

**INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF
CALIFORNIA CODE OF REGULATIONS, TITLE 18,
SECTIONS 23038(b)-1, 23038(b)-2, 23038(b)-3, AND
THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18,
SECTIONS 23038(b)-4 AND 23038(b)-5**

Pursuant to California Government Code section 11346.2(b), the California Franchise Tax Board ("Board") hereby presents an initial statement of reasons for proposing amendments to California Code of Regulations, Title 18, sections 23038(b)-1, 23038(b)-2 and 23038(b)-3, and the adoption of sections 23038(b)-4 and 23038(b)-5.

PROBLEM THE PROPOSED AMENDMENTS ARE INTENDED TO ADDRESS

The intent of the proposed amendments to California Code of Regulations, Title 18 ("CCR"), sections 23038(b)-1, 23038(b)-2 and 23038(b)-3, and the proposed adoption of CCR sections 23038(b)-4 and 23038(b)-5 (hereinafter the "Proposed Regulations"), is to make California's regulations consistent with amendments to corresponding federal regulations and to prevent confusion or potential inconsistent tax treatment of business entities because of differences between the federal and state regulations.

In 1997, the Internal Revenue Service issued Treasury Regulations, 26 Code of Federal Regulations ("CFR") sections 301.7701-1, 301.7701-2, and 301.7701-3, commonly referred to as the "check-the-box" regulations, which provided rules for the classification of business entities for federal tax purposes. In general, section 301.7701-1 provides rules for determining whether there is a separate entity for federal tax purposes. Section 301.7701-2 specifies those business entities that automatically are classified as corporations for federal tax purposes. Section 301.7701-3 defines "eligible entity" and provides the rules whereby an eligible entity can elect to be classified as either an association (and therefore a corporation) or a partnership for federal tax purposes.

In 1997, California Revenue & Taxation Code ("RTC") section 23038 stated in part that the classification of a business entity "shall be determined under regulations of the Franchise Tax Board, which shall be consistent with federal regulations as in effect January 1, 1997, that classify a business entity as a partnership or an association taxable as a corporation or disregard the separate existence of certain business entities for tax purposes." Pursuant to RTC section 23038(b)(2), California promulgated the regulations at CCR sections 23038(b)-1, 23038(b)-2 and 23038(b)-3.

After the existing regulations were adopted in 1997, the Internal Revenue Service amended the corresponding federal regulations at 26 CFR sections 301.7701-1, 301.7701-2, and 301.7701-3, and added a new regulation designated 26 CFR section 301.7701-5.

On September 14, 2014, the California governor approved California Assembly Bill Number 1143. (Enacted as Stats. 2014, ch. 325. ("the bill")) The bill amended RTC section 23038, by requiring that the regulations issued by the Board, related to the classification of a business

entity, be consistent with federal regulations as in effect May 1, 2014. The Proposed Regulations are intended to comply with the bill, and make California's regulations consistent with the amendments to the federal regulations through May 1, 2014.

SPECIFIC PURPOSE OF EACH AMENDMENT OR ADOPTION

In general, the purpose of the Proposed Regulations is to make California's regulations consistent with amendments to corresponding federal regulations at 26 CFR sections 301.7701-1, 301.7701-2, 301.7701-3, and 301.7701-5 so that the state and federal regulations provide uniform rules and guidance to taxpayers regarding entity classification.

Proposed Amendments to CCR section 23038(b)-1.

The proposed amendments to CCR section 23038(b)-1 are necessary in order to comply with existing law at RTC section 23038 which requires consistency between the applicable California and the federal regulations in effect on May 1, 2014. The proposed amendments are reasonably necessary to promote the purpose of the check-the-box regulations to simplify entity classification for tax purposes; avoid confusion and uncertainty that could result from having different federal and state regulations; and prevent the potential inconsistent treatment of business entities under federal and state tax law.

CCR section 23038(b)-1, subsection (c), is amended to reflect the amendments in the federal regulation at 26 CFR section 301.7701-1, paragraph (c), which changed the phrase "*qualified* cost sharing arrangements" to "cost sharing arrangements"; and changed the phrase "any arrangement that is treated by the Commissioner as a *qualified* cost sharing arrangement under § 1.482-7 of this chapter ..." to the phrase "including any arrangement that the Commissioner treats as a CSA under § 1.482-7(b)(5) of this chapter ..." The amendments are reasonably necessary in order to make the California regulation consistent with the corresponding federal regulation and to avoid disparate treatment of cost sharing arrangements.

