

**FINAL STATEMENT OF REASONS
PROPOSED AMENDMENTS TO REGULATION SECTIONS 17951-4 AND 25137-1,
PERTAINING TO APPORTIONMENT OF PARTNERSHIP INCOME**

UPDATE OF INITIAL STATEMENT OF REASONS

Prior to the formal regulatory hearing that was held on December 18, 2017, four written comments were received from the public pertaining to the proposed amendments to Regulation sections 17951-4 and 25137-1. These comments are summarized and addressed below. During the formal regulatory hearing that was held on December 18, 2017, four verbal comments were presented. These comments are summarized and addressed below. After considering the verbal comments received during the formal regulatory hearing, staff made an edit to the proposed regulatory text, excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1), and noticing this change to the public with a 15-day Notice issued on February 15, 2018. One comment was received during this 15-day Notice period, and is summarized and addressed below. Thereafter, staff determined that guidance from the three-member Franchise Tax Board was necessary with respect to the excision to Regulation section 17951-4 at subsection (d)(1), as noticed in the 15-day Notice. To that end, at the April 12, 2018 public meeting of the three-member Franchise Tax Board, after hearing a report from staff regarding the 15-Day Notice, and entertaining public comment from four persons (summarized below), the three-member Franchise Tax Board instructed staff by formal motion to excise the proposed amendment to Regulation section 17951-4 at subsection (d)(1). Staff has complied with this directive. Therefore, the current text to Regulation section 17951-4 at subsection (d)(1) does not reflect any proposed amendment.

COMMENTS RECEIVED DURING THE PERIOD THE TEXT WAS AVAILABLE TO THE PUBLIC DURING THE NOTICE PERIOD FROM NOVEMBER 3, 2017 THROUGH DECEMBER 18, 2017

Comment 1 (see Rulemaking File Exhibit 7, Public Comments): The commenter indicated that with respect to the proposed amendment to Regulation section 17951-4(d)(1), it should not impact the existing rules contained in Regulation sections 17951(d)(3).

Reject in full: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) was excised as noticed in the 15-day Notice issued on February 15, 2018. Therefore, this comment has essentially been rendered moot.

Comment 2 (see Rulemaking File Exhibit 7, Public Comments): The commenter requested an opportunity to submit comments at a later date.

Reject in full: Any comments received after the noticed comment period expired would be considered; however, the representative never submitted any additional comments.

Comment 3 (see Rulemaking File Exhibit 7, Public Comments): The commenter identified numerous editorial errors with existing regulations that were not part of the proposed amendments.

Reject in full: These identified errors can be rectified through the informal regulatory administrative process. Moreover, the identified errors do not relate to the proposed amendments that are the subject of this rulemaking project.

Comment 4 (see Rulemaking File Exhibit 7, Public Comments): The commenter noted that the proposed amendment to Regulation section 25137-1 at subsection (f)(4) defines "partnership interest" as the partner's interest in the profits of the partnership but that the phrase "partner's interest in the profits" is vague. Additionally, the commenter noted the proposed amendments to Regulation section 17951-4(d)(1) and (2) are not necessary because they do not add anything to the application of the existing rules.

Reject in full: Because Regulation section 25137-1 pertains to the apportionment of business income, the partner's interest in the profits of the partnership are the most relevant interest to consider rather than the partner's interest in the capital assets of the partnership. Moreover, the applicable tax schedule that reflects the partner's distributive share of partnership tax items, the Schedule K-1, will reflect the percentage of the partner's interest in the profits of the partnership.

As addressed above, the previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised. Therefore, as the comment relates to this provision, the issue has been rendered moot. Additionally, the proposed amendment to Regulation section 17951-4 at subsection (d)(2) provides that if the partnership and a trade or business of a nonresident partner are unitary, the applicable business income is apportioned at the partner level. This provides necessary clarification as to the level where apportionment occurs.

