

**INITIAL STATEMENT OF REASONS FOR THE  
ADOPTION OF CALIFORNIA CODE OF REGULATIONS,  
TITLE 18, SECTION 25128.5**

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

California Revenue and Taxation Code section 25128.5 was enacted in 2009 and is operative for taxable years beginning on or after January 1, 2011. The new statute allows certain taxpayers subject to California franchise or income tax an annual election to use a single-sales factor method to apportion their business income to California. This method uses only a sales factor instead of the current three-factor formula based on property, payroll, and sales. There is no existing regulation under California Revenue and Taxation Code section 25128.5 that explains how the single-sales factor election will operate. Revenue and Taxation Code section 25128.5(c) authorizes the Franchise Tax Board to issue regulations necessary or appropriate regarding the making of an election under this section, including "regulations that are consistent with rules prescribed for making an election under Section 25113."

**SPECIFIC PURPOSE OF THE REGULATIONS**

The purpose of the proposed regulation is to instruct multistate taxpayers on how to make a single-sales factor election. The regulation will achieve that purpose by providing definitions, guidelines, and examples that provide information beyond that provided by the underlying code section.

**NECESSITY**

During 2009, the California Legislature adopted Revenue and Taxation Code section 25128.5, operative for taxable years beginning on or after January 1, 2011. This new statute allows certain taxpayers subject to the California franchise or income tax the opportunity to elect an alternate method of apportionment that uses only a sales factor instead of the current three-factor formula based on property, payroll, and sales. California Revenue and Taxation Code section 25128.5, subdivision (c), authorizes the Franchise Tax Board to issue necessary or appropriate regulations regarding the making of the election. Since Revenue and Taxation Code section 25128.5 lacks specificity regarding certain aspects of the single-sales factor election, a regulation is necessary to inform taxpayers how, when, and under what circumstances the new single-sales factor election may be made.

There are many issues to be addressed by way of regulation so that procedures are in place to implement this new alternate method of apportionment. Some of these issues include the following: what is required to execute a valid election, the timing required to execute the election, whether the election applies to all members of a combined reporting group, any

circumstances under which the election would be terminated, what happens when some members of a combined reporting group make the election and others do not make the election, what happens when there are mid-year changes in membership of the combined reporting group, what happens when a member of the combined reporting group is de-combined at audit years after the close of the taxable year, and what happens when a taxpayer files conflicting returns (both electing and non-electing) prior to the due date of the return.

The Franchise Tax Board looked to existing statutes and regulations that address the water's-edge election and used these as a model, adopting some of the definitions, and adding others that were needed for the single-sales factor election but not contained in the model language. The water's-edge statutes and regulations reviewed included California Revenue and Taxation Code section 25110 (two versions, both applicable to taxable years beginning on or after January 2006), California Code of Regulations section 25110, California Revenue and Taxation Code section 25113, California Code of Regulations section 25113 (adopted May 6, 2009, applicable to taxable years beginning on or after January 1, 2008.)

Subsection (a) defines terms contained within the regulation and was largely taken from California Code of Regulations section 25113, subsection (b) which contains the definitions for the water's-edge election of apportioning taxpayers with the addition of some terms that were not contained in the water's-edge regulations. The following definitions were modeled from section 25113, subsection (b) with the defined term followed by the subsection number of California Code of Regulation section 25113 upon which the definition was modeled: "original return," subsection (b)(2); "timely filed," subsection (b)(3); "commencement date," subsection (b)(4); "net book value," subsection (b)(5); "parent corporation," subsection (b)(6); "business assets," subsection (b)(10); "good cause," subsection (b)(12).

The term "affiliated corporations" in proposed subsection (a)(1) is included to provide a simple definition of corporations that are related by ownership. The definition of "affiliated corporation" in the water's-edge statutes and regulations is not used because it refers to California Revenue and Taxation Code section 25105 which includes subsections not needed in this proposed regulation. Other definitions such as those in the Internal Revenue Code and Treasury Regulations are too complicated and cumbersome. The defined term is needed so that the proposed regulation can use the term in stating that taxpayers that own two lines of business that are separate need not make the same decision regarding the single-sales factor election for both lines of business. This defined term lays out that the two lines of business have some common ownership between them but are not unitary. If the two lines of business are unitary, then both would need to make the same election decision as they would be within one combined reporting group.

