

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 10:00 a.m., on November 23, 1998, at 9645 Butterfield Way, Sacramento, California, to consider the amendment of section 25128 and the adoption of sections 25128-1 and 25128-2 in Title 18 of the California Code of Regulations pertaining to the formula to be used to apportion the business income of a corporate taxpayer which has business income from sources both within and without this state. An employee of the Franchise Tax Board will conduct the hearing, and a report will be submitted to the three-member Franchise Tax Board for its consideration, along with a recommendation as to whether the three-member Board should hold a hearing on the proposed regulatory action. Government Code section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action, if any person makes such a request. If a request is received, the three-member Board will hold a hearing.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD:

Written comments will be accepted until 5:00 p.m., November 23, 1998. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY & REFERENCE:

Section 19503 of the Revenue and Taxation Code authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001 of the Revenue and Taxation Code). The proposed regulatory action interprets, implements, and makes specific section 25128 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW:

When a corporate taxpayer has income from trade or business activity that is taxable both within and without this state, section 25121 of the Revenue and Taxation Code requires that the taxable portion of the business income from such activity be determined by means of an apportionment formula. Revenue and Taxation Code section 25128, as amended in 1993, 1994, 1996, and 1997, defines the applicable formulas. For most corporations, the applicable formula is a fraction whose numerator is the property factor plus the payroll factor plus twice the sales factor, and whose denominator is four. However, if the corporation derives more than 50 percent of its gross business receipts from one or more "qualified business activities," the applicable formula is a fraction whose numerator is the property factor plus the payroll factor plus the sales factor, and whose denominator is three. The qualified business activities subject to the special three-factor formula are "agricultural business activity," "extractive business activity," "savings and loan activity," and "banking or financial business activity."

Existing Regulation section 25128 was adopted prior to the 1993 and other recent amendments of Revenue and Taxation Code section 25128. It specifies the exclusive use of a three-factor apportionment formula. The purpose of the proposed amendment to Regulation section 25128 and of the proposed adoption of new Regulation sections 25128-1 and 25128-2 is to bring the regulations into conformity with the 1993 and later amendments to section 25128 and to help taxpayers decide whether to use a three-factor formula or a four-factor formula. In particular, the regulatory action being proposed is intended to provide guidance regarding (1) the activities which constitute agricultural and extractive business activities within the meaning of Revenue and Taxation Code section 25128, (2) the effects on the classification of such business activity if the taxpayer processes agricultural or extractive commodities into finished products, and (3) the way to compute gross business receipts from a taxpayer's qualified and nonqualified business activities. The proposed amendments to Regulation section 25128 contain general definitions and rules; proposed new Regulation section 25128-1 defines extractive business activity; and proposed new Regulation section 25128-2 defines agricultural business activity.

Amended Regulation section 25128 defines "gross business receipts" to mean "sales" as defined in other statutes and regulations related to income apportionment. The regulation also states that only sales to unrelated third parties will be used to determine whether the taxpayer obtains more than 50 percent of its gross business receipts from qualified business activities.

Revenue and Taxation Code section 25128, subdivision (d)(3), defines extractive business activity as "activities relating to the production, refining, or processing of oil, natural gas, or mineral ore." Proposed Regulation section 25128-1 explains the meaning of the terms "production," "refining," and "processing." The regulation defines "production" as the location, extraction, and initial processing of oil, gas, or minerals, and it provides detailed examples of the specific activities that are included. The regulation defines "refining" as the separation, purification, or conversion of oil, gas, or minerals into valuable products in a refinery. The regulation lists examples of specific activities that constitute oil refining and other types of refining, and it also lists examples of products that are produced in oil refineries and in other refineries. "Processing" is defined as activities intended to create valuable products from oil, gas, or minerals that have not already been refined. The regulation provides that receipts from sales of services or from sales of products purchased from third parties are not gross business receipts from extractive business activity. Exceptions are allowed, however, for resales of

products acquired from other taxpayers either as the result of exchanges of similar extractive products or because of a temporary interruption in the taxpayer's normal supply of crude oil or refined products.

Proposed Regulation section 25128-2 defines "agricultural business activity." It states that this term applies only to taxpayers engaged in the business of farming, as that business is defined for federal income tax purposes, and includes only activities that are considered to be farming activities for federal tax purposes. The regulation contains a detailed list of qualifying activities and products. It also states that receipts from resales of products purchased from others are not gross business receipts from agricultural business activity, and that receipts from sales of services are not gross business receipts from agricultural business activity unless the taxpayer is engaged in the farming business. An exception is made, however, for resales of agricultural products acquired in an exchange of such products. The regulation says that agricultural cooperatives are not engaged in "agricultural business activity," and that patronage dividends received by a taxpayer are not receipts from qualified agricultural business activity.

These proposed regulatory changes address a specific California problem. There is no federal law comparable to Revenue and Taxation Code section 25128, because apportionment of income between states is not necessary under federal law.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION:

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Adverse Economic Impact on business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: None

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: The effect on small businesses will be minimal because these regulations apply only to multijurisdictional businesses.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES:

In accordance with Government Code section 11346.5(a)(12), the Board must determine that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

In addition, the proposed regulatory action pertains to corporate taxpayers and therefore does not affect private persons.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS:

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The Franchise Tax Board has determined that it is not feasible to draft the text of the proposed regulations in plain English due to the technical nature of the regulations. However, a noncontrolling plain English summary of the text of the proposed regulations, as well as the initial statement of reasons and all information upon which the proposed regulatory action is based, and the express terms of the proposed action, are available upon request from the agency officer named below.

CHANGE OR MODIFICATION OF ACTIONS:

The three-member Franchise Tax Board may adopt the proposed regulatory action after consideration of any comments received during the comment period. Government Code section 15702(b) provides for consideration by the three-member Board of any proposed regulatory action, if any person makes such a request. If a request is received, the three-member Board will hold a hearing.

The regulations and amendments may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS:

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter, including sign language, should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT:

All inquiries concerning this notice or the hearing should be directed to Beverly Moore at Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; telephone (916) 845-3354; Fax (916) 845-3648; E-Mail: bev_Moore@ftb.ca.gov. The notice, initial statement of reasons and express terms of the regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.