

INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTIONS 23663-1 THROUGH 23663-5

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATIONS ARE 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) and 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, subdivision (b), paragraph (3) as an affiliated corporation which is a member of the same combined group as the assignor in both the taxable year the credits were earned and the taxable year the credits are assigned to the assignee.

An assignment is made as an election on a taxpayer's original tax return on Form FTB 3544 and is irrevocable under RTC section 23663, subdivision (c). In some situations taxpayers have made defective elections, such as when the taxpayer's total credits available to be assigned are later determined to be less than the taxpayer thought it had when the original tax return was filed. These situations often occur when credits have been adjusted at audit, or when an assignee was not a member of the same combined reporting group on the dates required under the statute. Because the assignment election is irrevocable, taxpayers are left with no clear recourse regarding the consequences of such defective elections, and the Franchise Tax Board ("FTB") has not yet established any standards to apply in adjusting such defective elections.

BENEFITS ANTICIPATED FROM REGULATORY ACTION

The proposed regulations will benefit taxpayers, tax practitioners, and the state of California by providing clarity that does not currently exist in connection with the treatment of a defective election to assign credits pursuant to RTC section 23663. The proposed regulations would give taxpayers certainty as to how credits are allocated when a defective election occurs. The proposed regulations also give taxpayers flexibility in determining how credits are allocated when there is agreement between the parties involved in the defective election. Finally, the proposed regulations give taxpayers one year to correct certain errors in defective elections. The clarity from the proposed regulations will eliminate uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California by providing definitions, guidelines, flexibility and examples relating to defective

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. There are no benefits of the proposed regulations to the health and welfare of California residents, worker safety and the state's environment.

DISCUSSION OF NECESSITY AND SPECIFIC PURPOSE OF THE PROPOSED REGULATIONS

The purpose of the proposed regulations to RTC section 23663 is to give taxpayers certainty as to how credits are allocated when a defective election occurs. The proposed regulations will achieve the purpose of giving taxpayers certainty regarding the allocation of credits in a defective assignment by providing definitions, guidelines and examples relating to defective assignments. The proposed regulations also give taxpayers flexibility in determining how credits are allocated when there is agreement between the parties involved in the defective election. Finally, the proposed regulations give taxpayers one year to correct certain errors in defective elections. The proposed regulations will achieve the purpose of giving flexibility in dealing with defective assignments and the ability to correct certain errors by providing definitions, guidelines and examples. RTC section 23663 and related provisions do not address these specific issues.

Subdivision (e), paragraph (4) of RTC section 23663 authorizes the FTB to adopt regulations implementing the purposes of the section, including to specify the treatment of any assignment that does not comply with the requirements of the section.

The FTB conducted three Interested Parties Meetings and issued a Sixty-Day Notice from 2012 to 2014 in order to obtain input from taxpayers and other members of the interested public. Discussion Topics and/or Explanations for draft language and the draft language, itself, were provided in advance of those meetings and the notice. The substance of the proposed regulations appears as follows.

Because of the uncertainty created by the statute's silence on what happens following a defective election, the FTB, under the broad legislative rulemaking delegation of RTC section 23663, subdivision (e), paragraph (4), proposes to issue these regulations as the exclusive means by which defective elections may be corrected. In order to ensure consistency in correcting defective elections, the regulations create a "request" process whereby the FTB will review a taxpayer's request to apply any of the permissive correction provisions in the regulations and either approve or deny such request. It is contemplated that requests that are granted will be formally memorialized between the affected parties and the FTB.

The correction and allocation provisions of the regulations are structured to provide broader and more favorable corrections the earlier the taxpayer self-identifies defective assignments and files a request with the FTB. This approach was chosen to encourage taxpayers to self-identify and seek correction of defective elections as early as possible, and before the FTB

has initiated any audit activity with respect to the taxpayer's return. Both taxpayers and the FTB benefit under this structure by creating certainty as to which corporations have which credits as soon as possible, and before taxpayer and audit resources are expended dealing with defective elections.

The most favorable and liberal correction and allocation rules are contained in Regulation 23663-4 which allows taxpayers to correct defective elections when a taxpayer discovers and files a request to correct the defective election at least 60 days before filing its subsequent taxable year's California tax return. The next most favorable set of rules in Regulation 23663-2 allow taxpayers flexibility in allocating credits when the assignor files a request with the FTB after the period in Regulation 23663-4 has passed but before first contact for an audit has occurred. Finally, Regulations 23663-2 and 23663-3 provide default allocation rules that allocate credits pursuant to a mechanical formula either upon a taxpayer's request and FTB's approval, or by the FTB during an audit.

Regulation 23663-5 contains a series of special rules and ordering rules, and Regulation 23663-1 contains definitions of the terms used throughout these regulations.

Proposed Regulation 23663-1 – Definitions

1. Subsection (a) defines the date on which any adjustment to a defective assignment the FTB allows under Regulations 23663-2 through 23663-5 shall be treated as being made. In the case of adjustments made by the FTB, the adjustment date shall be the calendar date on which a notice is mailed. In the case of requests made by a taxpayer, the adjustment date shall be the date a taxpayer's request is received by the FTB, even though the adjustment is approved later. In addition, the adjustment date provides the specific date on which the FTB will determine the amount of credits claimed in a closed year for purposes of reallocating credits pursuant to Regulations 23663-2 through 23663-5. This subsection is necessary to provide a clear date on which an adjustment under the regulations occurs. Without this subsection, users of the regulations will be left with uncertainty regarding the date adjustments are made under the regulations.

2. Subsection (b) defines "affiliated corporation" using the same definition used in RTC section 23663(b)(1). This subsection is necessary to avoid ambiguity as to what the term "affiliated corporation" means in the regulations, and to provide that the definition in the regulations is the same definition used in the underlying statute. Without this definition, it is possible affected taxpayers could apply inconsistent definitions of the term "affiliated corporation" which would result in ambiguity in the regulations.

3. Subsection (c) defines the term "aggregated eligible assignees" to include all eligible assignees that receive identical credits from the same assignor in the same taxable year, since those eligible assignees are subject to aggregation for purposes of determining the

validity of those assignments and any reallocation of credits under Regulations 23663-2 through 23663-5. This subsection is necessary to avoid repetition in identifying the eligible assignees assigned the same type of identical credit in the same taxable year. Without this definition, taxpayers would be left with uncertainty when multiple assignments of the same type of identical credits occur.

4. Subsection (d) defines "assignee" as the recipient of an assignment under RTC section 23663, including any successor in interest. This definition further states that the assignee may be any affiliated corporation whose name or identifying information is on the original assignment form. For purposes of applying these regulations, this definition is meant to encapsulate all potential assignees of a defective assignment, including situations where an assignor lists the identifying information of different assignees in a single assignment. This subsection is necessary to avoid ambiguity as to exactly what the term "assignee" means in the regulations. Without this definition inconsistent definitions of the term "assignee" could be asserted by the users of the regulations which would result in ambiguity in applying the regulations and frustrate the regulations' purpose of providing certainty and clarity to taxpayers.

5. Subsection (e) defines the term "assignment" to specifically refer to an assignment made pursuant to RTC section 23663, and further provides that each assignment will be treated on its own and each defective assignment will be treated separately. Special rules will aggregate multiple such defective assignments where necessary to apply the allocation rules in the regulations. This subsection is necessary to avoid ambiguity as to exactly what the term "assignment" means in the regulations. Without this definition inconsistent definitions of the term "assignment" could be asserted by the users of the regulations which would result in ambiguity in the regulations and frustrate the regulations purpose of providing certainty and clarity to taxpayers.

6. Subsection (f) defines the term "assignor" to mean the taxpayer, including any successor in interest, which makes an election to assign credits to an assignee. This subsection is necessary to avoid ambiguity as to exactly what the term "assignor" means in the regulations and to provide continuity with the use of the term in the underlying statute. Without this definition inconsistent definitions of the term "assignor" could be asserted which would result in ambiguity in the regulations and frustrate the regulations' purpose of providing certainty and clarity to taxpayers.

7. Subsection (g) defines the term "closed year" to mean any taxable year for which the FTB determines that, as of the adjustment date, it is precluded from mailing a notice of proposed deficiency assessment with respect to any credits that were assigned or claimed in a defective assignment. The regulations further provide that once a closed year determination has been made for purposes of applying these regulations, any subsequent

application of these regulations to that particular year will consistently treat that year as a closed year. This definition is necessary because allocations under these regulations first look to credits claimed in taxable years that are closed, to avoid the possibility of credits being claimed more than once. Without this definition inconsistent definitions of the term "closed year" could be asserted by the users of the regulations which would result in ambiguity in applying the regulations and frustrate the regulations' purpose of providing certainty and clarity to taxpayers.

8. Subsection (h)(1) defines a "defective assignment" as any assignment that does not comply with the requirements of RTC section 23663, and identifies some of the types of defective assignments, which include assignments which fail to clearly identify the year from which the assigned credit was generated, fail to clearly identify the amount of assigned credit, fail to identify the type of assigned credit, assign more credits than the assignor has available to assign, assign a credit that is not an eligible credit, or assign a credit to an assignee who is not clearly identified or is not an eligible assignee. Subsection (h)(2) clarifies that an assignor's purpose or intent in assigning credits, such as the intention to assign one half of the available credits to its wholly owned subsidiary, is not relevant in determining whether an assignment is a defective assignment. Finally, subsection (h)(3) provides five examples to illustrate some of the above rules.

As the main purpose of these regulations are to give clarity when there is a defective assignment, subsection (h) creates certainty regarding whether there is a defective assignment. This bright line approach makes it clear when a defective assignment has occurred and what the resultant allocation of credits will be. For example, in determining whether a taxpayer has a valid assignment election, Example 4 of subsection (h)(3) exemplifies that there will only be a valid assignment election if a Form 3544 is filed. Pursuant to subsection (h)(2) the regulations reject contemplation of the concept of whether an assignor substantially complied with the assignment election or whether an assignee's filing of a Form 3544A reflects an intent or desire of the assignor to elect to assign credits.

This subsection is necessary to determine when an election is defective. Without this definition inconsistent definitions of the term "defective assignment", and thus whether an assignment was defective, could be asserted by users of the regulations which would result in ambiguity in applying the regulations and frustrate the regulations' purpose of providing certainty and clarity to taxpayers.

9. Subsection (i) defines "the effective date of an adjustment" as the date on which an adjustment under Regulations 23663-2 through 23663-5 is treated as being legally effective, which generally will be the same date that credits would have been retained or assigned if the defective assignment on the assignor's original tax return had been a valid assignment. This subsection is necessary to provide a clear date on which an adjustment

under the regulations occurs. Without this definition, users of the regulations will be left with uncertainty regarding when credits allocated or adjusted under the regulations could be allowed against a taxpayer's tax.

10. Subsection (j) defines "election" to mean the irrevocable election to assign by an assignor to an assignee a credit on the assignor's original tax return under the rules of RTC section 23663. This subsection is necessary to avoid ambiguity as to exactly what the term "election" means in the regulations and to provide continuity with the use of the term in the underlying statute. Without this definition inconsistent uses of the term "election" could be asserted by the users of the regulations which would result in ambiguity in applying the regulations.

11. Subsection (k) defines the term "eligible assignee" using the same definition used in RTC section 23663(b)(3). This subsection is necessary to avoid ambiguity as to exactly what the term "eligible assignee" means in the regulations and to provide clarity that the definition in the regulations is the same definition used in the underlying statute. Without this definition inconsistent definitions of the term "eligible assignee" could occur which would result in ambiguity in applying the regulations.

12. Subsection (l) defines "eligible credit" using the same definition used in RTC section 23663(b)(2). This subsection is necessary to avoid ambiguity as to exactly what the term "eligible credit" means in the regulations and to provide continuity between the regulations and the underlying statute. Without this definition inconsistent definitions of the term "eligible credit" could occur which would result in ambiguity in applying the regulations.

13. Subsection (m) defines "FTB" to mean the Franchise Tax Board. This subsection is necessary to avoid having to redefine the term "FTB" in each of the regulations which allows the regulations to be more streamlined and easy to understand.