The term "apportioning trade or business" in proposed subsection (a)(2) is one that is in the underlying statute authorizing the single-sales factor election at California Revenue and Taxation Code section 25128.5, subsection (a) where it states, in pertinent part, "...any apportioning trade or business ... may make an irrevocable annual election on an original timely filed return, in the manner and form prescribed by the Franchise Tax Board..." Since

only "taxpayers" have the obligation to file a tax return in California, "apportioning trade or business" is defined to include at least one member that is a "taxpayer."

The term "apportionment" in proposed subsection (a)(3) is included so that it can be used in the proposed regulation text in the definition of "standard formula" in proposed subsection (a)(18), in Example 1 in proposed subsection (b)(4)(B), in the Example after proposed subsection (b)(4)(D), in the partnership subsection in proposed subsection (c)(2), and in Example 1 following that subsection. The definition refers to Revenue and Taxation Code sections 25128 through 25137 and section 25141 as the general statutory sections governing apportionment.

The term "banking and financial business activity" in proposed subsection (a)(4) is included in the proposed regulation so that the term can be used in the Example following proposed subsection (b)(3). After the second interested parties meeting, a question arose about whether combined reporting groups that fall under California Code of Regulations section 25137-10 would be allowed to make the single-sales factor election. California Code of Regulations section 25137-10 provides apportionment rules for combined reporting groups that have both bank and financial corporations and general corporations in the same combined reporting group and applies when the general corporation activities are predominant in that they give rise to gross income that is more than 50 percent of the unitary business's gross income. The question arose because the underlying statute at California Revenue and Taxation Code section 25128.5, subsection (a), states, "...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..." A bank or financial is one of the four types of business described in California Revenue and Taxation Code section 25128, subsection (c) where "qualified business activities" is defined for use in California Revenue and Taxation Code section 25128, subsection (b). It is necessary to provide guidance as to the exclusion of businesses engaged in qualified activities set forth in California Revenue and Taxation Code section 25128.5, subsection (a). That guidance is provided in proposed subsection (b)(3) and the Examples following that subsection.

The term "business asset test" in proposed subsection (a)(6) is included as this test is applied in the water's edge statutes and regulations but not explained other than by example. This can be seen at California Code of Regulations section 25113 (adopted May 6, 2009), subsection (c)(2)(A)4, subsection (d)(3)(A), and subsection (f)(2). The business asset test is also used in California Revenue and Taxation Code section 25113, subsection (c)(2), subsection (c)(4), and subsection (c)(5). It is beneficial to offer a definition of "business asset test" rather than simply a definition of "business assets." The water's-edge regulation defines "business assets" and uses the term in applying the test, but never defines the test itself. The definition allows for efficient reference rather than always providing an example or fully explaining in each instance where the business asset test is applied.

The term "combined reporting group" in proposed subsection (a)(7) incorporates the definition at California Code of Regulations section 25106.5, subsection (b)(3) so that this term can be used in the text of the following subsections of this proposed regulation: (a)(5); (a)(6); (a)(14); (a)(15); (b)(1); (b)(2); (b)(3); (b)(4); (b)(5); (c)(2); and (c)(3).

The term "common ownership" in proposed subsection (a)(9) is included so that it can be used within the definition of "affiliated corporations" in proposed subsection (a)(1) explained above. The main source of this language is Revenue and Taxation Code section 25105, subsection (b), which defines "commonly controlled group." The term "commonly controlled group" is not used because that term refers to corporations that are in the same combined reporting group and the term "common ownership" is to be used without regard to unity. Select portions of Revenue and Taxation Code section 25105 are included to define "common ownership" for purposes of this proposed regulation without regard to unity. Accordingly, language from California Code of Regulations section 25105, subsections (b)(1)(A) and (B) are used within this proposed subsection.

