PROPOSED REGULATION SECTION 25136
INTERESTED PARTIES MEETING DISCUSSION PAPER

In February, 2009, SBX3-15 enacted new legislation operative for taxable years beginning on or after January 1, 2011, which included the repeal of the current version of California Revenue and Taxation Code (RTC) section 25136 and the enactment of a new version of RTC section 25136 applicable for taxable years beginning on or after January 1, 2011. RTC section 25136 provides the sales factor numerator assignment rules for all sales other than sales of tangible personal property.

RTC Section 25136 – For Taxable Years Beginning Before January 1, 2011

Prior to its recent amendment, RTC section 25136 generally provided that sales of other than tangible personal property are assigned to the state where the income-producing activity that gave rise to the sale occurred. When income-producing activity was performed both inside and outside California, the sale would be assigned to California if the greater costs of performance in connection with the income-producing activity were incurred in California. The recent amendment to RTC section 25136 repeals those provisions for taxable years beginning on or after January 1, 2011. As a result, the former income-producing activity/greater-cost-of-performance provisions of RTC section 25136 apply only to taxable years beginning before January 1, 2011.

California Code of Regulations (CCR), title 18, section 25136, is currently based on the pre-2011 version of RTC section 25136 and provides more detail regarding the rules on how to assign sales other than sales of tangible personal property. A public hearing is currently scheduled for January 13, 2010 to discuss amending current CCR section 25136 to make assignments based on activities of both the taxpayer and those performed on behalf of by a taxpayer. However, that public hearing will not address the recent changes to RTC section 25136 applicable for taxable years beginning on or after January 1, 2011.

RTC Section 25136 – For Taxable Years Beginning On Or After January 1, 2011

For taxable years beginning on or after January 1, 2011, Revenue and Taxation Code section 25136 generally provides that sales of other than tangible personal property are assigned on a *market* basis. The statute states that: (1) sales from services are assigned to this state to the extent the purchaser of the service received the benefit of the service in this state, (2) sales from intangible property are assigned to this state to the extent the property is used in this state (in the case of marketable securities, sales will be assigned to this state if the customer is in this state), (3) sales from the sale, lease, rental or licensing of real property are assigned to this state if the real property is in this state, and (4) sales from the rental, lease, or licensing of tangible personal property are assigned to this state if the property is located in this state.

Because the switch to market-based rules starting in 2011 represents a marked departure from the current income-producing activity/greater-cost-of-performance rule, the existing regulation will need to be completely rewritten. This regulation project is intended to implement and make specific the new market-based rules.

Discussion Topics

In order to encourage private sector participation in this project, staff is not proposing draft language at this time. Instead, the interested parties meeting will include discussion of the approaches taken in other states and the elements of those approaches that the private sector would like to see adopted in California, as well as a discussion of the provisions in other states that are seen by staff or industry as potentially flawed or in need of refinement.

The statutes and regulations adopted in other states have many common elements that should likely be incorporated into a revised California regulation. Staff envisions that these terms will need to be defined and included in the revised California regulation as well.

In order to focus the discussion, staff is making available language from two states: an Iowa administrative code section ("Apportionment of income derived from business other than the manufacture or sale of tangible personal property"), and an Ohio administrative code section ("Situsing of identified services for purposes of the commercial activity tax.") The language in these states focus on where the benefit of the service or use of the property is received. It is staff's objective to promote consistency and uniformity amongst states with similar language to RTC section 25136. Staff hopes to discuss the variations of Iowa and Ohio and other states' approaches at the interested parties meeting, with interested parties providing input on which aspects of these variations would be appropriate for California, as well as what areas would be problematic. Staff hopes to receive input in the following areas:

1. RTC Section 25136(a)(1): "Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state." Does the specific term "purchaser" need to be defined? How does one determine where the purchaser received the benefit? How does one determine how a purchaser received a benefit?
2. If a purchaser receives the benefit of the service in more than one state, how should the receipt derived from that service be assigned? Would the ratio method contained in the Iowa provisions work well? What approach does industry prefer?
3. RTC Section 25136(a)(2): "Sales from intangible property are in this state to the extent the property is used in this state." Would specific definitions for various intangible properties be practical or desirable such as defining and providing specific rules for patents versus copyrights? Should the specific term "used in this state" be defined?
4. In assigning sales from intangibles, the statute specifies that the location of use must be determined. Should the location of use be the location of the ultimate customer of the product produced utilizing the intangible? If it is not practicable to determine the location of the ultimate purchaser or customer, should there be alternative options available to industry? For example, if the intangible is utilized by the royalty payor to produce a telecommunication device, should the taxpayer be allowed to use public data, such as is available at the FCC, for determining the percentage of California customers for the product produced by the royalty payor?
5. In connection with royalties or payments for patents and other technology, should all or part of RTC section 25127 be incorporated into CCR section 25136?

6. Staff would also like to discuss whether the method proposed in SB 1750 (Alquist), as introduced February 22, 2008, for assignment of royalty payments on patents and other intellectual property in the numerator of the sales factor could be used in the revised regulation. In essence, the proposed language provides that receipts of unitary intercompany royalty payments are assigned to California if those payments relate to sales of tangible property in this state and the sale was made outside the unitary group. A rebuttable presumption is created that a taxpayer is deemed to have properly reported those payments if the taxpayer computes the amount of receipts by applying a specified percentage.
7. Is there a meaningful difference in the terms "purchaser" and "customer"? If so, how should each be defined?
8. Would examples for RTC section 25136(a)(3) and (4) be appropriate to consider?
9. Are there industries that have industry-specific concerns and require specific language?
10. When a taxpayer is not subject to income or franchise tax in states where some of its receipts would be assigned, would a throwback or throwout rule be appropriate?