

PROPOSED REGULATION SECTION 25136-2 AMENDMENTS INTERESTED PARTIES MEETING DISCUSSION PAPER

For taxable years beginning on or after January 1, 2011, Revenue and Taxation Code (RTC) section 25136 provides the sales factor numerator assignment rules for all sales other than sales of tangible personal property. RTC section 25136, subdivision (b), provides the market-based rules for assignment of sales of other than sales of tangible personal property where taxpayers have made a single-sales factor election.

California Code of Regulations (CCR), title 18, section 25136-2, which will become effective March 27, 2012, and is operative for taxable years beginning on or after January 1, 2011, provides cascading rules for sales of services and sales of intangible property. In those rules, there are specific provisions for assignment of sales of stock or interests in a pass-through entity and for the incorporation of the special industry rules under CCR section 25137, including those for mutual fund providers under CCR section 25137-14. Currently, there are no provisions for assignment of dividends under CCR section 25136-2.

Discussion Topics

There are three (3) areas which are in need of further development within CCR section 25136-2:

1. Assignment of the sale of stock by reasonable approximation in the event the seller does not have available to it the factor information of the underlying corporation or pass-through entity such as when the seller has a minority interest or the interest is in a start-up company.
2. Assignment of fees and/or other income received in connection with asset management activities which are not covered under CCR section 25137-14.
3. Assignment of dividends.

In order to encourage private sector participation and input in this project, staff is not proposing draft language at this time. Instead, the interested parties meeting will include discussion of possible approaches to assignment of the above-listed sales:

1. Reasonable approximation of sale of stock in the event the seller does not have available to it the factor information of the underlying corporation or pass-through entity.

Under CCR section 25136-2(d)(1)(A)1.a, in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where 50% or more of the amount of the assets of the corporation or pass-through entity are being sold or transferred, the sale will be assigned by averaging the California payroll and property factors of the entity sold. Under CCR section 25136-2(d)(1)(A)1.b, in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where more than 50% of the amount of the

corporation's or pass-through entity's underlying assets consist of intangible property, the sale will be assigned by using the California sales factor of the entity sold.

Some concern has been expressed that it would be difficult to reasonably approximate the factors of the underlying corporation or pass-through entities when the seller has a minority interest or the interest is in a start-up company.

Our suggestions to begin discussion of the issue are as follows: In light of the purpose of market-based rules, reasonable approximation of the sales factor of the underlying corporation should be a reasonable approximation of the market of the underlying business, which options would include population as provided in the definition of "reasonable approximation." Reasonably approximating the property and payroll factors may be more problematic. One possible approach is to use the commercial domicile of the underlying corporation. Another approach is to use the number and location of the underlying business's establishments, where the earnings and profits are generated, based on public information. For start-up companies, the sales factor could be reasonably approximated using the anticipated market for the product or technology being developed. Again, the property and payroll factors could be reasonably approximated by using the commercial domicile of the underlying interest or based on the location of the intangible or product being developed.

Also for discussion, should there be language addressing these issues or would illustrative examples addressing each situation be sufficient?

2. Assignment of fees or other income received in connection with asset management activities, which fees or income is not covered under CCR section 25137-14.

All special industry rules under CCR section 25137 are incorporated in CCR section 25136-2, including CCR section 25137-14 for mutual fund providers.

It has been pointed out that not all asset management fees and income are assignable under the provisions of CCR section 25137-14. As a result, provisions need to be drafted addressing assignment of those fees and income.

For discussion purposes, the following questions are provided. Should all fees and income in connection with asset management be assigned to the location of the ultimate customer similar to the approach of CCR section 25137-14? Is there a legitimate reason to assign fees or other income differently than how CCR section 25137-14 does? What would be an alternate assignment mechanism?

3. Assignment of dividends. As the regulation is now written, there are no provisions for the assignment of dividends. A possible approach would be to assign dividends in the same manner that a sale of stock is assigned. Is there a reason for treating dividends differently than a sale of stock? Another approach would be to assign the dividends to the commercial domicile of the payor.

COST IMPACTS OF PROPOSED RULEMAKING

In addition to comments on the language proposed for this regulation, the Administrative Procedure Act (APA) requires the department to assess the economic impact of this proposed regulation on business, representative private persons, and small businesses. Recent legislation (SB 617, Stats. 2011, ch. 496) revised certain aspects of the standardized regulatory cost impact analysis, particularly with respect to "major regulations" (as defined), but also with respect to other rulemaking activities. As a result, the department intends to solicit information from interested parties during the pre-APA process that will assist in preparation of the regulatory cost impact analysis.

Specifically, the APA requires the department to assess the economic and fiscal impact of this regulation on the following –

- (1) Estimated private sector cost impacts on businesses and/or employees, small businesses, jobs or occupations, competitiveness of California businesses, reporting requirements, or individuals. This includes the total number and types of businesses impacted, including the number or percentage of those businesses that are small businesses, the number of businesses that will be created or eliminated, the geographic extent of the impacts (local or statewide), the number of jobs created or eliminated, and the ability of California businesses to compete with businesses in other states.
- (2) Estimated total statewide dollar costs that businesses and individuals may incur to comply with this regulation, including start-up and ongoing costs. This includes an identification of the costs for each industry affected, the annual costs a typical business may incur to comply with these requirements (including programming, recordkeeping, reporting and other paperwork, whether or not the paperwork is required to be submitted), whether the regulation directly impacts housing costs, and whether there are comparable federal regulations.
- (3) Estimated benefits from the regulation (both whom will benefit and by how much).
- (4) Any suggested alternatives to the proposed regulation, and the costs and benefits of those suggested alternatives under 1, 2 and 3 above.
- (5) Whether the estimated costs of this regulation to California businesses will exceed \$10 million.

The department encourages submission of any comments and/or cost data on the items set forth above by any interested parties.