

TITLE 18. FRANCHISE TAX BOARD
[Notice published May 11, 2018]
NOTICE OF PROPOSED RULEMAKING

Pursuant to California Government Code sections 11346.4 and 11346.5(a), the California Franchise Tax Board ("Board") proposes to amend California Code of Regulations ("CCR"), Title 18, sections 23038(b)-1, 23038(b)-2 and 23038(b)-3; add a placeholder for a reserved regulation at CCR section 23038(b)-4; and adopt a proposed regulation at CCR section 23038(b)-5.

PUBLIC HEARING

The Board has not scheduled a public hearing on this proposed action. However, the Board will hold a hearing if it receives a written request for a public hearing from any interested person, or his or her authorized representative, no later than 15 days before the close of the written comment period indicated below. The request should be submitted to the Board officer named below. In addition, Government Code section 15702(b) provides for consideration by the Board of any proposed regulatory action if any person makes such request in writing.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Board. The written comment period closes at 5:00 p.m. on June 26, 2018, and the Board will consider only comments received at the Board offices by that time. The Board encourages submission of comments in electronic form, rather than in paper form. Comments may be submitted by email to Bradley.Kragel@ftb.ca.gov.

Submit comments in paper form to:

Mailing Address:

Bradley Kragel, Tax Counsel III
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Fax:

(916) 843-0279

AUTHORITY AND REFERENCE

Revenue and Taxation Code ("RTC") Section 19503 authorizes the Board to prescribe regulations necessary for the enforcement of Part 11 (commencing with section 23001) of the RTC. RTC section 23038, subdivision (b)(2)(B)(i), requires that the classification of a business entity shall be determined under regulations of the Board that shall be consistent with federal regulations as in effect May 1, 2014.

INFORMATIVE DIGEST / POLICY STATEMENT OVERVIEW

(A) Existing Laws & Regulations.

In 1997, the Internal Revenue Service issued Treasury Regulations, 26 CFR sections 301.7701-1 through 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.

The federal regulations include 26 CFR section 301.7701-1 Classification of organizations for tax purposes; 26 CFR section 301.7701-2 Business entities; definitions; and 26 CFR section 301.7701-3 Classification of certain business entities.

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.

Under RTC section 23038(b)(2)(B), California tax law conforms to the federal entity classification election system. In 1997, RTC section 23038 stated in part that the classification of a business entity as an association taxable as a corporation "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."

In 1997, California issued its own regulations, which are set forth at CCR sections 23038(b)-1 through 23038(b)-3, titled as follows: CCR section 23038(b)-1 Classification of Organizations for California Income and Franchise Tax Purposes; CCR section 23038(b)-2 Business Entities; Definitions; and CCR section 23038(b)-3 Classification of Certain Business Entities.

Since 1997, the Internal Revenue Service has amended 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")) Among other things, 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.

RTC section 20308(b)(2)(B)(i) currently states "For purposes of the preceding subparagraph, the classification of a business entity (including a business trust) as an association taxable as a corporation (under Chapter 3 (commencing with Section 23501)) shall be determined under regulations of the Franchise Tax Board, that shall be consistent with federal regulations as in effect May 1, 2014, 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."

(B) Effect of Proposed Amendments.

The effect of the proposed amendments to CCR sections 23038(b)-1, 23038(b)-2 and 23038(b)-3, is that California's regulations will conform to corresponding federal regulations at 26 CFR sections 301.7701-1, 301.7701-2 and 301.7701-3, as in effect on May 1, 2014, to the extent those regulations are applicable to California's income and franchise tax law. The effect of adopting a placeholder regulation at CCR section 23038(b)-4 is that the proposed regulation at CCR section 23038(b)-5 will numerically match the equivalent federal regulation at 26 CFR section 301.7701-5. The effect of adopting a proposed regulation to CCR section 23038(b)-5 is that California's regulations will conform to corresponding federal regulation at 26 CFR section 301.7701-5, as in effect on May 1, 2014, to the extent that regulation is applicable to California's income and franchise tax law.

(C) Objectives of Proposed Amendments.

In general, the purpose of the federal check-the-box regulations, and the corresponding California regulations, is to provide guidance to taxpayers as to how various types of eligible entities are to be classified for tax purposes. The objective of the amendments to the existing regulations and the proposed adoption of regulations is to make California's regulations consistent with the corresponding federal regulations, to the extent those regulations are applicable to California's income and franchise tax law, and to comply with the provisions of the bill, which revised RTC section 23038.

(D) Anticipated Benefits.

The specific benefits of the amendments to the existing regulations and the proposed adoption of regulations include 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.

(E) Compatibility with Existing State Regulations.

