

TITLE 18. FRANCHISE TAX BOARD
(Notice published September 13, 2024)

NOTICE OF PROPOSED RULEMAKING

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

PUBLIC HEARING

The Board has not scheduled a public hearing on this proposed action. However, the Board will hold a hearing if it receives a written request for a public hearing from any interested person, or their authorized representative, no later than 15 days before the close of the written comment period indicated below. The request should be submitted to the FTB officer named below. In addition, Government Code section 15702, subdivision (b) provides for consideration by the Board, itself, of any proposed regulatory action if any person makes such request in writing.

WRITTEN COMMENT PERIOD

Any interested person, or their authorized representative, may submit written comments relevant to the proposed regulatory action to the Board. The written comment period closes at **5:00 p.m. on October 31, 2024**. The Board will consider only comments received at the Board offices by that time. The Board encourages submission of comments in electronic form, rather than in paper form. Comments may be submitted by email to hanna.cho@ftb.ca.gov.

Comments in paper form may be submitted to:

Hanna Cho, Attorney
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Fax: (916) 855-5786

AUTHORITY & REFERENCE

California Revenue and Taxation Code section ("RTC") 19503 authorizes the Board to amend the proposed regulation. The proposed regulation implements and interprets, the provisions in RTC 25136 which the Board has specific statutory authority to prescribe regulations for carrying out the purposes of under RTC 25136(b).

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

This rulemaking action amends existing regulations for the assignment of sales under RTC 25136 which assigns sales, other than sales of tangible personal property, for purposes of apportioning business income.

Summary of Existing Laws and Effect of the Proposed Action:

RTC 25136, and California Code of Regulations, title 18, section (Regulation) 25136-2 apply to taxpayers that conduct business within and without California and sell something other than tangible personal property. The statute and regulation refer to such sales as: “sales, other than sales of tangible personal property.” The net income of such taxpayers includes both business income and non-business income. The amount of business income treated as California source income is determined by apportionment formula. For most taxpayers, the apportionment formula is based entirely on sales. Regulation 25136-2 provides rules for determining the correct amount of sales to be included in the sales factor numerator for sales, other than sales of tangible personal property, which includes: sales from services; sales from intangible property; sales from the sale, lease, rental, or license of real property; and sales from the rental, lease, or license of tangible personal property.

In the course of administering Regulation 25136-2 and since its initial promulgation in 2012 and subsequent amendment in 2016, FTB staff has learned that simplifying the rules, and creating specific rules for certain industries, is in the interests of both taxpayers and the department as it increases both compliance and administrability.

The regulatory amendment project seeks to improve compliance and administrability both through simplification of rules for assignment of sales and through creating specific rules for certain industries.

The proposed amendments to Regulation 25163-2, subsection (b) provide definitions to key terms used throughout the regulation. Subsection (c) clarifies existing rules of assignment for sales of services and adds new provisions for specific service industries. Subsection (d) provides clarifying amendments and examples for sales of intangible property. Subsection (e) provides new rules for sales that are a blend of services and intangible property. Subsection (f) provides, as amended, rules for the sales of marketable securities that have been clarified from the current rules. Subsections (g) and (h) as amended are existing provisions that have been re-lettered. Subsection (i) as amended provides clarification on existing key terms. Subsection (j) provides an applicability date for the proposed amendments.

Broad Objectives and Specific Benefits of the Proposed Action:

The broad objective of the proposed rulemaking action is to ensure that taxpayers, their representatives, and the state of California have more clarity in determining the correct amount of tax. The clarity from the proposed regulatory action will reduce uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California.

The proposed action will benefit taxpayers, tax practitioners, and the state of California by providing clarity that does not currently exist for determining the correct amount of sales to be included in the sales factor numerator for sales, other than sales of tangible personal property. These benefits are the result of goals developed by the Board with input from interested parties and based on broad authority provided to the Board by RTC 25136(b).

Consistency and Compatibility with Existing State Regulations:

During the process of developing this regulation, the FTB, pursuant to Government Code Section 11346.5, subdivision (a)(3)(D), conducted a search of any similar state regulations and has concluded that this regulation is neither inconsistent nor incompatible with any existing state regulations.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

The Board has made the following initial determinations:

Mandate on local agencies and school districts: None

Cost or savings to any state agency: Because this is a clarification for Regulation 25136-2, the FTB believes that proposed changes would have a nominal impact on state operations and could result in an insignificant cost savings.

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

Effect on Housing Costs: None

Significant Statewide Adverse Economic Impact Directly Affecting Business, Including the Ability of California Businesses to Compete with Businesses in Other States: Based on the FTB's economic analysis of the proposed regulations, the FTB concludes that the impact on business, including the ability to compete, will not be significant or adverse.

