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CALIFORNIA SOURCE NET OPERATING LOSSES: A PROPOSAL FOR ELIMINATING INEQUITY IN COMBINED REPORTING BY PROVIDING TAXPAYERS IN A COMBINED REPORTING GROUP WITH AN OPTION TO ASSIGN CALIFORNIA SOURCE NET OPERATING LOSSES TO OTHER MEMBERS IN THE SAME COMBINED REPORTING GROUP

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[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.

EXECUTIVE SUMMARY

The issue is straightforward – the existing provisions within California's combined reporting regulations regarding the utilization of California source net operating losses generated by taxpayer members of a combined reporting group results in the incongruent tax treatment of taxpayers required to use combined reporting compared to taxpayers that use separate accounting. In addition, with respect to the application of California source net operating losses, the existing provisions within California's combined reporting regulations are inconsistent with California's rules regarding the utilization of most tax credits generated by taxpayer members of a combined reporting group.

Under the existing provisions, a taxpayer member of a California combined reporting group may only reduce its own post-apportioned California source income with a net operating loss the taxpayer member incurred in a prior year. Consequently, a California source net operating loss, which is calculated by aggregating the profits and losses of all members of the California combined reporting group, may not be shared with another taxpayer member of the same combined reporting group to offset or reduce the other taxpayer member's portion of California source business income attributed to the combined reporting group.

In 1999, the California Franchise Tax Board adopted the combined reporting regulations in accordance with California's tax laws at the time. Since then, there have been significant changes and developments to the state taxation of combined reporting groups and the calculation of the California apportionment factor, which impacts the effect of California's combined reporting regulations. As a result, certain provisions within California's existing combined reporting regulations have been operating in a manner that results in the disparate treatment of California source net operating losses (compared to other tax attributes generated by members of a combined reporting group), to the detriment of the individual taxpayer that generated the California source net operating loss as well as the other taxpayer members within the same combined reporting group.

This paper proposes that the Franchise Tax Board amend subsections(c)(1)(C) and (e) of California Code of Regulations Section 25106.5 to provide taxpayer members of a combined reporting group with an option to assign California source net operating losses generated while a member of a combined reporting group to other taxpayer members within the same combined reporting group. Enacting this change would parallel how California currently treats most tax credits generated by taxpayer members of a combined reporting group. As such, providing an option to assign California source net operating losses to other taxpayer members of a combined reporting group resolves the incongruent tax treatment between taxpayers required to use combined reporting and those that use separate accounting, while also resolving the disparate treatment between most tax credits and general business net operating losses generated by taxpayer members of a combined reporting group.

DISCUSSION

I. APPLICABLE LAW

A. Overview of Combined Reporting

California Revenue and Taxation Code ("R&TC") Section 23151 imposes a corporate franchise tax on the net income of every corporation doing business in California.[3]

For corporations that derive income from sources both within and without California, R&TC Section 25101 provides that the corporate franchise tax is measured by net income derived from or attributable to California sources. [4] Generally, corporations conducting business in multiple states, including California, determine the portion of their total net income attributable to California based on an apportionment formula that relies on one or more factors (i.e., sales, property, and payroll).

In the case of two or more corporations that are members of a commonly controlled group and are engaged in a "unitary business" within and without California, are required to use a California combined report to determine their California source income subject to tax under R&TC Section 25101.[5] The corporate franchise tax is measured in the same manner for

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[3] Cal. Rev. & Tax. Code § 23151.

[4] Cal. Rev. & Tax. Code § 25101 (stating that "When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120).").

[5] Cal. Rev. & Tax. Code § 25105 (Generally, a commonly controlled group exists when stock possessing more than 50% of the voting power is owned, or constructively owned, by a common parent corporation (or chains of corporations connected through the common parent) or by members of the same family. A

unitary business groups as it is for a non-unitary single corporations (i.e., measured by net income derived from or attributable to California sources).[6] The only distinction arises when determining the portion of a unitary business's total income attributable to California sources because California utilizes the unitary business principle.[7]

The unitary business principle is premised on the notion that a common business activity conducted by a commonly owned or controlled group of corporations is considered to be a single trade or business. [8] In a nutshell, the unitary business principle recognizes that for tax purposes, a company can be an integral part of a larger unitary system, and thus, the use of "separate accounting is inadequate and unsatisfactory when ascertaining the true result (i.e., business income) of the activities and values attributable to that business."[9]

In general, California considers a group of commonly controlled corporations to be engaged in a single trade or business (a "unitary business") if there is evidence to indicate that the corporations' activities within and without California are integrated with, dependent upon, or contribute to each other and the operations of the corporation as a whole.[10] Corporations that are required to be included in the same California combined report are collectively referred to as the "combined reporting group."[11]

The purpose of the combined report is to provide a fair method for computing California source income for corporations engaged in a unitary business. In other words, the combined report is a means by which the business income of a unitary business is divided ("apportioned") among the various taxing jurisdictions in which the unitary trade or business is

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commonly controlled group also includes corporations that are stapled entities.); FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).

