

FINAL STATEMENT OF REASONS  
FOR PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS,  
TITLE 18, SECTION 25128.5

The proposed regulations do not impose any mandate on local agencies or school districts.

**UPDATE OF INITIAL STATEMENT OF REASONS**

The public notice required by section 11346.4 of the Government Code was mailed and published in the California Notice Register on January 20, 2011. The hearing was held, as noticed, on March 29, 2011, to consider the adoption of Regulation section 25128.5, which provides guidance on how to make the single-sales factor formula election. There were nine attendees at the hearing. No oral testimony was received. Two written comments were received during the comment period, which ended at 5:00 p.m. on March 29, 2011.

As a result of comments received, changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on May 16, 2011. One comment was received regarding the 15-day changes.

As a result of the comment received, changes were made to the initial proposed regulation. The changes were noticed in a second 15-day change notice, mailed on June 8, 2011. One comment was received regarding the 15-day changes. No further changes were made.

Changes were made to the proposed regulation for clarity as part of the 15-day changes. The proposed modifications constitute sufficiently related changes (within the meaning of Govt. Code section 11346.8). These modifications are described below:

1. The final phrase in subsection (a)(1), "without regard to unity," is deleted as unnecessary and possibly confusing. The subsection is amended to read:
  - (1) Affiliated corporations. "Affiliated corporations" are corporations related by common ownership ~~without regard to unity.~~
2. Subsection (a)(2) is modified to delete references to Revenue and Taxation Code (RTC) sections 25101 and 25120. RTC section 25101 states, "When the income of a taxpayer subject to the tax imposed under this part..." A comment was received that this language, if incorporated in this regulation, would appear to limit application of this regulation to taxpayers that are subject to the corporate franchise or income tax because Part 11 of the Revenue and Taxation Code is the Corporate Tax Laws and Regulations. Since apportioning trades or businesses can operate in business forms other than corporations, referencing RTC section 25101 is deleted. In addition, RTC section 25101 specifically refers to RTC section 25120. As a result, that section is deleted as well. Language is added to define "apportioning trade or business" rather than to incorporate specific sections in the Revenue & Taxation Code. It is explained that an apportioning trade or business

"has income derived from sources within this state and from sources outside this state." Finally, language is added to provide guidance on the types of business forms an apportioning trade or business may operate within. This is a non-exclusive list of business forms provided so that an explanation of how the single-sales factor formula election is made for each business form can be included within the regulation. Subsection (a)(2) is amended to read:

(2) Apportioning trade or business. "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned because it has income derived from sources within this state 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 and from sources outside this state. An apportioning trade or business ~~includes at least one taxpayer~~ 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 is operated by an individual who is not a resident of California.

3. Subsection (a)(3) is modified to delete references to "group" and a "combined report" since an apportioning trade or business may operate outside of a group and a combined report. Deleting these references and adding a reference to "an apportioning trade or business" removes the restriction that the business must operate within a group setting. The subsection is amended to read:

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

4. Subsection (a)(4) is modified to provide consistent formatting. The subsection is amended to read:

(4) Banking or financial business activity. "Banking or financial business activity" means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

5. Subsection (a)(7) is modified to provide consistent citation formatting. The subsection is amended to read:

(7) Combined reporting group. A "combined reporting group" is as defined by California Code of Regulations section 25106.5, subsection (b), ~~paragraph~~ (3).

6. A minor modification is made to subsection (a)(10) to recognize that Subchapter S is a reference to Subchapter S, Tax Treatment of S Corporations and Their Shareholders, contained in Chapter 1 of the Internal Revenue Code at Sections 1361 through 1379. All corporations with a valid federal S corporation election are also S corporations for California purposes (RTC section 23801). The subsection is amended to read:

(10) Corporation. References to "corporation" include a ~~S~~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.

7. Subsection (a)(11) is added to define "disregarded entity" by reference to California Code of Regulations, title 18, section 23038(b)-2, allowing the term used in the regulation to have consistent meaning. The new subsection reads:

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

8. The numbering of subsection (a) is modified starting at subsection (a)(11) due to the addition of a new subsection (a)(11).

9. Minor changes are made to former subsections (a)(12) and (a)(17) to correctly refer to "subdivision" when referencing the statutes of the Revenue and Taxation Code. The subsection is amended to read:

~~(12)~~(13) Gross business receipts. "Gross business receipts" is as defined by Revenue and Taxation Code section 25128, ~~subsection~~subdivision (d)(1).

~~(17)~~(22) Qualified business activities. "Qualified business activities" are as defined in Revenue and Taxation Code section 25128, ~~subsection~~subdivision (c).

