INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25137-15

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

Under the Uniform Division of Income for Tax Purposes Act ("UDITPA"), Revenue and Taxation Code ("RTC"), section 25120 et seq., businesses that conduct business both within and without California must apportion their income in order to determine what portion of their income is subject to tax in this state. When the standard allocation and apportionment formulas of UDITPA do not fairly reflect the business activity of an apportioning taxpayer's activity in this state, RTC section 25137 states that the Franchise Tax Board ("Board") may allow or impose an alternative formula in order to do so. In cases where certain industries derive income in ways that the application of the standard apportionment provisions of UDITPA do not result in a fair reflection of activity, the Board is empowered to promulgate special industry regulations to achieve the goal of UDITPA. (See, for example, title 18, California Code of Regulations ("CCR"), section 25137-7 applicable to air transportation companies; 25137-9 applicable to railroads; and 25137-11 applicable to trucking companies.)

In recent years, private industry has begun transporting property, and ultimately, persons, into space for profit. Therefore, a need has arisen for space transportation businesses operating within California to apportion their income in order to compute their tax liabilities. Similar to the other transportation industries operating in California, the standard allocation and apportionment provisions of UDITPA have proven difficult to apply to this emerging business model. Consequently, the Board has worked with industry to promulgate a special industry regulation similar to other transportation industry regulations (truck, railroad, air, and sea transportation) so that the apportionment of the income of space transportation companies fairly reflects the activities of such businesses in this state.

SPECIFIC PURPOSE OF THE REGULATION

The purpose of the proposed regulation at CCR section 25137-15 is to prescribe an apportionment formula for taxpayers engaged in the space transportation industry business, which will provide these taxpayers clarity in connection with how to determine the amount of business income subject to tax by this state.

NECESSITY

Every business actively engaging in transactions or activity in this state for the purpose of pecuniary gain or profit is subject to tax for the privilege of doing business in this state. (RTC 23101.) Businesses that engage in business activity within and without this state must apportion their incomes according to the provisions of UDITPA. Beginning in 2013, most taxpayers must use an apportionment formula based on sales, which is referred to as market based apportionment.
Currently, there is uncertainty for space transportation industry companies on how they should apportion their business income as a result of the new market based apportionment rules. Generally, the standard apportionment rules now require the location of a service for apportionment purposes to be determined according to where the location of the benefit of a service is received. In cases where goods or property are transported into space, it is unclear where the benefit of such services is located. The proposed regulation at CCR section 25137-15 clarifies how income from space transportation services should be apportioned and resolves this uncertainty by providing clear and consistent rules for space transportation companies.

Subsection (a) of the proposed regulation introduces the subject matter of the regulation and outlines the intended scope of the regulation by providing that only space transportation companies are subject to its terms. This subsection limits the scope of application of the rules that will follow, necessary to set forth the parameters of the proposed regulation.

Subsection (b) of the proposed regulation contains definitions for many words and phrases used in the regulation, providing clarity and eliminating ambiguities in applying terms used. Subsections (b)(1) and (b)(2) are definitions that together narrow the scope of the regulation and define the class of taxpayers to which this proposed regulation applies. Subsections (b)(3) through (b)(9) define terms that are used in the proposed regulation in order to clarify the application of the provisions of the proposed regulation.

Subsection (c) of the proposed regulation specifies the apportionment formula to be used by space transportation companies. At the Interested Parties Meetings discussing this proposed regulation, participants expressed support for bright-line determinations that reflect both the mileage traveled to get to space and the location of launch. This subsection provides that certainty and clarity.

Subsection (d) of the proposed regulation outlines recordkeeping requirements for space transportation companies. This subsection is required because sales, or receipts, of space transportation activities often occur over a period of multiple years. In addition, these recordkeeping requirements are necessary because audits of such contracts by the department are likely to occur several years later.

Subsection (e) of the proposed regulation provides an illustrative example of the application of the apportionment formula outlined in subsection (c). This subsection will provide clarity and assist taxpayers in applying the apportionment formula specified in the regulation.

Subsection (f) of the proposed regulation is reserved for future possible regulatory action to address the combination of Space Transportation Activities with other Trades or Business.

Subsection (g) of the proposed regulation provides the applicable date of the regulation. This subsection will provide clarity to taxpayers in knowing when the apportionment formula specified in the regulation is applicable. This subsection sets the applicability date to be January 1, 2016. The text of this subsection was modified from the text previously presented to the full three-member Franchise Tax Board for review at its meeting on July 12, 2016. The modifications to the text now clarify the applicability date, and remove erroneous
references to "effective" date. Because the effective date is determined according to provisions of California Government Code section 11343.4(a), references in this subsection to "effective" have been removed and replaced with applicable date references. Accordingly the words "Applicable Date of Regulation" now replaces "Effective Date" in the title of the subsection, and the words "applicable to" replace "effective for" in the body of the subsection. In addition, the modifications add a calendar date to the provided applicable month and year, and the language of this subsection now reads as "January 1, 2016" instead of "January 2016."

