

California Apportionment and Allocation of Partnership Income – Proposed FTB Amendments

Overview

On December 18, 2017, the California Franchise Tax Board (“FTB”) held a hearing to discuss the December-issued Draft Language (“December Draft Language”) proposing amendments to California Code of Regulations, Title 18, (“CCR”) Sections 17951-4 and 25137-1.¹ On February 15, 2018, the FTB issued a 15 Day Notice (“15 Day Draft Language”),² indicating that the FTB made one substantive and various non-substantive changes to the previously issued December Draft Language. Specifically, the FTB deleted its prior proposed amendment to CCR Section 17951-4(d)(1) which had stated that California Revenue and Taxation Code (“CRTC”) Section 17952 did not apply in determining the source of income allocated to a non-resident taxpayer by a partnership.³

The FTB also announced that written comments will be accepted until 5 p.m. on March 5, 2018, for modifications made to the FTB’s proposed amendments to CCR Sections 17951-4 and 25137-1, related to apportionment and allocation of partnership income. The FTB requested that comments be limited to the proposed substantive change made to CCR Section 17951-4(d) in the 15 Day Draft Language.⁴

This tax alert summarizes the notable amendments proposed to CCR Sections 17951-4 and 25137-1 in both the December Draft Language and the subsequent 15 Day Draft Language, as well as provides some taxpayer considerations.

Background

Generally, CCR Section 17951-4 addresses sourcing of income from a business, trade, or profession (including income from partnerships) for non-resident or part-year residents of California.⁵ CCR Section 25137-1 addresses the apportionment and allocation of partnership income.⁶

In the FTB’s 15 Day Draft Language, the FTB stated that the proposed amendments to CCR Section 25137-1 and 17951-4 seek to provide the following:

- Confirmation that the apportionment rules for partnerships in which an interest is held by an apportioning corporation also apply to tiered partnerships.
- Determination of whether the distributive share of income from a non-unitary partnership is treated as apportionable business income or allocable non-business income is based on the activities of the non-unitary partnership.
- Establish rules for eliminating sales between a unitary partnership and any member of the partner’s combined reporting group.

¹ FTB Notice of Proposed Rulemaking (Nov. 3, 2017, available [here](#)); FTB December Draft Language, Proposed Regulations Sections 25137-1 and 17951-4 (Dec. 18, 2017, available [here](#)).

² FTB 15 Day Notice (Feb. 15, 2018, available [here](#)); FTB 15 Day Draft Text for 15 Day Notice, Proposed Regulations Sections 25137-1 and 17951-4 (Feb. 15, 2018, available [here](#)).

³ *Id.*

⁴ FTB 15 Day Notice, p.3

⁵ See Cal. Code Regs. tit. 18, § 17951-4

⁶ See Cal. Code Regs. tit. 18, § 25137-1

External Multistate Tax Alert

- Establish rules for unitary partnerships that engage in long-term construction contracts.⁷
- Establish rules for determining the income sourced to California when a partnership and a non-resident partner are unitary with one another.⁸

The FTB also has proposed amending the definition of “partnership interest” under CCR Section 25137-1(f)(4) to clarify that a taxpayer’s partnership interest for purposes of computing a taxpayer’s apportionment factors shall be “determined by the taxpayer’s interest in the partnership” which is “determined by reference to its interest in profits of the partnership.”⁹

Application of 25137-1(a) to Tiered Partnerships

CCR Section 25137-1(a) provides the general rules for determining whether a corporation’s distributive share of partnership income is sourced to California where a corporation has an interest in a partnership and either the corporation or the partnership (or both) have income from sources within and without California.¹⁰ The December Draft Language seeks to clarify that CCR Section 25137-1 applies not only to partnership interests held directly by corporations, but also to lower-tier partnerships that are held indirectly by corporations. Specifically, the FTB added the following language to CCR Section 25137(a), “[t]he same principle applies when a taxpayer has an interest in a partnership that itself owns an interest, directly or indirectly, in one or more other partnerships.” This proposed revision is retained in the 15 Day Draft Language.

