INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 23663-6, AND AMENDMENT OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 23663-1

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATORY ACTION IS INTENDED TO ADDRESS

California Revenue and Taxation Code ("RTC") section 23663 permits the assignment of credits among affiliated members of the same combined reporting group. RTC section 23663 was added by Section 10 of AB 1452 (Stats. 2008, ch. 763). It is specifically operative for assignments made in taxable years beginning on or after July 1, 2008, and first permits assigned credits to be claimed against the tax of the assignee in taxable years beginning on or after January 1, 2010. The statute specifies that credits may only be assigned to an eligible assignee, which is generally defined in RTC section 23663(b)(3) as an affiliated corporation that is a member of the same combined reporting group as the assignor in both the taxable year the credits were earned and the taxable year the credits are assigned to the assignee.

However, taxpayers have uncertainty regarding whether assignments would be permissible when corporate reorganizations and other corporate restructurings occur. For example, as a result of a corporate merger, the assignor may not be the entity that originally earned the credit, and so, taxpayers have uncertainty regarding which combined reporting group (i.e., the assignor's combined reporting group or the combined reporting group of the taxpayer that originally earned the credit) is relevant in applying the eligible assignee requirements in RTC section 23663(b)(3).

Additionally, when the assignor and its subsidiaries have been acquired by an unrelated combined reporting group in the intervening time between the year in which the credits were earned and the year of the planned assignment, taxpayers have uncertainty as to which group members are eligible assignees. Similarly, the assignor (or a potential eligible assignee) may have participated in a corporate merger or reorganization, such as a reorganization under Internal Revenue Code ("IRC") section 368(a)(2)(F), and so, taxpayers have uncertainty as to whether the assignor (or potential eligible assignee) will be considered to have existed when the credits were earned. Due to these situations and others resulting from similar corporate events, taxpayers have uncertainty regarding which entities are eligible to be assigned credits under the credit assignment statute.

SPECIFIC PURPOSE OF THE REGULATORY ACTION

The purpose of this proposed regulatory action under RTC section 23663, is to give taxpayers certainty by providing guidance as to which entities are eligible assignees when members of a combined reporting group have been affected by corporate reorganizations and other corporate restructurings. The regulatory action will also effectuate the purpose of the statute, which was to allow credits to be utilized by members of the same combined reporting group, while balancing the explicit limitations of the credit assignment statute, including that the assignor and assignee be in the same combined reporting group at the time the credit was earned and also at the time the credit was assigned. The proposed regulatory action achieves the statute's purpose by providing clear rules in the case of reorganizations and other corporate restructurings. The proposed regulatory action also contains numerous examples that provide additional clarity as to the identity of "eligible assignees" in specific scenarios.

Under RTC section 23663(e)(4), the Franchise Tax Board ("FTB") is specifically authorized to issue regulations to implement the purposes of the statute, including any regulations "necessary to specify the treatment of any assignment that does not comply with the requirements of this section (including, for example, where the taxpayer and eligible assignee are not properly treated as members of the same combined reporting group on any of the dates specified in paragraph (3) of subdivision (b) [of RTC section 23663])."

The proposed amendment to California Code of Regulations, title 18 ("Regulation") section 23663-1 will apply the definitions in Regulation section 23663-1 to proposed Regulation section 23663-6 so that these terms do not need to be redefined in the proposed regulation.

NECESSITY

1. The proposed amendment to Regulation section 23663-1 is described immediately below, with explanations describing the necessity for the suggested changes within the description.

Regulation section 23663-1, *Definitions*. This section contains definitions that apply to regulations regarding the assignment of credits. This section is being amended so that it also applies to proposed Regulation section 23663-6. This amendment is necessary so that the definitions do not need to be redefined in the proposed regulation, which would make the proposed regulation significantly longer and more difficult to understand.

2. The subsections of proposed Regulation section 23663-6 are described immediately below, with explanations describing the necessity for each subsection within each description.

- Subsection (a), *In general.*

Subsection (a) sets forth the purpose of Regulation section 23663-6, and provides an overview of what the regulation covers. This subsection states that the regulation gives guidance to taxpayers regarding credit assignments following reorganizations and other corporate restructurings. This subsection is necessary to provide users of Regulation section 23663-6 guidance regarding its scope, so that users can identify the applicability of the regulation to their specific issues.

