

**INITIAL STATEMENT OF REASONS
FOR THE PROMULGATION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18,
SECTION 17942**

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENTS, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

Revenue and Taxation Code (RTC) section 17942 was originally enacted in 1996 and is operative for taxable years beginning on or after January 1, 1997. Section 17942 provides the rules for determining the amount of the annual fee payable by Limited Liability Companies (LLCs) doing business in California. For tax years beginning on or after January 1, 2007, RTC section 17942 was amended to account only for "total income from all sources derived from or attributable to this state." There is no regulation under RTC section 17942 to explain how taxpayers should determine "total income from all sources derived from or attributable to this state" for purposes of calculating LLC fees. Subdivision (a) of RTC section 19503 provides that "[t]he Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with Section 17001)...."

SPECIFIC PURPOSE OF THE REGULATION

The purpose of the proposed regulation is to provide guidance to taxpayers on how to determine "total income from all sources derived or attributable to this state" for purposes of calculating LLC fees due under RTC section 19742. The regulation will achieve this purpose by providing definitions, guidelines and examples that will assist taxpayers in calculating the correct fees due under that section.

NECESSITY/PROBLEM THE REGULATION INTENDS TO ADDRESS

Prior to 2007, RTC section 17942 required LLCs doing business in this state to pay an annual fee determined by the amount of total income reportable to this state during a taxable year. The California Legislature amended RTC section 17942 in 2007 by changing the base for determination of the LLC fee from "total income reportable to this state" to "total income from all sources derived from or attributable to this state." The proposed regulation provides taxpayers with guidance to calculate the LLC fee based on the revised statutory base and a simplified method for determining the LLC fee.

The Franchise Tax Board looked to existing statutes addressing LLCs and used those as a model for the proposed regulation, adopting some definitions from other statutes and adding others that were needed for calculating the LLC fee but not contained in other statutes. The LLC statutes and regulations reviewed included RTC section 17941 (imposing a tax on LLCs) and the original enactment of RTC section 17942. After the amendment of RTC section 17942 in 2007, the Franchise Tax Board then held an Interested Parties Meeting on June 17, 2008. The Franchise Tax Board then modified the LLC Income Worksheet (FTB Form 568), to provide general guidance to taxpayers.

Proposed regulation section 17942 will provide guidance in four areas. First, it provides a simplified method for determining the LLC fee that allows an LLC to use its sales factor numerator, calculated for purposes of the Schedule K-1, as a means to determine "total income from all sources derived from or attributable to this state" under RTC section 17942. This method also allows taxpayers with sales factor numerators above \$5 million, who will pay the maximum fee regardless of the method of calculation, to avoid the costly and time-consuming process of determining total income from all sources derived from or attributable to this state. Second, the proposed regulation provides guidance on how taxpayers should treat multiple-tier LLCs, which occur when one LLC is the owner of another, or when an LLC receives income from a pass-through entity that itself is not subject to the fee. Third, the proposed regulation mandates that the sales factor methodology utilized by a taxpayer pursuant to an election under RTC section 25128.5, shall also apply for purposes of calculating the LLC fee. This mandate exists because the assignment of receipts to the California sales factor numerator for LLC fee purposes under RTC section 17942 is tied to RTC section 25135, relating to the sales of tangible personal property, and to RTC section 25136, relating to the sales of other than tangible personal property, which are affected by an election to use the single sales factor pursuant to RTC section 25128.5. Lastly, the proposed regulation provides guidance for sourcing income for LLC fee purposes when, pursuant to RTC sections 25135 and 25136, income is not sourced to any particular location for apportionment purposes.

Subsection (a) of the regulation restates the general rule that every LLC subject to California taxation must pay an annual fee determined by the "total income from all sources derived from or attributable to this state." This fee is in addition to the tax imposed on LLCs pursuant to RTC section 17941.

Subsection (b) defines "total income from all sources derived from or attributable to this state," and is a restatement of the rule outlined in RTC section 17942(b)(1)(A):

(b) "Total income from all sources derived from or attributable to this state" means gross income, as defined in Revenue and Taxation Code section 24271, plus the cost of goods sold that is paid in or incurred in connection with the trade or business of the taxpayer. This amount does not include, however, any allocation or attribution of income or gain or distributions made to the limited liability company in its capacity as a member or holder of an economic interest in another limited liability company, so long as the income of the limited liability company that earned the income was itself subject to the fee described in Revenue and Taxation Code section 17942.