The proposed amendments to Regulation 25136-2 are not expected to have any noteworthy adverse economic impact on California businesses. The proposed changes are expected to provide clarity to businesses with sales, other than sales of tangible personal property. Since

this regulation is currently in place, the amendments to this regulation may cause some initial short-term administrative adjustments for some taxpayers. However, in the long-term the proposed amendments would have the benefit of reducing confusion for taxpayers and tax practitioners currently applying this regulation to assign sales, other than sales of tangible personal property, that cross state lines. It is possible that for some taxpayers the improved clarity from the amendments for this regulation may result in changes in the amount of tax liability reported. These changes may be increases or decreases but are expected to be within the boundaries provided in the Standardized Regulatory Impact Assessment ("SRIA") for this proposed rulemaking.

SUMMARY OF DEPARTMENT OF FINANCE COMMENTS AND FTB RESPONSES TO DOF COMMENTS ON RESULTS OF THE STANDARDIZED REGULATORY IMPACT ASSESSMENT

As required by California Government Code section 11346.5(a)(10), the following contains a summary of Department of Finance ("DOF") comments on the SRIA for this proposed rulemaking concerning two areas where possible modifications to the SRIA were identified, and the FTB's response to same.

DOF Comment 1. "First, the SRIA must include two regulatory alternatives to the proposed regulation, not including the status quo in the absence of the regulation. While the public discussions did not yield any proposed alternatives, the SRIA must nonetheless provide a second alternative (along with the listed alternative that would nest the additional professional services rules within the existing regulation), such as implementing the proposed rules for professional services but not for financial services."

FTB's Response to DOF Comment 1. The SRIA has been revised to include an alternative to the proposed regulation considered other than the status quo.

DOF Comment 2. "Second, the SRIA must explain if and why this proposed regulation is not expected to have disparate impacts on different socioeconomic, geographic, age-specific, or ethnic populations."

FTB's Response to DOF Comment 2. The SRIA has been revised to include a new section titled "Benefits to the Health, Safety, and Welfare of California Residents, Worker Safety, and the State's Environment and Quality of Life" explaining why the regulation is not expected to have disparate impacts on different socioeconomic, geographic, age-specific, or ethnic populations.

RESULTS OF THE STANDARDIZED REGULATORY IMPACT ASSESSMENT

Creation or Elimination of Jobs within the State

The proposed amendments may lead to the creation or elimination of a few hundred jobs within the State. The proposed amendments to this regulation are intended to provide clarity on how to assign sales, other than sales of tangible personal property. These clarifications could result in some taxpayers changing their method for assigning these sales which could,

in turn, change the amount of taxes paid by some taxpayers. Because taxpayers do not currently report the method used to source sales, other than sales of tangible personal property, for the proposed changes to Regulation 25136-2, the FTB cannot determine whether the net impact of these changes will be an increase, decrease, or no change in state tax revenue. Any increase in taxes paid to California by affected taxpayers could result in the creation of new state government jobs or in private sector jobs funded through state programs. Any decrease in taxes paid to California could result in the elimination of existing government jobs or private sector jobs funded through state programs. It is also possible that there could be no net change in state revenue and thus no change in jobs. Any increase or decrease in state spending from the proposed amendments would also produce a corresponding increase or decrease in general economic activity that would increase or decrease the number of jobs in the state. The FTB estimates the impact of changes in economic activity resulting from changes in tax payments could range from the creation of up to 462 jobs to an elimination of up to 469 part-time and full-time jobs. The actual change in the number of jobs would likely be within the boundaries provided in the SRIA.

Creation of New Businesses or Elimination of Existing Businesses within the State

The proposed amendments to this regulation are intended to provide clarity on how to assign sales, other than sales of tangible personal property. The proposed changes may result in the creation or elimination of businesses within the state in the first year of implementation. Because taxpayers do not currently report the method used to source sales other than sales tangible personal property, the FTB cannot determine whether the proposed changes to the regulation will result in an increase, decrease, or no change in tax liability for affected taxpayers. To the extent that there is an increase, decrease, or no change in state tax revenues it is possible that the resulting changes in state spending could change the overall level of economic activity in the state, which could impact a small number of businesses doing business in this state but would likely be within the boundaries provided in the SRIA.

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

The proposed amendments to Regulation 25136-2 could result in changes to the income tax liability of some businesses currently doing business within this State. An increase (decrease) in tax liability for any one business could create a disadvantage (advantage) for that business and a corresponding advantage (disadvantage) for its competitors currently doing business in the state. While there could be some shifting of business between firms, there should, in aggregate, be little to no impact on the competitiveness of this industry in the state.

