

**INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF CALIFORNIA CODE OF
REGULATIONS, TITLE 18, SECTIONS 25137-1 AND 17951-4**

**PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR
CIRCUMSTANCE THAT THE PROPOSED AMENDMENTS ARE INTENDED TO ADDRESS**

California Code of Regulations, title 18, (Regulation) section 25137-1 applies to corporations that conduct business within and without California in a unitary enterprise and are included in a combined report, and which own interests in partnerships which also conduct business within and without California. Regulations addressing the apportionment and allocation of the income of such partnerships were first promulgated in 1976. The regulations were further amended and renumbered in 1985. Regulation section 17951-4 addresses individuals who are nonresidents or part-year residents of California for tax purposes, who own interests in partnerships which conduct business within and without California. Regulations addressing these taxpayers were first promulgated in 1976. The regulations were further amended in 1982. Since Regulation sections 25137-1 and 17951-4 were last amended, additional factual scenarios have arisen from partnerships that conduct business within and without California. These additional situations are not adequately addressed by the current version of the regulations. With a view to providing affected taxpayers with the proper guidance, Regulation sections 25137-1 and 17951-4 are proposed to be amended to address the new situations that have arisen. In addition, Regulation section 25137-1 is proposed to be modified so that the term "income year" is changed to "taxable year" for consistency with the appropriate statutory terminology.

Regulation Section 25137-1(a)

In many instances, partnerships that conduct business within and without California in turn own interests in partnerships which also conduct business within and without California. The proposed amendments to the regulation indicate that the rules embedded in it also apply to partnerships that conduct business within and without California which are owned, or partially owned, by other partnerships which also conduct business within and without California. This revision is necessary to clarify that the rules embedded in the regulation apply not only to partnership interests held directly by taxpayers, but also to lower-tier partnerships that are held indirectly by taxpayers as well.

Pursuant to Regulation section 25137-1(g), if a partnership and its corporate partner are not engaged in a unitary business, the distributive share income allocated to the corporate partner is treated as income from a separate trade or business that takes place within and without California. However, despite this explicit rule, some taxpayers have asserted that in accordance with California Revenue and Taxation Code section 23040, which addresses sourcing income to California from intangible property, the income allocated must be treated as nonbusiness income because a partnership interest qualifies as intangible property. The regulation is being amended to clarify that the determination of whether the distributive share of income from a non-unitary partnership is treated as apportionable business income or allocable nonbusiness income is based on the activities of the non-unitary partnership and not through the operation of California Revenue and Taxation Code section 23040.

Regulation Section 25137-1(e)

Regulation section 25137-1(e) is being revised for a textual edit, revising "distributed" to "allocated".

Regulation Section 25137-1(f)

The regulation is being revised to explicitly state that this subdivision pertains to the apportionment factors relating to the taxpayer's interest in the partnership. The current language in the subdivision was unclear in that it did not explicitly state that the apportionment factors pertained to the taxpayer's interest.

Ordinarily, sales between the members of a combined reporting group are not reflected in the combined reporting group's sales factor because such sales have no economic impact outside the combined reporting group, and thus, they do not generate income. (See *Chase Brass & Copper Co., Inc. v. Franchise Tax Board* (1977) 70 Cal.App.3d 457.) When Regulation section 25137-1 was promulgated and amended it did not explicitly provide that sales between the unitary partnership and other members of the taxpayer's combined reporting group should not be reflected in the combined reporting group's sales factor. Similar to sales between members of a combined reporting group, sales between a unitary partnership and other members of the taxpayer's combined reporting group do not generate income. The regulation is being revised to explicitly state that sales between a unitary partnership and other members of the taxpayer's combined reporting group should not be reflected in the combined reporting group's sales factor.

The regulation is being clarified to specify that a taxpayer's partnership interest for purposes of computing a taxpayer's apportionment factors shall be "determined by the taxpayer's interest in the partnership," which is "determined by the portion of total interest in profits of the partnership assigned to the partner for the taxable year." The existing regulation provides that a taxpayer's partnership interest is referenced for purposes of determining the portion of the unitary partnership's apportionment factors that are reflected in the taxpayer's combined report. Apportionment factors are utilized for purposes of sourcing income. Therefore, the regulation is being revised to provide that the type of partnership interest that will be referenced for determining the portion on the unitary partnership's apportionment factors that are reflected in the taxpayer's combined report is the taxpayer's interest in the profits of the unitary partnership. Profits are being referenced because profits are more closely related to the apportionment of income than a taxpayer's interest in the capital of the partnership, which is the current partnership interest that is referenced for purposes of determining the portion of the unitary partnership's apportionment factors that are reflected in the taxpayers' combined report.

Regulation Section 25137-1(h)

The regulation is revised to delete provisions relating to long-term contracts. Instead, the regulation provides a reference to Regulation section 25137-2 for the appropriate rules on long-term contracts. This change eliminates repetitive provisions and any confusion this may cause to taxpayers.