[6] *Id*.

[7] FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 4 (July 1, 2019).

[8] *Edison Cal. Stores, Inc. v. McColgan*, 30 Cal.2d 472 (1947); *Container Corporation v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Tenneco W., Inc. v. Franchise Tax Bd.*, 234 Cal.App.3d 1510, 1518, 286 Cal.Rptr. 354, 357 (App. 4th Dist. 1991).

[9] *Edison Cal. Stores, Inc. v. McColgan*, 30 Cal.2d 472 (1947); *Container Corporation v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

[10] Cal. Rev. & Tax. Code §§ 25101, 25120; FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 4 (July 1, 2019) (California has never adopted statutes to define precisely the scope of application of the unitary business principle. Instead, the law has evolved through a series of judicial decisions.).

[11] Cal. Code Regs. tit. 18, § 25106.5(b)(3).

conducted.[12] In a combined report, the entire amount of unitary business income of all corporations in the combined reporting group (including unitary members with no property, payroll, or sales within California) is aggregated into the combined report.[13] Subsequently, the total combined business income is apportioned to California in accordance with California's combined reporting method, and to the unitary members subject to tax in California, by formula apportionment commonly referred to as "intrastate apportionment".[14]

It is important to note that only when two or more corporations conduct a unitary business within and without California are they required to file a combined report. In contrast, unitary businesses that are wholly within California, have the option to file a combined report or use separate accounting.

B. Mechanics of the California Combined Report

Although the California Legislature ("Legislature") established the general statutory framework for combined reporting in California, it did not provide taxpayers with any guidance regarding the mechanics of California combined reporting. Instead, the Legislature delegated its rulemaking authority to the Franchise Tax Board ("FTB") in R&TC Section 25106.5, by specifically granting the following authority:

> The FTB "may adopt regulations necessary to ensure that the tax liability or net income of any taxpayer whose income derived from or attributable to sources within this state which is required to be determined by a combined report pursuant to Section 25101 or 25110 of this chapter, and of each entity included in the combined report, both during and after the period of inclusion in the combined report is properly reported, determined, computed, assessed, collected, or adjusted."[15]

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[12] FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).

[13] *Edison Cal. Stores, Inc. v. McColgan*, 30 Cal.2d 472 (1947); *Container Corporation v. Franchise Tax Bd.*, 463 U.S. 159 (1983); FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).

[14] Cal. Code Regs. tit. 18, § 25106.5(b)(2) (The "combined reporting method" refers to the method under which the total combined report business income of all members of the combined reporting group is apportioned to California, to determine each taxpayer member's combined report business income from California sources."); FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).

[15] Cal. Rev. & Tax. Code § 25106.5(a).

In accordance with this authority, the FTB published in 1999, a set of combined reporting regulations under Sections 25106.5 through 25106.5-11 of the California Code of Regulations ("CCR"), which provide definitions, procedures and detailed rules regarding the general mechanics of combined reporting.[16]

C. Taxation of Members in a Combined Reporting Group

California recognizes each member of the combined reporting group as a separate legal entity with its own distinct tax liability.[17] In other words, each member of a combined reporting group is subject to tax in California individually, as a separate company.[18] Thus, despite being engaged in a unitary business, a combined reporting group may include two types of members: (i) taxpayer members, which are subject to tax in California, and (ii) non-taxpayer members, which are not subject to tax in California but are members of the combined reporting group because they are unitary with the taxpayer members.[19]

As a result, CCR Section 25106.5(c) provides that each member of a combined reporting group is required to compute its California source income in accordance with a seven-step process, in the order indicated below.[20] Please note, the paper is only focused on the issue presented in the last step, relating to the utilization and carryforward of California source net operating losses generated in a combined reporting group.

First, each member of a combined reporting group must identify its total separate net income as if the member was not part of the combined reporting group, subject to the following three modifications:

(A) Intercompany Transactions – California conforms to federal consolidated return regulations for intercompany transactions (i.e., Treasury Regulation Section 1.1502-13), and thus provides for the

[16] Cal. Code Regs. tit. 18, §§ 25106.5 through 25106.5-11.
[17] FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).
[18] *Id*.
[19] Cal. Code Regs. tit. 18, § 25106.5(b)(10)(The term "member" refers to a single corporation included in the combined reporting group and is inclusive of both taxpayer members and all other corporations (e.g., non-taxpayer members) included in the combined reporting group.); and Cal. Code Regs. tit. 18, § 25106.5(b)(11)(the term "taxpayer member" refers to a corporation that is a member of the combined reporting group and which is specifically required to file a California tax return.).
[20] Cal. Code Regs. tit. 18, §§ 25106.5(c)(1).

deferral of gains or losses from intercompany transactions in order to produce the effect of transactions between divisions of a single corporation.[21]

