

REQUEST FOR PERMISSION TO PROCEED WITH THE FORMAL REGULATORY PROCESS TO AMEND CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25136-2, RELATING TO SOURCING OF SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

Introduction

The purpose of amending California Code of Regulations, Title 18, section 25136-2 is to seek to improve compliance with and administrability of Regulation 25136-2 through simplifying amendments to the Regulation.

Background

The net income of businesses that do business both within and without California is generally subject to taxation by the state of California. This can occur either through the corporate franchise tax or through taxation of individual's income where a net income tax does not occur at the entity level. The portion of the worldwide net income of such businesses that is deemed to be California sourced income is determined by apportionment formula. For most businesses the apportionment formula is based entirely on sales, with a greater proportion of a business' net gains or losses attributed to California if a greater proportion of its sales are sourced to California. Some industries and classes of transactions have a sourcing rule specific and appropriate to that specific industry or transaction. However, Regulation 25136-2, which formally assigns sales of other than tangible personal property, functions as the default rule for determining which of a business' sales should be sourced to California. As a default rule, the universe of transactions subject to Regulation 25136-2 is quite broad.

In the course of administering Regulation 25136-2 since the regulation was initially promulgated staff has learned that simplifying the rules is in the interests of both taxpayers and the department as it increases both compliance and administrability. Staff has also learned from experience that for certain industries all parties are best served with rules specifically tailored to that particular industry. This regulatory amendment project seeks to improve compliance and administrability both through simplification of the default rule and through creating specific rules for certain professional service industries.

Interested Parties Meetings

The first IPM was held on January 20, 2017 to provide the public with an opportunity to discuss and provide comments on potential amendments to the Regulation. Staff explained the purpose of the Regulation and the public responded positively to receiving additional guidance by way of amendments to the Regulation. Numerous topics were discussed, including whether the regulation should address asset management services, government services contracts, reasonable approximation as a sourcing methodology, as well as a discussion of proper sourcing methodology for several other service industries.

The second IPM was held on June 16, 2017. Staff presented draft language after consideration of comments received from the first IPM. A number of comments were raised with regard to government services, asset management services, as well various other topics including long term contracts, research and development services, and reasonable approximation as a sourcing methodology. Based on input received at the second IPM Staff determined to propose simplifying rules for the sourcing of services. The third IPM was held on May 18, 2018 to further elicit public input regarding potential amendments to the Regulation. Staff presented new draft language. Staff and the interested parties in attendance discussed in detail the simplifying rules Staff had proposed which simplified the rules for sourcing services. Staff proposed to replace the cascading for sourcing business services with a simpler set of rules that was based on presumptions. Based on input received at the third IPM Staff determined to extensively modify the proposed asset management services rule.

The fourth IPM was held on July 19, 2019. Staff presented draft Regulation language along with an explanation of the draft Regulation language and received input from the public. Staff discussed the asset management services rule with members of the public as well as several other proposals from members of the public pertaining to several particular industries. Based on input received at the fourth IPM, Staff determined to further simplify the sourcing rules for services through the merger of the sourcing rules for businesses and the sourcing rules for individuals.

The fifth IPM was held on July 21, 2020. Staff presented draft Regulation language along with an explanation of the draft Regulation language and received input from the public. Staff discussed the proposed merging of the sourcing rules for services of individual and business customers. Public comments received after the meeting stressed the importance of retaining an example for accounting services. After consideration of public comments Staff proposed a professional services rule.

The sixth IPM was held on June 4, 2021. Staff presented draft Regulation language along with an explanation of the draft Regulation language and received input from the public. Staff discussed the proposed professional services rule with participants. During the IPM and from subsequent written comments during the comment period Staff received comments that were broadly supportive of the proposed professional service rule.

The Proposed Regulatory Text

After the sixth IPM, Staff considered public comments. As a result of public input and staff consideration of all IPMs, the proposed major amendments to the Regulation text are explained as follows:

Subsections (b)(1), (b)(2), and (b)(9) were added to provide definitions of key terms used throughout the Regulation. Definitions were included to provide detailed clarity, provide consistency within the Regulation, and to avoid redundancy.

Subsection (c)(1) was substantially rewritten as the simplified sourcing rule for services sold to both individuals and businesses. The functions of unamended (c)(1) and (c)(2) have effectively been merged into (c)(1) as amended.

Subsection (c)(2) was substantially rewritten as a specific sourcing rule for asset management services. The rule that had been at unamended (c)(2) has been merged into (c)(1) as amended.

Subsection (c)(3) was added as a new rule for the sourcing of professional services.

Subsection (f)(1) was amended to define the customer when there is a sale of marketable securities.

Subsection (i)(2) was amended to clarify the rules for using reasonable approximation as a sourcing methodology.

Request for Permission

Staff believes that the amended regulation provides appropriate criteria and guidance in implementing the procedures for sourcing sales from business activities for purposes of apportioning business income under the Revenue and Taxation Code, and now requests permission to commence the formal regulatory process under the Administrative Procedure Act.