Determination of Distributive Share of Income from Non-Unitary Partnerships

Pursuant to CCR Section 25137-1(g), if a partnership and its corporate partner are not engaged in a unitary business (disregarding ownership requirements), the distributive share of income allocated to the corporate partner is treated as income from a separate trade or business.¹¹ To accompany the December Draft Language, the FTB issued its Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Sections 25137-1 and 17951-4 (“Initial Statement of Reasons”). In the FTB’s Initial Statement of Reasons, the FTB stated that “despite this explicit rule, some taxpayers have asserted that in accordance with [CRTC Section] 23040, which addresses sourcing income to California from intangible property, the income allocated must be treated as nonbusiness income because a partnership interest qualifies as intangible property.”¹² As a result, the FTB proposed amending CCR Section 25137-1(a) to clarify that the determination of whether the distributive share of income from non-unitary partnerships is treated as apportionable business income or allocable non-business income is made at the partnership level based on the partnership’s trade or business activities, and not CRTC Section 23040.¹³ This proposed revision is retained in the 15 Day Draft Language.

Elimination of Intercompany Sales between Partnerships and other Members of Combined Group

Generally, sales between members of a combined group are not reflected in the combined reporting group’s sales factor because such sales have no economic impact outside the combined reporting group and do not generate income.¹⁴ The original version of CCR Section 25137-1 did not explicitly provide that sales between a unitary partnership and other members of the taxpayer’s combined reporting group should not be reflected in the combined group’s sales factor.¹⁵ In the December Draft Language, the FTB proposed amending CCR Section 25137-1 to explicitly provide that such sales should be eliminated from the combined group’s sales factor.¹⁶ The proposed revision is retained in the 15 Day Draft Language.

CCR 17951-4(d) and 25137-1 Applicable to Partners and Partnerships Engaged in a Unitary Enterprise

CCR Section 17951-4(d) provides that “if a nonresident [individual] is a partner in a partnership that carries on a unitary business, trade or profession within and without this state,” then the “total business income of the

⁷ In the FTB’s Initial Statement of Reasons for the Amendment of California Code of Regulations, Title 18, Sections 25137-1 and 17951-4 (page 2) (available [here](#)) (“Initial Statement of Reasons”) and its 15 Day Draft Language (page 10), the FTB deletes the provisions relating to long-term contracts and instead provides that CCR Section 25137-2 applies to long-term contracts.

⁸ FTB 15 Day Notice, p.1.

⁹ FTB Initial Statement of Reasons, p.2; FTB 15 Day Draft Language, p.8.

¹⁰ Cal. Code Regs., tit. 18, § 25137-1(a).

¹¹ Cal. Code Regs., tit. 18, § 25137-1(g).

¹² FTB Initial Statement of Reasons, p.1.

¹³ *Id.*; FTB 15 Day Draft Language, p.1.

¹⁴ FTB Initial Statement of Reasons, p.2.

¹⁵ *Id.*

¹⁶ FTB 15 Day Draft Language, p.5.

External Multistate Tax Alert

partnership shall be apportioned at the partnership level” under CRTC Sections 25120 to 25139. However, CRTC Section 17952 provides that income for nonresidents from intangible personal property is not California source income absent a business situs in California.

In its Initial Statement of Reasons, the FTB stated that “[s]ome taxpayers have asserted that an interest in a partnership that conducts business within and without California comes under the purview of [CRTC Section] 17952.”¹⁷ To clarify that CRTC Section 17952 did not apply, the FTB, in the December Draft Language, originally included a statement in CCR Section 17951-4(d) that “[CRTC Section] 17952 is not applicable in determining the source of income allocated to the nonresident taxpayer by the partnership.”¹⁸ After initial public comments were received, the FTB has deleted this language in the 15 Day Draft Language.¹⁹

In the December Draft Language, the FTB also proposed amending Regulation Section 17951-4(d) to state that “[i]f the partnership and the business activity of the partner are part of one unitary business, then the rules of [Regulation Section 25137-1(f)] apply and the apportionment of the partnership business income is done at the partner level for the unitary partner or partners.”²⁰ This proposed revision is retained in the 15 Day Draft Language.

Considerations

Taxpayers with ownership interests in tiered partnership structures, including those that sell a partnership interest, should consult their tax practitioners to evaluate how the FTB’s proposed amendments to CCR Sections 25137-1 and 17951-4 may impact their businesses and whether the submission of written comments to the FTB merits consideration. The FTB must receive any comments by 5 p.m. on March 5, 2018. The FTB will review and respond to written comments as part of the compilation of the rulemaking file.²¹

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¹⁷ FTB Initial Statement of Reasons, p.3.

¹⁸ *Id.*; 15 Day Draft Language, p.18.

¹⁹ FTB 15 Day Notice, p.2; FTB 15 Day Draft Language, p.18.

²⁰ FTB 15 Day Draft Language, p.18.

²¹ FTB 15 Day Notice, p.3.

External Multistate Tax Alert

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