14. Subsection (n) defines "first contact" to mean the date the initial audit contact, as defined in Regulation 19032, is first sent to any assignor or assignee with respect to any taxable year in which either an assignment of credits is made or the taxable year in which assigned credits are claimed. This subsection is necessary to clearly define the point in time in which the initial audit contact occurs. Without this definition inconsistent uses of the term "first contact" could occur which would result in ambiguity in applying the regulations.

15. Subsection (o) defines "identical credit" to mean any credit that is (i) allowed under the same RTC section as the other credit, (ii) is originally allowed in the same year, and, (iii) in the case of certain credits with limitations that only allow use against income generated in the same zone or program area, is a credit based on activity in the same zone or program area. Identical credits may be aggregated under Regulations 23663-2 through 23663-5 for

purposes of determining if an assignment is a defective assignment and also for purposes of applying the allocation provisions in those regulations. This subsection is necessary to provide a clear definition of what an "identical credit" is so that credit aggregation rules within the regulations can be applied. Without this definition inconsistent references to a credit would result in ambiguity in allocations of credits and in determining when a defective election to assign credits occurred, especially when an election is defective due to multiple elections to assign the same type of identical credit in the same taxable year. In those situations there would be ambiguity if the assignment elections were not viewed in the aggregate.

16. Subsection (p) defines "parties to a defective assignment" to include the assignor and each potential assignee to a defective assignment. The definition also includes all assignees to whom the assignor defectively assigns the same type of credit in the same taxable year. This definition is necessary because the default allocation rules within these regulations are impacted by credits claimed in closed years by other assignees who are assigned the same type of credit. In addition, this definition is also necessary since it identifies which entities must consent to allocations and corrections under these regulations. For example, Regulation 23663-4 allows corrections of errors that may result in the assignee listed on a defective assignment no longer receiving a credit. Therefore, requiring consent of all parties to a defective assignment is necessary before the FTB will make an allocation pursuant to such a request. This provides notice to the entity no longer receiving the credit. Without this definition inconsistent uses of the term "parties to a defective assignment" could occur which would result in ambiguity in applying the regulations.

Proposed Regulation 23663-2 – Assignor Has Less Credits Than Assigned

1. Subsection (a) begins by referencing the rules set forth in Regulation 23663-5 that credits which are the subject of a defective assignment cannot be claimed, assigned or used for any purpose unless and until the FTB has allocated those credits to a taxpayer pursuant to Regulations 23663-2 through 23663-5. This subsection generally describes this regulation as containing rules for allocating credits from an assignment which is defective due to an assignor discovering that it has less credits than the amount it assigned in the original assignment. There is also an elective mechanism under this regulation, the alternative allocation rules, which is only available before first contact and when requested by the assignor and other parties to a defective assignment. There is a cross-reference to Regulation 23663-4 that acknowledges that when there is overlap between this regulation and Regulation 23663-4, Regulation 23663-4 shall apply. This subsection is necessary to provide users of Regulation 23663-2 guidance regarding what is covered in Regulation 23663-2 and to also cross reference the connections with related regulations, so that users of the regulations can efficiently locate the regulation that applies to their specific issues.

2. Subsection (b) provides rules for aggregating multiple defective assignments for purposes of applying the default allocation rules and the alternative allocation rules of this regulation. The purpose of these rules is to treat all assignments of the same credit type in the same taxable year in a uniform manner, including the regulation's approach of allocating defectively assigned credits to assignees "pro rata". These aggregation rules first identify all defective assignments of the same credit type (i.e., "identical credits") that were assigned by an assignor in the same taxable year, and then aggregate these identical credits for purposes of determining whether all the assignments in that taxable year are valid or defective. As a result of this aggregation rule, where an assignor has less identical credits available for assignment than were assigned in a single taxable year, all of the assignments of that type of credit made in that taxable year will be treated as defective assignments. Four examples are provided to illustrate these concepts, the first two demonstrate how the basic aggregation rules will apply, and the latter two illustrate the scope of the identical credit definition. This subsection is necessary to set forth a method as to how to proceed when multiple assignments of the same type of identical credits occur in the same taxable year. This method would avoid ambiguity in multiple allocations of credits and in determining when a defective election to assign multiple credits occurs. This subsection is also necessary to set forth a method to determine when an assignment is defective due to multiple elections to assign the same type of identical credit in the same taxable year. Without this subsection there would be ambiguity if these assignment elections were not viewed in the aggregate.

3. Subsection (c) provides the default allocation rules that apply under this regulation. This regulation applies when an assignor assigns more credits than it actually has. This situation often comes up when an assignor's credits are reduced during an audit. In these cases where an assignment is defective only because an assignor assigned more credits than it actually had, the regulation generally allocates the credits the assignor actually does have to the assignee of the defective assignment. If an assignor assigned the same type of identical credit to multiple assignees, then the regulation allocates the assignor's actual credits to the assignees on a pro rata basis based on the amount of credits assigned to each assignee in the original defective assignment. The purpose of these default rules allocating credits to the assignee is to try to give effect to the assignor's intent to assign credits to that assignee. Notably, the structure of the regulation effectuates the assignor's intent to assign credits. This, however, should not be confused with the rules of these regulations that an assignor's intent is not relevant in determining when an assignment is a defective assignment.

Also, under this regulation no credits are allocated back to the assignor since this regulation applies when the assignor had less credits than it assigned and all the assignor's credits are allocated to the assignee. However, in limited circumstances the alternative allocation rules, discussed below, give taxpayers flexibility to allocate credits to the assignor.

When the assignor or assignee has claimed credits from a defective assignment in a closed year, subsection (c)(2)(A) requires that identical credits first be allocated to that assignor or assignee. The requirement to first allocate credits to the assignor and/or assignee who used those credits in a year that is a closed year is necessary since closed years cannot be changed and the taxpayer has already received a tax benefit as a result of their utilization of the credits in that closed year. To allocate those credits in any other manner would result in them being claimed twice.

Subsection (c)(2)(B) applies if the same type of identical credits were assigned to multiple eligible assignees in the same taxable year. In which case, after first allocating credits under subsection (c)(2)(A), based on those credits being claimed in closed years, subsection (c)(2)(B) would then allocate any remaining credits to the other eligible assignees in order to result in a pro rata allocation to all eligible assignees. If no credits had been claimed in closed years, subsection (c)(1) would have allocated credits to the eligible assignees on a pro rata basis based on their relative original assigned amounts. Therefore, subsection (c)(2)(b)'s allocation methodology is designed to achieve, if possible, the same pro rata result despite any necessary but non-pro rata allocations in subsection (c)(2)(A). If allocations under subsection (c)(2)(B) result in all eligible assignees receiving a pro rata allocation of identical credits, then subsection (c)(1) would allocate any remaining identical credits to such eligible assignees on a pro rata basis. Four examples are provided that illustrate the application of these rules.

The pro rata allocation is based on the credits the assignor listed as assigning to the assignee in the defective assignment form. Using the assignment form as the basis for a pro rata allocation is the best contemporaneous reflection of the assignor's intent since it results in credits being allocated in the same proportions that the assignor originally assigned them.

If the rules of this subsection and Regulation 23663-3 are applied at the same time, then the credits which Regulation 23663-3 allocates back to the assignor would then be available to be allocated under this subsection. By specifying that Regulation 23663-3 applies first before Regulation 23663-2, the application of these two regulations are consistent with this subsection's general purpose of first giving effect to the assignor's intent to assign credits.

Subsection (c) is necessary to provide a methodology which allocates credits in the defective scenario that the assignor assigns more credits than it actually has available. Without this subsection users of the regulation would be left with uncertainty regarding whether the defectively assigned credits stayed with the assignor, went to the assignee or some other result.

4. Subsection (d) provides rules for alternative allocations that may be requested by an assignor before first contact. Under such a request, and when joined by other parties to a defective assignment, an assignor is able to choose the allocation of credits among the eligible assignees of a defective assignment and may even allocate credits to itself, subject to some limitations.

In order to be consistent with the underlying statute's requirements that assignments are irrevocable once made and must be made on the original tax return, any request for an alternative allocation under subsection (d) can only allocate identical credits to those parties involved in the original defective assignment. Further, the amounts listed as being assigned to an assignee or retained by the assignor on the original assignment form represent a maximum ceiling limiting what can be allocated to either an assignee or the assignor in an alternative allocation. These limitations are consistent with the underlying statute since the assignor should not be entitled to retain credit amounts in excess of what would have been retained if the defective assignment had been valid. The same principle applies with respect to each assignee, since they should not end up with more credits than they were originally assigned. As a result, the alternative allocation gives the assignor some flexibility to allocate the identical credits it actually has within the general framework of how the assignor originally allocated the identical credits.

Subsection (d) provides that an alternative allocation may only allocate credits to the assignees who join the request; therefore, the assignor and all assignees involved in an alternative allocation must be knowingly involved in the process of allocating credits in a manner different than the default allocation rules of subsection (c). However, if any assignees do not join the alternative allocation request, then subsection (d)(5) (as well as Regulation 23663-5(e)(3)) excludes the amount originally assigned to such non-consenting assignee from being part of an alternative allocation request. Another special rule under subsection (d) requires that identical credits claimed in closed years must be taken into account first before any allocations are made among the assignor and eligible assignees under these alternative allocation rules.

The limitation that an alternative allocation must be requested before first contact is intended to incentivize taxpayers to come forward to correct a defective assignment before being audited, and also is intended to preclude taxpayers from reallocating credits during an audit, which staff believes would be allowing hindsight tax planning that is inconsistent with the irrevocable nature of the original assignment statute. Moreover, the alternative allocation is not available for frequent use on a year after year basis, since that would be inconsistent with the irrevocable nature of the original election to assign. Instead, once an alternative allocation is used, another alternative allocation will not be allowed for the rolling four year period, consisting of the taxable year for which an alternative allocation is requested as well as the three taxable years preceding and following that taxable year.

Seven examples are provided to illustrate different alternative allocations, as well as the special rules described above.

Subsection (d) is necessary to give taxpayers flexibility to modify the default allocation rules set forth in subsection (c) so that the allocation is more custom fit to a taxpayer's particular situation. This subsection provides a mechanism to allow taxpayers to avoid an undesirable allocation pursuant to the default allocation rules.

5. Subsection (e) provides a cross-reference to Regulation 23663-5(f), which contains the form and manner requirements for requesting a default allocation under subsection (c) of this regulation and an alternative allocation under subsection (d) of this regulation. This subsection is necessary to provide users of the regulations a cross reference to the form and manner requirements for making requests under this regulation. Without this subsection taxpayers following the regulation may have difficulty determining the form and manner in which a request under this regulation is made.

Proposed Regulation 23663-3 – Other Defective Assignments

1. Subsection (a), similar to Regulation 23663-2, begins by reiterating the rules set forth in Regulation 23663-5 that credits which are the subject of a defective assignment cannot be claimed, assigned or used for any purpose unless and until the FTB has allocated those credits to a taxpayer pursuant to Regulations 23663-2 through 23663-5. The subsection goes on to provide that this regulation applies to all defective assignments not covered under either Regulation 23663-2, relating to assignments that are defective because the assignor assigned more credits than it had available for assignment, and Regulation 23663-4, which applies only to requests for corrections that are made before the filing of the subsequent taxable year's tax return. This subsection is necessary to provide users of Regulation 23663-3 guidance regarding what is covered in Regulation 23663-3 and to also cross reference the connections with related regulations, so that users of the regulations can efficiently locate the regulation that applies to their specific issues.

2. Subsection (b) provides the default allocation rules for all defective assignments that are defective for reasons other than those specified under Regulation 23663-2(c), which addresses situations where an assignor assigns more credits than it has, or under subsection (c) of this regulation, which addresses assignments, where the type, amount, or both, of assigned credits are unspecified. Specifically, the general rule of subsection (b)(1) is to allocate credits from such defective assignments back to the assignor. The purpose of the rule allocating credits back to the assignor is because, unlike Regulation 23663-2(c) where the requirements of the underlying statute were met except for the assignor having fewer credits available to assign than it originally assigned, in these situations the other requirements of the statute were not met. In addition, in these situations the assignment intent of the assignor is often not clearly reflected on the defective assignment form.

