

Summary of Third Interested Parties Meeting
Regulations 25137-1 and 17951-4
Partnerships and Apportionment

I. Administration: An interested parties meeting was held on July 8, 2014 to discuss possible revisions of Regulations 25137-1 and 17951-4. Parties attended in person and by telephone. Those physically present were asked to register at the entrance. Phone participants introduced themselves. The session was tape recorded for reference but there will be no attribution of comments and no transcript. The Hearing Officer was Carl Joseph. Available handouts were: notice of the meeting, proposed language setting forth revisions to the regulations at issue, and an explanation of the proposed language.

II. Discussion: The discussion was organized around the proposed draft language, with the hearing officer going through each proposed change in the regulations, explaining why the language is drafted in the manner that it is proposed, and inviting comment from the public on each change.

Regulation section 25137-1

Subdivision (a)

1. Subdivision (a) of the regulation is amended to change from 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.

Comments:

No comments were received on this change.

2. 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 was also amended in the proposed language 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 was 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.

Comments:

Commentators suggested that this language was still confusing and did not provide the clarity that staff sought to provide. The commentators suggested changing the language to provide additional clarity.

Subdivision (f)

1. The rules in subdivision (f)(3) were amended to provide additional clarity regarding the sales factor treatment of transactions that occur between a partnership and a partner with whom the partnership is engaged in a unitary business. The amendments provide that such sales, whether made directly with the unitary partner, or with another member of the unitary partner's combined reporting group, should not be included in the sales factor. Staff also explained at the interested parties meeting that these amendments will be prospective.

Comments:

No comments were received. Staff has now inserted subdivision (j) into the proposed amendments to provide for prospective application of all of the amendments made as part of this regulatory effort.

2. The rule in subdivision (f)(4), which defines the term "partnership interest," is amended as part of this regulatory effort to specify that a taxpayer's "interest in the partnership" means its interest in profits of the partnership.

Comments:

Comments were received that the language did not address situations where the individual's profits in the partnership can change from year to year, such as when there is a gain to the partners under IRC section 704, nor did the language address the use of special allocations that are sometimes used by partnerships, such as assigning a certain amount of partnership profits to one partner and then profits to the other partners only if profits exceed that amount. The hearing officer responded that the level of complexity in this area is high, and that staff was attempting to provide a guiding general rule rather than specific guidance for all possible scenarios that could arise. The hearing officer agreed to consider additional language to address the concerns of the commentators.

Subdivision (h)

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.

Comments:

No comments were received on this change.

Regulation section 17951-4

Regulation 17951-4 provides guidance for nonresidents who are engaged in a trade or business. As part of the regulation, rules are provided for a nonresident 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 nonresident 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. Subsection (d)(2) is also 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.

Comments:

Comments were received that the language that staff has added to this section does not provide adequate clarity, and staff received a written request after the interested parties meeting that provided additional input on this issue and suggested language to clarify that the amendment that staff is seeking applies to apportionable business income as determined at the partnership level and not to allocable nonbusiness income earned by the partnership. Staff will consider the language provided and propose to amend the regulation to address these concerns.

The changes to 17951-4 will also be applied prospectively and language will be added to the regulation to make this clear.