

TITLE 18. FRANCHISE TAX BOARD

[Notice published November 24, 2017]

NOTICE OF PROPOSED RULEMAKING

The Franchise Tax Board ("Board") proposes to adopt proposed regulations described below after considering all comments, objections, and recommendations regarding the proposed action.

PUBLIC HEARING

The Board has not scheduled a public hearing on this proposed regulatory action. However, the Board will hold a hearing if it receives a written request for a public hearing from any interested person, or his or her authorized representative, no later than 15 days before the close of the written comment period indicated below. The request should be submitted to the agency officer named below.

In addition, Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action if any person makes such a request in writing.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Board. The written comment period closes at 5:00 p.m. on January 11, 2018. The Board will consider only comments received at the Board offices by that time. The Board encourages submission of comments in electronic form, rather than in paper form. Comments may be submitted by email to Ciro.Immordino@ftb.ca.gov.

Submit comments in paper form to:

Mailing Address:

Ciro Immordino, Tax Counsel IV
Legal Division (MS A260)
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Fax:

(916) 843-0450

AUTHORITY AND REFERENCE

California Revenue and Taxation Code section 23663(e)(4) authorizes the Board 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.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

This rulemaking action gives taxpayers certainty as to how credits are allocated when a defective election occurs and also, in certain situations, flexibility in allocating defectively assigned credits.

Summary of Existing Laws and Regulations:

California Revenue and Taxation Code section 23663 permits the assignment of credits among affiliated members of the same combined reporting group. In some situations taxpayers have made defective elections to assign credits under this section. Because the assignment election is irrevocable, taxpayers are therefore left with uncertainty regarding the allocation of credits which are the subject of a defective election, as well as having no clear recourse to correct a defective election.

Effect of the Proposed Regulations:

The effect of the proposed regulations is to 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.

Broad Objectives and Specific Benefits of the Proposed Regulations:

The broad objectives of the proposed regulations are to ensure that taxpayers, their representatives, and the state of California have guidance on how to determine when a defective election to assign credits occurs, how to allocate defectively assigned credits and to give taxpayers flexibility in determining the allocation of credits in certain instances.

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 California Revenue and Taxation Code section 23663. The benefits are the result of goals developed by the Board with the input of interested parties, and is based on broad statutory authority.

Consistency and Compatibility with Existing State Regulations:

The Board has determined that the proposed regulations are consistent and compatible with existing regulations. After conducting a review for any regulations that would relate to or affect this area, the Board has concluded that these are the only regulations that concern the allocation of credits when there is a defective election to assign credits pursuant to California Revenue and Taxation Code section 23663.

DISCLOSURES REGARDING THE PROPOSED ACTION

The Board Has Made the Following Initial Determinations:

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with California Government Code sections 17500, of Division 4: None.

Other nondiscretionary cost or savings imposed on local agencies: None.

Cost or savings in federal funding to the state: None.

NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The FTB has determined that the proposed regulations to California Revenue and Taxation Code section 23663 will not have a significant adverse economic impact on business. The proposed regulations will have no impact on a private person or non-corporate business. The proposed regulations apply only to corporations. Although the proposed regulations will impact corporations, the Board concludes that the adverse economic impact, including the ability of California businesses to compete with businesses in other states, will not be significant, especially as the proposed regulations provide clarity that does not currently exist in connection with the treatment of a defective election to assign credits pursuant to California Revenue and Taxation Code section 23663.

FTB RESPONSES TO DOF COMMENTS ON RESULTS OF THE STANDARDIZED REGULATORY IMPACT ANALYSIS

As required by California Government Code Section 11346.5(a)(10), the following contains Department of Finance (DOF) comments on the Standardized Regulatory Impact Assessment (SRIA) for this proposed rulemaking concerning four areas where possible revisions to the SRIA were identified, and the Board's responses to same.

DOF Comment 1. "First, the estimate of revenue losses must be calculated on the basis of all information to date, and include the impacts of corporations learning to use the flexibility in the proposed regulation. The current approach by the FTB to estimating an average rate removes outliers and assumes a high degree of learning will yield a declining impact. However, most revenue impacts are driven by a few large taxpayers, so discarding large observations, or indeed any observations, may severely underestimate the revenue loss from the proposed regulation. In addition, most corporations take a few years to learn how best to manage their tax liabilities given new regulations, and the revenue impact would likely grow, as shown in the last few years of data about reassignments. Given this data the SRIA must contain analysis of state revenue losses on the high side, for example, no adjustment to credit assignments involved and a rising annual rate based upon the most recent years of data."

Board's Response to DOF Comment 1. The SRIA has been revised to include additional information modifying the revenue impact discussion. In accordance with DOF guidance, the Board has revised its analysis in section 9.1.1 of the SRIA. The assignments on returns with defective credit assignments (table 5) now includes the few large observations previously listed as outliers. Additionally, based on data updated as of September 2017, table 5 now includes the credits claimed on returns with defective assignments, and a range

of values showing the credits which would be reverted if 25, 50, and 75 percent of these credits turn out to be defective. For tax years 2011-2014 the average, if all credits claimed on tax returns turn out to be defective, is \$26 million. Over the 25, 50, and 75 percent range these averages are \$6 million, \$13 million, and \$19 million. Therefore, going forward, as taxpayers learn to avoid making defective assignments, FTB estimates the level of defective assignments to be in the range of \$10 million to \$20 million per year, and the expected costs to the state from adopting these regulations would be \$6 million to \$14 million per year.