- Subsection (b), *Eligible Credit*.

Subsection (b) clarifies the definition of an eligible credit set forth in RTC section 23663(b)(2). An eligible credit is defined in the statute as "[a]ny credit earned by the taxpayer" on or after July 1, 2008 or earned before July 1, 2008 that can be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008. The purpose of this subsection is to clarify that eligible credits (credits that can be assigned) includes credits allowed to a taxpayer through corporate events, such as reorganizations and other corporate restructurings. In these situations, taxpayers may be confused as to whether the taxpayer meets the definition of having "earned" the credits. Therefore, this subsection provides clarity as to when credits are considered to have been earned. This subsection is necessary to clarify which credits are included in the definition of an eligible credit or else users of the regulations and the statute may apply inconsistent definitions of the term "eligible credit". Also, consistent with RTC section 23663, the proposed language clarifies that eligible credit does not include credits that a taxpayer received by assignment or sale.

- Subsection (c), *Eligible Assignee*.

Subsection (c) clarifies that an eligible assignee must have been in the same combined reporting group as the entity that earned the credit when the credit was originally earned. The statute specifies that an eligible assignee must have been in the assignor's combined reporting group when the assignor originally earned the credit. However, if the assignor was not the entity that originally earned the credit, but instead, held the credit because, for example, it merged with the entity that earned the credit, taxpayers have uncertainty as to which entity's combined reporting group is looked at to satisfy the requirement—the assignor's combined reporting group when the credit was originally earned, or the combined reporting group of the taxpayer that originally earned the credit. Thus, this subsection clarifies that the relevant combined reporting group for purposes of the requirement in RTC section 23663(b)(3) is that of the taxpayer that originally earned the credit..

This subsection contains four illustrative examples. In Example 1, B is the assignor in 2013. To determine the "eligible assignees," the subsection of the regulation looks to the members of B's combined reporting group in 2010 when B earned the credits. According to this snapshot, A and C are the only potential eligible assignees. Second, the subsection of the regulation looks to the members of B's combined reporting group in 2013, the year of assignment. In 2013, X, Y, Z and C are potential eligible assignees. However, C is the only potential eligible assignee in both the year the credit was earned and the year the credit is assigned. As such, C is the only eligible assignee.

Examples 2, 3 and 4 address IRC section 355 transactions – spin-offs, split-offs and split-ups. These transactions generally involve the creation of a new entity that is a continuation of a part of the prior company's business. However, the new entity is not considered an eligible assignee. The new entity does not meet the requirements of the statute because it was not a member of the assignor's combined reporting group when the assignor earned the credits.

This subsection is necessary to avoid uncertainty regarding who is an eligible assignee after corporate reorganizations and other corporate restructurings occur. As discussed above, these corporate restructurings may create uncertainty regarding which combined reporting group is looked at to satisfy the requirements of the statute: the assignor's combined reporting group when the credit was originally earned or the combined reporting group of the taxpayer that originally earned the credit. This subsection, therefore, clarifies that the statute looks at the combined reporting group of the taxpayer that originally earned the credit as the correct combined group.

- Subsection (d), *Pre-Reorganization Credits.*

Subsection (d) addresses situations in which the assignor is not the taxpayer who originally generated the credits, but instead received the credits as a result of a corporate reorganization or other corporate restructuring. Taxpayers have uncertainty regarding the identity of the eligible assignees when the assignor is not the taxpayer that originally earned the credits because, for purposes of the requirements found in RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i), it is not clear which combined reporting group is looked at to satisfy the requirements of the statute – the assignor's combined reporting group or the combined reporting group of the taxpayer that originally earned the credits. Thus, this subsection clarifies that the statutory requirements of RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i) are based on the combined reporting group of the taxpayer that originally earned the credits. The subsection specifies that the taxpayer that earned the credits is treated as the assignor to determine which entities are eligible assignees. As such, when the assignor originally earned the credits, but assigns credits under RTC section 23663, an eligible assignee must meet the requirements of Regulation section 23663-6 and RTC sections 23663(b)(3)(A)(i) and (b)(3)(B)(i) in relation to the taxpayer that originally earned the credits. This result is consistent with the statute because it allows assigning credits to entities that were members of the combined reporting group of the entity that originally earned the credits.

