

## Background and Summary

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, such as 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.

Under RTC section 23663, subdivision (e), paragraph (4), the FTB is specifically authorized to issue necessary regulations to specify the treatment of any assignment that does not comply with the requirements of section 23663, including where the taxpayer and assignee are not members of the same combined reporting group on the dates required.

These proposed regulations start from the premise that under the statutory language in RTC section 23663, a defective election is invalid. 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 mandate 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 via a closing agreement 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.
2. Subsection (b) defines "affiliated corporation" using the same definition used in RTC section 23663(b)(1).
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.
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.
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.
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.
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. This determination is necessary because allocations under these

regulations first look to credits claimed in taxable years that are closed, because not taking such closed year claimed credits into account would result in credits being claimed more than once. 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.

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.

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.

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.

11. Subsection (k) defines the term "eligible assignee" using the same definition used in RTC section 23663(b)(3).

12. Subsection (l) defines "eligible credit" using the same definition used in RTC section 23663(b)(2).

13. Subsection (m) defines "FTB" to mean the Franchise Tax Board.

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.

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.

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 standard allocation rules are impacted by credits claimed in closed years by other assignees who are assigned the same type of credit. Beyond the standard allocation rules, this definition is also important in identifying which entities have to consent to allocations and corrections under these regulations. For example, Regulation 23663-4 allows, under limited circumstances, corrections of errors, which may result in the assignee listed on a defective assignment no longer receiving a credit, so requiring consent of all affected parties is necessary before the FTB will make an allocation pursuant to a such a request.

## 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.

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.

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.

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)(3) 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)(6) 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.

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.

## 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.

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) 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.

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.

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. 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)(1) 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)(1). 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.

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.

## 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.

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.

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.

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.

First, 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. Second, 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.

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 special election is intended to allow taxpayers to correct defective assignments made in years prior to the promulgation of these regulations to come forward to correct all defective assignments without limitation on the number of requests or the type of defect.

## 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.

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.

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.

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.

5. Subsection (e) provides a series of additional rules that apply to Regulations 23663-2 through 23663-5. 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)(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 rule also gives 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.

Subsection (e)(2)(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)(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.

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. This rule is based on the statute's requirements that an assignment be irrevocable and be made on an original tax return, and 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. In this regard, allowing assignors to make multiple adjustments to a single defective assignment would also give the parties to the defective assignment no certainty as to the finality of these adjustments.

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 rule 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 and what the ultimate allocation of credits would be. Accordingly, under subsection (e)(2) and other provisions of these regulations 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.

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.

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.

Four examples are provided to illustrate some of the above rules.

6. 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.

7. 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)(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)(3) clarifies that the variables discussed in the various examples within the regulations are the focus of the examples, and that it is not intended by the FTB that information omitted from a particular example may be relied upon in any manner as supporting 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.