Increase or Decrease of Investment in the State

This regulation does not mandate, require, or provide incentives for additional business investment in the state. The proposed regulation is intended to provide clarity on how to assign sales, other than sales of tangible personal property. Any resulting increase (decrease) in state revenue could result in an expansion (contraction) in state spending and

an increase (decrease) in the overall size of the state economy, some of which would be in the form of increased (decreased) investment.

Incentives for Innovation in Products, Materials, or Processes

This regulation does not mandate, require, or provide incentives for additional innovation in products, materials, or processes. The proposed regulation is intended to provide clarity on how to assign sales, other than sales of tangible personal property. Any resulting increase (decrease) in state revenue could result in an expansion (contraction) in state spending on innovations. Any changes in spending for innovation would be consistent with the Governor's budgetary priorities.

Benefits to the Health, Safety, and Welfare of California Residents, Worker Safety, and the State's Environment and Quality of Life

The proposed amendments to this regulation are not expected to have an impact on the health, safety and welfare of California residents, worker safety, and the state's environment and quality of life. The proposed amendments to this regulation seek to clarify the sourcing rules for sales, other than sales of tangible personal property and could result in an increase, a decrease, or no change in state revenues. However, due to the limited nature of the proposed amendments, they are not expected to have any disparate impacts on different socioeconomic, geographic, age-specific, or ethnic populations nor are they expected to impact any other populations.

Benefits

Adoption of the proposed amendments to Regulation 25136-2 for the sourcing of sales, other than sales of tangible personal property, would provide clarity to taxpayers and tax practitioners on how to assign sales, other than sales of tangible personal property. This is expected to resolve any confusion taxpayers and tax practitioners have with the current regulation. However, these effects cannot be quantified.

Cost Impacts on a Representative Private Person or Business:

Regulation 25136-2 is the default rule for apportionment of sales and any taxpayer who does business both within and without California would be an apportioning corporation, pass-through entity, or sole proprietorship. The proposed amendments to this regulation are intended to provide clarity on how to assign sales, other than sales of tangible personal property. As such, the FTB believes that any additional cost impacts on a representative private person or business from the clarifications in this regulation would be de minimis.

Effect on Small Business:

The FTB has determined that the proposed regulation would primarily affect large corporations, but some small businesses with services sourced both within and without California could be affected by the regulation. Because sourcing methodology currently used

by the taxpayer is not reported on their tax return, the amount of tax change from the proposed regulation is unknown, however the FTB expects any change in the tax liability of a small business to be minor.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code Section 11346.5, subdivision (a)(13), the Board must determine that no reasonable alternative it considered or that has otherwise been identified and brought to its attention 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 than the proposed action, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provision of law.

The Board invites interested persons to present statements or arguments with respect to alternatives to the proposed regulatory action during the written comment period or if a hearing is requested at the scheduled hearing.

CONTACT PERSONS

Inquiries concerning the proposed regulatory action may be directed to:

Hanna Cho – Attorney
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-7298
Email: Hanna.Cho@ftb.ca.gov

The backup contact person for these inquiries is:

Jayson Gottman
Legal Division MS A260
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P.O. Box 1720
Rancho Cordova, CA 95741-1720
Telephone: (916) 845-4576
Email: Jay.Gottman@ftb.ca.gov

Please direct requests for copies of the proposed text (the "express terms") of the regulations, the initial statement of reasons, the modified text of the regulations, if any, or other information upon which the rulemaking is based to Mr. Gottman at the above address or send the request by email to Jay.Gottman@ftb.ca.gov.

AVAILABILITY OF DOCUMENTS

Availability of Statement of Reasons, Text of Proposed Regulation, and Rulemaking File

The Board will have the entire rulemaking file available for inspection and copying throughout the rulemaking process at its office at the above address. As of the date this notice is published in the Notice Register, the rulemaking file consists of this notice, the proposed text of the regulations, and the Initial Statement of Reasons. Copies can be obtained on the Board's [website](#) at www.ftb.ca.gov or by contacting Mr. Gottman at the address, phone number or email address listed above.

Availability of Changed or Modified Text

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

Availability of the Final Statement of Reasons

Upon its completion, copies of the Final Statement of Reasons will be published on the Board's [website](#) at www.ftb.ca.gov and may also be obtained by contacting Mr. Gottman using the contact information provided above.

Availability of Documents on the Internet

Copies of this Notice of Proposed Action, the Initial Statement of Reasons, and the proposed text of the regulations can be accessed through the Board's [website](#) at www.ftb.ca.gov.