Returning the credits defectively assigned in these situations back to the assignor creates certainty that the credits are available to be reassigned, so that the assignor can immediately move forward once the default rules are applied.

In the case where a defective assignment has multiple potential assignees, then the reduction rules of subsection (b) are applied to each potential assignee. This is intended as a general rule of fairness when an assignor creates a situation where multiple assignees could reasonably believe that they were the intended assignee, so the assignor's credits should be reduced based on any credits claimed in any closed year by any of the potential assignees. Notably, this rule has the potential to reduce the assignor's credits in an amount in excess of the credits assigned on the defective assignment because multiple potential assignees could have claimed all of the credits listed on the assignment. Without this rule, it is possible that credits could be claimed more than once due to the assignor's error on the original defective assignment.

The default allocation rules under subsection (b) first require that closed years be taken into account in a manner similar to Regulation 23663-2(c), so that any credits that are the subject of a defective assignment under subsection (b)(2) of this regulation will be reduced by the amount of credits claimed in a closed year by an assignee. However, consistent with the fact that the assignment under RTC section 23663 was not valid, credits are not allocated to an assignee. Therefore, to the extent the assignee's closed year opens for the claimed credits and the FTB discovers the year is open, the FTB would attempt to assess the assignee for those claimed credits.

In the case of multiple potential assignees of a defective assignment, subsection (b)(3) requires the closed year rule to be taken into account for each potential assignee. If the application of this closed year rule to these multiple potential assignees reduces the assignor's identical credits reflected on the original defective assignment form below zero, then the assignor's other identical credits as of the year of the defective assignment will be reduced. There are two examples provided, one illustrating the mechanics of the application of these rules, and the other illustrating a situation where there might be more than one potential assignee attempting to claim a credit from the same defective assignment.

Subsection (b) is necessary to provide a methodology which allocates credits in defective assignments to which Regulation 23663-2 does not apply. Notably, the allocation methodology in Regulation 23663-2 is only valid when all the other requirements of RTC section 23663 are met except for the assignor having less credits than it assigned. In all other defective assignments, the requirements of RTC section 23663 are not met and, therefore, the default allocation in Regulation 23663-3 allocates the defectively assigned credits to the assignor. Without this regulation, there would be uncertainty as to where credits went when they were part of a defective assignment.

3. Subsection (c) provides a different default allocation rule when assignments are defective assignments because the type, amount, or both, of assigned credits are unspecified or unclear in the original assignment. Because the credit type or amount may not be specified clearly in the original assignment, the approach in subsection (b) of analyzing the identical credit being assigned does not work for these types of situations. Instead, this subsection reduces the assignor's credits using a standard methodology depending on whether the amount, or the type, of credit was not clearly specified in the original assignment.

Thus, in the case of assignments where the credit type is not clearly specified, the assignor's credits will be reduced based on the amount of credits claimed by an assignee in a closed year. If the assignor partially lists the type of credit being assigned (for example, where a research and development credit is specified, but the year in which such credit was originally allowed is unspecified), then the assignor's partially-listed type of credit is first reduced. The rules also provide that the amount of an assignor's credits that may be reduced are capped at an amount equal to the amount of credits listed on the original assignment form. In the case of assignments where the amount of credits to be assigned are not listed or clearly specified, the assignor's credits will be reduced based on the amount of credits an assignee claims in a closed year. Similar to the reduction rules throughout these regulations, the purpose of this rule is based upon the fact that it was the assignor's defective assignment that created the opportunity for credits to be claimed by a potential assignee in a year that is now closed to adjustment. As a result, the reduction provisions apply only when an assignee claims credits in a closed year, since this results in the possibility that credits will be claimed more than once due to the assignor's error.

The type of credits reduced under subsection (c) are based on what the assignor lists on the defective credit assignment form, regardless of whether the assignee lists more detailed information on its own tax return (usually on Form 3544A). This approach is consistent with the regulations' general approach that the consequences to the assignor are generally based on the assignor's actions.

The methodology of reducing the assignor's credits in the subsection is structured so that the assignor's unclaimed and unassigned credits are reduced, followed by the assignor's claimed credits, and, lastly, by the assignor's assigned credits. This methodology is structured so that the assignor's claimed and assigned credits are not disturbed unless all other credits have been reduced, with the assigned credits being the last to be unwound.

Five examples are provided illustrating the various types of defective assignments that are covered by subsection (c), as well as how the default allocation rules applicable to these types of defective assignments will apply.

Subsection (c) is necessary to provide a methodology to determine the credits effected in a defective assignment when the amount or type of credits is not identified in the defective assignment. Notably, in a defective assignment the assignor or assignee may have utilized credits they perceived they received in the defective assignment or an allocation of credits may be required; however, without a methodology to determine which credits or what amount of credits are effected, taxpayers would be left with uncertainty regarding which credits were reduced or otherwise impacted.

4. Subsection (d) provides the rules that apply to any assignment that is defective because the assignee is not an eligible assignee. This generally occurs when the assignee is not unitary with the assignor at either the date the credit was originally earned (or June 30, 2008, if the credit was earned before July 1, 2008) or the date of the original assignment. This is the most difficult defective assignment to address in these regulations because the determination of whether an assignee is eligible often requires an in-depth factual and legal unitary analysis. In addition, the assignor and assignee might argue different positions, thereby making it difficult for the FTB staff to analyze the fundamental question of whether an assignment is defective without a comprehensive audit. FTB staff is especially concerned about situations where an assignor argues that an assignee was not unitary, which would cause assigned credits to be allocated back to the assignor under the general rules of this regulation, while the assignee simultaneously claims that it was in fact unitary at both relevant dates, thereby causing those same credits to be part of a valid and irrevocable assignment and stay with the assignee. To avoid this potential whipsaw situation, this subsection requires that both the assignor and assignee apply for relief according to this regulation, and consent to the potential adjustment, before the provisions of this subsection are applied.

Subsection (d) also contains several provisions that prohibit an assignor from claiming or assigning credits until a final determination has been made regarding whether the assignee was not an eligible assignee, thereby freezing use of the credits as to the assignor until the status of the assignee is resolved. Further, once an assignee asserts that it is not an eligible assignee, then, as a condition of the FTB making a finding that the assignee was not an eligible assignee, the assignor and assignee will be precluded from subsequently changing their position on this issue, even though the FTB might conclude later, upon audit, that the assignor and assignee were in fact unitary. Even in the case of an audit adjustment, the assignor will not be able to claim or assign a credit in an ineligible assignee situation until determinations of whether the assignee is an eligible assignee are final for both the assignor and assignee. Once again, this is to prevent the assignor and assignee from arguing contrary positions, and both claiming the credit, and also to reduce the ability of taxpayers from claiming an assignee was not an eligible assignee as a form of retroactive tax planning.

Subsection (d) gives assignors and assignees an opportunity to finalize this issue quickly by jointly coming forward to the FTB before first audit contact. This option allows taxpayers to finalize an allocation of credits in an assignment dealing with an ineligible assignee in a much quicker fashion than would otherwise be possible, and notably without the requirement for a final determination to be made for both the assignor and assignee. If the assignor and assignee jointly come forward, then the FTB staff will complete a streamlined review of the claim that the assignee was not an eligible assignee. This review will be a high level review and of much less detail than a regular audit. If the FTB deems that the evidence submitted demonstrates that the assignee was not an eligible assignee, then the credits in the defective assignment will be allocated back to the assignor. However, because the FTB's review in this situation will be streamlined, the determination that is made will be limited in its scope to the allocation of credits under RTC section 23663 and will not impact nor raise any inference under any other parts of the Revenue and Taxation Code, including the issue of whether unity exists under Part 11.

Specifically, the assignor and assignee could later be audited by the FTB and it might be determined that the assignor and assignee were in fact unitary at the relevant dates, with the assignee being found to be an eligible assignee. In this situation, the credits previously allocated back to the assignor under subsection (b)(1) would remain with the assignor, providing certainty that the allocation of credits back to the assignor based on the streamlined review may be relied upon. This follows a general goal of these regulations of making adjustments as early as possible once defects are discovered, and making adjustments upon which taxpayers can rely. In order to take advantage of subsection (b)(1), the assignor and assignee must agree to not later assert that the assignor and assignee were unitary in the years they asserted they were not unitary in the request under subsection (d). This requirement was implemented based on fairness because the assignor and assignee have more information than the FTB; and the FTB is not doing a normal unitary audit. Finally such a rule reduces the opportunity to utilize the remedies contained in this regulation as a retroactive tax planning device.

Four examples are provided to illustrate these situations and the rules described above.

This subsection is necessary to give taxpayers an opportunity to move forward with a credit allocation when the issue of whether an assignee is an eligible assignee is in dispute. Such disputes can take many years to resolve and could leave many years of tax returns with uncertainty as the issue of whether the assignor or assignee holds credits is determined.

5. Subsection (e) provides a cross-reference to Regulation 23663-5(f), which contains the form and manner requirements for requesting allocations under this regulation. This subsection is necessary to provide users of the regulations a cross reference to the form and manner requirements for making requests under this regulation. Without this

subsection taxpayers following the regulation may have difficulty determining the form and manner in which a request under this regulation is made.

23663-4 – Correction of Error

1. Subsection (a), similar to Regulations 23663-2 and 23663-3, begins by reiterating the rules set forth in Regulation 23663-5 that credits which are the subject of a defective assignment cannot be claimed, assigned or used for any purpose unless and until the FTB has allocated those credits to a taxpayer pursuant to Regulations 23663-2 through 23663-5. The subsection goes on to generally describe that this regulation will permit the parties to an assignment that is defective to correct the errors in those assignments, so long as the correction is requested prior to the filing of the subsequent taxable year tax return and subject to the other limitations in this regulation. The errors on defective assignments which may be corrected under this regulation include, for example, originally-filed assignment forms that contain unclear, inconsistent or incomplete information, erroneous assignors, erroneous assignees, or clerical errors listing the wrong credit types or amounts.

Note that this regulation contains the most favorable rules to correct defective assignments. By allowing parties to a defective assignment to correct a wide range of errors, the FTB is providing the opportunity for taxpayers to come forward and request the FTB correct errors and thereby gain certainty regarding the allocation of credits before the filing of their subsequent taxable year's tax return. Because the taxpayer is self-identifying the errors before the filing of its next return, this regulation permits the widest range of corrections to a defective assignment. Two examples are provided to illustrate when a defective assignment might or might not be eligible for correction under this regulation.

This subsection is necessary to provide users of Regulation 23663-4 guidance regarding what is covered in Regulation 23663-4 and to also cross reference the connections with related regulations, so that users of the regulations can efficiently locate the regulation that applies to their specific issues.

2. Subsection (b) contains the conditions that must be satisfied in order to request a correction of an error under this regulation. Specifically, the request must be filed in the form and manner specified in Regulation 23663-5(f), and may only be used to correct defective assignments. Taxpayers will not be able to use this regulation to change, amend or revoke an otherwise valid assignment. Moreover, all parties to a defective assignment must join in the request and consent in writing to the correction, since the FTB will not reallocate credits from one taxpayer to another without all affected parties' written consent.

The assignor must demonstrate by clear and convincing objective evidence that is contemporaneous with the original assignment that an error was made, and must further demonstrate with clear and convincing objective evidence that is contemporaneous with the

original assignment that the requested correction is consistent with the assignor's original intent. Tax preparation workpapers, which are generally comprised of the calculations and financial statements that a preparer will use to complete an income or franchise tax return, are not enough to meet the clear and convincing standard for purposes of this regulation. Moreover, the regulation requires other contemporaneous evidence to corroborate tax workpapers, such as emails, memos, and Forms 3544A.

The requested corrected assignment also has to meet all other requirements of RTC section 23663. In order to allow the FTB enough time to review a request in time to approve or deny the request before the assignor and any assignees' tax filing deadline, the request must be made at least 60 days before the assignor and assignees file their subsequent year's tax return. The purpose of having the request approved before the next year's tax return is to have consistent tax filings of all taxpayers involved in a corrected defective assignment.