**BENEFITS OF THE REGULATION**

Proposed regulation 25137-15 provides specific guidance for space transportation industry companies in how to determine the apportionment of their business income, and thus, clarity and certainty to taxpayers and the state. Promulgating this regulation will allow space transportation companies to determine their tax liabilities with much higher degrees of certainty, reducing the need for both audits and disputes that might follow. Reducing uncertain tax positions will have an immediate benefit to taxpayers who will no longer have to anticipate the financial and practical repercussions of reporting their incomes according to uncertain or untested applications of UDITPA. In addition the State of California has always prided itself on being in the technological forefront and the proposed tax regulation will provide concrete evidence that the state actively engages with industry to address emerging industries.

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

In drafting the proposed regulation, the Board primarily relied on suggestions from members of the public obtained throughout the course of two Interested Parties Meetings, as well as application of apportionment principles previously applied to other types of transportation companies. The Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing this regulation.

**ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESSES**

In accordance with the requirement of Government Code section 11346.2, subdivision (b)(4) that the Board consider alternatives to the proposed regulatory action, staff of the Board conducted two Interested Parties Meetings. A preliminary Interested Parties Meeting was held on July 9, 2015. Staff did not provide proposed language at that meeting, but sought input from the public on the practicality of the application of the standard apportionment provisions of UDITPA to space transportation companies, as well as the alternative of drafting a special industry regulation. At the meeting the general consensus of participants was that a special industry regulation was needed to address the apportionment and allocation of income of space transportation companies.

A second Interested Parties Meeting was held on April 13, 2016, at which staff provided proposed regulatory language. At that meeting, input was sought as to various alternatives to apportion such income from those drafted in the provided proposed regulatory language.
One alternative discussed was whether the Board might propose a regulation with more open ended language defining the taxpayers to which a regulation would apply. This alternative was rejected because staff felt that the scope of any proposed regulation had to be clearly defined, in order to provide tax certainty. Because open-ended language defining taxpayers subject to the proposed regulation lacks certainty as to the applicability of the regulation, staff determined this was not a viable alternative.

A second alternative considered was whether the regulation should apply to specific income items on the basis of the unitary business principle instead of to specific taxpaying entities engaged in space transportation activities. Although possibly valid, this alternative was rejected because tax certainty was an objective and the proposed language generated more certainty than this alternative as to the taxpayers who would be subject to the proposed regulation.

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 adoption of Regulation section 25137-15, or would be as effective and less burdensome with respect to small businesses than the proposed regulation. In addition, the proposed regulation at CCR section 25137-15 pertains only to multistate and multinational businesses and therefore will have little or no impact on small business.

**ECONOMIC IMPACT ASSESSMENT**

**Creation or Elimination of Jobs within the State**

The space transportation industry is an emerging industry in this state with significant growth potential. Absent this regulation, uncertainty about California tax treatment of space transportation activities could cause the industry to focus its activities elsewhere. In that eventuality there would be some job losses.

Conversely, increased certainty about the tax treatment will lead to increased activity in the industry and will foster an atmosphere of growth and prosperity once present during the golden age of California's aviation industry, thereby creating jobs as the industry thrives in this state. When this will take place, how many jobs will be created, and the rate of job growth, cannot be determined. However, in the near term, the Board does not anticipate that there will be an effect on the creation of jobs from the proposed regulation.

**Creation of New or Elimination of Existing Businesses within the State**

The space transportation industry is a young industry with significant growth potential. Currently, only a small number of companies have the capability to engage in such activities. However, future entrepreneurs may be encouraged by an atmosphere that provides tax certainty and fosters establishing space transportation-related businesses in this state. The proposed regulation would encourage the expansion of the space transportation industry and existing businesses in the industry and would not result in the elimination of such businesses. However, should this industry be forced to relocate because of a more
favorable business climate outside California, it is likely that existing space transportation-related businesses would be eliminated.

**Expansion of Businesses doing business within the State**

The space transportation industry is an emerging industry with significant growth potential. Industry representatives have informed staff that promulgation of this regulation will encourage existing space transportation companies to continue to do business here and expand as appropriate. Absent this regulation, uncertainty about California tax treatment could cause the industry to focus its expansion or location efforts elsewhere. A move away from California will result in the elimination of existing industry-related businesses.

**Benefits to the Health and Welfare of California Residents, Worker Safety, and the State’s Environment**

The proposed regulation provides an alternate formula for the space launch industry for apportioning income to California. It is not believed that adopting this tax formula will have any direct impact on the health and welfare of California residents, or work safety, or the state’s environment.

**ADVERSE ECONOMIC IMPACT ON BUSINESS**

The Board has determined that the proposed regulation at CCR section 25137-15 will not have a significant overall economic impact on business. The proposed Regulation clarifies the appropriate methodology for the apportionment of business income of space transportation companies.