There are two examples that illustrate the rules in this subsection. In Example 5, after the corporate reorganization, B no longer exists in the year of assignment because it merged into Y, and Y wants to assign B's historical credits. In this situation, Y is the assignor, but was not the entity that earned B's historical credits. In this case, absent this subsection of the regulation, it is unclear which entities are "eligible assignees" because the requirements of RTC section 23663(b)(3)(B)(i) do not identify which entity is treated as the assignor for purposes of determining the combined reporting group. In this situation, as the example demonstrates, the eligible assignees for B's historical credits are determined by looking to B's combined reporting group in the year B earned the credits. At that time, A and C were in B's combined reporting group, and therefore, A and C are potential eligible assignees. In the year of assignment, of the two potential eligible assignees, only C meets the requirement found in RTC section 23663(b)(3)(B)(ii). Thus, C is the only eligible assignee, assuming C meets all other applicable requirements.

Example 6 is the reverse situation of the situation in Example 5. In Example 6, C has no eligible assignees because C did not earn the credits, and A and B were not in Z's combined reporting group when Z earned the credits. Again, the statute leaves taxpayers with uncertainty as to which entities are "eligible assignees" because the assignor (entity C in Example 6) did not earn the credits. This subsection of the regulation clarifies this ambiguity by explaining that because A and B were not part of Z's combined reporting group when Z earned the credits, there are no eligible assignees.

This subsection is necessary to provide clarity and guidance to taxpayers for purposes of determining the identity of eligible assignees when the assignor was not the taxpayer that earned the credits. This subsection advances the purpose of the statute by clarifying that, even after a corporate reorganization or other corporate restructuring where the taxpayer that originally earned credits is merged into another entity, the taxpayer that originally earned the credits is treated as the assignor when determining the eligible assignees of a credit. The fact patterns in examples 5 and 6 illustrate how without this subsection of the regulation, determining an eligible assignee would be unclear, and the examples provide clarity and guidance on determining an eligible assignee.

- Subsection (e), *F Reorganizations.*

Subsection (e) sets forth the rule that a potential eligible assignee who would have been an eligible assignee but for a reorganization under IRC section 368(a)(1)(F) ("F reorganization"), will be treated as an eligible assignee for purposes of this subsection. This rule would treat the resulting corporation from an F reorganization the same as the original corporation that disappeared in the F reorganization.

An F reorganization is unique in that the new corporation is treated for tax purposes as a continuation of the old corporation. Old and new corporations of an F reorganization are considered functional equivalents in the context of the larger transaction and with respect to related transactions or events.

Example 7 illustrates the narrow rule found in subsection (e) of the regulation.

This subsection is necessary to allow corporations affected by F reorganizations to be treated as eligible assignees, assuming the corporations have met all other requirements of the statute. Without the rule, there would be ambiguity as to whether a corporation affected by an F reorganization would be an eligible assignee. This subsection of the regulation makes clear that a corporation that has met all other requirements of the statute but is affected by an F reorganization can be an eligible assignee.

- Subsection (f), Ineligible Assignee.

Subsection (f) imposes a business assets test to determine the eligibility of a potential eligible assignee. This subsection prevents instances where a corporation with a relatively low level of business activity and assets is combined with a corporation outside of the group which has much higher business activity and assets. The result is that the relatively much smaller corporation now houses the relatively much larger corporation that was acquired. While the relatively small corporation was part of the assignor's combined reporting group when the credits were earned and in the year of assignment, the relatively larger corporation would not have been an eligible assignee, but for the merger with the relatively smaller corporation.

This subsection provides consistency with the same combined reporting group requirement under RTC section 23663(b)(3) and sets forth rules which deny assigning credits in situations that would be contrary to the purpose of the statute. By requiring an assignee be in the same combined reporting group when credits are both earned and assigned, this subsection ensures the purpose of the statute is maintained. The intent of the statute was to require that the assignor and assignee be members of the same combined reporting group both when the credit was originally earned and when the credit was assigned. As such, RTC 23663 allows the utilization of credits within the assignor's combined reporting group, but only so long as the limitation rule for the year the credits were originally earned and assigned was satisfied. Corporate reorganizations and corporation restructuring of differently size corporations create uncertainty for taxpayers as to whether the post-merger corporation would be an eligible assignee. The greater the percentage an out-of-group corporation comprises a post-merger corporation, the more the post-merger corporation fundamentally is a continuation of the out-of group corporation.