CCR section 23038(b)-1, subsection (d), is amended and CCR section 23038(b)-5 is created, to reflect amendments in the federal regulations at 26 CFR section 301.7701-1, paragraph (d). Prior to amendment, paragraph (d) set forth definitions of "domestic entity" and "foreign entity." The federal regulations deleted those definitions and added 26 CFR section 301.7701-5 containing rules that determine whether a business entity is domestic or foreign. The amendments to CCR section 23038(b)-1, subsection (d), and the adoption of CCR section 23038(b)-5, are reasonably necessary in order to make the California regulations consistent with the corresponding Federal regulations and to avoid having conflicting definitions of "domestic entity" and "foreign entity" under the federal and state regulations.

CCR section 23038(b)-1, subsection (f), is amended to reflect a federal change relating to paragraph (c) of 26 CFR section 301.7701-1. The amendments are reasonably necessary in order to identify the application dates of the above referenced amendments.

Proposed Amendments to CCR section 23038(b)-2.

The proposed amendments to CCR section 23038(b)-2 are necessary in order to comply with existing law at RTC section 23038 which requires consistency between the applicable California and the federal regulations in effect on May 1, 2014. The proposed amendments are reasonably necessary to promote the purpose of the check-the-box regulations to simplify entity classification for tax purposes; avoid confusion and uncertainty that could result from having different federal and state regulations; and prevent the potential inconsistent treatment of business entities under Federal and state tax law.

CCR section 23038(b)-2, subsection (a), is not amended, although there were amendments to the corresponding federal regulation at 26 CFR section 301.7701-2, paragraph (a). The federal regulation added subparagraphs (iv) and (v). The Board's regulations are required to be consistent with the federal regulations for purposes of the California income and franchise tax law. Subparagraphs (iv) and (v) do not relate to income and franchise tax law. Therefore, the new language is not added to the amendments to the California regulations.

CCR section 23038(b)-2, subsection (b), is amended to reflect federal changes at 26 CFR section 301.7701-2, paragraph (b). CCR section 23038(b)-2(b)(8)(A) is amended to include additional foreign entity names and revised foreign entity names consistent with the federal amendments at 26 CFR section 301.7701-2, paragraph (b)(8). CCR section 23038(b)-2(b)(8), subparts (B)-(D), are amended to reflect the federal changes in corresponding provisions. CCR section 23038(b)-2, subsection (b)(9), is added to reflect federal amendments relating to "business entities with multiple charters." The amendments to CCR section 23038(b)-2, subsection (b), are reasonably necessary in order to make the California regulations consistent with the corresponding federal regulations and to avoid having conflicting rules regarding which entities are deemed to be "corporations" under the federal and state regulations.

CCR 23038(b)-2, subsection (c)(2), is amended to reflect federal changes at 26 CFR section 301.7701-2, paragraph (c)(2). However, the California regulation is not amended to reflect the addition of subparagraphs (iv) and (v) to the federal regulation which provides special rules for employment tax purposes and certain excise tax purposes. These provisions were not added to the California regulations because they do not relate to income and franchise tax.

CCR 23038(b)-2, subsection (d)(3)(A)4 is added to reflect the addition to the federal regulation at 26 CFR section 301.7701-2, paragraph (d)(3)(i)(D). The amendment to the California regulation is reasonably necessary in order to make the California regulation consistent with the corresponding federal regulation and avoid disparate treatment of foreign business entities subject to termination of grandfather status under the regulations.

CCR section 23038(b)-2, subsection (e), is amended to state application dates with regard to the above-referenced amendments. The amendments are reasonably necessary in order to identify the application dates of the foregoing amendments.

Proposed Amendments to CCR section 23038(b)-3.

The proposed amendments to CCR section 23038(b)-3 are necessary in order to comply with existing law at RTC section 23038 which requires consistency between the applicable California and the federal regulations in effect on May 1, 2014. The proposed amendments are reasonably necessary to promote the purpose of the check-the-box regulations to simplify entity classification for tax purposes; avoid confusion and uncertainty that could result from having different federal and state regulations; and prevent the potential inconsistent treatment of business entities under federal and state tax law.

CCR section 23038(b)-3, subsection (a), is amended by changing the reference to subsection (f) to subsection (h) in the last sentence to reflect the changes in the federal regulations at 26 CFR section 301.7701-3, paragraph (a). This change was reasonably necessary to ensure consistency in numbering and clarity in the readability of the proposed amended regulation.

CCR section 23038(b)-3, subsection (b), is amended by replacing the phrase "the effective date of this regulation" with "January 9, 1998" in subsections (b)(3)(A), (b)(3)(B), (b)(4)(A), and (b)(4)(A)1 of section 23038(b)-3. This change is reasonably necessary in order to ensure that the provisions addressing "existing eligible entities" are only applicable to those eligible entities that were in existence when the regulation was first made effective.