Regulation Section 25137-1(j)

The regulation is revised to explicitly provide that the revisions contained in subdivisions (a), (e), (f) and (h) are effective only as of the effective date of the changes. In other words, the revisions are to be applied prospectively only.

Regulation Section 17951-4(d)

California Revenue and Taxation Code section 17952 provides that for purposes of determining income from sources within California from certain intangible property held by nonresidents or part-year residents, certain intangible property must have a business situs in California. Some taxpayers have asserted that an interest in a partnership that conducts business within and without California comes under the purview of California Revenue and Taxation Code section 17952. The regulation is being revised to explicitly provide that California Revenue and Taxation Code section 17952 does not apply with respect to an interest in a partnership that conducts business within and without California. The regulation is further revised to provide that if the partner and the partnership that conducts business within and without California are engaged in a unitary enterprise, then the rules embedded in Regulation section 25137-1 apply for purposes of determining the income from the partnership from California sources attributable to the partner. These changes necessitate renumbering existing provisions of the subdivision. Finally, the regulation is revised to provide that the revisions are effective only as of the effective date of the changes. In other words, the revisions are to only be applied prospectively.

Regulation Section 17951-4(f)

Regulation section 17951-4(f) is being revised to reflect the changes in the references to Regulation section 17951-4(d), which was revised to reflect the changes outlined in the previous paragraph.

Regulation Section 17951-4(i)

Regulation section 17951-4(i) is being revised to provide for a textual edit, revising "he" to "the".

Regulation Section 17951-4(j)

Regulation section 17951-4(j) is being revised to prescribe the effective date of the changes to the regulation.

SPECIFIC PURPOSE OF THE REGULATIONS

The purposes of the proposed revisions to the regulations are to:

1. Specify that the existing provisions of Regulation section 25137-1 also apply to lower-tier partnerships.

2. Indicate that California Revenue and Taxation Code section 23040 does not apply for purposes of sourcing income from partnerships that conduct business within and without California.
3. Provide that sales between a unitary partnership and members of the taxpayer's combined reporting group are not reflected in the sales factor of the combined reporting group.
4. Specify that the portion of the partnership's apportionment factors that are included in a taxpayer's combined report are based on the taxpayer's interest in the profits of a partnership.
5. Delete references to rules pertaining to long-term contracts.
6. Indicate that California Revenue and Taxation Code section 17952 does not apply for purposes of sourcing income to California to nonresidents and part-year residents from partnerships that conduct business within and without California. Instead, the rules embedded in Regulation section 25137-1 are applicable for purposes of sourcing income to California to nonresidents and part-year residents from partnerships that conduct business within and without California.

NECESSITY/PROBLEM THE REGULATIONS INTEND TO ADDRESS

Regulation Section 25137-1(a)

A revision is necessary to provide that the rules embedded in the existing regulation also pertain to lower-tier partnerships. It is very common for partnerships to own interests in other partnerships. Without the revision, only one level of partnership income would be appropriately sourced to California. Moreover, a revision is also necessary to explicitly provide that the income from partnerships that conduct business within and without California is sourced in accordance with Regulation section 25137-1, and not according to the rules for sourcing income from intangibles that is contained in California Revenue and Taxation Code section 23040. Without the revision, taxpayers might be confused as to the proper rules to apply for sourcing income from partnerships which conduct business within and without California.

Regulation Section 25137-1(f)

A revision is necessary to provide that sales between a unitary partnership and members of the taxpayer's combined reporting group are not reflected in the sales factor of the combined reporting group. Because these types of sales do not generate income, including the receipts in the sales factor could yield an apportionment factor that does not fairly reflect the extent of a taxpayer's activity in this state. A revision is further necessary to explicitly provide that the partnership's apportionment factors that are reflected in the taxpayer's combined report are based on the taxpayer's interest in the profits of the partnership. An interest in the partnership's profits is a measure that is more closely related

to the apportionment of income than a taxpayer's interest in the capital of the partnership, which is the current partnership interest that is referenced for purposes determining the portion of the unitary partnership's apportionment factors that are reflected in the taxpayer's combined report.

Regulation Section 25137-1(h)

References to long-term contracts are being deleted because they are duplicative of similar provisions in other regulations.

Regulation Section 25137-1(j)

The effective date of the revisions needs to be specified.

Regulation Section 17951-4(d)

California Revenue and Taxation Code section 17952 relates to sourcing income to California from intangible property to nonresidents and part-year residents. Some taxpayers have asserted that an interest in a partnership conducting business within and without California comes under the purview of California Revenue and Taxation Code section 17952. A revision is necessary to clarify that California Revenue and Taxation Code section 17952 does not apply in order to alleviate any confusion. A further revision is necessary to explicitly state that if the partner and the partnership that conducts business within and without California are engaged in a unitary enterprise, the rules embedded in Regulation section 25137-1 apply for purposes of determining the income from California sources attributable to the partner. This revision will provide more definitive guidance to taxpayers. Finally, the effective date of the revisions needs to be specified.