Thus, in order to give taxpayers a bright line standard, this subsection disallows credit assignments to entities that engaged in a reorganization or other corporation restructuring such that the amount of business assets after the merger are more than 80% of the amount of business assets of the surviving entity before the merger.

Example 8 illustrates this bright line standard to the "eligible assignee" requirements found in subsection (f) of the proposed regulation. In example 8, C was a relatively small corporation with minimal assets, but was a member of B's combined reporting group when B earned its credits. B acquired Z and merged Z into C, with C being the surviving entity. Thus, C is now over 80% comprised of Z's business assets. However, allowing C to be an eligible assignee would be inconsistent with the purpose of the statute. Consequently as explained in example 8, this subsection disqualifies C as an eligible assignee because C's business assets were less than 20% of the surviving entity's assets after the merger.

This subsection is necessary to provide users of the regulations with a clear test for determining when a corporation will be treated as an eligible assignee after another entity has merged into the corporation. Without this subsection, users of the regulations would be left with uncertainty regarding eligible assignees after a merger or corporate reorganization and would be left applying a nebulous substance analysis. This subsection furthers the Legislature's purpose of limiting the assignment of credits to members of the same combined reporting group as the taxpayer that originally earned the credit.

- Subsection (g), *Limitations*.

Subsection (g) states that limitations on the allowance of credits against the assignor's tax will also apply to the allowance of credits to the assignee's tax. If the assignor's use of credits against its tax was subject to limitations or would have been subject to limitations but for the assignment, then the same limitations apply to the assignee's ability to use the credits against its tax.

Example 9 illustrates these limitations in the context of Enterprise Zone ("EZ") credits. If B had EZ credits subject to the limitations found in RTC section 23622.7(j) and assigned those credits to C, C's ability to use the credits against its tax would be subject to the same limitations that applied when B held the credits. Accordingly, as explained in example 9, the limitations on B's use of the credits do not extinguish upon assignment, but instead, apply consistently to the use of the credits before and after the assignment.

This subsection is necessary to avoid uncertainty regarding whether the limitations on the allowance of credits are impacted by an assignment. Without the clarity provided by this subsection of the regulation taxpayers would be unaware of the limitations that accompany the credit when assigned. Taxpayers should be aware of these limitations because it is an important factor when determining how to assign credits. This subsection provides guidance and makes taxpayers aware of the limitations that accompany the assignment of credits and furthers the purpose of the statute.

BENEFITS ANTICIPATED FROM THE REGULATORY ACTION

The proposed regulatory action will benefit taxpayers, tax practitioners, and the State of California by providing clarity that does not currently exist through guidance to identify entities that are eligible assignees for purposes of the assignment of credits pursuant to RTC section 23663. The proposed regulatory action will clarify which taxpayers are eligible assignees in situations resulting from corporate reorganizations and other corporate restructurings. The clarity from the proposed regulatory action will reduce uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California by providing rules and examples relating to proper elections to assign credits. These benefits are the result of goals developed by the FTB with input from interested parties and based on broad statutory authority.

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

In drafting the proposed regulatory action, the FTB primarily relied on RTC section 23663 and related IRC sections. The FTB also relied on suggestions from members of the public obtained throughout the course of two interested parties meetings ("IPMs"). The FTB 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 FTB consider alternatives to the proposed regulatory action, staff of the FTB conducted two IPMs. A preliminary IPM was held on June 12, 2014 to solicit input from the public. Staff discussed with attendees a general structure to determine which members of an assignor's combined reporting group were "eligible assignees" in situations in which the assignor was not the taxpayer that originally earned the credit and when the members of the assignor's combined reporting group changed in the time between when the credit was earned and when the credit was assigned. A summary of the first IPM was thereafter made available to the public. A second IPM was held on June 12, 2018, at which staff provided proposed language. As noted above, the purpose of the meeting was to provide participants with an opportunity to discuss and provide comments on the proposed language of the proposed regulation. The summary of the second IPM was thereafter made available to the public. In addition, the Background and Explanations of the Proposed Draft Language was also made available to the public. After the second IPM, staff did not receive any comments from the public.