There are seven examples, the first two of which illustrate these various conditions, and the remaining five of which discuss the contemporaneous evidence and clear and convincing evidence standards that will be applied in evaluating requests for corrections of an error.

This subsection is necessary so that taxpayers can correct certain defective assignments before the filing of their subsequent taxable year's tax return which can avoid a lengthy dispute resolution process. The various restrictions in the subsection are also necessary to give effect to the underlying statute's requirements to assign credits, including that assignment elections be made on an original tax return and are irrevocable once made.

3. Subsection (c) states the rule that no correction request shall be granted where the correction would result in the actuality or possibility of the credits being claimed more than once.

This subsection is necessary to protect California against multiple taxpayers claiming the exact same credits against their tax liability since taxpayers are generally in control of the factors which could result in the same credit being claimed by multiple taxpayers.

4. Subsection (d) contains additional limitations that will apply to defective assignments made in taxable years beginning on or after January 1, 2017. The purpose of this rule is to allow taxpayers to become familiar with the requirements under RTC section 23663 and these regulations, and to allow taxpayers to correct errors for approximately one year after this regulation's assumed effective date before the rules become more restrictive.

The additional limitations provide that no corrections of an error under this regulation will be allowed that have the effect of allocating an amount of credits greater than that shown on the original assignment form, which means that in the case of defective assignments where the amount is not clear on the original assignment form, this rule would preclude any

correction since the amount for the limitation would be zero. In addition, in the case of defective assignments relating to the wrong assignor, the wrong, ineligible or unspecified assignee, the wrong or unspecified amount of identical credit, or the wrong or unspecified amount of credits assigned, a request under this regulation would only be permitted once every four years, with the four years to be determined on a rolling basis. Three examples illustrate the additional limitations described above.

Subsection (d) is necessary to enforce the statute's requirement that the assignments are irrevocable and taxpayers have the requirement under the statute to make accurate assignments on their original tax returns. While this subsection does not apply for taxable years before January 1, 2017 in order to allow taxpayers to cure pre-regulation defective assignments, going forward, without this subsection, taxpayers may attempt to retroactively modify their assignments.

5. Subsection (e) provides a special election for taxpayers whereby for one year following the effective date of this regulation, assignors may elect to request corrections of prior defective assignments without regard to the rule precluding application of this regulation after the subsequent taxable year's tax return is filed.

This subsection is necessary to allow taxpayers to correct defective assignments made in years prior to the promulgation of these regulations. Without this subsection taxpayers would have years of defective assignments with no clear course to resolve those assignments except for a lengthy dispute resolution process.

23663-5 – Special Rules

1. Subsection (a)(1) provides that a credit assigned in a defective assignment cannot be claimed, assigned or used in any way by any taxpayer, including the assignor or assignee, unless and until the FTB has specifically allocated that credit to a taxpayer pursuant to Regulations 23663-2 through 23663-5. The purpose of effectively freezing credits until the FTB has allocated them is to make it clear that taxpayers may not apply the rules in Regulations 23663-2 through 23663-5 on a self-help basis, but instead, the rules may only be applied by the FTB either on its own initiative or upon request by an assignor and following review of that request.

Subsection (a)(2) provides that an assignor cannot unilaterally reassign credits which were the subject of a defective assignment unless and until the rules of Regulations 23663-2 through 23663-4 have been applied as of an adjustment date and allocated any credits back to the assignor by the FTB, even though the rules contained in these regulations would have allocated these credits back to the assignor as of the time of the defective assignment (the "effective date of an adjustment"). Subsection (a)(2) treats any attempted assignment by the taxpayer before an allocation back to the assignor as an "invalid assignment" that

cannot be corrected or otherwise fixed rather than as a defective assignment under Regulations 23663-2 through 23663-5. The reason for this rule is that an invalid assignment is viewed as an attempt to sidestep one of the core principles of these regulations, which is that a credit in a defective assignment must be allocated by the FTB, either upon request or following an audit, under these regulations to be available to an assignor or assignee.

Subsection (a)(3) provides that where an assignee has claimed a credit in a closed year that was the subject of an invalid assignment as described above, then the assignor's remaining credits shall be reduced in the same manner as specified in Regulation 23663-3(c); notably, even if the assignee were an otherwise eligible assignee, the credits claimed in a closed year would result in the assignor's credits being reduced and not allocated to the eligible assignee as would be the case for a defective assignment under Regulation 23663-2. Later, to the extent the assignee's closed year opens for the improperly claimed credit and the FTB discovers it, the FTB would attempt to assess the assignee for that claimed credit. An example is provided to illustrate an invalid assignment.

Subsection (a) is necessary to provide that the regulations are the sole vehicle under which defective credit assignments are allocated. In this regard, subsections (a)(1) and (a)(2) require that credits must be allocated in accordance with the regulations, and subsection (a)(3) reduces credits if a taxpayer claimed credits in a closed year. Without this subsection it would be unclear whether taxpayers could allocate credits in a manner different than the manner prescribed by the regulations would result in ambiguity and disputes regarding the allocation of defectively assigned credits.

2. Subsection (b) provides rules regarding the finality of an election to assign credits, and also specifies the allocation and reduction ordering rules that apply to defective assignments. The purpose of these rules is first to clarify that if audit or other later adjustments result in an increase in the assignor's tax liability for the taxable year of the original assignment, the valid assignments will not become defective or otherwise be set aside to offset the increased tax liability of the assignor. Specifically, under these rules, the assignor's available credits for a taxable year are first allocated to valid assignments, and adjusted by the allocations and reductions pursuant to these regulations, and, lastly, available to be claimed against the assignor's tax liability. Allocating available credits first to assignments is consistent with the statute's requirement that assignments are irrevocable once made. This approach is also consistent with having adjustments under Regulation 23663-3 occur before adjustments under Regulation 23663-2, when simultaneous adjustments occur under both regulations, as this allows an otherwise defective assignment due to the assignor not having enough credits to be a valid assignment.

This subsection is necessary to establish a methodology that allocates credits to assignments before credits are allowed against a taxpayer's tax liability. Without this rule any credit assignment would be uncertain as the credit assignment could be reduced if the assignor was assessed additional tax.

3. Subsection (c) provides several ordering rules that apply to Regulations 23663-2 through 23663-5. First, for purposes of limitations on requests that can be made either for corrections of an error or alternative allocations, subsection (c)(1) specifies that if the request doesn't clearly specify the regulation and subsection under which the request is being made, and the request could have been made under Regulation 23663-4 and also under Regulation 23663-2 or 23663-3, then the request is treated as if it were made under Regulation 23663-4.

Subsection (c)(2) specifies that when both Regulation 23663-2 and 23663-3 are being applied to correct defective assignments simultaneously, the rules of Regulation 23663-3 are applied before the rules of Regulation 23663-2. Applying the rules in this order increases an assignor's available credits for assignment so that an assignment which would have otherwise been a defective assignment under Regulation 23663-2 may become a valid assignment and, in the case where an assignment is defective under Regulation 23663-2 because an assignor does not have the amount of credits being assigned, there would be a larger pool of credits to allocate to the intended eligible assignees.

Subsection (c)(3) provides that in any situation where an assignee has claimed credits in a closed year, for purposes of calculating the amount of credits claimed by such assignee in the closed year, Regulations 23663-2 and 23663-3 shall first reduce credits of the same type that the assignee has from other sources, such as where the assignee generated the credits itself or was assigned the credits under a different provision of the RTC. Thus, this rule would, to the extent that an assignee claimed a credit in a closed year and has the same type of credit from sources other than from the defective assignment, treat the claimed credit as first coming from a source other than the defective assignment. Not only does this potentially increase the amount of credits to be allocated back to the assignor or to other assignees, but it reduces the number of situations where assignees claim credits that they were improperly assigned for adjustments dealing with Regulation 23663-3 and allows a more pro rata allocation of credits for adjustments dealing with Regulation 23663-2. Finally, three examples are provided to illustrate the ordering rules above.

This subsection is necessary to create an ordering system for the adjustments under the regulations. Without this subsection users of the regulations would be left with uncertainty and disputes could arise regarding the order under which adjustments under the regulations occur which require a lengthy dispute resolution process.

4. Subsection (d) provides a special rule regarding the effect and timing of any adjustments under Regulations 23663-2 through 23663-5, so that they are treated as if they had been made on the originally-filed tax return in the year of the defective assignment. Likewise, any credits that are required to be reduced under Regulations 23663-2 through 23663-5 are also treated as being reduced as of the taxable year of the defective assignment. These rules also allow, in certain instances, credits allocated back to an assignor to be allocated to another assignment in the taxable year of the defective assignment which would otherwise have been another defective assignment due to an assignor having less credits than the amount assigned. Further, this subsection provides that if the allocated credits are again the subject of a later defective assignment, the original assignment for purposes of analyzing the subsequent defective assignment under Regulations 23663-2 through 23663-5 is the previous allocation made under these regulations, not the actual original defective assignment made on the assignor's originally-filed tax return. Finally, an example is also provided.

This subsection is necessary to provide a timeframe for adjustments under the regulations so that users of the regulations can know when credits impacted by these regulations are available for use. Without this subsection users of the regulations would not be certain when defectively assigned credits become available to be assigned or used, and how those credits would interact with other events impacting credits in the same taxable year.

5. Subsection (e)(1) provides a series of additional ordering rules. First, subsection (e)(1)(A) provides that all assignments made in a taxable year are treated as having been made simultaneously. This simultaneous rule results in assignments made in the same taxable year all being treated the same and is also consistent with Regulation 23663-2(b), which groups same year assignments of the same type of credit in determining whether all are defective assignments. Subsection (e)(1)(B) specifies a first-in-time rule whereby assignments made in prior taxable years are treated as having occurred prior to assignments made in subsequent taxable years. Subsection (e)(1)(C) provides an ordering rule for assignments made in the same taxable year under different sections of the RTC. To the extent an assignor assigns a credit under a RTC section different than RTC section 23663 and also assigns that same identical credit type under RTC section 23663 in the same taxable year, the subsection treats assignments under the sections other than RTC section 23663 as being made before assignments under RTC section 23663.

Subsection (e)(1) is necessary because setting forth an ordering methodology allows for an unambiguous system to allocate credits. Without set ordering rules, users of the regulations would be left with uncertainty regarding the order in which assignments occur and credits are used which would lead to uncertainty and a lengthy dispute resolution process.

6. Subsection (e)(2) provides that an adjustment based on credits being claimed in a closed year are final, and even if the defective assignment is later adjusted again under these regulations, the allocations based on a year being closed will not be revisited even if the year is open at the time of the subsequent adjustment date. This is consistent with the rules in subsection (d), which treats an adjustment under these regulations as having been made on a timely-filed original tax return and having occurred at the time of the original tax return.

This subsection is necessary in order to give taxpayers certainty that an adjustment is final and the basic adjustment ratios will not later change even if a closed year opens up. This approach also adds finality to adjustments so that they are not contingent on future events possibly occurring, and avoids a perceived burdensome administrative issue.

7. Subsection (e)(3) provides the rule that any credits defectively assigned to an assignee that does not join a request to apply Regulations 23663-2 through 23663-4 will not be adjusted under those regulations. Instead, the credits will remain unadjusted credits from a defective assignment which cannot be claimed by either the assignor or assignee until the rules of these regulations are first applied. Notably, the language in subsection (d) which treats adjustments as having been assigned on a valid original tax return do not apply to these credits which are not allocated. Also, if a defective assignment is corrected and a portion of the credits are excluded from the correction due to a party to the defective assignment not joining a request to apply these rules, then the portion of credits that are adjusted under these rules are treated as having been assigned on a valid tax return but the unadjusted credits are not. Therefore, if the FTB then issues a notice of proposed deficiency assessment regarding this defective assignment, the adjusted credits would be allocated based on the adjustments being treated as having occurred on an original tax return, and the unadjusted amounts would be adjusted based on the actual original tax return.

This subsection is necessary to allow defective assignments to be remedied when a party to a defective assignment does not join in a request to apply the regulations. Without this subsection taxpayers would not be able to proactively remedy defective assignments if all the parties to the defective assignment were not joining in the request, and, instead, would need a lengthy dispute resolution process.