(B) Capital Gains and Losses – Capital gains and losses, Internal Revenue Code ("IRC") Section 1231 and involuntary conversion gains and losses shall not be taken into account, and instead shall be apportioned and allocated in accordance with the provisions of CCR Section 25106.5-2.[22]

(C) Net Operating Loss Deductions - Net operating loss deductions shall not be taken into account, as discussed in further detail in subsection (e) of CCR Section 25106.5.[23]

Second, each taxpayer member may elect to determine its net income under accounting methods and other elections, independently of the net income of the other members of the combined reporting group.[24] Third, the resulting total separate income of each member of the combined reporting group is then adjusted to remove income items attributable to the member's nonbusiness income, and business income items that do not constitute combined report business income of the group.[25]

Fourth, expenses are assigned to business and nonbusiness income.[26] Fifth, if the accounting period of the principal member and one or more of the other members of the combined reporting group do not begin and end on the same dates, adjustments must be made to fiscalize the other members' combined report business income and apportionment data in order to assign an appropriate amount of those values to the accounting period of the principal member.[27] Sixth, the combined report business income of all members aligned to the accounting period of the principal member is then aggregated, resulting in total group combined report business income.[28]

The final step is a two-part process. In part one, the total group combined report business income is multiplied by the California

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[21] Cal. Code Regs. tit. 18, §§ 25106.5(c)(1)(A); 25106.5-1.
[22] Cal. Code Regs. tit. 18, §§ 25106.5(c)(1)(B); 25106.5-2.
[23] Cal. Code Regs. tit. 18, § 25106.5(c)(1)(C).
[24] Cal. Code Regs. tit. 18, § 25106.5(c)(2).
[25] Cal. Code Regs. tit. 18, § 25106.5(c)(3).
[26] Cal. Code Regs. tit. 18, § 25106.5(c)(4).
[27] Cal. Code Regs. tit. 18, § 25106.5(c)(5).
[28] Cal. Code Regs. tit. 18, § 25106.5(c)(6).

apportionment percentage of the combined reporting group to arrive at the group's California source combined report business income.[29] In most cases, the California apportionment percentage is based on a single-sales factor apportionment formula, which utilizes a fraction, the numerator of which is the combined reporting group's total California sales, and the denominator of which is the combined reporting group's total everywhere sales.[30] In part two, the resulting California source total group combined report business income is intrastate apportioned between the taxpayer members of the group to arrive at each taxpayer member's California source combined report business income.[31] The steps of intrastate apportionment are as follows:

(i) Each taxpayer member of the combined reporting group (and only the taxpayer members) determines its California sales factor.[32]

(ii) The taxpayer member then determines its California apportionment percentage. In determining its California apportionment percentage, the taxpayer member must use the same apportionment formula (likely single-sales factor) the combined reporting group uses in determining the group's California apportionment percentage.[33]

(iii) Next, the taxpayer member determines its intrastate apportionment percentage. That percentage is the ratio of the taxpayer member's California apportionment percentage to the sum of all of the California taxpayer members' California apportionment percentages.[34]

(iv) Finally, the taxpayer member multiplies the group's California source combined report business income by its intrastate apportionment percentage to arrive at the taxpayer member's California source combined report business income.[35]

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[29] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(1).
[30] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(1)(b)(iii).
[31] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(2)(For purposes of this clause, "taxpayer member" means a taxpayer member, as defined in subsection (b)(11) of this regulation, whose tax is measured by net income.).
[32] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(2)(a).
[33] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(2)(b).
[34] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(2)(c).
[35] Cal. Code Regs. tit. 18, § 25106.5(c)(7)(A)(2)(d).

After each taxpayer member determines its California source combined report business income, each taxpayer member then adds or subtracts any other California source income or loss items (as set forth under CCR Sections 25106.5(d)(2)) to its California source combined report business income.[36]

Finally, the taxpayer member may reduce its current taxable year California source income by applying any California source net operating loss ("CSNOL") carryforward deductions to it.[37] Accordingly, the final resulting value is considered the taxpayer member's California source income subject to taxation under R&TC Section 25101.[38]

D. California Apportionment Formula

Apportionment is the process by which business income is divided between taxing jurisdictions. For a unitary business, the apportionment formula calculates the percentage of the unitary business attributable to and taxed by California, because the unitary business's total business income is multiplied by the California apportionment percentage to derive the amount of business income apportioned to this state. For taxable years beginning on or after January 1, 2013, California generally requires all business income of an apportioning trade or business to be apportioned to California using a single-sales factor apportionment formula.[39]

Prior to transitioning to a single-sales factor apportionment formula, the Legislature adopted the *Finnigan* rule into California law for taxable years beginning on or after January 1, 2011.[40] In *Finnigan,* the State Board of Equalization ("SBE") concluded that the term "taxpayer" means "all the corporations within the entire unitary group."[41] Therefore, in the context of sales factor sourcing of tangible personal property, the SBE held that when sales are shipped from California to another state by a member of a unitary group, the throwback rule does not apply if *any* of the corporations within the unitary group are taxable in the other state.[42] In other words, the throwback

