

## **25136-2 -- Summary of March 2012 Interested Parties Meeting**

### **Issues Summary**

At the March 29, 2012 Interested Parties Meeting (IPM), six (6) issues were raised and discussed:

(1) How is a sale of an interest in a corporation or pass-through entity assigned by reasonable approximation where the taxpayer may not have available to it the factor information of the underlying corporation or pass-through entity, such as where a taxpayer has a minority interest or an interest in a start-up company?

(2) What is the definition of the term "marketable securities" so that a taxpayer can determine whether to assign the sale of an interest under the sale of stock rules under California Code of Regulations (CCR) Section 25136-2(d)(1)(A)1 or the marketable securities rule under California Revenue and Taxation Code (RTC) Section 25136(a)(2)?

(3) What are the rules for assignment of sales of marketable securities under RTC Section 25136-2(a)(2)?

(4) How are fees for asset management activities which are not assignable under CCR Section 25137-14 assigned?

(5) How are dividends assigned?

(6) How is the deemed sale of an asset (goodwill, for example) under Internal Revenue Code (IRC) Section 338 assigned?

The following is a summary of the comments made on these issues.

### **Comments Summary**

#### **Issue (1)**

(1) How is the sale of an interest in a corporation or pass-through entity assigned by reasonable approximation where the taxpayer may not have available to it the factor information of the underlying corporation or pass-through entity, such as where a taxpayer has a minority interest or an interest in a startup company?

#### **Background on issue (1)**

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 underlying assets of the corporation or pass-through entity consist of tangible

personal property or real property, 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 using the California sales factor of the entity sold.

### **Comments on issue (1)**

It was stated that generally assignment rules should be based on the type of documentation a taxpayer might have, and that the rules should be simple.

One person suggested resurrection of the old RTC Section 24402 where the Franchise Tax Board (FTB) tracked and published taxpayers' factors. It was noted that that approach would cause a great deal of work for the FTB.

It was asked whether this regulation applies to day-traders, and another replied that it depends on the trade or business of the taxpayer.

The issue of how much research the taxpayer is required to do was raised. A suggestion was made that the taxpayer would know where the startup business is located. Another commentator pointed out that the startup company may not have revenue yet. A third commentator noted that because the company would be just starting-up, it may be located in only one state.

It was suggested by multiple individuals that cascading rules would be appropriate. Several commentators suggested that as a last result the sale in this situation be thrown out.

Subsequent to the March 2012 IPM, a commentator suggested that a safe harbor rule for taxpayers who own less than 20% interest in a corporation or pass-through entity be provided such that the sale of a less than 20% interest would be assigned to the commercial domicile of the corporation or pass-through entity whose interest was sold.

### **Issues (2) and (3)**

(2) What is the definition of the term "marketable securities" so that a taxpayer knows whether to assign the sale of an interest in a corporation or pass-through entity under the sale of stock rules in CCR Section 25136-2(d)(1)(A)1. or the marketable securities rule under RTC Section 25136(a)(2)?

(3) What are the rules for assignment of sales of marketable securities under RTC Section 25136(a)(2)?

## **Background on Issues (2) and (3)**

RTC Section 25136(a)(2) provides in pertinent part that "In the case of marketable securities, sales are in this state if the customer is in this state." Previously, there have been no discussions of the definition of "marketable securities" or how to assign the sales of marketable securities "if the customer is in this state."

## **Comments on Issues (2) and (3)**

Related to the discussion about assignment of the sale of interests in corporations and pass-through entities, a commentator suggested that the term "marketable securities" be defined. Subsequent to the IPM, several additional taxpayers and/or their representatives contacted the FTB to suggest that the term "marketable securities" be defined and provided suggested language. In connection with determining the location of the customer under RTC section 25136(a)(2), these commentators proposed that billing addresses be used.

## **Issue (4)**

(4) How are fees of asset management activities which are not assignable under CCR Section 25137-14 assigned?

## **Background on issue (4)**

CCR Section 25137-14 only applies to those entities providing asset management of RICs (regulated investment companies).

Asset management fees for any other similar investment would be assigned under CCR Section 25136-2.

## **Comments**

It was observed that all other similar sales fall under the assignment rules of CCR Section 25136-2.

A commentator noted that using different rules in connection with receipt of asset management fees for RICs (mutual funds) could end up with different outcomes, i.e., a taxpayer using the regular benefit of the service rules under CCR Section 25136-2 could have a different outcome from a taxpayer using CCR Section 25137-14 rules.

In addition, a commentator suggested that how a taxpayer would assign such a sale depends on how one defines "customer." It was asked whether an asset manager's investment fund is the true client of the manager's services or whether the investors in the fund are the true customers.

Another commentator pointed out that CCR Section 25137-14 does not have reasonable approximation rules for assignment of the fees (that regulation, however, does provide reasonable approximation for determining the location of the shareholder.)

### **Issue (5)**

How are dividends assigned?

### **Background on issue (5)**

Assignment of dividends was not addressed in the original drafting of CCR Section 25136-2.

### **Comments on issue (5)**

A commentator remarked that under the United States Supreme Court ruling in *Mobil Oil Corp. v. Commissioner of Taxes of Vt.* (1980) 445 U.S. 425, dividends should be assigned in the same manner as a sale of stock. Several commentators further advised that interest should be assigned in the same manner as dividends.

### **Issue (6)**

How is the deemed sale of an asset (goodwill, for example) under Internal Revenue Code (IRC) Section 338 assigned?

### **Background on issue (6)**

Legal Ruling 2006-3 provides the assignment rules for gains recognized in an IRC Section 338 transaction. CCR Section 25136-2 provides for rules of assignment of stock.

### **Comments on issue (6)**

A commentator requested clarification on whether a taxpayer should assign goodwill according to Legal Ruling 2006-3 (asset by asset) or by the sale of stock rules under CCR Section 25136-2. RTC Section 25125(d) for assignment of the sale of partnership and RTC Section 25135 for assignment of the sale of a tangible asset were discussed in connection with possible options for assignment provisions of goodwill.

A commentator also suggested that the issue be addressed by way of example.