Subsection (b) also provides an example of the application of the definition. The example illustrates the meaning of a taxpayer being "subject to" an LLC fee. In this case, the LLC in the example (LLC A) owns an interest in another LLC (LLC B), which has \$200,000 of total income from all sources derived from or attributable to California. The example concludes that because LLC B has income below \$250,000, it is not required to pay a fee. Furthermore, in determining the fee owed by LLC A, LLC A's distributive share of LLC B's income will not be included in LLC A's total income from all sources attributable to this state

for purposes of determining LLC A's fee because LLC B's income was "subject to" the LLC fee even though LLC B does not owe the fee.

Subsection (c) of the regulation explains that income and distributions received from pass-through entities, other than LLCs that are also subject to the fee, must be included in the base for calculating the LLC fee. These amounts include an LLC's distributive share of a pass-through entity's cost of goods sold. Subsection (c) further provides that items of income received from pass-through entities not subject to the LLC fee must be computed and assigned for purposes of the LLC fee, just like any item of income derived directly by the LLC. The subsection provides:

(c) "Items of total income from all sources derived from or attributable to this state that a limited liability company receives from pass-through entities, other than other limited liability companies that are themselves subject to the fee, must be computed and assigned for purposes of the limited liability company fee calculation. This means that a limited liability company's distributive share of items allocated to it by another pass-through entity that is not itself a limited liability company must be adjusted to include cost of goods sold, if applicable, in order to compute the correct amount of total income for fee purposes.

The example in subsection (c) illustrates how an LLC with a 50-percent interest in a partnership will be allocated not only 50 percent of the partnership's total income, it will also be allocated 50 percent of the partnership's cost of goods sold for LLC fee purposes.

Subsection (d) explains that to determine total income from all sources derived from or attributable to this state, the assignment rules of RTC sections 25135 and 25136 and the regulations thereunder, as modified by regulations under RTC section 25137, other than those provisions that exclude receipts from the sales factor, are to be utilized. Subsection (d)(1) explains that for LLC fee purposes, income derived from the passive holding of intangible property must be assigned to the location where the intangible property is managed. The example in subsection (d)(1) posits an Indiana LLC that holds a portfolio of bonds and employs a portfolio manager who is located in Nevada. Under the example, the interest income from the bonds will be assigned to Nevada for LLC fee purposes. This subsection is necessary because the rules contained in Regulation section 25137(c)(1)(C) may exclude these receipts and not assign them to a location; but in the context of the LLC fee, these receipts must be assigned to a location pursuant to RTC section 17942(b)(1)(B). By providing a clear rule, the fee calculation is made more certain, consistent with a comment made during the Interested Parties Meeting process.

Subsection (d)(2) provides that while an occasional sale may be excluded from the sales factor of the apportionment formula pursuant to Regulation section 25137, the receipts from occasional sales must assigned to a location be under the rules set forth RTC sections 25135 or 25136 for LLC fee purposes.. In addition, this subsection clarifies by example that if a taxpayer elects the single-factor sales apportionment methodology pursuant to RTC section 25128.5, then the taxpayer must apply the same assignment rules for purposes of calculating the LLC fee. This subsection is necessary because of RTC section

17942(b)(1)(B), which provides that the provisions of RTC section 25137 that exclude receipts from the sales factor, do not apply to the calculation of the LLC fee.

Subsection (d)(3) provides a rule that total income received from a pass-through entity, other than as provided in subsection (b) of the regulation, shall be assigned to the state where the partnership assigns the income on the Schedule K-1 provided to the LLC. This rule constitutes a catch-all provision for the assignment of receipts from pass-through entities that is easy to apply because it relies on information already provided to the holder of the interest, the Schedule K-1.

Subsection (e) explains that if an LLC conducts all of its business in California, then it may calculate its total income without regard to the above rules, as the same amount will result under either method.

