

TITLE 18. FRANCHISE TAX BOARD

(Notice Published February 7, 2014)

NOTICE OF PROPOSED RULEMAKING

As required by Section 11346.4 of the Government Code, the Franchise Tax Board hereby gives notice of its intention to adopt California Code of Regulations, title 18, section 17942, pertaining to the limited liability company ("LLC") fee. There will not be a public hearing unless requested by an interested person at least 15 days before the close of the written comment period. Any request for a public hearing should be submitted to the agency officer named below. 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 request in writing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., March 27, 2014. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officers named below.

AUTHORITY & REFERENCE

Revenue and Taxation Code ("RTC") section 19503 authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001). Regulating under RTC section 17942 is necessary to provide guidance and examples for the proper application and implementation of RTC section 17942.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

LLCs doing business in California are required to pay an annual fee to the Franchise Tax Board based on the total amount of income attributable to California during the taxable year. In 2007, the requirement to pay an annual fee was amended to address concerns that the fee was based in part on income not attributable to California. The objective of this proposed regulation is to provide clarification and offer guidance to LLCs doing business in California, and thus, those that are required to pay the annual fee, as to the proper methodology to be used in calculating such fee.

Regulation section 17942, subsection (a) – General Rule

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.

Regulation section 17942, subsection (b) – Definitions

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 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 an LLC 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 because LLC B's income was "subject to" the LLC fee even though it does not owe the fee.

Regulation section 17942, subsection (c) – Treatment of Pass-through Entities

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 purposes of calculating the LLC fee.

Regulation section 17942, subsection (d) – Assignment Rules

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. However, 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.

Regulation section 17942, subsection (d)(2) – Occasional Sales and Single Sales Factor

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, for LLC fee purposes RTC sections 25135 and 25136 apply, and the occasional sale must be assigned pursuant to the rules contained therein. 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.

Regulation section 17942, subsection (d)(3) – Assignment of Pass-through Income

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.

Regulation section 17942, subsection (e) – Simplification Rule for Intrastate Businesses

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 assignment rules because the same amount of LLC fee will result under either method.

Regulation section 17942, subsection (f) – Alternative Method

Subsection (f) provides an alternative method for assigning total income from all sources derived from or attributable to this state. This alternative method is provided 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.

Regulation section 17942, subsection (f)(1) – Alternative Method for Sales Factor Over \$5 Million

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 purposes of calculating the LLC fee because reporting any larger amount will have no impact on the 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.

Regulation section 17942, subsection (f)(2) – Alternative Method for Sales Factor Under \$5 Million

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 also subject to the LLC fee (subsection (f)(2)(C)), consistent with subsection (b) of this regulation.

Regulation section 17942, subsection (g)

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.

Anticipated Benefits from the Proposed 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.

Consistency and Compatibility with Existing State Regulations

During the process of developing this regulation, the Franchise Tax Board, per Government Code section 11346.5(a)(3)(D), has conducted a search of any similar regulations on this topic and has concluded that this regulation is neither inconsistent nor incompatible with existing regulations.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agencies: None.

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

Other non-discretionary cost or savings imposed upon local agencies: None.

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

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost impact to directly affected private persons/businesses potential: The agency is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

Effect on small business: The department has made an initial determination that the adoption of the proposed regulation will not affect small businesses. The proposed regulation merely clarifies existing requirements imposed by RTC section 17942, and does not impose any additional requirements. The department does not expect the proposed regulation to have any impact on the number of small businesses, nor does it create additional reporting requirements for small businesses.

Significant effect on housing costs: None.

RESULTS OF THE ECONOMIC IMPACT ANALYSIS

Pursuant to Government Code section 11346.3, subdivision (b), the Franchise Tax Board has determined in the economic impact analysis that there are no effects on the creation or elimination of jobs in the state, no effect on the creation of new businesses or elimination or expansion of existing business with the state, and that the proposed Regulation section 17942 will benefit taxpayers by clarifying the rules for calculating the annual LLC fee.

Benefits of the regulation to the health and welfare of California residents, worker safety, and the state's environment: None. For additional information on benefits, please see "Anticipated Benefits" under the Informative Digest/Policy Statement Overview.

CONSIDERATION OF ALTERNATIVES

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

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The Franchise Tax Board has prepared an initial statement of reasons for the proposed regulatory action. The express terms of the proposed regulatory action, the initial statement of reasons for the regulatory action, and all the information upon which the proposed regulatory action is based are available upon request from the agency officer named below. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website at www.ftb.ca.gov.

CHANGE OR MODIFICATION OF ACTIONS

The regulations and amendments may also be adopted with modifications if the changes are non-substantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If a hearing is held, the hearing room will be accessible to persons with physical disabilities. The hearing room will be accessible to persons with physical disabilities. Any person who is in need of a language interpreter, including sign language, should contact the officer named below at least two weeks prior to any scheduled hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone: (916) 845-3306; Fax: (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. In addition, all questions on the application of Regulation section 17942 should be directed to Doug Barish; Telephone: (916) 845-7839 or E-Mail: Douglas.Barish@ftb.ca.gov. This notice, the initial statement of reasons and express terms of the proposed regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.