

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 1:00 p.m., August 10, 2011, at 9645 Butterfield Way, Town Center, Golden State Room A/B, Sacramento, California, to amend section 25136 under Title 18 of the California Code of Regulations, pertaining to sales of other than tangible personal property.

An employee of the Franchise Tax Board will conduct the hearing. Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action if any person makes such a request in writing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., August 10, 2011. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer below.

AUTHORITY AND REFERENCE

Section 19503 of the Revenue and Taxation Code (RTC) authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. RTC section 25136, subdivision (c), specifically provides that "[t]he Franchise Tax Board may prescribe those regulations as necessary or appropriate to carry out the purposes of subdivision (b)." The proposed regulatory action interprets, implements, and makes specific section 25136, subdivision (b), of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Taxpayers who have business activities within and without California are required to determine the amount of income properly attributed to activities in California by use of the Uniform Division of Income for Tax Purposes Act (UDITPA), and RTC Section 25120 et seq. Under UDITPA, business income is assigned to a state either through the application of a three-factor apportionment formula that separately compares a business' property, payroll and sales within California to those values everywhere or a single sales factor formula, if elected by the taxpayer, which compares a business' sales within California to sales everywhere. Under the three-factor apportionment formula, as applied by California, the percentages are added together, with the sales factor counted twice (see RTC section 25128), and the resulting sum of these four factors is then divided by four. Under the single sales factor formula which becomes operative for taxpayers who elect it for tax years

beginning on or after January 1, 2011, the taxpayer's sales factor percentage (sales within California divided by sales everywhere) is applied to the business income of the taxpayer to determine the percentage of business income attributable to California.

The sales factor component of the UDITPA apportionment formula has three assignment rules. Sales of tangible personal property are generally assigned to the location of the customer (the "destination" rule contained in RTC section 25135). Sales of other than tangible personal property are assigned to a jurisdiction based on either (1) where the income-producing activity/costs of performance related to the sale occurs (RTC section 25136(a), or (2) if the taxpayer makes a single sales factor election, sales of other than tangible personal property are assigned to the numerator of the sales factor based upon the location where the benefit of the services was received or the location of the use of the intangibles (25136(b)).

The proposed regulations address the assignment rules set forth in RTC section 25136, subdivision (b), and are meant to supply additional guidance pertaining to how to determine where the benefit of the service is received, and where intangibles are used, by the purchaser of the taxpayer's services or intangibles. The regulation is divided into various subsections.

Subsection (a) of the regulation states the general rule that sales of other than tangible personal property are in this state if the taxpayer's market is in this state. These market-based rules for assignment of sales of other than tangible personal property are in addition to those described in RTC section 25135, which contains the rules for assignment of sales of tangible personal property.

Subsection (b) defines terms contained within the regulation.

In subsection (b)(1) the term "benefit of a service is received" is defined as the location where the taxpayer's customer has either directly or indirectly received value from the delivery of a service.

The examples in subsection (b)(1) are provided to illustrate where the benefit of a service is received for purposes of the statute in specific situations.

In subsection (b)(2) the term "service" is defined as consisting of activities engaged in by one for another for consideration. The definition excludes activities outside the taxpayer's regular course of business as well as activities undertaken for other members of the taxpayer's unitary business.

Subsection (b)(3) defines the term "cannot be determined" as meaning that the taxpayer's records, or the records of the taxpayer's customer available to the taxpayer, do not indicate the location where the benefit of the service was received or where the intangible property was used. The alternative method is a reasonable approximation of the taxpayer's market and is defined and discussed below.

In subsection (b)(4) the definition of "commercial domicile" is defined as the place where the trade or business is directed or managed by the taxpayer.

Subsection (b)(5) lists, without limitation, twenty-two (22) specific terms and ends with the catch-all, "other similar intangible assets."

In subsections (b)(5)(A), (B) and (C), the terms "marketing intangible," "non-marketing and manufacturing intangible," and "mixed intangible" are defined using existing Massachusetts law on assignment of intangible property. A "marketing intangible" is intangible property whose value lies predominantly in the marketing of the intangible property. A "non-marketing and manufacturing intangible" is intangible property where the value of the intangible property lies predominately in its non-marketing or manufacturing use. "Mixed intangible" is intangible property whose value includes both the license of a marketing intangible property and a license of a non-marketing or manufacturing intangible property.