10. A new subsection is added at subsection (a)(15) to define "limited liability company" by reference to RTC section 17941, subdivision (d), allowing the term used in the regulation to have consistent meaning. The new subsection reads:

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

11. A new subsection is added at subsection (a)(15) to define "member" by reference to California Code of Regulations, title 18, section 25106.5, subsection (b)(10), allowing the term used in the regulation to have consistent meaning. The new subsection reads:

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

12. A new subsection is added at subsection (a)(19) to define "nonresident" by reference to California Code of Regulations, title 18, section 17014, allowing the term used in the regulation to have consistent meaning. The new subsection reads:

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

13. A new subsection is added at subsection (a)(21) to define "partnership" by reference to RTC section 17008 and California Code of Regulations, title 18, section 23038(b)-3, allowing the term used in the regulation to have a consistent meaning. This term was used in the original language, but was not defined. The new subsection reads:

(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.

14. New subsections are added at subsections (a) (23), (a)(24), (a)(25), and (a)(26) to define "qualified Subchapter S subsidiary," "resident," "S corporation," and "sole proprietorship," allowing these terms used in the regulation to have a consistent meaning. The new subsections read:

(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.

(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).

(25) S corporation. An "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.

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

15. A new subsection is added at subsection (a)(28) to define "taxpayer," allowing this term to have consistent meaning. Only "taxpayer member" was defined in the original language, yet "taxpayer" is used throughout the regulation. The new subsection reads:

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

16. A new subsection is added at subsection (a)(31) to define "unitary," allowing the term to have consistent meaning. The original language defined "unitary business" but did not define "unitary," though that term is used in the regulation. The new subsection reads:

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

17. Subsection (b)(1) and the example that follows are amended to make minor grammatical corrections, eliminate unnecessary words, and make stylistic changes. The words "combined reporting group" are retained in this subsection because this subsection addresses whether all members of a combined reporting group must elect to have a valid single-sales factor formula election. The subsection is amended to read:

(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~~For an election to be effective for purposes of apportioning the business income of a combined reporting group ~~to be effective~~, 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.

Example: Corporation P, a calendar year California taxpayer, has a subsidiary, Corporation A, ~~whewhich~~which is also a calendar year California taxpayer. Corporation P and Corporation A are members of the same combined reporting group. On its separate timely filed return, Corporation P makes a single-sales factor formula election. Conversely, on its separate timely filed return, Corporation A does not make a single-sales factor formula election. As a result, neither Corporation P nor Corporation A are deemed to have made a single-sales factor formula election.

18. Subsection (b)(3) is amended to change from references to "combined reporting groups" to the singular "apportioning trade or business" to remove the limitation that the business operate within a group setting. The amended subsection reads:

(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 ~~combined reporting group~~apportioning trade or business does not derive more than 50 percent of its gross business receipts from qualified business activities.

19. Examples 1 and 2 following subsection (b)(3) are amended to specify that the receipts being discussed are from qualified banking and financial activities rather than specifically referring to the receipts from Corporation A because Corporation A may have some receipts that are not from qualified banking and financial activities and there may be other entities in Group X that have qualified banking and financial activities that would be included in the calculation to determine whether Group X has more than 50 percent of gross business receipts from qualified business activities. This clarification was requested by a commentator. The examples as amended read:

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, ~~subsection subdivision (b)~~, and is precluded from making a single-sales factor formula election. Group X may not make the single-sales factor formula election.

20. Examples 3 and 4 are added to subsection (b)(3) to provide further guidance using different fact patterns with different types of entities and different combinations of unitary and nonunitary relationships. The original Example 1 and Example 2 only involved corporations. Example 3 includes a partnership and two partners that are not unitary with the partnership. Example 4 includes unitary corporate partners. The new examples read:

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 qualified business activities.

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.

21. Subsection (b)(4)(A) is deleted as unnecessary. The identity of any members of a combined reporting group that during the year become subject to taxation under Part 11 of the Revenue and Taxation Code will be known at the end of each taxable year when the single-sales factor formula election is made and hence no deemed election is needed. The numbers of the succeeding subsections are adjusted to accommodate this deletion. The deleted subsection reads:

(4) Deemed Single-Sales Factor Formula or Standard Formula Elections and Non-Elections.

~~(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.~~

22. The example following former subsection (b)(4)(D) is amended at the current subsection (b)(4)(C) to correct an error in the date in the original text and to correct an error by deleting "last" six-month period and inserting "first" six-month period. The example as amended reads:

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 ~~June 30, 2012~~December 31, 2011. 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.