8. Subsection (e)(4) provides that an assignor may only request that the defective assignment rules be applied to a defective assignment once. Afterwards, the assignor is prohibited from requesting that the default rules be applied, even if another defect is discovered. In this situation, neither the assignor nor the assignee would be able to claim or assign the credits until an adjustment under these regulations allocates the credits to the assignor or assignee as of an adjustment date. Consistent with the statute's requirements that an assignment be irrevocable and be made on an original tax return, subsection (e)(4)

requires an assignor correcting a defective assignment to thoroughly prepare their request to correct a defective assignment, as opposed to revisiting the defective assignment on a continual basis.

This subsection is necessary to make requests allowed under the regulations final. Allowing assignors to make multiple adjustments to a single defective assignment would give the parties to the defective assignment no certainty as to the finality of these adjustments. This subsection is also necessary to avoid a burdensome administrative issue of having to review the same defective assignment multiple times.

9. Subsection (e)(5) provides a rule to allow the FTB to allocate credits if taxpayers do not provide requested credit usage information. Since many of the rules of these regulations require information as to the amount of credits claimed in closed years, subsection (e)(5) assumes that the FTB may not have access to information regarding whether a party to a defective assignment has claimed credits in a closed year. Therefore, this subsection requires that a party to a defective assignment provide the FTB with tax returns upon request. If the party does not provide the FTB with copies of the relevant tax returns, then adjustments are made under these regulations based on the conclusive presumption that a party who did not provide the required tax returns in fact claimed all credits allocated to it in a closed year.

This subsection is necessary for the administration of these regulations; otherwise, adjustments made by the FTB would give taxpayers and the FTB no certainty that an adjustment was final nor the ultimate allocation amount of credits. In order to allow taxpayers to use credits allocated to them under the regulations it is necessary that an adjustment based on this subsection is a final adjustment as if made on an originally-filed tax return, and cannot be contested even if the party who did not respond within 45 days later provides evidence that no credits were claimed in a closed year. Without this subsection, the resolution of whether a resolution is final would involve a lengthy dispute resolution process.

10. Subsection (e)(6) provides that if two different assignors assign the same assignee the same type of identical credits in defective assignments, then any credits of that type which are considered claimed in a closed year shall be allocated under these regulations pro rata between the two defective assignments. However, if one assignor assigned credits in a valid assignment and another assignor assigned the same type of credits to the same assignee in a defective assignment, then any credits of that type which are considered claimed in a closed year are first attributable to the valid assignment.

This subsection is necessary to set forth a methodology for the allocation for the administration of these regulations; otherwise, the regulations would be ambiguous as to which credits were claimed in closed years when there were multiple assignors.

11. Subsection (e)(7) provides that any adjustments under these regulations are not treated as if the credit being adjusted was recaptured under any recapture rules that may exist with respect to a particular credit that was assigned.

This subsection is necessary to avoid ambiguity that the regulations do not trigger credit recapture.

12. Subsection (f) provides the form and manner in which requests to apply Regulations 23663-2 through 23663-4 must be made, including any requirements that must be met in order for the request to potentially be allowed. Any requests which do not contain all of the required information are not considered valid requests under these regulations. When a taxpayer's request is incomplete, subsection (f)(5) allows the FTB, in its sole discretion, to give the taxpayer an additional 30 days to provide the missing information in which case the cured request will be treated as received on the date the original request was received. The purpose of subsection (f)(5) is to give the FTB discretion to allow a taxpayer to cure a request which included all necessary information, but would otherwise be invalid due to a minor piece of information not being included with the taxpayer's request.

Subsection (f) is necessary to administer the regulations by informing taxpayers of the information taxpayers must provide to make requests under the regulations.

13. Subsection (g) contains some miscellaneous rules. First, subsection (g)(1) states the rule that credit adjustments made by the FTB under these regulations could require the FTB to disclose relevant taxpayer information to other parties to a defective assignment, notably whether another taxpayer claimed a credit in a closed year, since this fact changes the allocations and reductions of credits required under these regulations. The disclosure rule clarifies that these disclosures during audit, protest or pursuant to a claim for refund are all treated as made during an administrative proceeding regarding tax administration for purposes of the disclosure provisions of RTC section 19545.

Subsection (g)(1) is necessary for the administration of these regulations in order to eliminate any confusion that the processes in these regulations are considered administrative proceedings. Without this subsection there would be confusion regarding whether the necessary disclosures to other parties to a defective assignment could be made.

14. Subsection (g)(2) states the rule that any credits improperly claimed in a manner inconsistent with the provisions of Regulations 23663-2 through 23663-5 shall be treated as a math error adjustment under RTC section 19051.

Subsection (g)(2) is necessary for the administration of these regulations so that any credit allocations inconsistent with the regulations are timely and efficiently adjusted as a math error adjustment. Without this subsection, inconsistent credit allocations would need to go through a lengthy dispute resolution process.

15. Subsection (g)(3) clarifies that the variables discussed in the various examples within the regulations are the focus of the examples, and that FTB does not intend that information omitted from a particular example may be relied upon in any manner to support a conclusion on a different issue under these regulations. Due to the many requirements of the statute and underlying regulations, the examples in these regulations would be untenably long if all background information were included in each example.

Subsection (g)(3) is necessary to avoid drawing improper conclusions due to information excluded from examples and, instead, allow the regulations to utilize examples that are easy to understand. Without this subsection, examples would need to be contain more detailed information which is not relevant to the example. This would make the examples more difficult for users of the regulations to understand which could lead to errors in applying the regulations.

STANDARDIZED REGULATORY IMPACT ANALYSIS

1. Need for the Proposed Regulations

The proposed regulations provide administrative procedures for resolving errors in the assignment of credits between members of a corporate group. Assembly Bill 1452 (Stats. 2008, Ch. 763) added Revenue and Taxation code (RTC) section 23663, which permits members of a combined corporate tax reporting group to assign tax credits to affiliated members of the same combined reporting group. Many corporate taxpayers are part of a unitary group that file a combined report for California. Prior to AB 1452, tax credits could be used only by the specific corporation that generated the credits to reduce that corporation's portion of the combined reporting group's total tax bill. The intent of AB 1452 was to view combined reporting groups as a unified entity for the purpose of using tax credits, allowing such credits to be used anywhere within the combined reporting group to reduce the unitary group's total tax.

AB 1452 allowed the assignment of credits to members of a combined reporting group for taxable years beginning on or after July 1, 2008. Assigned credits may be used by the assignee in taxable years beginning on or after January 1, 2010. The election is irrevocable, and must be made on the assigning taxpayer's original return for the year of the credit assignment.

There are a number of ways in which a taxpayer may make a defective election to assign credits. For example, an audit may result in the finding that the amount of credit generated by a taxpayer was less than the amount that the taxpayer assigned. Another possibility is that an audit may determine that either the assignor or the assignee was not a member of the combined group on all of the dates required in the statute. RTC Section 23663(e)(4) authorizes the Franchise Tax Board (FTB) to specify the treatment of any credit assignment that does not comply with section 23663.

The proposed regulations provide guidance for the treatment of defective elections to assign credits to affiliated members of a combined group. The proposed regulations allow taxpayers who make eligible mistakes in filing their tax returns to correct their elections, and provide guidance on the disposition of tax credits whose assignment cannot be corrected.

The proposed regulations will benefit taxpayers, tax practitioners, and the state of California by providing clarity that does not currently exist in connection with the treatment of a defective election to assign credits pursuant to RTC section 23663. The proposed regulations would give taxpayers certainty as to how credits are allocated when a defective election occurs. The proposed regulations also give effect to the statute's intent of allowing a combined reporting group to benefit from a group member's credits by giving taxpayers flexibility in determining how credits are allocated when there is agreement between the parties involved in the defective election. Similarly, the proposed regulations give taxpayers one year to correct certain errors in defective elections. The clarity from the proposed regulations will eliminate uncertainty for taxpayers and tax practitioners. The proposed regulations will improve administrative efficiency for both taxpayers and the FTB, and will facilitate tax administration for the State of California by providing definitions, guidelines, flexibility and examples relating to defective elections to assign credits. The proposed regulations will also give effect to the statute's intent by allowing taxpayers in many cases to use the credits in the tax year they were originally claimed, rather than have taxpayers pay assessments in the original tax year and then reassign and use the credits in future tax years. The proposed regulations will also, in some cases where there are no future liabilities for the credits to offset or where credits expire, enable taxpayers to utilize tax credits that would have been denied absent these regulations. These benefits are the result of goals developed by the FTB with input from interested parties and based on broad statutory authority.

2. Major Regulation Determination

Senate Bill 617 (Stats. 2011, Ch. 496) established new regulatory impact assessment standards for major regulations. State agencies must conduct a Standardized Regulatory Impact Assessment (SRIA) when it estimates that a proposed regulation has an economic impact exceeding \$50 million.

Because the revenue impact of AB 1452 is greater than \$50 million, the Department of Finance has instructed FTB that it is proper to treat this implementing regulation as a major regulation.

3. *Public Input*

FTB's process for drafting the proposed regulations included the following three interested party meetings and one 60-day notice to solicit additional input from taxpayers.

- October 1, 2012 – Held an interested parties meeting to elicit public input on proposed regulations which would authorize and establish specific procedures under which taxpayers may request that FTB staff permit the correction of defective elections, and identify general standards under which FTB staff review requests for the correction of a defective election, including examples of situations where such requests may or may not likely be granted following staff review.
- December 5, 2013 – Held an interested parties meeting to elicit public input on a proposed structural framework for the regulations.
- June 12, 2014 – Held an interested parties meeting to elicit public input on draft language for new regulations that address defective assignments, and to clarify when an assignee is considered an eligible assignee in the same combined reporting group.
- August 29, 2014 – Released minor modifications to the draft regulatory language based on comments received at the June 12, 2014 interested parties meeting. The public was given 60 days to review and provide comments on these revisions.

Taxpayers and the public had opportunities to discuss the proposed regulations and voice their concerns. No reasonable alternatives to these proposed regulations were identified which would have a lesser adverse impact to the state, enhance the state's business climate any further, or which could carry out the purpose of these regulations more effectively.

4. *Definitions*

This section defines several terms used in this analysis:

Combined Report: A tax return submitted by a unitary group of corporations. The combined report will include the total income earned and the amount of tax liability for both the group as a whole and for each corporate member of the group.

Affiliated Corporation: Another corporation that is a member of the same combined reporting group.

Assignor: A corporation that gives some of its tax credits to an affiliated corporation.

Assignee: A corporation that receives tax credits from an affiliated corporation.

Assignment: An election to transfer tax credits from a corporation to an affiliated corporation. Valid assignments are irrevocable, i.e., assigned credits may only be used by the assignee.

Defective Assignment: An assignment that does not comply with the requirements of RTC section 23663.

5. Mechanics of Combined Reports

Under California law, when a corporation is part of a unitary business it is required to use a combined report to determine its California tax liability. On a combined report, the amount of the unitary group's business income is aggregated and then apportioned to California based on the unitary group's California apportionment factors. Each member of the group calculates its California taxes separately using the group's apportionment ratio. This is done by multiplying each member's net income for California tax purposes by the unitary group's California apportionment percentage. For example, suppose taxpayers A and B are part of a combined reporting group and have the income and sales amounts described in below (table 1). To calculate the apportionment factor for this group, the California sales for all three taxpayers are added together and divided by the sum of all sales for all three taxpayers. The resulting factor (25 percent in this example) is used by each of the three taxpayers to determine how much of their income is taxable in California.

Table 1	A	B	Combined
Total Sales	\$10,000,000	\$20,000,000	\$30,000,000
California Sales	\$4,500,000	\$3,000,000	\$7,500,000
CA Apportionment Factor			25.0%
Income Subject to Apportionment	\$1,000,000	\$3,000,000	\$4,000,000
CA Apportionment Factor	25.0%	25.0%	
Income Apportioned to CA	\$250,000	\$750,000	\$1,000,000
Tax Rate	8.84%	8.84%	
Tax before Credits	\$22,100	\$66,300	\$88,400

Prior to AB 1452, tax credits could be used only by the specific corporation that generated the credits to reduce that corporation's portion of the combined group's tax bill. Thus, in the example below (table 2), if Corporation A generated \$80,000 in tax credits, it could use those credits to reduce its tax to the \$800 Minimum Tax for a California corporation, but Corporation B could not reduce its taxes.

