

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 recommended that certain changes be made which were published in a 15-day notice on May 16, 2011. One comment was received during the 15-day comment period. In response to that comment, further 15-day changes are now proposed to be made. Several of the modifications are minor adjustments to the facts in examples. Further adjustments are made for clarification, including adding one example.

1. Subsection (b)(3) is revised at Example 1 and Example 2 because it is possible that some of the general corporations in the Examples engage in qualified business activities. If that is the fact pattern, then, pursuant to Revenue and Taxation Code section 25128, gross business receipts from those qualified business activities of the general corporations would be included in the computation to determine if more than 50 percent of the gross business receipts of the combined reporting group are from qualified business activities. In addition, Example 4 is added to provide an illustration of when a single-sales factor election may not be made because a combined reporting group has more than 50 percent of its gross business receipts from qualified business activities.

Example 1: Corporation A is a bank or financial corporation. Corporations B and C are general corporations. Corporation A, B, and C are members of the same combined reporting group, Group X. Group X receives less than 50 percent of its gross business receipts from the qualified banking and financial activities of Corporation A. Accordingly, Corporation A may make the single-sales factor formula election along with Group X.

Example 2: Same facts as Example 1, except that Group X receives more than 50 percent of its gross business receipts from the qualified banking and financial activities of Corporation A. Corporation A must apportion pursuant to Revenue and Taxation Code section 25128, subdivision (b), and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

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 activityes.

Example 4: Same facts as Example 1, except that general corporations B and C are unitary partners in Partnership F that conducts banking and financial activity as a part of the combined reporting group, Group X. The distributive share of gross business receipts from Partnership F combined with the business receipts from Corporation A cause Group X to have more than 50 percent of its gross business receipts from qualified business activities. Group X may not make the single-sales factor formula election.

2. The example following subsection (b)(4)(C) is modified to provide the correct end date for the first common six-month period and to change "last" to "first" to correctly indicate that the first common six-month period is the first six months of Corporation D's fiscal year.

Example: Corporations A, B, C, and D are California taxpayer members of a combined reporting group. Corporations A, B, and C are calendar year taxpayers and are included in a group return. Their return filed for taxable year ending December 31, 2011 uses the single-sales factor formula. Conversely, Corporation D has a fiscal year end on June 30th. The return Corporation D files for the year end of June 30, 2012 uses the standard formula. The first common six-month period for taxable years beginning on or after January 1, 2011 for all of the taxpayers begins on July 1, 2011, and ends on ~~December 31, 2011~~ June 30, 2012. The business assets for the last six months of 2011 for electing Corporations A, B, and C are compared to the business assets of non-electing Corporation D for the same time period. If the business assets of electing Corporations A, B, and C are greater than the business assets of non-electing Corporation D for the common six-month period; then Corporation D is deemed to have elected the single-sales factor formula for apportionment. Conversely, if the business assets of non-electing Corporation D are greater than the business assets of Corporations A, B, and C for the common six-month period, there is no single-sales factor formula election for Corporations A, B, or C. For all taxable years thereafter, the business assets test will be based on a comparison of the business assets for the ~~last~~ first six-month period of Corporation D's fiscal year.

3. Subsection (b)(5) is modified to delete reference to subsection (A), since there are no other subsections. In addition, minor modifications are made to Examples 1 and 4.

Example 1: Corporations A, B, and C are included in a group return for calendar Years 1 through 6 that includes a single-sales factor formula election. On June 15 of Year 7 the Franchise Tax Board makes an audit determination that Corporation C was erroneously included in the combined report for every year. Corporation C must make the single-sales factor formula election for any of the Years 1 through 6 by August 15 of Year 7. Thereafter, Corporation C may make the single-sales factor formula election on its timely filed original returns.

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 13~~5~~ (60 days from the date of audit determination) 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~~ of Year 6 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.

4. Subsection (c)(1) is modified at Example 3 to change the level of ownership from 50 percent to 60 percent, making it clear that the limited liability company T that is taxed as a corporation is unitary with Partnership X and satisfies the unity of ownership requirement. As originally written, there could have been a unity of ownership issue with T owning exactly 50 percent of Partnership X.

Example 3: Partnership X operates an apportioning trade or business and is owned ~~54~~0 percent by a limited liability company (R) taxed as a partnership and ~~56~~0 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 shares 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 ~~540~~ 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.

5. Subsection (c)(2)(B) is modified to add the word "nonunitary" for clarification.

(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 nonunitary nonresident partners.

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 June 23, 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/>.