COMMENTS RECEIVED AT THE FORMAL PUBLIC HEARING ON DECEMBER 18, 2017

A formal public hearing was held on December 18, 2017 to consider the proposed amendments to Regulation sections 17951-4 and 25137-1. There were seven attendees at the hearing. Four comments were received at the formal public hearing and are detailed in the transcript of the formal public hearing within the rulemaking file and are summarized and addressed below.

Comment 1 (see Rulemaking File Exhibit 5, Documents for December 18, 2017 Public Regulation Hearing, Hearing Transcript pp. 6 – 9): The commenter stated the proposed amendment to Regulation section 17951-4 at subsection (d)(1) is inappropriate. It relates to sourcing income to nonresidents from partnerships. These same rules apply to sourcing income to nonresidents from S Corporations. The proposed amendment to Regulation section 17951-4 at subsection (d)(1) explicitly provides that Revenue and Taxation Code section 17952 is inapplicable with respect to sourcing income from a partnership to a nonresident. This is an attempt by the Franchise Tax Board to circumvent existing case law.

Reject in full: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018. Therefore, this comment has been rendered moot.

Comment 2 (see Rulemaking File Exhibit 5, Documents for December 18, 2017 Public Regulation Hearing, Hearing Transcript pp. 9 – 11): The commenter stated the proposed amendment to Regulation section 17951-4 at subsection (d)(1) is inappropriate. This is an attempt by the Franchise Tax Board to circumvent existing case law. Moreover, a regulation cannot circumvent a statute.

Reject in full: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018. Therefore, this comment has been rendered moot.

Comment 3 (see Rulemaking File Exhibit 5, Documents for December 18, 2017 Public Regulation Hearing, Hearing Transcript pp. 11 – 13): The commenter stated the proposed amendment to Regulation section 17951-4 at subsection (d)(1) is inappropriate. This is an attempt by the Franchise Tax Board to circumvent existing case law. Moreover, due to the lapse of time between the last Interested Parties Meeting with respect to this regulation project and the formal regulatory hearing, the Franchise Tax Board should allow an additional 30 days for public comment on this matter.

Reject full: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018. Therefore, the portion of this comment providing that the amendment is inappropriate has been rendered moot. With respect to considering further public comment on this matter, the noticed comment period from November 3, 2017 to December 18, 2017 was not extended, however, staff received further comment during the 15-day Notice period.

Comment 4 (see Rulemaking File Exhibit 5, Documents for December 18, 2017 Public Regulation Hearing, Hearing Transcript pp. 13 – 14): The commenter asked a question about the effect of existing case law if the proposed amendment to Regulation section 17951-4 at subsection (d)(1) is applied prospectively.

Reject in full: This was not a comment, but a question. However, the previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018. Therefore, this comment\question has been rendered moot.

COMMENTS RECEIVED DURING THE 15-DAY NOTICE PERIOD FROM FEBRUARY 15, 2018 THROUGH MARCH 5, 2018

One comment was received during the 15-day Notice period and is summarized and addressed below.

Comment 1 (see Rulemaking File Exhibit 7, Public Comments): The commenter noted that the proposed revision excising the proposed amendments to Regulation section 17951-4 at subsection (d)(1) is contrary to existing case law. Additionally, because the proposed

amendment to Regulation section 17951-4 at subsection (d)(1) was distributed to the public during the Interested Parties Meeting that was held four years previously and it was indicated at that time that the proposed amendments would be applied prospectively, the taxpayer and taxpayer representative community have taken filing positions based on the understanding that the Franchise Tax Board has essentially declared the existing case law as dispositive of the matter. Therefore, the proposed revision excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1) undermines the filing positions taken by the taxpayer and taxpayer representative community in reliance on the Franchise Tax Board's previous position with respect to this matter.

Reject in full: The proposed revision excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1) is not contrary to existing case law because it is merely excising a statement that a particular statute does not apply in a given situation. It does not address existing case law. Additionally, until final regulations are promulgated, for California tax purposes there is no authority that provides that the taxpayer and taxpayer representative community can rely on proposed regulations to support filing positions.