In subsection (b)(6) the term "intangible personal property is used" is defined as the location where the intangible property is employed by the taxpayer's customer or licensee.

In (b)(7) the term "reasonably approximated" is defined by reference to the business of the taxpayer's customer. Publicly available information, including population, may be used. Information that is specific in nature is preferred over information that is general in nature.

In subsection (b)(8) the term "to the extent" is defined to make clear that a receipt is to be divided proportionally between states when it relates to activities in more than one state.

Subsection (c) addresses assignment of sales from services to the extent that the benefit of the service is received in this state by the taxpayer's customer. This introductory language mirrors the language of the underlying statute, RTC section 25136, subdivision (b), and is segue to the cascading rules below.

Subsection (c)(1) sets forth the billing address as the primary rule for assigning sales of services where the taxpayer's customer is an individual. Subsection (c)(1) also provides a safe harbor rule for taxpayers so that if the taxpayer uses the individual customer's billing address as the mechanism for assignment of the sales, then the Franchise Tax Board must accept this presumptively correct assignment.

Subsection (c)(1)(A) sets forth the secondary rule for assignment which is applicable only when the taxpayer establishes by a preponderance of evidence that either the contract between the taxpayer and its customer or the taxpayer's books and records kept in the regular course of its business indicate the extent to which the benefit of the service was received in this state. If the taxpayer uses this alternative method of assigning the sales, this subsection allows the Franchise Tax Board the right to audit the alternative method to determine whether or not the taxpayer has overcome the presumption that the benefit of the service was received at the customer's billing address and also that the taxpayer's method reasonably reflects where the benefit of the service was received by the taxpayer's customers.

If the assignment cannot be determined under the alternatives set forth in subsections (c)(1) and (c)(1)(A), then subsection (c)(1)(B) states the determination of the location shall be reasonably approximated.

Subsection (c)(1)(C) provides examples for how the cascading rules in subsection (c)(1) operate. Example 1 illustrates assignment under subsection (c)(1). Example 2 provides an example of when the billing address presumption is overcome and assignment under subsection (c)(1)(A) is proper. Example 3 illustrates when the billing address presumption is not overcome by the taxpayer and therefore assignment under subsection (c)(1) is proper. One more example needs to be added to illustrate assignment by reasonable approximation under subsection (c)(1)(B).

Subsection (c)(2) addresses assignment of sales where the benefit of the services was received by corporate or other business entities.

Subsection (c)(2)(A) sets forth the first rule of assignment, which provides that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records are presumed to establish the location of where the benefit of the service is received, notwithstanding the billing address of the taxpayer's customer. The presumption may be overcome by a preponderance of the evidence that the contract and the books and records do not indicate the actual location of where the benefit of the service was received.

Subsection (c)(2)(B) sets forth the second rule of assignment that the location where the benefit is received is to be reasonably approximated by reference to the activities of the taxpayer's customer. The second rule only applies if the presumption in favor of the first assignment rule is overcome.

Subsection (c)(2)(C) sets forth the third rule of assignment which is the location from which the taxpayer's customer placed the order for the service. This rule only applies if where the benefit was received cannot be determined under the first two rules provided in subsections (c)(2)(A) and (B). This provision is the third-in-line cascading rule that seeks to establish the taxpayer's market in the event of a lack of best evidence, i.e. the contract, the taxpayer's books and records, and the inability to reasonably approximate the location of the taxpayer's market. This alternative is only available in the event the first two cascading rules cannot determine the location where the benefit of the service was received.

Subsection (c)(2)(D) sets forth the final rule of assignment as the taxpayer's customer's billing address. This final rule is a catch-all when none of the provisions above can establish the location where the benefit of the services was received.

Subsection (c)(2)(E) gives examples showing how the cascading rules in subsection (c)(2) operate. Examples 1, 2 and 3 illustrate assignment under subsection (c)(2)(A) using a taxpayer's books and records. Example 4.a illustrates assignment under subsection (c)(2)(A) using a taxpayer's books and records and example 4.b illustrates assignment under subsection (c)(2)(B) by reasonably approximating where the benefit of the services was received. Example 5.a illustrates assignment under subsection (c)(2)(C) when the first three cascading rules are unavailable and the sale must be assigned to the location from where

the services were ordered and example 5.b illustrates subsection (c)(2)(D) where the first four cascading rules are unavailable and the sale must be assigned to the customer's billing address.