The alternative to adopting the proposed regulatory action is the status quo, which would not provide taxpayers improved guidance on credit assignment issues and would result in increased costs to deal with defective assignments of credits. The status quo puts at risk taxpayers' willingness to assign credits to eligible assignees because there is a current lack of clarity as to the identity of eligible assignees following corporate reorganizations or corporate restructurings.

Accordingly, the FTB has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulatory action, or would be less burdensome with respect to affected private persons or small businesses than the proposed regulatory action.

ECONOMIC IMPACT ASSESSMENT

Creation or Elimination of Jobs within the State

The proposed regulatory action will not impact employment in California—jobs will neither be created nor eliminated due to this regulatory action. This is due to the fact that the proposed regulatory action would merely provide clarity on assigning credits under RTC section 23663 by stipulating who would be considered an eligible (or an ineligible) assignee in corporate reorganizations or corporate restructurings. The increased certainty from this regulatory action will result in fewer errors in the future and eliminate taxpayer confusion on this issue. FTB does not anticipate that there will be an effect on the creation or the elimination of jobs from the proposed regulatory action.

Absent this regulatory action, there is uncertainty as to which entities are eligible assignees when members of the combined group have been affected by corporate reorganizations or corporate restructuring. In that eventuality, based on recent historical data, if 10 percent of these credit assignments are made to invalid assignees, and the errors are undetected, the tax revenue loss is likely to be minor, in the range of $70,000 to $300,000 annually. If discovered in audit these minor losses to the business entity would be addressed within existing cash balances and would not result in elimination (or creation) of jobs.

Creation of New or Elimination of Existing Businesses within the State

The proposed regulatory action would neither create nor eliminate businesses in California. Credit assignments are made to assignees which are related members of the same combined reporting group who, most likely, have the liability against which the credits may be applied. This regulatory action would fill gaps in current law for existing businesses that have some uncertainty regarding whether assignments would be permissible in certain situations that may result from corporate acquisitions or corporate reorganizations. The clarification provided with respect to who is an eligible assignee for the purpose of using the assigned credits would neither result in new business creation or elimination of existing businesses, because economic decisions and business investments would not be effected. Therefore, this regulatory action would not provide an incentive for the creation of new businesses within the state or the elimination of existing ones.

Expansion of Businesses Currently Doing Business within the State

The proposed regulatory action is intended to provide clarity to existing law for taxpayers, tax practitioners, and the state regarding the assignment of credits to ineligible assignees where the assignor and/or members of the combined reporting group are involved in corporate reorganizations or corporate restructurings. Regulation section 23663-6 would not impact the business climate in the state, and therefore, it would not result in the expansion of businesses doing business in California. This is because the goal of this regulatory action is to provide information to ensure any questions regarding the assignment of credits to assignees in corporate reorganizations or corporate restructuring situations are clearly addressed, and the likelihood of invalid assignments is minimized. Absent this regulatory action, there is some uncertainty for taxpayers and tax preparers about the valid assignment of credits which could lead to errors of unknown magnitude in the future. The proposed regulatory action, therefore addresses questions raised by related members of the same combined reporting group and would not affect the expansion or elimination of existing businesses within the state.

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

The purpose of the proposed regulatory action is to clarify rules regarding the eligibility of assignees that are impacted by corporate restructuring and corporate reorganizations. It is believed that this regulatory action would not have any direct impact on the health and welfare of California residents, or work safety, or the state’s environment.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Board has determined that the proposed regulatory action will not have a significant economic impact on business. The proposed regulatory action clarifies which taxpayers within the same combined reporting group are eligible assignees in certain situations resulting from corporate reorganizations and corporate restructurings. The FTB has determined therefore that there would be no adverse economic impacts on business. This regulatory action would result in fewer attorney and audit staff hours spent discussing this issue and provide clarification to taxpayers and tax practitioners. The FTB estimates minor savings of about $15,000 per year would be redirected to other tax related uses.