Table 2	Before AB 1452	A	B	Combined
Tax before Credits		\$22,100	\$66,300	\$88,400
Available Credits		\$80,000	0	0
Credits Used		\$21,300	0	\$21,300
Tax After Credits		\$800	\$66,300	\$67,100
Unused Credits		\$58,700	0	\$58,700

Under AB 1452, members of a combined group may assign tax credits to other members of the group (table 3). In the example below, A could assign credits to B. Since B can now use the credits, the tax liability of the combined group is lower.

Table 3	After AB 1452	A	B	Combined
	Tax before Credits	\$22,100	\$66,300	\$88,400
	Available Credits	\$80,000	0	\$80,000
	Transferred Credits	\$58,700		
	Received Credits		\$58,700	
	Credit Used	\$21,300	\$58,700	\$80,000
	Tax After Credits	\$800	\$7,600	\$8,400
	Unused Credits	0	0	0

6. Tax Credits Assigned and Used

Taxpayers were allowed to assign credits to an affiliated corporation for tax years beginning on or after July 1, 2008, but could not use the assigned credits to reduce liability until tax years beginning on or after January 1, 2010. For tax years 2008 – 2014, taxpayers assigned approximately \$4.2 billion of credits to affiliates on more than 1,000 tax returns (Table 4). Of that total, approximately \$1.6 billion in assigned credits were used to reduce tax liability for tax years 2010 – 2014. Usage of assigned credits was highest in 2010, the first year that they could be used, then dropped as some taxpayers depleted their stock of unused credits. Assigned tax credits are used on about 225 combined reports annually.

Table 4.	Usage of Assigned Credits (\$ in millions)						
	2008/09	2010	2011	2012	2013	2014	Total
Returns Transferring Credits	4	199	237	232	300	265	1,237
Credits Assigned	\$1,804	\$622	\$374	\$462	\$436	\$504	\$4,202
Assigned Credits Claimed	\$0.050	\$484	\$293	\$236	\$299	\$273	\$1,585

7. Defective Assignments

The assignor can make an election to assign a credit, using Form 3544, to an assignee that is a member of the same combined reporting group. The assignee uses Form 3544A to specify how much assigned credit will be used each year.

A defective assignment occurs when an assignment does not comply with the requirements of RTC section 23663 and includes any assignment which:

- Assigns an amount of credit (or the aggregated amount of the same credit) in excess of the amount of the assignors eligible credits for the tax year;
- Fails to clearly identify the amount of the credit to be assigned;
- Fails to clearly identify the type of the credit intended to be assigned;
- Assigns a credit which is not an eligible credit; or

- Assigns a credit to an assignee that is not clearly identified or is not an eligible assignee.

A defective assignment may be discovered by the taxpayer or during audit. A taxpayer that discovers an assignment error may submit a request in writing to the FTB asking to correct the defective assignment. If granted permission, the correction would be effective as of the year of the defective assignment. If the defective assignment is discovered during an audit, it would likely be three to four years at a minimum after the tax return was filed. The taxpayer's defectively assigned credits would be allocated based on the regulations and the taxpayer will be notified and billed for any taxes due. Audit will adjust the credit carryover to accurately reflect the credits available. Any defectively assigned credits which are allocated to the assignor may be reassigned on an original tax return in a future tax year. Upon the approval of the proposed regulations the taxpayer will have one year to correct any past assignment errors made in years for which the statute of limitations has not expired.

There are several common types of defective assignments. This section compares the administrative procedures and timing of cash flows for the most common types before and after the promulgation of the proposed regulations.

7.1. More Credit Assigned than Generated

Suppose that Corporation A files a 2012 tax return on which it states that it generated \$75 of credit and assigned all of that credit to Corporation B. Corporation B uses the \$75 credit to reduce its 2012 tax liability. In 2017, FTB audit determines that Corporation A had only generated a \$50 tax credit in 2012.

Without the Proposed Regulations:

The election would be invalid. The credit would revert back to Corporation A and be reduced to \$50. The \$50 credit could either be used by A in a future tax year, or be reassigned correctly in a future tax year. An assessment would be issued for the entire \$75 on the group's 2012 return. Corporation A could reassign the \$50 credit to Corporation B on a 2017 or later tax return.

If any member of the combined group has sufficient tax liability in 2017 to use the \$50 credit, the group will reduce its payments for the 2017 tax year at approximately the same time that it pays the assessment due on the 2012 tax year. The net payment will be \$25, the same as it would be with the regulations.

If no member of the group has tax liability in 2017 against which to use the \$50 credit, the payment to the state will be \$75, \$50 greater than it would have been with the regulations. Future payments by the group would be reduced by \$50 if the group is able to use the credit in a future tax year.

Under the Proposed Regulations:

The credit used in 2012 by Corporation B would be adjusted down from \$75 to \$50, and an assessment issued for the remaining \$25.

The effect of the regulations is, therefore, nothing if the group has current liabilities against which to use the credit, a temporary increase of \$50 in payments to the state if the group has future but not current liabilities against which to use the credit, or a permanent \$50 increase in payments to the state if the group will never again owe tax greater than Minimum or Alternative Minimum Tax.

A slightly more complicated case arises if Corporation A had transferred \$50 of credit to Corporation B and \$25 to Corporation C before being determined to have only generated \$50.

Without the Proposed Regulations:

As in the case above, no credit could be used against 2012 taxes, but the reverted \$50 could be used in a later year. Depending on the taxpayer's ability to use the credit in the year the assessment is finalized, the assessment may or may not have a real effect on cash flow.

Under the Proposed Regulations:

The \$50 of credit would be allocated to Corporations B and C pro rata based on the ratio of credit assigned to them in the defective assignment, but Corporations B and C would still be allowed to use \$50 of credit on their 2012 tax return. The effect of the regulations would still be nothing, a temporary increase in payments, or a permanent increase in payments, depending on the group's ability to use the credits in a future year.

7.2 Clerical Errors in the Assignment

This category covers a number of possible errors. For example, a taxpayer may fail to specify the type of credit being assigned or the year in which the credit was generated.

Without the Proposed Regulations:

Credits assigned with these types of errors would be returned to the assignor and could then be reassigned at the next available opportunity.

For example: Corporation D assigned a \$100 credit to Corporation E in 2014. In 2018, it is discovered that the assignment contained an error. The credit would revert to Corporation D. Corporation D may either use the credit itself or reassign the credit to Corporation E or any other qualified assignee in 2018 or another future tax year. As in the case described above, the taxpayer would be assessed \$100 of additional tax for tax year 2014. If the taxpayer is able to use the credit in 2018, it would likely reduce the tax payments made to the state in 2018 by \$100. If the taxpayer does not have sufficient liability against which to

apply the credit, any increase in payments to the state will be reversed in a future year in which the taxpayer can benefit from the credits.

Under the Proposed Regulations:

Taxpayers would be allowed to fix many types of clerical errors, so the identification of the error would not result in any assessments to the taxpayer. As above, the regulations may result in no net change in payments to the state, a temporary increase, or a permanent increase in payments to the state, depending on the group's ability to use the defectively assigned credits in future years.

7.3 Assignor or Assignee is Ineligible

If either the assignor or the assignee is ineligible, the credit goes back to the assignor. This section of the proposed regulations provides the taxpayer with certainty as to the allocation of defectively assigned credits, but does not allow the credits to be used in the year of the original return.

With or Without the Proposed Regulations:

The assignor would need to wait until a current or future year to reassign a credit. For example: Corporation G assigns \$100 credit to Corporation H in tax year 2013. In 2018, Audit determines that H was an ineligible assignee. The credit would go back to Corporation G, who may keep the credit or reassign the credit to Corporation I in 2018. As in the above cases, there would be little impact if Corporation G, I, or another eligible member of their group can use the credit in 2018. If the credit cannot be used in 2018 there would be either a temporary or permanent transfer from the taxpayer to the state. Unlike the case of clerical errors in the assignment, there would be no change in the pattern of payments with or without the regulations in the case of ineligible assignments.

8. *Timing Issues in Net Tax Payments.*

If the proposed regulations are adopted, the FTB will issue fewer assessments for taxes owed because of defective assignments. The next two sections will explore the expected amount of these foregone assessments. To model the economic impact of these changes, FTB considered three groups of taxpayers, assuming that the proposed regulations are not adopted.

8.1 No Impact

The first group of taxpayers has current tax liability against which to use their tax credits.

The proposed regulations will have very little effect on these taxpayers.

For example, in 2018 it is determined that the assignment of a \$10,000 credit in 2013 from Corporation A to Corporation B was defective. The credit was defective because the taxpayer did not specify the year in which the credit was generated. Corporation B has

\$30,000 in tax before credits for 2018. After the determination that the 2013 assignment was defective, the credit will revert to Corporation A and may be reassigned in the future. Corporation A subsequently specifies the year the credit was generated and reassigns the credit to Corporation B in tax year 2018, reducing Corporation B's 2018 tax to \$20,000. The taxpayer may reduce its payments toward its 2018 tax by \$10,000 at approximately the same time that it pays the \$10,000 it owes for 2013 taxes. These two changes effectively cancel each other out, so there should be no economic impact.

8.2 Temporary Impact

The second group of taxpayers cannot use all of the reassigned credits immediately, but can use them within a few years.

Again assume that in 2018 it is determined that the assignment of a \$10,000 credit in 2013 from Corporation A to Corporation B was defective. The credits from the defective assignment in 2013 revert to Corporation A. Assume this time that neither A nor B has a 2018 tax liability, but that A can use the \$10,000 to reduce tax in 2019. In this case Corporation A may make a payment to the state in 2018, and reduce payments to the state by a like amount in 2019. There could be short run economic impacts from the increased tax payments in 2018 and from the decrease in tax payments in 2019. Since this transfer of funds to the state is temporary, it is expected to have little long run economic impact.

8.3 Long Term Impact

Assume instead that the taxpayer A generates enough tax credits each year to reduce each member of the combined reporting group's taxes to the Minimum Tax (or in some cases the Alternative Minimum Tax) and that credits from the defective 2013 election have reverted back to Corporation A.

Absent the proposed regulations, the taxpayer will be assessed tax for the defective 2013 assignment but will not have current or future tax liability to offset these assessments. This results in a permanent increase in tax payments.

These increased tax payments are all associated with past tax years for which the taxpayer's economic decisions are irreversible. Since this group of taxpayers is already able to reduce their tax to the Minimum Tax for the foreseeable future, the presence or absence of the regulations will have no effect on their future tax payments. For this group of taxpayers, therefore assessments for prior tax years are "sunk costs" that should have no impact on economic behavior. It follows that the economic impact of the proposed regulations arises primarily from the change in revenue available to the state from assessments on this group of taxpayers.

8.4 Payments, Refunds, and Interest

The discussion above has described taxpayers making payments to the state when their use of tax credits is disallowed. In fact, most corporate taxpayers leave extra money on account with FTB to cover audit related payments. Many audit assessments, therefore, result in the

taxpayer requesting a smaller refund at the conclusion of the audit rather than the taxpayer making an actual payment to the state. The economic impact of an assessment should not depend on whether it results in a larger payment from or a smaller refund to the taxpayer. The remainder of this analysis will continue to use the term payments to describe either an increase in payments or a reduction in refunds.

This discussion has not yet considered differences that may arise in the amount of interest paid by taxpayers on the assessments described above with or without the regulations. The amount of interest will be small for two reasons. First, most large corporate taxpayers leave extra money on account with FTB. If the amount of money on account is greater than the assessment, these taxpayers will not have underpaid their tax, so they will not owe any interest. Second, for those taxpayers that do not have sufficient funds on account to cover their assessments, interest rates are currently low.