Subsection (d) addresses assignment of sales from intangible property. Sales are assigned to this state to the extent the intangible property is used in this state.

Subsection (d)(1) addresses assignment of sales from intangible property where a complete transfer of all property rights for a jurisdiction or jurisdictions has been made.

Subsection (d)(1)(A) sets forth the first assignment rule for a sale where a complete transfer of all rights in intangible property has occurred. It provides that if the contract between the taxpayer and the purchaser indicates the extent of the location[s] where the purchaser will use intangible property at the time of purchase, then the assignment will be on that basis. Subsection (d)(1)(A) continues by stating that if the contract or the taxpayer's books and records do not specify where the purchaser will use the property, then the use the taxpayer made of the intangible property prior to the purchase will be used. The presumption may be overcome by a preponderance of the evidence that the actual location of the use by the purchaser is not consistent with the terms of the contract or the taxpayer's books and records.

Subsection (d)(1)(B) provides that if the assignment cannot be made by subsection (d)(1)(A), then the location of the use of the intangible property shall be reasonably approximated by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser will use the intangible at the time of the purchase, to the extent this information is available to the taxpayer. This rule assumes that the purchaser will use the intangible where it is doing business at the time of purchase. This rule also contains a limitation that the taxpayer cannot assign the use of the intangible to places where the purchaser does not conduct its business at the time of purchase.

Subsection (d)(1)(C) provides the final place of assignment as the billing address of the purchaser. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(1)(A) or (B).

Subsection (d)(1)(D) provides examples showing how the cascading rules in subsection (d)(1) operate. Example 1 involves a sale of 100% of the stock in a business and makes the assignment based upon where the assets controlled by the intangible are located and will be used by the purchaser. This is accomplished by reference to the apportionment factors of the subsidiary that is sold. This is an application of the subsection (d)(1)(A) rule. Example 2 illustrates an assignment under the second rule based upon the taxpayer's knowledge of where the purchaser was doing business under subsection (d)(1)(B). Example 3 illustrates circumstances when the final alternative, the purchaser's billing address, under subsection (d)(1)(C) would apply.

Subsection (d)(2) sets forth the rules for assigning receipts from the licensing, leasing, rental or other use of intangible property, as defined in subsection (b)(5), not including sales of intangible property provided for in paragraph (1).

Subsection (d)(2)(A), entitled "Marketing intangibles," provides the rules for the assignment of sales where a license is granted to use intangible property in connection with the marketing of goods, services or other items to customers in this state. The receipts from these types of licensing agreements are assigned to the location of the retail customers who purchased the goods, services or other items that are marketed in connection with the intangible property.

Subsection (d)(2)(A)1 sets forth the first rule of assignment that the contract between the taxpayer and the licensee or the taxpayer's books and records will establish the extent to which the goods are purchased by retail customers in this state, in which case the sales will be assigned to this state.

Subsection (d)(2)(A)2 provides that if the information is not available to assign the sales pursuant to subsection (d)(2)(A)1, the location of the use of the intangible property (the retail customers of the licensee) is to be reasonably approximated by reference to the activities of the taxpayer's purchaser (the licensee) to the extent such information is available to the taxpayer. Reasonable approximation can include a population proxy, but may only be based on population data where the licensee uses the intangible to market goods.

Subsection (d)(2)(A)3 provides a special rule where the licensee does not sell directly at retail and therefore neither the taxpayer nor the licensee would have information on where retail sales occur. Where the sale is at the wholesale level rather than to retail customers, then the taxpayer may use the percentage of this state's population to the total population of the geographic area in which the licensee markets its goods. A limitation is provided that the population of foreign countries can only be used if the intangible is materially used in marketing goods in a foreign country.

Subsection (d)(2)(B), entitled "Non-marketing and manufacturing intangibles," provides the rules for assignment of sales where a license is granted for the right to use intangible property in a manufacturing process or for another non-marketing purpose. This type of sale is assigned to the location where the intangible property is used, i.e. the manufacturing plant or other place of use, rather than the location of the ultimate consumer who purchases the manufactured product.

Subsection (d)(2)(B)1 provides that the primary rule that the contract between the taxpayer and its licensee, or the taxpayer's books and records, is presumed to indicate the extent of the use of the intangible property in this state. Either the taxpayer or the Franchise Tax Board may rebut this presumption by showing that the place of use is not shown by the contract or the taxpayer's books and records.

