

Explanation of Discussion Draft for Proposed Amendments to Regulation 25137-1 and Regulation 17951-4.

An interested parties meeting was held on October 18, 2013 to discuss possible revisions of Regulations 25137-1 and 17951-4, relating to interests in partnerships and apportionment. Numerous topics were discussed at the IPM and staff has taken that input as well as its own research and has produced a discussion draft of revisions to the existing regulations that contain numerous suggested additions as well as deletions from the regulations. This Explanation is meant to accompany the discussion draft to allow members of the public to understand the reasons underlying the proposed changes to the existing regulations and provides a background for further discussions regarding the regulations at the next interested parties meeting.

Regulation 25137-1 changes

Subsection (a)

Subsection (a) of the regulation has been amended to change the obsolete term "income year" to the term "taxable year" to be consistent with newer regulations and laws. This change is made throughout the regulation.

The sentence *"The same principle applies when a taxpayer has an interest in a partnership that itself owns an interest, directly or indirectly, in one or more other partnerships"* has been added to the first paragraph to clarify that the rules contained in this regulation apply not only to partnership interests held directly by taxpayer corporations, but also to lower tier partnerships that are held indirectly by the taxpayer corporation as well. This is in response to concerns that the phrase "taxpayer" used throughout the regulation makes it unclear whether the rules of the regulation apply to lower tier partnerships not owned by a taxpaying entity directly but rather by another partnership entity.

The second paragraph has been amended to clarify that the determination of business and nonbusiness partnership income is made at the partnership level regardless of whether the partnership and the corporate partner are engaged in a unitary business. This change is suggested to remove confusion regarding whether a corporate partner should make a determination as to the sourcing of partnership income based on its ownership of the intangible interest in the partnership rather than treating the partnership as a separate trade or business of the partner corporation. The amendment provides:

Even if the partnership's business and the taxpayer's business are not unitary, such that subsection (g) applies, the distributive share income allocated to the taxpayer is from a separate trade or business of the taxpayer, not nonbusiness income of the taxpayer. The determination of whether an item of income is apportionable business income or allocable nonbusiness income is made at the partnership level based on the trade or business of the partnership. Revenue and Taxation Code section 23040 is not applicable.

Subsection (f)

The first amendment to this subsection addresses the "taxable year" vs. "income year" issue described earlier and provides:

(f) Apportionment of Business Income-Single Trade or Business. (f) Apportionment of Business Income -Single Trade or Business. If the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of such single trade or business attributable to this state shall be determined by an apportionment formula, pursuant to either Section 25128, Section 25128.5 or Section 25128.7, Revenue and Taxation Code, whichever is applicable, of the taxpayer and its share of the partnership's factors for any partnership taxable year ending within or with the taxpayer's taxable year. ~~for any partnership year ending within or with the taxpayer's income year as follows:~~ The apportionment factors related to the taxpayer's interest in the partnership shall be determined as follows:

Subsection (f)(5) is maintained to provide additional clarification regarding issues related to different accounting periods.

Subsection (f)(3) is amended to provide greater clarification regarding sales between an partner and a unitary partnership. This issue was discussed at length at the first interested parties meeting and staff now proposes these amendments to further clarify that intercompany sales within a unitary business are not includable in the sales factor, even if the sales are made to another member of the unitary business who is not the direct partner owner of the partnership interest itself.

(3) Sales Factor. In general the numerator and denominator of the sales factor shall be determined as set forth in Regulations 25134 to 25136, inclusive, and 25137(c). However, the following special rules shall apply:

(A) The partnership's sales which give rise to business income, shall be included in the denominator of the taxpayer's sales factor to the extent of the taxpayer's interest in the partnership. The amount of such sales attributable to this state shall also be included in the numerator of the taxpayer's sales factor. Intercompany sales between the partnership, on the one hand, and the taxpayer or any member of the taxpayer's combined reporting group, on the other, shall be eliminated from the denominator of the taxpayer or the taxpayer's combined reporting group (if applicable), as well as ~~the~~ and numerator of the taxpayer's sales factor or the numerator of another member of the taxpayer's combined reporting group, whomever made the sale to the partnership, as follows:

(i) Sales by the taxpayer, or any member of the taxpayer's combined reporting group, to the partnership to the extent of the taxpayer's interest in the partnership.