CCR section 23038(b)-3, subsection (c), is not amended. Although there were amendments to the corresponding federal regulation at 26 CFR section 301.7701-3, paragraph (c), the California regulation is not amended because the California regulation does not have rules relating to the manner of making elections as set forth in the corresponding federal regulation at 26 CFR section 301.7701-3, paragraph (c). Instead, the California regulation provides that the classification of an eligible business entity for California income and franchise tax purposes shall be the same as the classification for federal tax purposes.

CCR section 23038(b)-3, subsection (d), is amended to reflect changes in the federal regulation at 26 CFR section 301.7701-3, paragraph (d), which added new subparagraphs (d)(2) and (d)(4) and new subpart (d)(1)(ii) relating to "deemed relevance." These amendments are reasonably necessary in order to ensure that the provisions relating to "special rules for foreign eligible entities" are consistent in the California and federal regulations.

CCR section 23038(b)-3 is amended to include new subdivisions (f) and (g) to reflect amendments to the federal regulations at 26 CFR section 301.7701-3. New subdivision (f) relates to "changes in number of members of an entity" and new subdivision (g) relates to "elective changes in classification." These amendments are reasonably necessary in order to ensure that the California regulations and federal regulations provide for consistent treatment of entities that elect to change their classification for tax purposes.

CCR section 23038(b)-3, subsection (g), is further amended by the addition of subsection 3(g)(4) to include a provision in the federal regulation at 26 CFR section 301.7701-3, paragraph (c), subparagraph (1)(v)(C), relating to S corporations. The amendment is

reasonably necessary in order to ensure that the California regulations and federal regulations provide for consistent treatment of S corporations under the federal and state regulations.

CCR section 23038(b)-3, subsection (f), is relabeled subsection (h) and amended in order to reflect changes in the federal regulation at 26 CFR section 301.7701-3, paragraph (h). The amendments are reasonably necessary in order to identify the application dates of the above-referenced amendments and maintain consistency with the Federal regulations.

Proposed Adoption of Regulation at CCR section 23038(b)-4.

The Board is proposing the adoption of a new regulation designated CCR section 23038(b)-4 to act as a reserved section so that the proposed new regulation designated CCR section 23038(b)-5, also included in this proposed rulemaking, will be numerically consistent with the equivalent federal regulation which is designated 26 CFR section 301.7701-5.

Proposed Adoption of Regulation at CCR section 23038(b)-5.

The proposed adoption of CCR section 23038(b)-5 is reasonably necessary in order to comply with existing law at RTC section 23038 which requires consistency between the applicable California and federal regulations as in effect May 1, 2014. CCR section 23038(b)-5 is necessary for consistency with a new federal regulation designated 26 CFR section 301.7701-5 which was added for the purpose of "clarification of the definitions of a corporation and a domestic entity in circumstances where the business entity is considered to be created or organized in more than one jurisdiction."

ECONOMIC IMPACT ASSESSMENT

RTC section 23038 states that the classification of an eligible business entity as a partnership or an association taxable as a corporation in California shall be the same as the classification of the entity for federal tax purposes and that the separate existence of an eligible business entity shall be disregarded for California tax purposes if the separate existence of the business entity is disregarded for federal tax purposes. Thus, in most cases, the classification of a business entity would be the same with or without the Proposed Regulations and, therefore, the Board believes that the impact on jobs within the state and the economic impact on businesses, including the ability of California businesses to compete with those in other states, would be negligible. The proposal would have minimal impact on the health and welfare of California residents, worker safety or the State's environment as discussed below.

The Creation or Elimination of Jobs in California:

Under RTC section 23038 and the existing California regulations, the classification of a business entity for California tax purposes must be the same as the classification for federal tax purposes. However, because the federal regulations relating to classification of business entities have been changed, there could be confusion and uncertainty on the part of taxpayers regarding how a business entity should be classified for state purposes should a taxpayer file under the current California regulatory scheme.

The Proposed Regulations clarify the definition of business entities by conforming to federal regulation changes which provide, among other things, that certain foreign entity types, formed in specified jurisdictions, must file as a corporation for tax purposes. The existing California regulations are not consistent with the federal regulations as to the tax treatment of these entity types because the federal list includes entities that are not included on the state list. If the Board's interpretation of this issue is upheld in the absence of the Proposed Regulations, the filing status and tax owed by these taxpayers would be the same as that under the Proposed Regulations, so there would be no change in the number of jobs.

If the Board's interpretation of the statute is not upheld, taxpayers challenging the Board's interpretation (and other similarly situated taxpayers) might have a change in tax owed. Under this scenario, the Proposed Regulations would result in a change in tax paid by these taxpayers compared to a world without the Proposed Regulations. These changes in taxes could result in a change in the number of jobs within the state of California. In practice, because at most \$500,000.00 in tax liability is at risk in any one tax year, the impact on the creation or elimination of jobs in California would not be significant.