Subsection (f) provides an alternative method for assigning total income from all sources derived from or attributable to this state. This alternative method has been included in response to comments made during the Interested Parties Meeting process that there should be a way to calculate the fee that does not require looking at each item of income individually, especially when it is clear that the LLC will easily exceed the \$5 million threshold for the imposition of the maximum LLC fee.

Subsection (f)(1) provides that if the LLC reports to its members a sales factor numerator over \$5 million, the Franchise Tax Board will accept that amount as a proxy for "total income from all sources derived from or attributable to this state" for LLC fee purposes because reporting any larger amount would have no impact on the LLC fee. The use of the sales factor numerator is reasonable because similar rules are used to assign each item of income for fee purposes to those used for apportionment purposes in calculating the sales factor numerator for California.

Subsection (f)(2) provides that if an LLC reports a sales factor numerator below \$5 million, it may still choose to use the alternative method. However, in calculating the LLC fee it must adjust the numerator by including all items of total income that were previously characterized as nonbusiness income for apportionment purposes (subsection (f)(2)(A)). In addition, the numerator must be adjusted to include all items of total income that were excluded from the sales factor entirely pursuant to regulations under RTC section 25137 (subsection (f)(2)(B).) Lastly, the numerator must be adjusted to remove all items of total income received from other LLCs that were subject to the LLC fee (subsection (f)(2)(C)), consistent with subsection (b) of this regulation.

These additions and subtractions are necessary to reconcile the differences between the apportionment scheme contained in RTC section 25120 – 25137 and the LLC fee rules contained in RTC section 17942.

While a determination that an item of income is nonbusiness impacts whether it is apportioned through the apportionment formula or allocated directly to a state, the distinction between business and nonbusiness income is not necessary in the LLC fee context because the entire methodology of determining income from all sources derived

from or attributable to this state involves direct allocation as opposed to apportionment. Therefore, receipts allocated using the nonbusiness rules of RTC sections 25124–25127 must be reassigned using the rules contained in RTC sections 25135 and 25136 and, if applicable, RTC section 25137 in accordance with RTC section 17942(b)(1)(B), notwithstanding their characterization as nonbusiness income.

Similarly, items that are not assigned to any state's numerator, but are removed from the apportionment formula entirely by operation of regulations promulgated under RTC section 25137, must be assigned under RTC section 17942(b)(1)(B).

Moreover, receipts that are included in the sales factor numerator but derived from or attributable to other limited liability companies that were subject to the limited liability company fee must be removed, consistent with subsection (b) of the proposed regulation and in accordance with RTC section 17942(b)(1)(A).

Subsection (f)(3) provides that if the sales factor numerator is over \$5 million, but included in that amount is income received from another LLC such that removal of the income will result in the sales factor numerator falling below \$5 million, the LLC may remove that amount and then make the adjustments described in subsections (f)(2)(A) and (B).

Finally, subsection (g) provides that the proposed regulation would be retroactive in application to January 1, 2012. Under RTC section 19503, subdivision (b)(1), no regulation relating to Part 10 (commencing with Section 17001) "shall apply to any taxable year ending before the date on which any notice substantially describing the expected contents of any regulation is issued to the public." The Franchise Tax Board issued notice substantially describing the expected contents for this regulation to the public during the Interested Parties Meeting on October 4, 2011. Accordingly, the Franchise Tax Board may prescribe that this regulation be applied retroactively to 2012 or thereafter.

BENEFITS OF THE REGULATION

Taxpayers will benefit from guidance in the proposed regulation, thus reducing the burdens and costs of calculating the LLC annual fee. Moreover, the rules outlined in the proposed regulation will result in fewer disputes arising from calculating the LLC fee, reducing taxpayers' time and costs to pursue such disputes. The Franchise Tax Board will also save resources through enhanced taxpayer compliance.

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

In drafting the proposed regulation, the Franchise Tax Board primarily relied upon RTC sections 17941 and 17942, as well as the legislative history of each, and suggestions from members of the public obtained throughout the course of three Interested Parties Meetings. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

The first Interested Parties Meeting, held on June 17, 2008, allowed the public an opportunity to raise issues to be addressed in the proposed regulation. The Discussion

Topics from that meeting provided a general background of the purpose behind the proposed regulation and potential issues that may arise with regard to it. After the first Interested Parties Meeting, staff drafted language for the proposed regulation based upon the amendments to RTC section 17942. A second Interested Parties Meeting was held on November 19, 2010, during which a draft of the proposed language was discussed with the public. The meeting was successful and the proposed regulation language was generally found acceptable.