The term "corporation" in proposed subsection (a)(10) incorporates language from California Code of Regulations section 25110, subsection (b)(1) and California Code of Regulations section 25106.5, subsection (b)(19). These regulations provide a starting point for language in proposed subsection (a)(10) to which more detail is added for purposes of guidance. That additional detail includes references to subchapter S corporations and California Revenue and Taxation Code section 23038.5 for publicly traded partnerships. The term "corporation" is used throughout the proposed regulation.

The term "gross business receipts" in proposed subsection (a)(12) is added, incorporating the definition at Revenue and Taxation Code section 25128, subsection (d)(1) so that this term can be used in proposed subsection (b)(3). The term "gross business receipts" is used when determining whether a combined reporting group derives more than 50 percent of its gross business receipts from qualified business activities. If the combined reporting group derives more than 50 percent of its gross business receipts from qualified business activities, then it must use the three-factor apportionment formula as set forth at California Revenue and Taxation code section 25128, subsection (b), and may not make a single-sales factor election.

The term "group return" in proposed subsection (a)(13) incorporates the definition at California Code of Regulations section 25106.5, subsection (b)(13). This definition is added so that the term can be used in proposed subsection (b)(2), subsection (b)(4), subsection (b)(5), and subsection (c)(1).

The term "new combined reporting group" in proposed subsection (a)(15) is a definition that is a corollary to the one provided in California Code of Regulations section 25113, subsection (b)(8) which defines "new unitary affiliate group." The term from the water's-edge regulation is changed to "new combined reporting group" because the term "combined reporting group" by definition is the group after the water's-edge election has been made and is the correct term for the purposes of this proposed regulation. "Combined reporting group" is used in this proposed regulation because the single-sales factor election deciding the apportionment method is made after the water's-edge election deciding membership in the group and the single-sales factor election only pertains to the combined reporting group, whether worldwide or water's-edge.

The term "qualified business activities" in proposed subsection (a)(17) is added in response to a concern raised at the second interested parties meeting, as previously explained for

proposed subsection (a)(4). To explain under what circumstances corporations engaged in qualified business activities may make a single-sales factor election, it is necessary to use the term "qualified business activity." The proposed section (a)(17) incorporates the definition provided at California Revenue and Taxation Code section 25128, subsection (c).

The term "standard formula" in proposed subsection (a)(18) is added so that the proposed regulation can refer to the standard three-factor apportionment method used by a non-electing apportioning trade or business. This is necessary so that the term can be used in proposed subsection (a)(6) for the "business asset test" definition, in proposed subsection (b)(4) for deemed elections and non-elections, and in the Examples provided after numerous subsections of the proposed regulation.

The term "taxpayer member" in proposed subsection (a)(19) is added to make clear that the term uses the same definition already provided by California Revenue and Taxation Code section 25106.5, subsection (b)(11) which states that a "taxpayer member" is a corporation which is a member of a combined reporting group which is required to file a tax return in this state." The term "taxpayer member" is used within the definition of "apportioning trade or business" in proposed subsection (a)(2), in proposed subsection (b)(1) where it states that each taxpayer member must make the election, in proposed subsection (b)(2) where it states that an election on a group return binds all taxpayer members of that combined reporting group unless there are certain other circumstances, in proposed subsection (b)(4) discussing deemed elections and non-elections, and in proposed subsection (c)(3) discussing changes in affiliation.

The term "unitary business" in proposed subsection (a)(21) comes from California Code of Regulations section 25110, subsection (b)(5), which is one of the earlier water's-edge regulations. This definition is included so it can be used in proposed subsection (c)(1) which discusses that a taxpayer engaged in more than unitary business may make separate decisions about whether to make a single-sales factor election for each unitary business. The term is also used in an Example in proposed subsection (b)(8).