23. Examples 1, 2, and 3 following subsection (b)(5) are amended to use the phrase "Years 1 through 6" instead of the more cumbersome "Years 1, 2, 3, 4, 5, and 6" as it was stated in the original text. In addition, the phrase "any of the" was added to indicate that a single-sales factor formula election can be made for each year independently and the same election would not need to be made for all possible years. The examples as amended read:

Example 1: Corporations A, B, and C are included in a group return for calendar Years ~~1, 2, 3, 4, 5, and~~ 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, 2, 3, 4, 5, and~~ 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 2: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years ~~1, 2, 3, 4, 5, and~~ through 6 on December 26 of Year 7. There is no valid single-sales factor election for Years ~~1, 2, 3, 4, 5, and~~ through 6 because the election was made more than 180 days after the audit determination on June 15 of Year 7.

Example 3: Same facts as Example 1, except that Corporation C files amended returns using the single-sales factor formula for Years ~~1, 2, 3, 4, 5, and~~ through 6 on September 10 of Year 7. There is a valid single-sales factor election for Years ~~1, 2, 3, 4, 5, and~~ through 6 provided Corporation C successfully shows good cause for electing more than 60 days after the audit determination of June 15 of Year 7.

24. Subsection (b)(6) is amended to delete the reference to RTC section 25128, subdivision (d)(6), because that subdivision includes a reference to RTC section 25101 which in turn refers to "a taxpayer subject to the tax imposed under this part" which, consistent with comments received, is too limiting because using that definition would exclude apportioning trades or businesses operating in business forms other than corporations. The subsection as amended reads:

(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.

26. Subsection (b)(6) originally had no examples. Five examples are added to subsection (b)(6), with Example 1 moved to subsection (b)(6) from subsection (c)(1) and modified. One of the changes to Example 1 is to use the phrase "apportioning trade or business" to be consistent with the rest of the regulation. Other changes to Example 1 change phrasing and word choice for clarity. The four new examples (Examples 2 through 5) provide a variety of fact patterns for guidance. The examples as amended read:

Example 1: Corporations A and B are California taxpayers and are affiliated with each other and with, 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 unitary apportioning trade or business and form a combined reporting group, Group X. Corporations B, E, F, H, and I are engaged in another separate unitary apportioning trade or business and form a combined reporting group, 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 members of a combined reporting group that includes at least one California taxpayer, each may independently elect to file on a single-sales factor formula basis for purposes of apportioning business income of their respective 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.

Example 2: Corporation W is a taxpayer that owns 50 percent of two separate apportioning trade 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: 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 trade 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: 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: 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 trade or business of U and V as determined using the single-sales factor formula with U and V's sales factors.

27. Subsection (b)(7)(B) is modified to identify additional forms where the single-sales factor formula election may be made. These additions are compelled by changes made to other subsections of this regulation to make clear that apportioning trades or businesses operating in forms other than corporations may make the single sales factor election. As amended, subsection (b)(7)(B) now reads:

(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).

28. Subsection (c)(1) is deleted as redundant with subsection (b)(6). The example following subsection (c)(1) is moved to be Example 1 under subsection (b)(6) and modifications to Example 1 are shown under that subsection. The deleted subsection reads:

(c) Miscellaneous Provisions.

~~(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.~~

29. A new subsection (c)(1) is added. It addresses partnerships to the extent owned by corporations and explains when a single-sales factor formula election may be made and where the election is made. Three new examples follow subsection (c)(1) to provide guidance in a variety of fact patterns. The new subsection (c)(1) and examples read:

(c) Miscellaneous Provisions.

(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.

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: 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: Partnership X operates an apportioning trade or business and is owned 40 percent by a limited liability company (R) taxed as a partnership and 60 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 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 40 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.

30. Subsection (c)(2)(A) is added to address nonresident sole proprietorships that operate apportioning trades or businesses because these were not included in the original language. Since an apportioning trade or business can operate as a sole proprietorship owned by a non-resident, it is necessary to provide guidance on whether the non-resident may use the single-sales factor formula to determine California source income. The new subsection (c)(2)(A) and two examples read:

(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.

31. Subsection (c)(2)(B) is added to address partnerships to the extent owned by non-resident individuals to provide guidance on whether these non-resident individual partners may use the single-sales factor formula to determine their California source income. There was no guidance for non-resident partners in the original language. The new subsection (c)(2)(B) and one example read:

(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.

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.

The final version of the regulation was presented to the Franchise Tax Board for its approval at its July 7, 2011 public meeting. The Board was provided with all of the comments received during the regulatory process, as well as responses to the comments. The Board approved the regulation by a vote of 3-0.

#### **ALTERNATIVES DETERMINED**

The Franchise Tax Board has not received any proposed alternatives that would lessen the adverse economic impact that the proposed regulations would have on small businesses. The Franchise Tax Board has determined that no alternative would be more effective in carrying out the purpose of the proposed regulations or would be as effective and less burdensome to affected private persons than the proposed amendments to the existing regulation.