BENEFITS OF THE REGULATIONS

Taxpayers and the Franchise Tax Board will benefit from the clarifications provided by the revisions with respect to lower-tier partnerships, sales involving members of the taxpayer's combined reporting group and that apportionment factors are reflected in the combined report based on the taxpayer's interest in the partnerships profits. The revisions stating that provisions of the California Revenue and Taxation Code are inapplicable will provide guidance to taxpayers in determining the appropriate amount of income to source to California. Deleting provisions pertaining to long-term contracts will eliminate repetitive provisions in the regulations.

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

In drafting the proposed regulations, the Franchise Tax Board primarily relied on California Revenue and Taxation Code sections 25137 and 17951, their legislative history, and suggestions from members of the public obtained throughout the course of three Interested Parties Meetings. The Franchise Tax Board did not rely upon any other technical,

theoretical, or empirical studies, reports or documents in proposing the revisions to the regulations.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESSES

In accordance with the requirement of Government Code section 11346.2, subdivision (b)(5), that the Franchise Tax Board consider alternatives to the proposed regulatory action, staff of the Franchise Tax Board conducted three interested parties meetings. A preliminary interested parties meeting was held on September 19, 2008 to solicit input from the public. Staff did not provide proposed language at that time. Instead, a list of topics for discussion was distributed. A second interested parties meeting was held on October 18, 2013. Staff provided proposed language pertaining to the various revisions outlined above. A third interested parties meeting was held on July 8, 2014. Comments from the public were received about the lower-tier partnership and the interest in the partnership's profits provisions of the revisions to Regulation section 25137-1. Comments from the public were also generally received about the revisions to Regulation section 17951-4. These comments were considered and where staff deemed appropriate, further changes were made to the proposed revisions.

The proposed revisions to Regulation section 17951-4 apply to individuals who are nonresidents or part-year residents of California for tax purposes, who own interests in partnerships that conduct business within and without California. As such, these individuals are private persons who would be affected by the revisions. However, the current version of Regulation section 17951-4 already applies to such individuals. The proposed revisions provide needed clarity to the current version of Regulation section 17951-4. Accordingly, the proposed revisions will alleviate any adverse impact that currently exists.

The proposed revisions to Regulation section 25137-1 apply to corporations that conduct business within and without California in a unitary enterprise and are included in a combined report, and which own interests in partnerships which also conduct business within and without California. It pertains only to multistate and multinational businesses and therefore will have minimal impact, if any, on small business.

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 amendments to Regulation sections 17951-4 and 25137-1, or would be less burdensome with respect to affected private persons or small businesses than the proposed regulation amendments.

ECONOMIC IMPACT ASSESSMENT

The Franchise Tax Board estimates that less than twenty businesses will be impacted by the proposed revisions. Most are major corporations that conduct business within and without California. It is unknown but highly unlikely that any small businesses will be impacted. However, the Franchise Tax Board has determined in an economic impact statement and

relies on the conclusions therein, that the economic impact, including the ability of California businesses to compete with businesses in other states, will not be significant.

Creation or Elimination of Jobs within the State

Since the regulation relates to sourcing income from partnerships that are unitary with members of a combined report, there is no expected change in the number of new jobs created or existing jobs eliminated within California as a result of the proposed amendments to Regulation sections 25137-1 and 17951-4.

Creation of New or Elimination of Existing Businesses within the State

Since the regulation relates to sourcing income from partnerships that are unitary with members of a combined report, there is no expected change in the number of new businesses created or existing business eliminated within California as a result of the proposed amendments to Regulation sections 25137-1 and 17951-4.

Expansion of Business or Elimination of Existing Businesses within the State

Since the regulation relates to sourcing income from partnerships that are unitary with members of a combined report, there is no expected change in the number of businesses expanded or existing businesses eliminated within California as a result of the proposed amendments to Regulation sections 25137-1 and 17951-4.

Benefits to the Health and Welfare of California Residents, Worker Safety, and the State's Environment.

Since the regulation relates to sourcing income from partnerships that are unitary with members of a combined report, there is no expected change to the health and welfare of California residents, worker safety or California's environment as a result of the proposed amendments to Regulation sections 25137-1 and 17951-4.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed amendments to Regulation sections 25137-1 and 17951-4 will not have a significant impact on business.

California Revenue and Taxation Code section 19563 permits the Franchise Tax Board to publish statistical information. Based on discussions with staff in the Franchise Tax Board's Audit and Legal divisions, it is estimated that statistically less than twenty businesses will be impacted by the proposed revisions. Tax return information indicates that these are primarily major corporations that conduct business within and without California. In the unlikely event of an increase in tax liability as a result of these proposed amendments the increase would be a very small part of their overall business expenses. More importantly, these proposed regulation amendments provide clarity for sourcing income from partnerships that are unitary with members of a combined report. As such they enhance

rather than hinder or adversely impact businesses. Therefore the Franchise Tax Board has determined that the adverse economic impact on business will not be significant.