DOF Comment 2. "[T]he SRIA assumption that there are no investment or job creation benefits as a result of more flexible usage of tax credits runs contrary to the rationale for providing tax credits in the first place. The SRIA states proposed regulatory amendments do not affect prior investment decisions of taxpayers, but it does not acknowledge the new framework may positively affect taxpayers' future investment decisions which improve the California economy. While there may be unique circumstances for this regulation that would support this assumption, these circumstances must be explained in greater detail or an analysis of benefits must be included."

Board Response to DOF Comment 2. The SRIA has been revised to include further analysis on investment and job creation benefits in accordance with DOF guidance. The Board has revised its analysis in section 10.1 of the SRIA providing further qualitative exploration of the assumption, with supporting quantitative measures that are intended to help identify how the regulations could spur investment and job creation within the state, and result in a positive effect on the California economy. The impact to taxpayers suggested by the economic model, the impact on economic incentives in the near term, the impact to California, and the dynamic impact on the California economy are addressed in this section.

DOF comment 3. "[A] required element of SRIAs is analysis of alternatives to proposed regulations. The goal of alternatives analysis is to document the range of regulatory options considered and rationale behind tradeoffs made in the development of proposed regulations. The SRIA contains two smaller or less comprehensive regulatory alternatives, which is less helpful for identification of tradeoffs made in development of the regulations. FTB provides no quantification of economic impacts of these alternatives. As noted above, a lack of quantified benefits or costs limits ability to make well-informed evaluations of alternative and proposed regulations. To better highlight tradeoffs across alternatives, FTB must provide a quantitative assessment that includes a more comprehensive and a less comprehensive alternative to the proposed regulations."

Board Response to DOF Comment 3. The SRIA has been revised to include additional quantitative economic impact information for each alternative discussed. In accordance with DOF guidance, the Board has revised its analysis of the two alternatives in section 12 of the SRIA to provide a range for the economic impacts of each alternative under section 12.1

(for alternative 1) and section 12.2 (for alternative 2). This revised analysis provides additional information to the public that the Board used in generating its estimate of \$6 million to \$14 million expected costs to the state within the SRIA.

DOF comment 4. "[T]he SRIA must include the cost savings from fewer disputes for state government. It identifies that regulations will improve administrative efficiency for FTB, but claims no cost savings to the FTB as a result of this increased efficiency. An environment in which there is less contention for at least some audit findings of defective assignments of tax credits should lead to less time being spent disputing audits and reduced litigation associated with those disputes. These improved efficiencies in tax administration should result in cost savings to the FTB."

Board Response to DOF Comment 4. The SRIA has been revised to include additional information on the possibility of the Board experiencing cost savings from the adoption of these regulations. In accordance with DOF guidance, the Board modified the SRIA analysis in section 10.2 with additional information and a cost savings estimate. The Board estimates there would be administrative efficiencies from adopting these regulations which would free-up FTB resources which could be redirected to other revenue raising activities.

RESULTS OF THE STANDARDIZED REGULATORY IMPACT ANALYSIS

Creation or Elimination of Jobs within the State

The proposed regulatory action would neither create nor eliminate jobs in California. 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.

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 which allows the assignment of credits. In this regard, the proposed regulations deal with a small percentage of assignments and serve as a clarification of what happens to credits that are defectively assigned under the existing law. It is contemplated that corporate actions under the proposed regulations will be a nominal part of their current tax compliance and reporting activities.

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

corporations which typically assign credits are large corporations which do business in many states.

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. For these corporations, the SRIA notes that 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.

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. 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.

Benefits

Because of the backlog of credits, the initial loss to California could be as much as \$300 million. The ongoing revenue loss is expected to be in the range of \$6 million to \$14 million. Adoption of the proposed regulations would likely improve California's "business climate" as they provide certainty as to what happens to defectively assigned credits, but this effect 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.

COST IMPACTS ON REPRESENTATIVE PERSON OR BUSINESS

The proposed regulations will have no impact on a private person or non-corporate business. The proposed regulations apply only to corporations. Further, the proposed regulations will have no impact on most corporations as the proposed regulations will only apply to businesses that have multiple corporations in their combined reporting group. These corporations are typically large corporations that do business in a number of states. For these corporations, the proposed regulations will be a nominal portion of their overall tax reporting and compliance activities.

Therefore, the Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

SMALL BUSINESS DETERMINATION

The Board has determined that the proposed regulations do not affect small businesses as these regulations only apply to combined reporting groups that have multiple affiliated corporations. These corporations are typically large corporations that do business in multiple states.

CONSIDERATION OF ALTERNATIVES

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

The Board invites interested persons to present statements or arguments with respect to alternatives to the proposed regulations at the scheduled hearing or during the written comment period.

CONTACT PERSONS

Inquiries concerning the proposed administrative action may be directed to:

Ciro Immordino, Tax Counsel IV
Legal Division (MS A260)
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-4066
Email: ciro.immordino@ftb.ca.gov

Or

Richard Tay, Tax Counsel III
Legal Division (MS A260)
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-7917
Email: richard.tay@ftb.ca.gov

The backup contact person for these inquiries is:

Christy Keith
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-6080
Email: Christy.Keith@ftb.ca.gov

Please direct requests for copies of the proposed text (the "express terms") of the regulations, the initial statement of reasons, the modified text of the regulations, if any, or other information upon which the rulemaking is based to Ms. Keith at the above address or email address.

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

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

AVAILABILITY OF CHANGED OR MODIFIED TEXT

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

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

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

AVAILABILITY OF DOCUMENTS ON THE INTERNET

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