Subsection (b)(1) addresses the time and manner of making a valid election. For the election to be valid, it must be made on an original timely filed return and every member of the combined reporting group must make the election. An example is provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain when the election is to be made and which corporations must make the election. This proposed subsection is written to be consistent with California Code of Regulations section 25113, subsection (c)(1) with some alterations in language to meet the purposes of the single-sales factor election rather than the water's-edge election. For example, the statutory reference is different because the statute authorizing the single-sales factor election is different than the statute authorizing the water's-edge election. In addition, the word "self-assessed" is removed as being unnecessary. Finally, the phrasing of the second sentence is slightly different though the meaning is nearly identical.

Subsection (b)(2) generally states that if any member of a combined reporting group files a separate return without making the election, then every member of the combined reporting

group will be treated as if it had not made the election. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain what happens if one or more members of a combined reporting group fail to meet the requirements to make the election. This proposed subsection is written to be consistent with California Code of Regulations section 25113, subsection (c)(2) with some alterations in language to meet the purposes of the single-sales factor election rather than the water's-edge election. For example, the word "self-assessed" is removed as being unnecessary and the subsection references are different because the proposed regulation does not have the exact same subsections as the water's-edge regulation.

Subsection (b)(3) contains a rule regarding when a combined reporting group that has one or more entities that conduct qualified business activities may make the single-sales factor election. Examples are provided. After the second interested parties meeting, a question arose whether combined reporting groups that fall under California Code of Regulations section 25137-10 will be allowed to make the single-sales factor election. California Code of Regulations section 25137-10 provides apportionment rules for combined reporting groups that have both bank and financial corporations and general corporations in the same combined reporting group and applies when the general corporation activities are predominant in that they give rise to gross income that is more than 50 percent of the unitary business's gross income. The question arose because the underlying statute creating the single-sales factor election at California Revenue and Taxation Code section 25128.5, subsection (a), states, "...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..." Hence, an apportioning trade or business that derives more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities listed at RTC section 25128, subsection (c) are expressly prohibited from making a single-sales factor election under RTC section 25128.5, subsection (a). There are four types of businesses described in California Revenue and Taxation Code section 25128, subsection (c) where "qualified business activities" is defined for use in California Revenue and Taxation Code section 25128, subsection (b) and these are agricultural, extractive, savings and loan, and banking or financial activities. While the original question arose as to banking and financial activities, the treatment would be the same for all four of the qualified business activities; hence the proposed regulation refers to "qualified business activities" and only specifically refers to banking and financial activities in the Examples. It is necessary to provide guidance regarding the exclusion in California Revenue and Taxation Code section 25128.5, subsection (a) for "other than an apportioning trade or business described in subdivision (b) of Section 25128." When a combined reporting group derives 50 percent or less of its "gross business receipts" from one or more qualified business activities, then that combined reporting group may make the single-sales factor election for all members of the combined reporting group, even those conducting qualified business activities. The statute at RTC section 25128.5 does not explain under what circumstances a combined reporting group that contains corporations engaged in one or more qualified business activities may make a single-sales factor election. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain when corporations engaged in qualified business activities may make a single-sales factor election. That guidance is provided in proposed subsection (b)(3) and the Examples following that subsection.

Subsection (b)(4)(A) addresses a deemed election involving a corporation which, while a member of a combined reporting group that made a single sales factor election, previously was not considered a taxpayer itself, but subsequently is determined to be a taxpayer. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain what happens when a corporation that was not a taxpayer at the beginning of the taxable year becomes a taxpayer part way through the taxable year. This subsection explains that when the corporation becomes a taxpayer part way through the taxable year it is deemed to have made the single-sales factor election. This proposed subsection is written to be consistent with the rules already contained in California Code of Regulations section 25113, subsection (c)(2)(A)3. The language is nearly identical to that in the water's-edge regulation with only minor adjustments.

