

California – Proposed amendments to partnership income treatment

October 25, 2013

In brief

On October 18, 2013, the Franchise Tax Board (FTB) held an Interested Parties Meeting (IPM) to discuss potential amendments to California Code of Regulations (CCR) Section 25137-1, which provides guidance on apportioning and allocating a corporate partner's distributive share of partnership income. The FTB indicated that changes are intended to apply prospectively with no inference regarding prior year treatment.

Proposed changes to CCR Section 25137-1 include clarifying language on the treatment of distributive items from partnerships, eliminating intercompany sales between a partnership and any member of the partner's unitary combined reporting group, and providing guidance for applying the 20% safe-harbor rule in tiered partnership structures.

Because the regulatory project is in its initial stages, the FTB is receptive to additional public input. Interested taxpayers should consider getting involved and providing input in the regulatory process.

In detail

CCR Section 25137-1 provides rules on how taxpayers must apportion and allocate their distributive shares of partnership items. FTB staff identified 9 issues for discussion. As a key initial matter, the FTB indicated that amendments to the regulation would be applied on a prospective basis and would include a caveat that no prior year inference is intended. Possible amendments discussed during the meeting include:

1. Business income from a non-unitary partnership is to be treated as income from a separate trade or business

(with apportionment based on the partnership's apportionment). The classification as business or nonbusiness income depends on how such income would be properly treated by the partnership. The FTB believes that the regulation already provides for this treatment, but seeks to clarify the language because taxpayers sometimes attempt to characterize such distributive items as nonbusiness income to the partner.

2. Income that is nonbusiness income at the partnership level should be reclassified as

business income at the partner level if the asset would have produced business income had the partner owned the asset directly. The current version of CCR Section 25137-1 does not include this language.

3. Eliminating intercompany sales between a partnership and any member of the partner's unitary combined reporting group. Under the current language of CCR Section 25137-1(f)(3), partners are required to eliminate sales between a

partnership and its partner(s). Controversies have arisen regarding whether sales between the partnership and non-partner members of the partner's unitary combined reporting group should also be eliminated. Moreover, the FTB issued an FTB Notice specifying that structuring to create sales to non-partner members solely for the purpose of increasing the sales factor denominator is a listed transaction (see FTB Notice 2011-01).

4. Including a definition for determining a percentage of 'partnership interest' for the purpose of assigning a partnership's property, payroll, and sales to a unitary partner. The FTB is considering alternative definitions based on a partner's capital interest, profits interest, loss interest, or an average of the annual distributive share.
5. Deleting the current regulatory language that attempts to match partnership accounting periods to the partner. The purpose of the change is the recognition that federal accounting periods should be appropriate in most cases. In cases where federal accounting
- periods do not match the partner's accounting period, then CCR Section 25137 can be used to cure any distortion that may result.
6. Deleting the portion of the regulation discussing long-term contracts since such treatment is currently present in CCR Section 25137-2.
7. Including specific language confirming that partnership apportionment should be treated in the same manner for both corporate and individual taxpayers.
8. Providing guidance for applying the safe-harbor rule under CCR Section 17951-4 in tiered partnership structures. Currently, CCR Section 17951-4 provides a safe harbor exception from unitary combination for partnerships owned less than 20%. The FTB noted that there have been issues regarding how this rule applied in tiered partnership situations and believes that the 20% test should be applied in the aggregate, and should include indirect interests owned through tiered partnerships as well.
9. Replacing the term 'taxpayer' with the term 'partner' when

appropriate. The FTB is seeking to address the concern that partnerships are not 'taxpayers,' which can lead to questions about how the partnership rules apply in tiered structures when a partner is another partnership.

The FTB plans to circulate draft regulation amendments by the end of the calendar year and will notice another IPM in January or February.

The takeaway

Many of the proposals addressed in this project are in response to controversies in this area. California taxpayers with potential or ongoing FTB controversies with respect to partnership interests should pay special attention to the FTB's proposed amendments to CCR Section 25137-1, and related comments, for insight on the FTB's position on the issues. Additionally, due to the fact that the regulatory project is in its initial stages, the FTB is receptive to additional public input. Interested taxpayers should consider getting involved and providing input in the regulatory process.

Let's talk

If you have any questions or would like to provide any input in this regulatory process please contact one of the following individuals:

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