Much of the public response concerned the treatment of nonbusiness income in determining total income from all sources derived from or attributable to this state. Staff explained that the distinction between business and nonbusiness income was not an issue because all income is required to be allocated, rather than apportioned, under the statutory language of subdivision (b) of section 17942. Each item of income is assigned either to California or another location for purposes of RTC section 17942. Another public concern involved the application of fees in tiered ownership structures involving multiple LLCs. This concern was addressed at the second Interested Parties Meeting and the public was satisfied with staff's responses.

The third Interested Parties Meeting was held on October 4, 2011, allowing the public a final opportunity to raise issues to be addressed in the proposed regulation and to discuss two issues raised subsequent to the second Interested Parties Meeting. One issue concerned whether cost of goods sold includes the tax basis of real property. The other issue concerned whether an LLC may make a single sales factor election while a member of a unitary group.

After the meeting, department staff considered the public comments and determined that, with regard to the tax basis of real property, the LLC Income Worksheet (FTB Form 568) should be amended to specifically exclude the basis of real property from the cost of goods sold for purposes of calculating the LLC fee. This change would occur starting with the 2012 taxable year. With regard to the single sales factor election, staff determined that allowing the LLC to make an independent election is beyond the authority of RTC section 25128.5.

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

In accordance with the requirement of Government Code section 11346.5, subdivision (a)(13), the Franchise Tax Board consider alternatives to the proposed regulation, staff of the Franchise Tax Board conducted three interested parties meetings, as described in the preceding paragraphs.

As a result, the Franchise Tax Board has determined that no alternative would be more effective in carrying out the purpose for which the action is proposed, or would be effective and less burdensome to the affected private persons, than the proposed regulatory action. In addition, the proposed regulation pertains to corporate taxpayers with operations in multiple states. As a result, it does not affect private persons or most small businesses.

ECONOMIC IMPACT ANALYSIS

The purpose of Revenue and Taxation Code section 17942 is to provide clarification and offer guidance to LLCs doing business in California and thus, those that are required to pay an annual fee, as to the proper methodology to be used in calculating such fee. Revenue and Taxation Code section 19503 authorizes the Franchise Tax Board to adopt a regulation as necessary for the enforcement of Part 10, which includes Revenue and Taxation Code section 17942.

The proposed regulation implements and makes specific Revenue and Taxation Code section 17492, relating to the calculation of the LLC fee. The purpose of the proposed regulation is to provide a simplified formula in determining the fee for LLCs paying the maximum fee, to provide guidance as to how to treat multiple LLCs within the same group, to mandate use of the same apportionment formula for both income and fees, and to provide guidance in how to assign otherwise unassigned income. LLCs will benefit from having direction on how to comply with the statute, thus reducing the burdens and costs associated with calculating the LLC annual fee. The Franchise Tax Board will save resources through enhanced taxpayer compliance. All parties will benefit from a reduction in the costs associated with administrative protests and refund claims.

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has made the following assessments regarding the proposed regulation:

Creation or Elimination of Jobs Within the State

Since the proposed regulation only clarifies the rules contained in Revenue and Taxation Code section 17942, there are no effects on the creation or elimination of jobs within the state. LLCs impacted by the regulation are already required to pay an annual fee.

Creation of New or Elimination of Existing Businesses Within the State

Since the proposed regulation only clarifies the rules contained in Revenue and Taxation Code section 17942, there will be no effect on the creation of new businesses or elimination of existing businesses within the state.

Expansion of Businesses or Elimination of Existing Businesses Within the State

Since the proposed regulation only clarifies the rules contained in Revenue and Taxation Code section 17942, there will be no effect on the expansion of businesses or the elimination of existing business within the state.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed regulation under RTC section 17942 will not have a significant adverse economic impact on business. The proposed regulation simply provides clarification of how to calculate the LLC fee under various factual scenarios.