Subsection (b)(4)(B) addresses a deemed election involving a corporation which was previously not considered a combined reporting group member, but is subsequently determined to be a combined reporting group member. Examples are provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain what happens to the single-sales factor election made by a combined reporting group that has a corporation that was not a member of the combined reporting group at the beginning of the taxable year, but later becomes a member of the combined reporting group part way through the taxable year. This subsection explains that the corporation becoming a member part way through the taxable year is deemed to have made the single-sales factor election. This proposed subsection is consistent with the rules contained in California Code of Regulations section 25113, subsection (c)(2)(A)4. The operative language is nearly identical to that in the water's-edge regulation with additional text added. One addition is that in the parentheses the term "audit determination" is defined within the proposed regulation. This definition of "audit determination" is taken from California Code of Regulations section 25106.5-3, subsection (b) where "audit examination" is defined in parentheses for purposes of accounting methods and elections. Another addition to proposed subsection (b)(4)(B) from the water's-edge regulation used as a model is that the commencement date of the deemed election is included and this language comes from California Revenue and Taxation Code section 25113, subsection (c)(5), one of the water's-edge statutes. This proposed subsection also includes language from California Revenue and Taxation Code section 25113, subsection (c)(5)(B) that explains what happens if the value of the business assets of the electing taxpayer members does not exceed that of the non-electing taxpayer members. Finally, there is added language from California Revenue and Taxation Code section 25113, subsection (c)(5)(C) that explains that the business assets of non-taxpayer members of the combined reporting group are not included for purposes of the business asset test. Hence, the language in this proposed subsection derives from several sources.

Subsection (b)(4)(C) provides for the use of a business asset test to determine whether the standard formula or the single-sales factor formula will be used for an electing combined reporting group when a taxpayer member files a separate return using the standard formula. This subsection is added in response to taxpayer requests for a safety valve in case one of the members of the combined reporting group erroneously files a separate return on a non-electing basis. The business asset test is a proper mechanism to correct an error as it will

operate effectively in situations such as where a large conglomerate has a very small subsidiary that files a separate return on a non-electing basis. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain what happens to a single-sales factor election made by a combined reporting group if one taxpayer member files a separate return using the standard formula. This proposed subsection explains that the business asset test would be used to determine if the single-sales factor election of the combined reporting group survives the filing of a separate return on a non-electing basis.

Subsection (b)(4)(D) provides for the use of the business asset test to determine whether the standard formula or the single-sales factor formula will be used when taxpayer members file separate returns because their taxable years end on different dates and when some of the members have made the single-sales factor election and others have not made the single-sales factor election. An example is provided. This proposed subsection is included in response to concerns raised at the interested parties meetings about what would happen with taxpayer members of a combined reporting group that have different year ends. While those taxpayer members in a combined reporting group are required to align their accounting periods to the principal member (California Code of Regulations section 25106.5, subsection (c)(5)), the question arose as to how the business asset test would be applied to corporations with different year ends. The initial staff response was that the business assets for a 12 month period will be compared, however concerns from the public about the complexities of such a task were brought to staff attention and were addressed in this proposed subsection by reducing the period to the first common six-month period. Hence, this proposed subsection requires the business asset test to be applied using the first common six-month period to compare business assets between electing and non-electing taxpayer members of the combined reporting group with different year ends. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain how the business asset test will be applied with taxpayer members filing separate returns with different taxable year ends.

Subsection (b)(5) addresses making the election after forced de-combination at audit. Decombined taxpayers are allowed a period of time to file amended returns with the election. Examples are provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain whether a corporation de-combined at audit may make a single-sales factor election years later when that corporation is forced out of the combined reporting group at audit. Since the original return for that de-combined entity will already have been filed so that the window of opportunity to make a single-sales factor election will be otherwise closed; it is necessary to explain that the de-combined corporation will have 60 days to make a single-sales factor election on an amended return that will be treated as an original return. There is no corresponding section addressing de-combination in the water's-edge regulation as only forced combination is addressed, but since this concern arose at one of the interested parties meetings, Franchise Tax Board staff addressed the concern and allowed for a return to be filed during a 60 day period after de-combination to be treated as an original return. The language in parentheses defining "audit determination" was taken from California Code of Regulations section 25106.5-3, subsection (b) where "audit examination" is defined in parentheses for purposes of accounting methods and elections. To be consistent with the

