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.