During the process of developing this proposed regulatory action, the Board, pursuant to Government Code section 11346.5, subdivision (a)(3)(D), conducted a review for any similar state regulations. The Board has determined that the proposed regulatory action is not inconsistent or incompatible with existing regulations.

(F) Comparison to Federal Regulations.

The existing California regulations at CCR sections 28038(b)-1, 28038(b)-2, and 23038(b)-3, differ from the federal regulations in that the California regulations do not contain rules for making elections as set forth in 26 CFR section 301.7701-3, subdivision (c). Instead, the current California regulations provide that the federal tax classification is binding for California income and franchise tax purposes as stated in CCR section 23038(b)-3, subdivision (c).

The proposed regulatory action will not differ substantially from the amendments to the federal regulations, except that the proposed regulatory action is not incorporating certain paragraphs in the federal regulations at 26 CFR section 301.7701-2, paragraph (c)(2)(iv) (special rule for employment tax purposes) and paragraph (c)(2)(v) (special rule for certain excise tax purposes) because those paragraphs do not relate to California's franchise and income tax.

DISCLOSURES REGARDING THE PROPOSED ACTION

Mandate on local agencies and school districts: *None.*

Cost or savings to any state agency: *The Board has concluded that the proposed rulemaking may result in a fiscal effect on state government but it will not be significant. The Board estimates a possible change in yearly income tax revenue to the state's General fund that will be at most, \$500,000.*

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 to directly affected private persons or business: *The 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.*

Effect on small business: *The Board concludes it is likely the proposed rulemaking will primarily not affect small businesses. The proposed rulemaking relates to entity classification for business types that are generally owned by foreign parent entities, and which are therefore exempted from the definition of small business found in Government Code section 11342.610 given the nature of their business activities.*

Significant effect on housing costs: *None.*

RESULTS OF THE ECONOMIC IMPACT ASSESSMENT

Pursuant to Government Code section 11346.3, subdivision (b), the Board has determined in the economic impact assessment that there would be negligible effects on (a) the creation or elimination of jobs within the state; (b) the creation of new businesses or the elimination of existing businesses within the state; or (c) the expansion of businesses currently doing business within the state. The proposed regulatory action will positively impact the health and welfare of California residents, worker safety, and the state's environment as the proposed regulatory action will benefit taxpayers, tax practitioners, and the state of California by providing guidance and clarification regarding entity classification for tax purposes.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no reasonable alternative it considered or that has otherwise been identified and brought to the attention of the Board 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 action or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

The Board invites interested persons to present statements or arguments with respect to alternatives during the written comment period or at the hearing, if one is requested.

CONTACT PERSONS

Inquiries concerning the proposed administrative action may be directed to:

Bradley Kragel, Tax Counsel III
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-2861
Email: Bradley.Kragel@ftb.ca.gov

The backup contact person for these inquiries is:

Christy Keith

Legal Division MS A260

Franchise Tax Board

P.O. Box 1720

Rancho Cordova, CA 95741-1720

Telephone: (916) 845-6080

Email: Christy.Keith@ftb.ca.gov

AVAILABILITY OF INITIAL STATEMENT OF REASONS, TEXT OF PROPOSED REGULATIONS, AND RULEMAKING FILE

The Board will have the entire rulemaking file available for inspection and copying throughout the rulemaking process at its office at the above address. As of the date this notice is published in the Notice Register, the rulemaking file consists of this notice, the proposed text of the regulations, and the initial statement of reasons. Copies can be obtained on the Board's website at ftb.ca.gov or by contacting Christy Keith at the address, phone number or email address listed above.

AVAILABILITY OF CHANGED OR MODIFIED TEXT

After the close of the comment period and considering all timely and relevant comments received, the Board may adopt the proposed regulations substantially as described in this notice. If the Board makes modifications which are sufficiently related to the originally proposed text, it will make the modified text (with the changes clearly indicated) available to the public for at least 15 days before the Board adopts the regulations as revised. Copies of the modifications will be published on the Board's website at ftb.ca.gov and mailed to anyone that has expressed an interest in receiving the modification information. Please send requests for copies of any modified regulations to the attention of Christy Keith at the address or email address indicated above. The Board will accept written comments on the modified regulations for 15 days after the date on which they are made available.

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

Upon its completion, copies of the Final Statement of Reasons will be published on the Board's website at www.ftb.ca.gov and may also be obtained by contacting Christy Keith at the above address or email address.

AVAILABILITY OF DOCUMENTS ON THE INTERNET

Copies of the Notice of Proposed Action, the Initial Statement of Reasons, and the text of the regulations in underline and strikeout can be accessed through our website at www.ftb.ca.gov.