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[36] Cal. Code Regs. tit. 18, § 25106.5(d)(2).
[37] Cal. Code Regs. tit. 18, § 25106.5(d)(3).
[38] Cal. Code Regs. tit. 18, § 25106.5(d)(5).
[39] Cal. Rev. & Tax. Code § 25128.7.
[40] Cal. Rev. & Tax. Code § 25135.
[41] *Appeal of Finnigan Corp.,* No. 88-SBE-022 (Cal. State Bd. Equal. Aug. 25, 1988).
[42] *Id*.

rule only applies if no member of the combined reporting group is taxable in the destination state to which goods are delivered or shipped.[43]

Prior to the Legislature's adoption of the *Finnigan* rule in 2011, California followed the *Joyce* rule for tax years beginning on or after April 22, 1999 through December 31, 2010. In *Joyce,* the SBE concluded that the term "taxpayer" as used in R&TC Section 25135(a)(2)(B), refers to the individual corporation selling the product.[44] Therefore, in the context of sales factor sourcing of tangible personal property, the SBE held that when sales are shipped from California to another state by a member of a unitary group, the throwback rule only applies if the seller is not taxable in the destination state. In other words, under *Joyce,* California looked to each corporation in the combined reporting group separately, such that the throwback rule is applicable so long as the seller was not taxable in the destination state.[45]

E. California Source Net Operating Loss Deductions

Like other income tax deductions, net operating loss ("NOL") deductions are generally viewed as a matter of legislative grace.[46] The policy behind NOL deductions is to give taxpayers the ability to mitigate inequities resulting from businesses recognizing profits and losses in periods that do not always coincide with the tax reporting year.[47] Therefore, allowing a deduction for NOL carryforwards provides taxpayers with an opportunity to level out their income and losses over time so that a taxpayer with fluctuations in its income and losses over a certain period of time, will end up with the same cumulative income tax liability as a taxpayer with the same total income, but which was earned evenly throughout that same period of time.

Recognizing the potential inequities related to taxpayers earning income at different periods during the tax reporting year, California legislatively permits taxpayers to carryforward and deduct NOLs in subsequent tax years when calculating their California corporate tax liability. The general statute providing for NOL deductions in California is set forth under R&TC Section 24416 and provides that California generally computes

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[43] *Id*.
[44] *Appeal of Joyce, Inc.,* No. 66-SBE-070 (Cal. State Bd. Equal. Nov. 23, 1966).
[45] *Id*.
[46] *S. F. H., Inc. v. Commissioner*, 444 F.2d 139, 141 (3d Cir. 1971) (citing *New Colonial Co. v. Helvering*, 292 U.S. 435 (1934); *Deputy v. duPont*, 308 U.S. 488 (1940).).
[47] See Multistate Tax Commission for the Finnigan-Combined Filing Project Work Group and the Uniformity Committee Staff Memo – "DRAFT- NOL White Paper", p. 7 (July 15, 2019).

a NOL deduction in accordance with IRC Section 172, except as otherwise provided in R&TC Sections 24416.1, 24416.2, 24416.4, 24416.5, 24416.6, and 24416.7.[48]

R&TC 24416.1(b) provides that corporations whose income is subject to the provisions of R&TC Section 25101 or 25101.5 are required to compute their NOL deductions in accordance with R&TC Sections 25108.[49]

R&TC Section 25108 provides the following computation for NOL deductions:

(a) For corporations whose income is subject to the provisions of R&TC Section 25101, the NOL determined in accordance with IRC Section 172 for a particular taxable year shall be the corporation's "net loss for state purposes" as defined in subdivision (c).[50]

(b) The NOL deduction allowed by Sections 24416, 24416.1, and 24416.2, for a taxable year shall be deducted from "net income for state purposes" (as defined in subdivision (c)) for that taxable year.[51]

(c) "Net income (loss) for state purposes" means the sum of the net income or loss of that corporation apportionable to this state and the income or loss allocable to this state as nonbusiness income, as provided by Chapter 17 (commencing with Section 25101).[52]

Furthermore, California conforms to the federal anti-abuse rules under IRC Section 381 for carryovers in certain corporate acquisitions, and IRC Section 382, which imposes a limitation on net operating loss carryforwards and certain built-in losses following an ownership change under IRC Section 382.[53]

Although the Legislature did not enact a specific CSNOL statute for members of a combined reporting group, the combined reporting regulations

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[48] Cal. Rev. & Tax. Code § 24416.
[49] Cal. Rev. & Tax. Code § 24416.1(b).
[50] Cal. Rev. & Tax. Code § 25108(a).
[51] Cal. Rev. & Tax. Code § 25108(b).
[52] Cal. Rev. & Tax. Code § 25108(c).
[53] Cal. Rev. & Tax. Code § 24451. But see Cal. Rev. & Tax. Code § 24459, as added by 2015 Cal. A.B. 154, effective Sept. 30, 2015 (expressly decoupling from I.R.C. § 382(n) relating to special rules for certain ownership changes for tax years beginning on or after Jan. 1, 2015).