prior subsections that stated that the single-sales factor election must be made on a timely filed original return, rather than create an exception to that rule, the later filed return is treated as an original return, hence complying with the earlier proposed subsection (b)(1). The language regarding the election normally being made during an audit examination, regarding the 60 day window, regarding extension for good cause, regarding the claim for refund from the entity that was erroneously included in the combined reporting group, and regarding providing substantiating information all came from California Code of Regulations section 25106.5-3, subsection (b)(2) which addresses accounting methods and elections.

Subsection (b)(6) allows a taxpayer that is engaged in more than one apportioning trade or business to make separate elections for each trade or business. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain that a taxpayer that is engaged in more than one apportioning trade or business may separately decide whether to make, or not make, a single-sales factor election for each separate apportioning trade or business engaged in by the taxpayer. The term "apportioning trade or business" is used in RTC section 25128.5, subsection (a) and is defined in this proposed regulation at subsection (a)(2) as including at least one "taxpayer member" since it is "taxpayers" that have the obligation to file a tax return. The language is identical to that in California Code of Regulations section 25113, subsection (c)(2)(B), the water's-edge regulation.

Subsection (b)(7) provides the procedure for making a valid election. Generally the tax must be computed using the single-sales factor apportionment method and the taxpayer must complete Part B of schedule R-1 of the California form 100. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to identify the document where the election must be made and what must be included on that document. The language in this proposed subsection is modeled after that in California Code of Regulations section 25113, subsection (c)(3). There are minor changes in word choice, "single-sales factor formula election" replaces "water's-edge election," the form where the election is made was changed to refer to Part B of schedule R-1 of form 100 as this is where the single-sales factor election is to be made. This proposed subsection does not incorporate California Code of Regulations section 25113, subsection (c)(3)(C) that allows the Franchise Tax Board to consider other objective evidence to decide whether a water's-edge election has been made because the single-sales factor election will be evident on the schedule R-1 of form 100 and no other objective evidence would show that an election has been made.

Subsection (b)(8)(A) requires the election to be made on a timely filed, original return and provides examples to illustrate the requirement. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain when and where the election must be made. The language in this proposed subsection is identical to that in California Code of Regulations section 25113, subsection (c)(4)(A), the water's-edge regulation.

Subsection (b)(8)(B) provides for incorporation of a single-sales factor election made on an earlier timely original return into a later filed timely return that supplements the earlier return so long as the later return is consistent with the earlier return. The later timely filed

return is treated as the original return. Examples are provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to address the situation where there are two timely returns, but only one of the timely returns makes the single-sales factor election. The language in this proposed subsection is modeled from California Code of Regulations section 25113, subsection (c)(4)(B). The first sentence is identical to the water's-edge regulation up until the phrase "for purposes of making a" and then "single-sales factor election" replaces "water's-edge election." The "objective evidence" portion of California Code of Regulations section 25113, subsection (c)(4)(B) is not incorporated into this proposed regulation because if a single-sales factor election has been made, it will be evident on the schedule R-1 of the form 100 and no other objective evidence will reflect otherwise. The last sentence in the water's-edge regulation at subsection (c)(4)(B) that pertains to filings that clearly reflect an intent to withdraw an election is incorporated with the change that the filing must be a "timely" filing. In addition, the language in the water's-edge regulation stating "in reference to subsection (c)" is removed from the proposed subsection (b)(8)(B) as "timely filing" is all that is required for the purposes of this subsection .