9. Likely Cash Flows

9.1 Gross Amount of Defective Assignments

Taxpayers used \$1.6 billion in assigned credits in tax years 2008 - 2014. As of June 2017, \$677 million of the assigned credits are on returns that FTB Audit has identified as having at least some defective credit assignments. This total includes about \$190 million in credits assigned by taxpayers that did not have enough credit available to assign and about \$487 million in credits with other potential defects that may be correctable if the proposed regulations are adopted. Of the \$677 million, about \$372 million of these credits were actually used by taxpayers to reduce their liability for tax years 2010-2014, and could, therefore, generate assessments when these audits are completed. The amount of credit claimed in cases where the taxpayer did not have enough credit available to assign was about \$99 million. To the extent that these credits were never available, they would generate assessments even if the regulations are adopted, so the net difference in assessments with and without the regulations could be as high as \$273 million.

9.1.1 FTB is Still Investigating the Portion of These Assignments that are Actually Defective

As noted above, \$677 million of assigned credits and \$372 million of claimed credits are on tax returns on which we believe that at least some of the assignments are defective. FTB has undertaken an initial assessment of tax returns that account for more than 90 percent of assigned credits. The portion of credit assignments on these returns that is actually defective will not be known until a full audit is completed. The first row of Table 6 shows the amount credits assigned on returns with some defective assignments by tax year. The second row shows the number of credits claimed on these returns. The third, fourth, and fifth rows in the table show the amount of credits claimed with defective assignments if 75, 50, 25 percent of the all the assignments on these returns turn out to be defective.

Tax Year Assignment	2008	2009	2010	2011	2012	2013	2014
Assignments on Returns with Defective Assignments	\$14	\$137	\$259	\$109	\$29	\$42	\$86
Credits Claimed on Returns with Defective Assignments	\$2	\$33	\$233	\$29	\$17	\$21	\$36
Credits Reverted if 75% are defective	\$2	\$25	\$175	\$22	\$13	\$16	\$27
Credits Reverted if 50% are defective	\$1	\$17	\$117	\$15	\$9	\$11	\$18
Credits Reverted if 25% are defective	\$1	\$8	\$58	\$7	\$4	\$5	\$9

The credits claimed in tax years 2008 and 2009 are clearly in error since assigned credits could not legally be claimed until tax year 2010. More than half of the potentially defective credits claimed were claimed in 2010, the first year in which they could be used. For tax years 2011 – 2014, the average amount of assigned credits claimed on returns with at least some defective assignments was \$26 million per year. To the extent that a portion of the credits on these returns turn out not to be defective, the average annual adjustment will be less than \$26 million per year. If taxpayers learn over time to avoid making defective assignments the ongoing effect of these regulations will be even smaller. FTB estimates, therefore, that going forward the level of credits with defective assignments will be \$10 million to \$20 million per year.

9.2. Ability of Taxpayers to Use Credits Returned to the Assignor.

An examination of tax returns from taxpayers that used credits with defective assignments that could be fixed under the proposed regulations indicates the following:

About 20 percent of these credits were used by taxpayers whose tax liability in their most recent filing was greater than the defective tax credits that they previously used. Thus, if their tax liability for the next year that they file is at least as great as for their most recent filing, they will be able to reassign and use any defective credits returned to the assignor immediately. The proposed regulations should have little or no impact on these taxpayers.

About 20 percent of the credits with defective assignments were used by taxpayers whose most recent filing reported tax liability greater than zero, but less than the amount of credit in question. If this group of taxpayers reports the same amount of liability in future tax years, it will take them a few years to reassign and use any credits returned to the assignor. The portion of these credits that can be used immediately should have no economic impact. The remainder will, if the regulations are not adopted, result in a short term transfer of money from these taxpayers to the state as described in Section 7.2 above. For this group also there is unlikely to be a long run economic impact.

The remaining 60 percent in credits with defective assignments was used by taxpayers who consistently generate more credits than they can use. Without the proposed regulations the

reversion of these credits will result in a transfer to the state for the long term. Adoption of the regulations would reverse this result.

If the relative size of these 3 groups stays the same in the future, and future audits discover \$10 million - \$20 million annually in credits with correctable defective assignments, the ongoing transfer from the state to taxpayers of adopting these regulations would be \$6 million - \$14 million per year.

Because of the large initial backlog of defective credits, the loss to the state in the first year could be as much \$300 million (assuming that all \$372 million of credits on returns with some defective credits are in fact defective, that 60 percent are from taxpayers that cannot reuse any of them, and that 20 percent are from taxpayers that can immediately reuse only a portion of them. After the first year, the loss to the state should drop rapidly toward the steady state level of \$6 million - \$14 million per year. Table 6 presents the estimated cash flow from the state to taxpayers if the regulation is adopted and all of the assignments in question are found to be defective.

Table 6		
Cash Flow from Proposed Regulation if All Credits Being Examined are Found to be Defective (\$s, Millions)		
2017/18	2018/19	2019/20
\$300	\$14	\$14

10. Economic Impact

To assess the economic impact of the proposed regulations FTB had to consider the effect of the cash flows described in Section 8 on both the taxpayer and the government.

10.1 Impact to Taxpayers

10.1.1 Basic Economic Model Suggests that this Regulation Could Increase the California Economic Activity of Affected Corporations

This regulation will reduce corporate tax payments to California by as much as \$300 million initially, and \$6 million - \$14 million per year in the long run. Many models of the economy assume that the corporations benefitting from this regulation will reinvest a portion of this savings in the California economy. For example, the Bureau of Economic Analysis' Regional Input-Output Modeling System (RIMS II) produces regional multipliers that can be used to determine the economic impact of a project, or change in economic activity, on a particular region. Most of the assigned corporate tax credits are Research and Development Credits. Our analysis of RIMS multipliers for research intensive industries suggests that the change in overall California economic output could be about 1.5 times the cash flow generated by the proposed regulation. Thus, if all the credits in question turn out to be defective, the increase in economic activity could be as much as \$450 million initially and about \$20

million per year ongoing. An increase of this magnitude could include the creation of several hundred new jobs.

10.1.2 Actual Impact Likely Smaller than Suggested by a Basic Economic Model

10.1.2.1 Proposal Will Improve Taxpayers' Already Large Cash Balances

FTB expects a reduction in payments to the state if the proposed regulations are adopted. Most of the taxpayers affected by these proposed regulations are very large corporations for whom California taxes are a very small part of their business expenses. The total usage of defective assigned credits is less than one tenth of one percent of the cash balance on these corporations' balance sheets. This suggests that most of these taxpayers could easily transfer additional cash to FTB without disrupting ongoing operations. Conversely, the additional cash available to these corporations if the regulation is adopted will not be needed immediately for ongoing operations.

10.1.2.2 Proposed Regulation Does Not Alter Economic Incentives in the Near Term

The taxpayers who will make payments to the state if these regulations are not adopted are those who do not have current tax liabilities against which to use additional credits. Since the amount of tax they owe in the current tax year will not change if the regulations are adopted, the regulations will have little, if any, effect on their expected rate of return for current economic activities. The proposed regulations should not, therefore, have a significant effect in the near term on any real economic decisions. It will not impact taxpayer decisions regarding the level of employment, investment, or production.

10.1.2.3 Dynamic Impact of Improved Taxpayer Cash Balances Will Be Mostly Out-Of-State

The primary impact of the proposed regulations on taxpayers is an increase in cash balances concentrated in the largest corporations. These corporations can and will deploy that cash anywhere in the world that they believe will generate the greatest return on their investments. The fact that these corporations already have very large cash balances suggests that they likely have already exhausted all of the current investment opportunities that they believe will be profitable and, therefore, are likely to hold on to the additional cash made available by the proposed regulation. If they choose to hold onto the cash in liquid form, the cash will be dispersed throughout the global financial market. Even if the corporations quickly reinvest the cash in new or expanded business operations, those investments could occur anywhere in the world, and there is no reason to believe that a significant portion of this cash will be reinvested in California.

10.2 Impact to State

If the proposed regulations are adopted, cash flow to the state will be reduced by the amount described above. Since the state operates under a balanced budget requirement, the reduced payments should induce a similar decrease in state government expenditures. The regulations may free up some resources within FTB that could be redirected to other activities. FTB Audit and Legal estimate that administrative efficiencies from the proposed

regulation will save about 200 hours of staff time for a savings of about \$12,500. If these savings are redirected to revenue raising activities with a 3:1 cost-benefit ratio, that would result in the collection of an additional \$37,500 on other tax issues. Aside from this redirection of resources, these regulations would not impose any additional costs or result in additional savings to the FTB, or any other state agency.

10.3 Dynamic Impact on the State's Economy of Reduced State Revenue

As described above, the initial impact of the proposed regulations would be a reduction in state revenues and an equivalent increase in cash balances for affected corporations. The reduction in state revenues could be as much as \$300 million initially and \$6 - 14 million per year ongoing. The actual reduction will be less to the extent that only a portion of credits assignment on returns with defective assignments are defective and to the extent that FTB generates revenue by redirecting resources available because of administrative efficiencies created by the proposed regulation. The economic literature on the dynamic impact of changes in state spending provides a range of results that are summarized in Table 2 of Ramey (2011).¹ Many of the papers cited in this table find multipliers in the range of 1.5 - 2. This suggests that a reduction in state spending of \$300 million in the first year after the adoption of the proposed regulations would result in a decrease of \$450 - 600 million in statewide economic activity, and the ongoing loss of \$6 million - \$14 million in state revenue per year would result in an ongoing loss of \$9 million - 25 million per year.

10.4 Impact on Incentives for Innovation in Products

By providing a remedy for the correction of credit assignment errors these regulations are complementary to existing law which allow the assignment of credits. These regulations do not mandate, require, or provide incentives for additional investment in the state by individuals or businesses, and as such, will not impact any incentives for innovation in products, materials, or processes in this state.

10.5 Additional Benefits

Adoption of the proposed regulations would likely improve California's "business climate" as they provide certainty as to what happens to defectively assigned credits and improve the administrative efficiency for the taxpayer and the FTB. However, these effects cannot be quantified. The proposed regulations will not have any direct impact on the health and welfare of California residents, worker safety, and the state's environment.

11 Summary Conclusions

These regulations provide needed clarity in the area of defective elections and the assignments of credits. They enhance rather than hinder or adversely impact the ability of California businesses to compete with businesses from other states. They address the assignment of credits by all businesses that earn credits in California, both California and

¹ Ramey, Valerie A., "Can Government Purchases Stimulate the Economy?" *Journal of Economic Literature*, 2011, 49:3, 673-685.

foreign businesses without creating a competitive advantage or disadvantage to California businesses.