provide that each member of the combined reporting group is precluded from applying any NOL deductions when computing its separate net income.[54]

Specifically, subsection (c)(1)(C) of CCR Section 25106.5 provides that "a NOL deduction of a taxpayer member is allowed as a deduction only against the California source income (i.e., after apportionment and allocation) of the taxpayer member of the group" as further explained in CCR Section 25106.5(e).[55] Furthermore, CCR Section 25106.5(e) provides in relevant part, the following:

> "If the final resulting value of subsection (d)(5) of this regulation is a loss for a taxpayer member, that taxpayer member has a CSNOL. The CSNOL is subject to the NOL limitations and carryforward provisions of R&TC Sections 24416, 24416.1,24416.2, 24416.3 and 25108…A CSNOL incurred by one member of a combined reporting group cannot be used to reduce the income of any other member in a subsequent taxable year. Whether the CSNOL resulted from an apportioned business loss or an allocated nonbusiness loss, or a combination of both, the CSNOL is a deduction against positive California source income in a subsequent year, regardless of the composition of that income as apportioned, allocated or wholly within California."[56]

It is important to note that despite the combined return regulations referencing R&TC Sections 24416.1 and 25108, neither statute was enacted by the Legislature with the intent to address the computation of NOL deductions for taxpayer members of a combined reporting group.

II. REASONS FOR PROPOSED CHANGES: SIGNIFICANT DEVELOPMENTS IN STATE TAXATION OF COMBINED REPORTING GROUPS

As noted earlier, FTB published the combined reporting regulations in 1999 in accordance with California's tax laws at the time the regulations were established. However, since the regulations were first published, there have

[54] Cal. Code Regs. tit. 18, § 25106.5(c)(1)(C).
[55] *Id*.
[56] Cal. Code Regs. tit. 18, § 25106.5(e).

been several significant state tax developments, which impact California's combined reporting regulations. Furthermore, some of these developments were only partially incorporated into the combined reporting regulations in subsequent amendments, while other have still yet to be addressed.

A. Compared to Separate Accounting, Calculating California Source Income or Loss Using the Combined Reporting Method Leads to Inequitable Results That Are Further Compounded Upon by The Mechanics of The Existing Combined Reporting Regulations

Two or more corporations engaged in a "unitary business" within and without California, are required to use a California combined report to determine their California source income or loss subject to tax under R&TC Section 25101.[57] Although the corporate franchise tax is measured in the same manner as a non-unitary, separate corporation, to determine the portion of a unitary business's total income attributable to California sources, California utilizes the unitary business principle, which does not apply to non-unitary, separate corporations.[58] As a result, taxpayers engaged in a unitary business are required to determine their California source income or loss using the combined reporting method, while non-unitary separate corporations can use separate accounting to determine their California source income or loss.

Taxpayers that use separate accounting may have an advantage over taxpayers required to use the combined reporting method because separate accounting principles ignore and often inadequately capture the transfers of value that take place among a unitary business. As such, when the significant differences in the mechanics of separate accounting versus combined reporting are considered, it is apparent that the determination of California source income or loss leads to inequitable results for taxpayers required to file a combined report.

In addition to the inequity in the methodology used to compute California source income or loss, the inequity is further compounded upon when considering that CSNOLs are calculated and carried forward on a post-

[57] Cal. Rev. & Tax. Code § 25105 (Generally, a commonly controlled group exists when stock possessing more than 50% of the voting power is owned, or constructively owned, by a common parent corporation (or chains of corporations connected through the common parent) or by members of the same family. A commonly controlled group also includes corporations that are stapled entities.); FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 5 (July 1, 2019).
[58] FTB Publication 1061: 2018 Guidelines for Corporations Filing a Combined Report, Franchise Tax Board, p. 4 (July 1, 2019).

apportioned basis using the apportionment factor in the year in which the CSNOL was generated, and CSNOLs cannot be shared with other members of the same combined group. Since CSNOLs generated by taxpayer members of a combined reporting group cannot be shared with other members of the same combined group under the existing regulations, more income of combined reporting groups may result in being subjected to tax over time due to fluctuations in the California apportionment factor of the taxpayer members (e.g., changes in the sourcing of customer receipts). This is in direct contradiction of the overriding policy for allowing NOL deductions and carryovers in the first place.

B. Inherent Inequities Within the Combined Reporting Method Are Expanded Through the Interplay Between California's Tax Laws and The Combined Reporting Regulations

The inherent inequities underlying the combined reporting method are further expanded through the interplay of California's tax laws, the mechanics combined reporting regulations, and the various development and changes to state taxation of combined reporting groups.