The Creation of New Businesses or Elimination of Existing Businesses:

Although the Board believes that taxpayers are required, by statute, to classify business entities for California tax purposes the same as the classification for federal tax purposes, there could be uncertainty on the part of the taxpayers over how an entity should be classified because the existing California regulations are not consistent with the federal regulations in regard to specified foreign entity types which must file as a corporation for state purposes.

If the Board's interpretation of this issue is upheld in the absence of the Proposed Regulations, the filing status and tax owed by these taxpayers would be the same as if the Proposed Regulations were adopted and there would be no new businesses created nor a change in the number of existing businesses within the state of California.

If the Board's interpretation of this issue is not upheld in the absence of the Proposed Regulations, taxpayers challenging the Board's interpretation (and other similarly situated taxpayers) would have a change in tax owed. Thus, under this scenario, the Proposed Regulations would result in a change in tax paid by these taxpayers compared to a world without the Proposed Regulations. These changes in taxes could, in theory, induce a change in the number of businesses. In practice, based on return data indicating that no more than \$500,000.00 in liability is at risk in any given tax year, the impact on the creation of new business or elimination of existing business would not be significant.

The Expansion of Businesses Currently Doing Business in California:

As noted above, the Proposed Regulations might result in a change in aggregate tax owed for some businesses of not more than \$500,000.00 in any one tax year. These changes in taxes owed could, in theory, induce a change in real economic activity. In practice, because the dollar size of this potential tax change is a small fraction of California's economy, the impact would not be significant.

Benefits to the Health and Welfare, Worker Safety, and the Environment:

The Proposed Regulations would clarify current ambiguities in the applicable regulations at the state level for the application of the regulations already in place at the federal level since 1997. As such, it would have no impact on the health and welfare of California residents, worker safety or the State's environment other than to simplify entity classification for tax purposes and clarify the tax consequences resulting from an election. These benefits are discussed further in the section on benefits of the regulation, below.

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

In drafting the Proposed Regulations, the Board relied on California Revenue and Taxation Code section 23038; the existing California Code of Regulations, Title 18, sections 23038(b)-1, 23038(b)-2 and 23038(b)-3; and CFR, sections 301.7701-1, 301.7701-2, 301.7701-3, and 301.7701-5.

In addition, the Board relied upon comments from members of the public obtained during the course of two Interested Parties Meetings ("IPM"). At the first IPM, the attendees suggested several changes, and as a result staff made changes to the proposed regulations in accordance with comments received from the public. At the second IPM, there were no comments from the public to the latest revisions of the proposed regulatory text.

BENEFITS OF THE REGULATION

The Proposed Regulations will benefit California individuals and entities by making the California regulations conform to changes in the federal regulations since 1998 to the extent those regulations are applicable to California's income and franchise tax law; avoiding confusion and uncertainty that could result from different federal and state regulations; preventing the potential inconsistent treatment of entities under federal and state tax law; ensuring that taxpayers, their representatives, and the state of California have consistent guidance regarding the classification of business entities for tax purposes; providing greater clarity regarding entity classification thereby reducing the need for audits and disputes concerning entity classification and tax treatment; and simplifying entity classification for tax purposes and clarifying the tax consequences resulting from an election.

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

The Board has determined that no alternative has been identified or brought to the attention of the Board that 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 or small business than the proposed regulatory action or would be more cost-effective to affected private persons or small business and equally effective in implementing the statutory policy or other provision of law.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the Proposed Regulations will not have a significant overall economic impact on business. The Board reviewed data from multiple tax years which showed that no more than twenty entities in any one tax year have characteristics which might be impacted by the Proposed Regulations. RTC section 23038 conforms to the federal entity classification election system in place January 1, 1997, by mandating that an eligible business entity (an entity not classified as a corporation) be either, (1) classified as a partnership or taxable as a corporation, or (2) disregarded (treated as a sole proprietorship) for California tax purposes, just as it is for federal purposes. The California regulations also provide a default rule for an eligible entity that does not elect its classification. An election is necessary only when an eligible entity chooses to be classified initially other than under the default rule, or when the entity chooses to change its classification. Generally, any election made for federal purposes under the applicable federal regulations is binding for California tax purposes.

The Board reviewed California tax return data for multiple tax years identifying entities most likely to be impacted by the proposed rulemaking. RTC section 19563 permits the Board to publish statistical information. It was found that no more than twenty taxpayers statistically have filing characteristics which might be affected by the Proposed Regulations. A majority of these entities were comprised of companies in the Professional, Scientific, and Technical Services or Finance and Insurance industries. Additionally, in no single tax year was aggregate state net income for these entities more than \$5 million nor aggregate liability greater than \$500,000.00.