(ii) Sales by the partnership to the taxpayer or any member of the taxpayer's combined reporting group, not to exceed the taxpayer's interest in all partnership sales.

(B) Notwithstanding any intercompany eliminations described in subparagraph (A) above, sales made to nonpartners, other than members of the partner taxpayer's combined reporting group, shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership.

Subsection (f)(4) is revised to provide greater clarity for the term "interest in the partnership". This change is offered to address the uncertainty in the existing regulation's definition of "partnership interest". The change provides that a partner's interest percentage in the partnership shall be determined by its interest in profits, as opposed to capital. Staff believes this is easier to audit as well as more closely tied to the income subject to apportionment than a capital interest approach would provide. The revised section provides:

(4) Partnership Interest-Defined. A taxpayer's partnership interest for the purpose of computing the portion of the partnership's property, payroll and sales to be included in the taxpayer's property, payroll or sales factor shall be determined by the taxpayer's "interest in the partnership". ~~The taxpayer's interest in the partnership shall be determined by reference to its interest in profits of the partnership, determined under Chapter 10 of Part 10 of Division 2 of the Revenue and Taxation Code, and the regulations thereunder.~~

Subdivision (h) of the regulation is heavily amended to remove the provisions relating to long term contracts and instead simply provides a reference to the Regulation 25137-2 rules for long term contracts. The existing regulations provisions are repetitive and may cause confusion.

Regulation 17951-4 Changes

Regulation 17951-4 provides guidance for non-residents who are engaged in a trade or business. As part of the regulation, rules are provided for a non-resident who owns an interest in a partnership that conducts its trade or business both within and without of California. These rules cross reference to the apportionment rules set forth in Revenue and Taxation Code section 25120 through 25139 and the accompanying regulations thereunder. This includes Regulation 25137-1. Therefore, staff believes the rules in Regulation 17951-4 should be amended consistent with the rules set forth in Regulation 25137-1 where unique language is required to address the difference in treatment for non-resident individuals instead of corporations.

Regulation 17951-4(d)(1) is amended consistent with Regulation 25137-1(a) to provide that the apportionment of income is determined at the partnership level and not at the partner level. The addition in this section specifically provides that Revenue and Taxation Code section 17952 should not be applied by the partnership in sourcing income allocated to the nonresident partner. This clarification is meant to address the issue in the non-precedential determination of the Board of Equalization in Appeal of Venture Communications Inc., which was decided on February 5, 2003. In that appeal, the Board applied the rules of RTC section 17952, rather than the apportionment rules of Revenue and Taxation Code section 25120 -25139, to determine the source of income from the sale of an intangible by an S corporation. This is not consistent with the sourcing rules set forth in Regulation 25137-1 and this amendment is provided to remedy that inconsistency. The amendment provides:

(1) Except as provided, the total business income of the partnership shall be apportioned at the partnership level in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, Revenue and Taxation Code, and the regulations thereunder. Revenue and Taxation Code section 17952 is not applicable in determining the source of income allocated to the nonresident taxpayer by the partnership.

Subsection (d)(2) is added to the existing regulation to provide additional clarity regarding the use of Regulation section 25137-1 in the determination of California source partnership income when the partnership is engaged in a unitary business with another business activity of the partner. The new section provides:

(2) If the partnership and the business activity of the partner are part of one unitary business, then the rules of Regulation section 25137-1(f) apply and the apportionment of the partnership business income is done at the partner level for the unitary partner or partners. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.

Associated changes are made throughout Regulation 17951-4 to account for the addition of this new section.

Finally, no changes are proposed at this time regarding the operative date for the changes to Regulations 25137-1 or 17951-4. Staff would like further input from the public regarding whether the changes should be prospective only or retrospective to some extent.