When the combined reporting regulations were first published in 1999, the FTB stated that it relied on the *Joyce* approach when establishing the methodology for determining California source income or loss for members of a combined reporting group because at the time the regulations were adopted, California followed *Joyce*, and of the states that required combined reporting at the time, only two followed *Finnigan*. However, California adopted *Finnigan* in 2011, and yet the FTB did not update the provision in the combined reporting regulations relating to the methodology for determining California source income or loss to conform to *Finnigan* and current California tax laws. Therefore, although the FTB initially used *Joyce* to defend the disparate results that were unforeseen at the time the combined reporting regulations were drafted, those rules no longer provide the same protection to taxpayers under current California laws. In addition, to adopting *Finnigan*, the Legislature also changed the standard apportionment formula applicable to unitary businesses from the traditional three-factor apportionment formula to a single-sales apportionment factor, in the same year.

Each change in California tax law was significant in and of itself, but when coupled together further bolstered the extent of the inequity inherent in combined reporting. Since CSNOLs are calculated and carried forward on a post-apportioned basis, the change from three-factor to single-sales factor apportionment reduced the ability for some taxpayer members in a combined reporting group to utilize CSNOLs against future apportioned income in instances where the taxpayer's California apportionment factor was more heavily weighted in California under the former three-factor formula because it gave consideration to the taxpayer's in-state operations (i.e., property and payroll), and now has been reduced under the single-sales factor approach.

C. Relying on the Unitary Business Principle, the California Legislature Provides Taxpayer Members of a Combined Reporting Group with an Option to Elect and Assign Tax Credits to Other Members Within the Same Combined Reporting Group

Perhaps one of the most significant developments to impact California's combined reporting tax regime came through Assembly Bill 1452 ("AB 1452"), which enacted R&TC Section 23663 into California law.

R&TC Section 23663 permits taxpayer members of a combined reporting group to elect to assign tax credits to affiliated members of the same combined reporting group ("eligible assignees") for taxable years beginning on or after July 1, 2008.[59] The election is irrevocable and must be made on the assigning taxpayer's original return for the year of the credit assignment.[60] The assigned credits may be used by the assignee in taxable years beginning on or after January 1, 2010.[61]

Prior to the enactment of R&TC Section 23663, tax credits could be used only by the specific corporation that generated the credits to reduce that corporation's portion of the combined reporting group's total tax bill. According to the FTB's Initial Statement of Reasons:

> The legislative intent behind R&TC Section 23663 "was to view ***combined reporting groups as a unified entity for the purpose of using tax credits, allowing such credits to be used anywhere***

[59] Cal. Rev. & Tax. Code § 23663.
[60] Cal. Rev. & Tax. Code § 23663(c)(1).
[61] Cal. Rev. & Tax. Code § 23663(a)(2).

***within the combined reporting group to reduce the unitary group's total tax* [emphasis added]**."[62]

Furthermore, in explaining the reasoning for enacting R&TC Section 23663, the Legislative Analyst's Office stated the following:

> "…Generally speaking, unitary groups allow corporations to be taxed similarly no matter whether they are structured as a single entity with divisions or separate, but closely related, corporations…"[63]

When R&TC Section 23663 was enacted into California law, the Legislature provided taxpayers with long awaited and extremely valuable insight into how exactly the Legislature viewed each taxpayer member of a combined reporting group.

Most importantly, the Legislature acknowledged the unitary business principle and explicitly cited to the principle as its justification and rationale for distinguishing between members of a combined report and non-unitary separate corporations, to specifically allow members of a combined reporting group to elect to assign tax credits to other members of the same combined reporting group. Put another way, the underlying policy driving the Legislature's decision to carve out this exception to the general rule against assigning or sharing tax attributes with other taxpayers was based on the unitary business principle which allows corporations to be taxed similarly if they are engaged in a unitary business, regardless of whether they are structured as a single entity or separate entities that are closely related.

D. Based on The Legislator's Rationale in R&TC Section 23663, It Appears the California Legislature Intended to Carve Out an Exception to the General Rule Against Sharing CSNOLs for Corporations Engaged in a Unitary Business, Such That Taxpayer Members of a Combined Reporting Group May Have the Option to Elect to Assign CSNOLs to Other Members Within the Same Combined Reporting Group

[62] FTB: Initial Statement for Reasons for the Adoption of California Code of Regulations, Title 18, Sections 23663-0 through 23663-5, p.25 (Nov. 24, 2017).

[63] Legislative Analyst's Office, California Spending Plan 2008-2009, P. 21 (Nov. 2008).

In California, it is well-established that each corporation is individually subject to tax in California, and that tax attributes (i.e., tax credits) belong to the entity that generated the attribute, regardless of whether they were created in a combined report or not.