11.1 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 these regulations. This is due to the fact that the proposed regulations affect only corporations that are part of a multi corporation combined reporting group for tax purposes in which at least one corporation generates more tax credits than that corporation can use. For such corporations, it is contemplated that the proposed regulations will be a nominal part of their current tax compliance and reporting activities. Additionally, since the tax owed in the current year will not change with these regulations they will have little impact of current economic activities. Therefore, employment, investment and production should not be impacted. (Sections 10.1.2.1, 10.1.2.2)

11.2 Creation or Elimination of Businesses within the State

The proposed regulatory action would neither create nor eliminate businesses in California. The proposed regulations are complementary to existing law pertaining to the assignment of credits. In this regard, the proposed regulations deal with a small fraction of the total credits assigned since the proposed regulations give clarification for the small fraction of assignments which have defects. Most assignments do not have errors and so are not impacted by the proposed regulations. The clarification the proposed regulations provide with respect to what happens when credits are defectively assigned would neither result in new business creation nor elimination of existing businesses because economic decisions and business investment would not be effected with the proposed regulations as the proposed regulations merely provide certainty in the small fraction of assignments which have defects. It is contemplated that corporate actions under the proposed regulations will be a nominal part of their current tax compliance and reporting activities. (Sections 10.1.2.1, 10.1.2.2, 10.1.2.3, 10.4)

11.3 Competitive Advantages or Disadvantages for Businesses Currently Doing Business with the State

The proposed regulatory action would provide neither a competitive advantage nor disadvantage for firms currently doing business in California. This is due to the fact that the assignment law, and thus the proposed regulations, applies to all businesses which earn credits in California, including both California and foreign businesses. Further, the proposed regulations do not change the business environment after passage of the underlying credit assignment statute as the proposed regulations merely deal with the small fraction of assignments which have defects. (Sections 10.1.2.1, 10.1.2.2, 10.1.2.3)

11.4 Increase or Decrease of Investment in the State

The proposed regulatory action would neither increase nor decrease investment in California. The corporations which typically assign credits are large corporations which do business in many states. The total usage of defectively assigned credits is less than one tenth of one percent of the cash balance on these corporations' balance sheets. The

proposed regulations should not, therefore, have a significant effect on any real economic decisions – such as investment or production. Although, the clarification provided would enhance the business climate by providing certainty in the area of credit assignments. (Sections 10.1.2.1, 10.1.2.2, 10.1.2.3)

11.5 Incentives for Innovation in Products, Materials, or Processes

By providing a remedy for the correction of credit assignment errors these regulations are complementary to existing law which allow the assignment of credits. They bring clarity to existing law. These regulations do not mandate, require, or provide incentives for additional investment in the state by individuals or businesses, and as such, will not impact any incentives for innovation in products, materials, or processes in California. (Sections 10.1.2.2, 10.4)

11.6 Benefits

Because of the backlog of credits, the initial benefit from the proposed regulations could be to give certainty regarding the allocation of as much as \$300 million of defectively assigned credits. The ongoing benefit of the regulations is expected to provide certainty regarding the allocation of credits in the range of \$6 million to \$14 million annually. The proposed regulations will not have any direct impact on the health and welfare of California residents, worker safety, and the state's environment. Adoption of the proposed regulations would improve California's "business climate" as they provide certainty as to what happens to defectively assigned credits, but this effect cannot be quantified. (Sections 10.3, 10.5)

12 Alternative Regulations

No alternative regulations were proposed at the three stakeholder meetings, therefore, FTB has evaluated two less stringent versions of the proposed regulations as possible alternatives.

12.1 Alternative 1

Proposed Regulation section 23663-4 gives taxpayers one year to correct a defective assignment error. Assignment errors discovered by the taxpayer in the most recently filed tax return could be self-corrected prior to the submission of the next tax return under the Proposed Regulation section 23663-4. The majority of defective assignments are discovered in the audit process, and the process of correction and reallocation can take a number of years due to the length of time between the assignment on taxpayers' original tax return and resolution of the audit process, as well as a heavy audit workload.

Alternative 1 would be to remove Proposed Regulation section 23663-4. Taxpayers would be required to go through a much more time-consuming and burdensome process to correct a defective assignment. The one-year window is especially useful since it ties to the timing of taxpayers' next year's tax returns and incentivizes taxpayers to review their prior year tax returns' assignments when preparing the next year's tax returns.

The intent of the credit sharing legislation — the use of tax credits by assigning them to group members who have sufficient tax liability against which the credits could be allowed — would be hampered by requiring taxpayers to wait years in order for defective assignments to be corrected. Without Proposed Regulation 23663-4, the curing would generally take place in the audit process.

12.1.1 Economic Impact

Removal of the self-correction provision, would leave the error discovery and correction to the audit process which would result in four to five years during which tax liability would be temporarily understated. Once the error is detected and corrected the assignor's tax liability will be adjusted up to the appropriate level. For the purpose of determining an impact we have assumed that the revenue lost would be from the lost earnings over that five-year period. We therefore assume that the money would have been placed in an interest earning account at a rate of 2 percent per year. Changes to the FTB workload, if any, would be minimal as these tax returns are audited on a yearly basis anyway.

Estimating the economic impact of Alternative 1 would require determining the number taxpayers that will make assignment errors and correct them prior to filing their tax return for the next year, and the magnitude of those errors. Although the number of such taxpayers is likely to be minor, the dollar value of these adjustments could vary. For the purpose of quantifying the impact of this alternative the starting point is the average of the defective assignments involved from 2008 to 2014 at the 25, 50 and 75 percent levels. It is assumed that 10 percent of this total would be self-corrected within a year. Without the self-correction provision FTB Audit will discover the errors, which range from \$1.3 million to \$3.9 million, approximately 5 years after the filing. With self-correction the FTB receives between \$1.3 million and \$3.9 million within a year and gains the interest over the 5 years—gains ranging from \$100,000 to \$400,000.

Without the self-correction provision it is likely that the revenue collected will be less as most taxpayers contest the NPA and eventually negotiate a settlement for a lesser amount. Under the self-correction provision the change is initiated by the taxpayer and will likely not be disputed.

Applying the RIMS II, regional impact multipliers, without the self-correction provision the revenue shortfall to the state would range from \$100,000 to \$400,000; Final output would be lower by \$200,000 to about \$600,000, earnings would decline by \$60,000 to \$170,000, and result in up to four fewer jobs.

12.1.2 Cost-Effectiveness

Removing the one-year window will require FTB to detect this error as part of the audit, but would not increase the FTB workload or require additional staffing. A FTB audit is a complete review of all relevant components of the tax return and as such the credits assigned and assigned credits used will be verified in the course of the audit and the error would be discovered. Any additional workload or costs to the FTB would be minor. There would not be any additional compliance costs to the taxpayer, just a shift in the workload.

12.1.3 Reason for Rejecting Alternative 1

Allowing the taxpayer to self-correct and remedy an assignment error allows the taxpayer to correctly assign the credit and use it quickly rather than waiting for the lengthy audit process. Additionally, upon completion of an audit the taxpayer may protest the outcome of the audit and after a lengthy legal process settle with the FTB at a lower negotiated rate. It is a time saving remedy which promotes the purpose of the statute—to draw down existing credit balances by allowing the taxpayer to assign and apply these credits to outstanding tax liability.

12.2 Alternative 2

Existing law is unclear as to whether defectively assigned credits stay with the assignor or go to the assignee. When assignors assign more credits than they have available to assign (usually due to a reduction of credits during audit), Proposed Regulation 23663-2 allocates the credits that the assignor has to the assignee. For example, an assignor reports it has 100 credits available and assigns 100 credits, and upon audit it is determined that the assignor only has 80 credits, then the 80 credits will be assigned to the assignee. In every other instance, defectively assigned credits stay with the assignor pursuant to Proposed Regulation 23663-3 since it is unlikely the law would allow the credits to be allocated to assignees in such instances.

Alternative 2 would remove Proposed Regulation 23663-2 and, instead, in all instances defectively assigned credits would stay with the assignor pursuant to Proposed Regulation 23663-3. Therefore, in the example above, instead of FTB assigning the 80 credits to the assignee, those credits will stay with the assignor who would then correctly reassign them in the year following the completion of the audit—a lag of four to five years. According to Audit, roughly 70 to 80 percent of all defective payments are due to taxpayers claiming credits in excess of eligible credits for the tax year.

12.2.1 Economic Impact

Based on data from tax years 2008–2014 the average number of defective credit assignments involved due to credits assignments in excess of credits available totaled \$14.1 million. Assuming 40 percent (\$5.6 million) of those credits were in excess of the credits available, the actual number of credits available for reassignment is \$8.5 million.

Under current law, NPAs would be issued to the assignees for \$14.1 million and the correct amount of credits available, \$8.5 million, would be reassigned at the earliest opportunity. Under Regulation 23663-2, assignees' tax returns will be adjusted to correctly reflect the \$8.5 million credits available for assignment and NPAs will be issued for \$5.6 million—the excess credits assigned in error.

The difference is timing—under current law the \$14.1 million will be reassigned within a year or two as it is in the interest of the taxpayer to reduce tax liability sooner rather than later. Under Regulation 23663-2 the \$8.5 million would be correctly reflected immediately in

assignees' tax returns. In either case the NPAs are likely be challenged by the assignee and result in settlements amounting to a fraction of the NPAs, in some cases after several years.

For the purpose of assigning an impact to alternative 2 we have assumed the following: the \$14.1 million could generate interest income prior to reassignment, an interest rate of 2 percent per year, all reassignments take place at the end of year 2, no legal challenges to the NPAs, and the resulting revenues are held in interest bearing accounts.

If the NPAs are paid immediately and the credits are reassigned correctly after two years, the additional revenue to the state is approximately \$340,000, output would increase by \$540,000, earnings would increase by \$140,000 and state employment would increase by 3.

12.2.2 Cost-Effectiveness

This change will not impact the FTB audit workload. From an FTB perspective the credit assignment will be corrected and left with the assignor instead of the assignee. The taxpayer (the assignor) will have to reassign the credit correctly in a subsequent tax return filing, 4 or 5 years after the original defective assignment, whereas previously the correction was made by FTB and left with the assignee. There will be an additional duty placed on the taxpayer but it will be unlikely to impact the operations of the company significantly or result in additional compliance costs.

12.2.3 Reason for Rejecting Alternative 2

This alternative is less desirable since it frustrates the purpose of RTC section 23663 which was to allow credits to be used against the tax liability of other group members. Without Proposed Regulation 23663-2, taxpayers would need to reassign credits on their next original tax return when an audit reduces taxpayers' credits below the amount assigned. However, under Proposed Regulation 23663-2, this scenario would allocate the reduced amount of credits to the assignee as of the original assignment date and give effect to the taxpayer's election to assign credits.

TECHNICAL, THEORETICAL OR EMPIRICAL STUDY, REPORT, OR SIMILAR DOCUMENT

In drafting the proposed regulations, the FTB did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of these regulations.

BENEFITS ANTICIPATED FROM REGULATORY ACTION

The proposed regulations will benefit taxpayers, tax practitioners, and the state of California by providing clarity that does not currently exist in connection with the treatment of a defective election to assign credits pursuant to RTC section 23663. The proposed regulations would give taxpayers certainty as to how credits are allocated when a defective election occurs. The proposed regulations also give effect to the statute's intent of allowing

a combined reporting group to benefit from a group member's credits by giving taxpayers flexibility in determining how credits are allocated when there is agreement between the parties involved in the defective election. Similarly, the proposed regulations give taxpayers one year to correct certain errors in defective elections. The clarity from the proposed regulations will eliminate uncertainty for taxpayers and tax practitioners. The proposed regulations will improve administrative efficiency for both taxpayers and the FTB, and will facilitate tax administration for the State of California by providing definitions, guidelines, flexibility and examples relating to defective elections to assign credits. These proposed regulations will also give effect to the intent of the statute by allowing taxpayers in many cases to use the credits in the tax year they were originally claimed, rather than have taxpayers pay assessments in the original tax year and then reassign and use the credits in future tax years. The proposed regulations will also, in some cases where there are no future liabilities for the credits to offset or where credits expire, enable taxpayers to utilize tax credits that would have been denied absent these regulations. These benefits are the result of goals developed by the FTB with input from interested parties and based on broad statutory authority.

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

The FTB has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulations to RTC section 23663, or would be less burdensome with respect to affected private persons or small businesses than the proposed regulations. Notably, the proposed regulations pertain only to combined reporting groups that have multiple affiliated corporations and therefore will have little or no impact on small businesses.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD BE LESS BURDENSOME AND EQUALLY EFFECTIVE IN ACHIEVING THE PURPOSES OF THE REGULATIONS

The FTB has determined that there were no alternatives considered which would be less burdensome and equally effective in achieving the purposes of the regulations to RTC section 23663 in a manner that achieves the purposes of the statute.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The proposed regulations should not have a significant effect in the near term on any real economic decisions. Most of the taxpayers affected by these proposed regulations are very large corporations for whom California taxes are a very small part of their business expenses. The total usage of defective assigned credits is less than one tenth of one percent of the cash balance on these corporations' balance sheets. Any tax changes attributable to defective credits would be considerably smaller, and easily addressed by a

transfer of cash from the large cash balances these businesses hold without impacting ongoing operations.

Business decisions regarding the level of employment, investment, or production, which impact the economy and the business climate will not be effected. The regulations provide clarity in the area of defective credits and the assignment of credits. As such the regulations enhance rather than hinder or adversely impact the ability of businesses to compete. The regulations do not place an additional burden on businesses which take resources away from business operations and profitability. Therefore, there would be no adverse economic impacts on business.