Subsection (c)(1) addresses affiliated corporations engaged in two distinct unitary businesses. Each distinct unitary business may make an election with respect to one or more of the businesses, but need not elect for all of the businesses. An example is provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain whether two distinct unitary businesses with some common ownership may separately elect to use the single-sales factor formula. This subsection is similar to proposed subsection (b)(6) which states that a taxpayer that is engaged in more than one apportioning trade or business may make a separate election for each apportioning trade or business. This proposed subsection (c)(1) is included because the definition of "apportioning trade or business" at proposed subsection (a)(2) is defined as "a distinct trade or business whose business income is required to be apportioned..." and includes "at least one taxpayer member." Proposed subsection (b)(6) starts with "A taxpayer that is engaged in more than one apportioning trade or business...may make a separate election for each apportioning trade or business." The proposed subsection (b)(6) was taken directly from the water's-edge regulation as explained earlier, however proposed subsection (c)(1) explains that an owner of two separate unitary businesses can separately elect for each of those businesses, without using the circular terms of "apportioning trade or business" and "taxpayer" or "taxpayer member." As a result, proposed subsection (c)(1) is included in this proposed regulation along with a definition of "unitary business" at proposed subsection (a)(21) and a definition of "affiliated corporations" at proposed subsection (a)(1).

Subsection (c)(2) addresses the treatment of distributive shares of income from unitary partnerships when the combined reporting group has made an election. Examples are provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain whether a single-sales factor election may be made as to distributive shares of income from unitary partnerships and from nonunitary partnerships. This proposed subsection has no corresponding subsection in the water's-edge statutes and regulations because water's edge determines what entities are members of the combined reporting group, while the single-sales factor election determines what method of apportionment will be used after the group membership is determined.

Treatment of distributive shares of income from partnerships is not a membership question, but an apportionment question. California does not impose an income or franchise tax on partnerships which are pass-through entities without their own obligation to file a California form 100. Accordingly, the right to make the election is held by the corporation receiving the distributive share of income from the partnership. If the corporate owner is unitary with the partnership making the distribution, then the corporate owner may elect to use the single-sales factor method for all unitary business income, including the distributive share of income from the partnership. If the corporate owner is not unitary with the partnership making the distribution, then there can be no single-sales factor election that includes that distribution as the partnership is a separate trade or business and not a combined reporting group member. This is explained in this proposed subsection.

Subsection (c)(3) addresses changes in affiliation during the year. Generally, special rules are not needed for changes in affiliation because this is an annual election and group membership is known at the end of each taxable year. Statutes and regulations already in place provide the necessary guidance. Examples are provided. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to explain that changes in affiliation will necessarily be completed before the end of each taxable year so that separate rules to address changes in affiliation are not needed. The examples illustrate how changes in affiliation and the single-sales factor election operate. The water's-edge regulations provide many rules for changes in affiliation, but those rules do not need to be incorporated since the single-sales factor election is only a single year election.

Subsection (d) identifies the years to which the regulation applies. Since the purpose of the regulation is to instruct multistate taxpayers on how to make the single-sales factor election, it is necessary to set forth that this regulation applies to taxable years beginning on or after January 1, 2011, identical to RTC section 25128.5 that authorizes the single-sales factor election.

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

In drafting the proposed regulation, the Franchise Tax Board primarily relied upon California Revenue and Taxation Code section 25113 and California Code of Regulations, title 18, section 25113, relating to waters-edge elections. In addition, the Franchise Tax Board examined the two versions of Revenue and Taxation Code section 25110 and California Code of Regulations, title 18, section 25110, also relating to waters-edge elections. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

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

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation, or would be less burdensome with respect to affected private persons or small businesses than the

proposed regulation. The proposed regulation pertains only to corporate taxpayers and therefore does not affect private individuals. In addition, it pertains only to multistate and multinational businesses and therefore will have little or no impact on small business.

#### **ADVERSE ECONOMIC IMPACT ON BUSINESS**

The Franchise Tax Board has determined that the proposed regulation under Section 25128.5 will not have a significant adverse economic impact on business beyond the impact that the statute itself imposes, if any. The proposed regulation primarily explains to multistate corporations how to carry out a single-sales factor election.