We noted that with respect to tax credits, which are dollar-for-dollar reductions in California tax liability, the Legislature carved out an exception to the general rule for combined reporting groups engaged in a unitary business, by treating the combined reporting group as a single taxpayer under California's unitary business principle in order to enact R&TC Section 23663 into California tax law and permit members of a combined reporting group to assign tax credits generated in a combined report to other members within the same combined reporting group.

The same rationale would appear to apply to CSNOLs. Otherwise, without an option to elect to assign CSNOLs that are generated while part of a combined reporting group, CSNOLs run the risk of being carryforward indefinitely under the existing rules, such that if the California apportionment factors shift among members of the unitary group (for example, due to business restructurings) then the CSNOL carryforwards may be trapped and siloed within the entities that initially generated the CSNOLs, which would be in direct conflict with the unitary business principle as well as the policy supporting deductions of CSNOL carryovers.

E. A Stringent Rule Precluding Sharing CSNOLs with Other Members of the Combined Report Group is Not Necessary Because Less Restrictive Methods for Preventing CSNOL Trafficking are Already Built-In by the California Legislature's Existing NOL and CSNOL Rules Which Impose Limitations on the Use of NOLs and CSNOLs by Conforming to the Federal Anti-Abuse Limitations Imposed Under IRC Sections 381 and 382

As mentioned, California has expressly stated that it generally conforms to the computation of NOLs as set forth under IRC Section 172. Furthermore, California conforms to the federal anti-abuse limitations imposed on sharing NOLs under IRC Section 381 and 382.

Although we do not have the data to support this contention, we suspect that amending subsection (c)(1)(C) and (e) of CCR Section 25106.5 to include a mechanism that provides taxpayer members in a combined reporting group with an option to assign CSNOLs generated while part of a California combined reporting group to other members within the same California combined reporting group will not suddenly encourage or permit trafficking in tax attributes because California conforms to the federal anti-abuse limitations imposed on tax attribute succession under IRC Sections 381 and 382.

F. In July 2019, the Multistate Tax Commission Published A White Paper Concluding That the MTC Should Adopt Certain Uniform Provisions That Allow A Member of a Combined Reporting Group to Share NOLs with Other Members of the Same Combined Reporting Group Because the Majority of Combined Reporting States Already Allow NOLs Generated in a Combined Report to be Shared to Some Degree, And States that Follow the *Finnigan* Approach Already Largely Permit the Sharing of NOLs

The Multistate Tax Commission ("MTC") is currently conducting a combined reporting study that seeks to provide taxpayers required to file a combined report with an option to apportion the combined group's income using the *Finnigan* approach. As part of this study, the MTC examined the most common methods used by state tax agencies to provide NOL deductions in the context of combined/consolidated returns in order to determine whether the MTC should adopt certain uniform provisions for the "sharing" of net NOL carryover deductions. Based on its research, the MTC found that of the many states that now allow or require combined reporting and/or filing of consolidated returns, only eight states currently do not permit NOLs to be shared within the combined reporting group or consolidated group.[64] Further, the vast majority of states that do not permit NOLs to be shared with members of the combined reporting group or consolidated group follow the *Joyce* approach.[65] Therefore, based on these findings, the MTC staff concluded that the MTC should adopt certain uniform provisions that permit members of a combined report to share net operating loss carryovers with other members of the same combined report.

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[64] Multistate Tax Commission: Staff Analysis - NOL Sharing (Updating the April 3, 2019 Memo), p. 10 (May 23, 2019).

[65] Multistate Tax Commission: DRAFT – NOL White Paper, p. 19 (July 15, 2019).

III. PROPOSED CHANGES

Based on the foregoing, we believe that the Legislature should enact a general CSNOL assignment statute into California law that mirrors the assignment provision set forth under R&TC Section 23663.

In addition, we believe that the FTB should make amendments to subsections (c)(1)(C) and (e) of CCR Section 25106.5 to conform to the Legislature's intent, and carve out an exception to the general rule that provides members of the same combined reporting group with an option to elect to assign CSNOLs generated while part of a combined reporting group to other members of the same combined reporting group.

A. Proposed Amendments

First, the authors of this proposal believe that an assignment provision very similar to that which currently exists under R&TC Section 23663 for tax credits generated by members of a combined reporting group should be added to the R&TC for CSNOLs generated by members of a combined reporting group.

Second, we propose to amend CCR Section 25106.5(c)(1)(C) to read as follows:

> "Net operating loss deductions shall not be taken into account. The net operating loss deduction of a taxpayer member is allowed as a deduction ~~only~~ against either the California source income (i.e., after apportionment and allocation) of the taxpayer member of the group that generated the loss or an eligible taxpayer member of the group that was assigned the loss (see subsection (e) of this regulation)."

Third, we believe that the same assignment provision that we have proposed to be added to California law should also be added to CCR Section 25106.5(e).