COMMENTS RECEIVED DURING APRIL 12, 2018 THREE-MEMBER FRANCHISE TAX BOARD MEETING

Four comments were made during the April 12, 2018 Three-member Franchise Tax Board meeting, and they are summarized and addressed below.

Comment 1 (see Rulemaking File Exhibit 12, Request for Permission, Board Minutes, and Transcript, Transcript pp. 36 - 38): The commenter supported the revision excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1) as detailed in the 15-day Notice. Additionally, the commenter stated the 15-Day Notice should be revised to excise any reference to nonbusiness income.

Accept in part, reject in part: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018. There is no procedure for revising a 15-Day Notice, so this portion of the comment is rejected. Moreover, to the extent the commenter is now seeking a revision to the proposed regulatory text to excise any reference to nonbusiness income, this comment is also rejected as untimely, since it was not raised during any applicable comment period, and was not the subject of the three-member Franchise Tax Board Meeting.

Comment 2 (see Rulemaking File Exhibit 12, Request for Permission, Board Minutes, and Transcript, Transcript p. 39): The commenter supported the proposed revision excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1) as detailed in the 15-day Notice.

Accept in full: The previously proposed amendment to Regulation section 17951-4 at subsection (d)(1) has been excised as noticed in the 15-day Notice issued on February 15, 2018.

Comment 3 (see Rulemaking File Exhibit 12, Request for Permission, Board Minutes, and Transcript, Transcript p. 39 - 41): The commenter opposed the proposed revision excising the proposed amendment to Regulation section 17951-4 at subdivision (d)(1) as contrary to existing case law. Additionally, because the proposed amendment to Regulation section 17951-4 at subsection (d)(1) were distributed to the public during the Interested Parties Meeting that was held four years previously, and it was indicated at that time that the proposed amendments would be applied prospectively, the taxpayer and taxpayer representative community have taken filing positions based on the understanding that the Franchise Tax Board has essentially declared the existing case law as dispositive of the matter. Therefore, the proposed revision excising the proposed amendment to Regulation section 17951-4 at subsection (d)(1) undermines the filing positions taken by the taxpayer and taxpayer representative community in reliance on the Franchise Tax Board's previous position with respect to this matter.

Reject in full: The proposed revision excising the proposed amendments to Regulation section 17951-4 at subsection (d)(1) is not contrary to existing case law because it is merely excising a statement that a particular statute does not apply in a given situation. It does not address existing case law. Additionally, until final regulations are promulgated, for California tax purposes there is no authority that provides that the taxpayer and taxpayer representative community can rely on proposed regulations to support filing positions.

Comment 4 (see Rulemaking File Exhibit 12, Request for Permission, Board Minutes, and Transcript, Transcript pp. 41 - 42): The commenter stated that staff previously proposed the amendment to Regulation section 17951-4 at subdivision (d)(1). However, staff should now seek guidance from its three-member Franchise Tax Board as to whether the proposed amendment to Regulation section 17951-4 at subsection (d)(1) should be excised.

Accept in full: Staff sought guidance from its three-member Franchise Tax Board as to whether the proposed amendment to Regulation section 17951-4 at subsection (d)(1) should be excised, and to allow additional public comment on that matter in an open forum.

ALTERNATIVES DETERMINED

The Franchise Tax Board has determined that no alternative to the proposed amendments it considered would be more effective in carrying out the purpose of the proposed amendments or would be as effective and less burdensome to affected private persons than the adopted amendments, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law, in accordance with Government Code section 11346.9, subdivision (a)(4). The proposed amendments are the only text identified by or proposed to the Franchise Tax Board that accomplishes the intent of the regulation and no alternatives have been identified or proposed that would reduce costs to those regulated.

ALTERNATIVES THAT WOULD LESSEN ADVERSE ECONOMIC IMPACT ON SMALL BUSINESS

The Franchise Tax Board has determined that the proposed amendments will not have a significant impact on small business. The Franchise Tax Board estimates that less than twenty businesses will be impacted by the proposed amendments. 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.

LOCAL MANDATE DETERMINATION

The proposed regulations do not impose any mandate on local agencies or school districts.