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., December 18, 2006, at 9645 Butterfield Way, Town Center Golden State Room A/B, Sacramento, California, to consider adoption of section 25137-14 under Title 18 of the California Code of Regulations, authorized under section 25137 of the California Revenue and Taxation Code, pertaining to the use of alternative apportionment methodologies.

An employee of the Franchise Tax Board will conduct the hearing. Thereafter, a report will be made to the three-member Franchise Tax Board for its consideration. Government Code section 15702, subdivision (b), provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request in writing. The three-member Board will consider the proposed regulation and comments submitted with respect to the proposed regulation prior to acting upon it at one of its meetings.

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., December 18, 2006. 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 25137 of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Taxpayers who have business activities within and without California are required to determine the amount of income properly attributed to activities in California by use of the Uniform Division of Income for Tax Purposes Act (UDITPA), Section 25120 et seq., Revenue and Taxation Code (RTC). Under UDITPA, business income is assigned to a state through the application of a three-factor apportionment formula that separately compares a business' property, payroll and sales within California to those values everywhere. These percentages are then added together, with the sales factor counted twice (see RTC section 25128), and the resulting sum of these four factors is then divided by four. This percentage is then applied to the business income of the taxpayer to determine the percentage of business income attributable to California.

The three-factor apportionment formula was adopted as a way of reflecting the different elements that provide value to a taxpayer's operation in a given state. The payroll factor reflects the amount of labor utilized by the taxpayer in performing its activities in the state. The property factor reflects the amount of capital utilized by the taxpayer in the state. The sales factor reflects the market for the goods or services of the taxpayer in the state. It has been stated that the purpose of the sales factor is "to give weight to the obtaining of markets," balancing to some extent property and payroll factors that favor production or manufacturing states.

The sales factor component of the UDIPTA apportionment formula has two assignment rules. Sales of tangible property are generally assigned to the location of the customer (the "destination" rule contained in RTC section 25135). If sales of tangible property are made into a destination where the taxpayer is not taxable, then the sales are "thrown back" to the jurisdiction from which the property was shipped. Sales of other than tangible property are assigned to the jurisdiction where the income producing activity related to the sale is performed (RTC section 25136). UDITPA also contains a provision, RTC section 25137, which allows for modification of the statutory assignment rules where they do not fairly represent the activities of the taxpayer within the state.

The assignment of sales derived from the provision of services to mutual funds is subject to the income producing activity rules of RTC section 25136. In the case of many service providers, the normal rule of section 25136 works just fine. For example, a company that cleans carpets usually will have its employees perform the income producing activity (carpet cleaning) in the same state as the customer, therefore assigning the receipt to that state does reflect the market for the taxpayer. It is only when a service provider undertakes its income producing activity in a sole location, or very few locations, while having a market throughout the country, that the rules of section 25136 break down. Mutual fund service providers are an example of such a service provider.

For mutual fund service providers, the income producing activity, and most of the cost of performance, relates to services provided by their employees. Because of this, the location of the employees is almost always the location where the receipts will be assigned under normal sales factor rules. The result is that the sales factor will essentially mirror the payroll factor. Similarly, the property factor also reflects the location of the employees, as the property factor is primarily composed of the offices and equipment used by the employees performing the services. However, in contrast to the carpet cleaning company example, the customers of these companies are the fund shareholders, who receive the benefit of the services in locations scattered amongst all fifty states. Because the services are concentrated to one location, the receipts follow, even though this is not indicative of the market.

For this reason, many states have changed the sales factor rules for mutual fund service providers to allow them to assign their sales factor utilizing a ratio of shares owned by shareholders in this state to shares owned by shareholders located everywhere. This allows a reflection of the actual market and corrects the over-taxation of in-state mutual fund service providers by assigning receipts outside of the home state. Similarly, if the service provider were located outside of the state, rather than having a zero numerator in the California sales factor, they would have a factor based on the market through the reflection of shares owned by California shareholders.

The proposed regulation essentially adopts a similar shareholder location sales factor approach to that adopted in other states where mutual fund service providers are located.

Subsection (a) of the proposed regulation addresses the definitions of the various terms contained in the rules to follow. These definitions were largely taken from regulatory language utilized in other states and therefore provide a level of uniformity.

Subsection (b) of the proposed regulation contains the new apportionment rules for mutual fund service providers. The only divergence from the normal UDITPA rules is in regards to the sales factor. The proposed regulation adopts a shareholder ratio approach calculated on a fund-by-fund basis (See subsection (b)(1)(A)).

Subsection (b)(1)(A)1 contains rules regarding the assignment of shares owned by a shareholder of record that holds the shares for the benefit of a separate account. The rule allows these shares to be assigned based on a reasonable method derived from information received from the shareholder of record. If no information is received, then the shares are disregarded in determining the ratio for the given fund.

Subsection (b)(1)(B) provides rules for the assignment of receipts from asset management services. The rule only applies to unitary businesses that are also mutual fund service providers. This was done to limit the scope of the regulation. The rule adopts a domicile concept to represent the market. It also provides rules for pension plans and other entities and assigns these based on the domicile of the beneficiaries under subsection (b)(1)(B)(i) and, if this is not known, by a reasonable method to approximate this information statistically. Subsection (b)(1)(B)(ii). If no method is developed, these receipts are excluded.

Subsection (b)(1)(C) sets forth an approach to deal with the assignment of receipts to California when the underlying entity providing the services to California shareholders is not a California taxpayer. This section is included to make sure that there will be market assignment of receipts based on the activities of the entire unitary group rather than on an entity-by-entity basis. It is fairly common for mutual fund service providers to separate their various service activities into separate entities for regulatory or other purposes. Nevertheless, it is the group, acting as a unitary business, which provides all of the services required by the funds. The regulation recognizes this by assigning receipts on a unitary basis.

Subsections (b)(1)(C)1 and 2 then contain all of the rules necessary to implement this approach in determining the combined report business income to be assigned to each taxpayer member of the mutual fund service provider.

Subsection (b)(1)(D) contains a throwback rule based on the activities of all members of the unitary business. If no member of the mutual fund service provider's unitary business is taxable in a given state, then the receipts assigned to that state are thrown back to the state where the general rules of RTC section 25136 would have assigned the receipts. This rule is necessary to eliminate nowhere income concerns, the same concerns that gave rise to the throwback rule contained in RTC section 25135.

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.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Potential cost impact on private persons or businesses affected: The Franchise Tax Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

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. In-state mutual fund service providers have asked for and received relief under the provisions of RTC section 25137 on an individual basis in the past. This regulation therefore should not change their behavior.

Effect on small business: The regulation is generally utilized by large multinational corporations and not small businesses.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), 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.

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 express terms of the proposed text of the regulation and the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website mentioned below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted by the three-member Franchise Tax Board after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantive or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation 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 or sign language assistance, 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 Colleen Berwick at the Franchise Tax Board, Legal Branch, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen_berwick@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.