Lastly, based the proposed amendments to CCR Section 25106.5, the authors considered whether any related statutory amendments were required for R&TC Section 25108 to allow for the assignment of NOLs within a combined reporting group. The authors concluded that amendments to R&TC

Section 25108 may not be necessary because CCR Section 25106.5 sets forth the general rules for combined reporting, and we have proposed the enactment of a separate assignment statute for CSNOLs. Should the Legislature choose to not add a separate assignment provision patterned after R&TC Section 23663, then it will provide clarity to both the FTB and taxpayer if the Legislature amended R&TC Section 25108 to include a provision that mirrors the assignment provisions set forth under R&TC Section 23663.

B. Feasibility of Proposal

We believe the addition of an assignment provision to California tax law, along with amendments to subsections (c)(1)(C) and (E) of CCR Section 25106.5 provides a long term, narrowly tailored solution to the issues currently associated with California's combined reporting regulations being inconsistent with the unitary business principle and California's rules regarding the utilization of most tax credits generated by taxpayer members of a combined reporting group. Furthermore, we were unable to identify any existing California statutes or regulations that address these issues.

Besides the technical support for assignment of CSNOLs to members of the same combined reporting group, we believe providing taxpayers with an option to assign CSNOLs to another member of the combined reporting group is good policy for several reasons.

California has a legitimate state interest in ensuring that all business income from interstate business is accurately accounted for and fairly apportioned to California. Of course, the desired result is the ascertainment and apportionment of the true result of the activities and values attributable to the unitary business.[66] While not disregarding the corporate entity, the desired ultimate outcome is parity in the taxation of a multistate business conducted by a single entity and a multistate business conducted by multiple legal entities engaged in a single unitary trade or business.

First, it would achieve the Legislature's intent and provide equal treatment under California's tax laws for tax credits and CSNOLs generated by taxpayer members of the combined reporting group. By providing an assignment mechanism for CSNOLs, the combined reporting group is able to make a more accurate determination of business income from year-to-year,

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[66] 10.1.2. Actual Impact Likely Smaller than Suggested by a Basic Economic Model, FTB Initial Statement of Reasons for The Adoption of CCR Section 23663-0 to 23663-5, p. 41 (Nov. 24, 2017).

since the assignment of CSNOLs would only be permitted to other members of the combined reporting group that were members of the group when the CSNOL was first generated. In addition, under the unitary business principle, it can be argued that the assignee indirectly contributed to the creation of the CSNOL, so it is consistent with the combined reporting method to allow assignment of CSNOLs.

Second, by providing an assignment mechanism, once a member leaves the combined reporting group, the entity takes with it only its remaining unused and unassigned tax attributes. Since tax attributes are assigned only on an as-needed basis, and no combined reporting group attribute exists which must be partitioned away when a member leaves a group, the concern with tracking in CSNOLS is largely alleviated.

Third, as the FTB mentioned in the Initial Statement of Reasons for the Adoption of CCR Section 23663-0 to 23663-5 for tax credit assignments, we suspect that like tax credits, most of the taxpayers that would be impacted by the proposed amendment to the R&TC and CCR Section 25106.5 are very large corporations for whom California taxes are a very small part of their business expenses. Likewise, we imagine taxpayers who will make payments to the state if the proposed CSNOL assignment mechanism is not adopted are those who do not currently have tax liabilities against which to use additional CSNOLs or tax credits. Since the amount of tax they currently owe will likely not change if the proposed CSNOL assignment mechanism is adopted, the proposed amendments will appear to have little, if any, effect on their expected rate of return from an economic perspective.

For these reasons, taxpayer members of a combined reporting group should have the option to assign CSNOLS incurred by a member of a combined reporting group to other taxpayer members of the same combined reporting group, similar to tax credits. To continue to require CSNOLs to be utilized and carried forward on a separate company basis while permitting credits to be treated differently would run counter to the goal of ascertaining the net income of the unitary business by unduly focusing on separate company mechanical computations. Furthermore, concluding otherwise would not only continue to amplify the disparate treatment between two different tax attributes generated in the same combined reporting group (i.e., CSNOLs and tax credits), but we suspect that it could lead to increased tax credit assignments in combined reporting groups, which could result in additional lost tax revenue to California, since tax credits are dollar-for-dollar offsets of tax while CSNOLs only reduce a taxpayer's California source income subject to tax.

IV. CONCLUSION

Our proposal provides guidance to taxpayers in an area that guidance has long been needed. Further, the guidance provided is a simple and reasonable approach to aligning the rules surrounding the utilization of CSNOLs through straightforward amendments to California tax laws and regulations, which mirror existing California tax laws and regulations applicable to tax credits. The clarity provided by these changes will allow the FTB to continue to be effective in its function as a tax administrator, while also keeping the combined reporting rules and regulations as consistent, equitable and streamlined as possible.

For these reasons, we believe the Legislature should add a CSNOL assignment provision to the R&TC, while the FTB should amend the combined reporting regulations to continue to meet its obligation to "properly report, determine, compute, assess, collect, or adjust" the "tax liability or net income" of a combined reporting taxpayer."