Subsection (d)(2)(B)2 provides the second rule of assignment that the location of the use of the intangible property is to be reasonably approximated by reference to the activities of the licensee to the extent this information is available to the taxpayer. This second rule only applies if the first rule cannot be applied.

Subsection (d)(2)(B)3 provides a third rule of assignment which is the state of the licensee's billing address. This rule only applies if the first two rules cannot be applied. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(2)(B)1 or 2.

Subsection (d)(2)(C), entitled "Mixed Intangibles," provides the segue for the rules for assignment of those sales where a license is granted for the right to use intangible property in both a marketing and manufacturing or other non-marketing purpose.

Subsection (d)(2)(C)1 provides that where the fees for the marketing are separately stated in the licensing contract from the fees for the manufacturing or other non-marketing purpose, then the fees shall be assigned based on that separate statement. However, if the separate statement is not reasonable, then the Franchise Tax Board may use a reasonable method that accurately reflects each use of the intangible property.

Subsection (d)(2)(C)2 provides that where the fees are not separately stated, then it is presumed that the fees are paid entirely for the intangible property in connection with the marketing of goods, services or other items. Either the taxpayer or the Franchise Tax Board is allowed to establish that the fee was not paid exclusively for marketing.

Subsection (d)(2)(D) provides examples for how to assign sales in connection with the licensing of intangible property in subsections (d)(2)(A), (B) and (C) above. Example 1 illustrates assignment pursuant to subsection (d)(2)(A)1 in connection with a marketing intangible where the licensing fees are based on a percentage of total products sold in each state. Example 2 illustrates assignment pursuant to subsection (d)(2)(A)2 in connection with a marketing intangible using a reasonable approximation method. Example 3 illustrates assignment pursuant to subsection (d)(2)(B)1 in connection with a non-marketing intangible using the taxpayer's contract and books and records. Example 4 illustrates an assignment pursuant to subsection (d)(2)(C)2 in connection with mixed intangible under an agreement which does not separately state marketing and manufacturing licensing fees. Example 5 illustrates assignment pursuant to subsection (d)(2)(C)1 in connection with a mixed intangible under an agreement that does separately state marketing and manufacturing licensing fees. Examples need to be added to show assignment pursuant to subsections (d)(2)(A)3, (d)(2)(B)2 and 3, and (d)(2)(C)1.

Subsection (e) provides that sales from the sale, lease, rental or licensing of real property is in this state if the real property is located in this state.

Subsection (f) provides that sales from the rental, lease, or licensing of tangible personal property are in this state if the tangible personal property is located in this state. There is an example provided.

Subsection (g) provides introductory language to the special rules for this regulation.

Subsection (g) (1) states that the Franchise Tax Board must consider the effort, expense and resources required of a taxpayer to obtain the necessary information to assign sales under RTC section 25136, subdivision (b). The Franchise Tax Board may accept a reasonable approximation where appropriate such as when a smaller business cannot develop the

necessary data from its financial records kept in the regular course of its business. An example is provided.

Subsection (g)(2) provides that in determining customers' or licensee's use of intangible property in connection with "Marketing Intangibles" under subsection (d)(2)(A)2, factors to be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold in each state, or other data including population. This language provides guidance as to how to "reasonably approximate" marketing intangibles.

Subsection (g)(3) segues for special rules in determining reasonable approximation of the location of the market for the benefit of the services or the location of the use of intangible property.

Subsection (g)(3)(A) states that once a taxpayer has used a particular reasonable approximation method under any provision of the regulation, then the taxpayer must continue to use that method in subsequent taxable years. To use a different method the taxpayer must seek permission of the Franchise Tax Board.

Subsection (g)(3)(B) states that the method of reasonable approximation must reasonably relate to the income of the taxpayer. For instance, if the taxpayer includes countries in its reasonable approximation for which no sales exist, then the taxpayer's method for reasonable approximation does not reasonably relate to its income.

Subsection (g)(4) incorporates, with appropriate modifications, provisions under CCR section 25137 into the regulations under section 25136(b). Subsection (g)(4)(A) provides that references in the regulations promulgated under RTC section 25137 that refer to RTC section 25136 and CCR section 25136 shall, for purposes of section 25136(b), refer to RTC section 25136, subdivision (b), and CCR section 25136(b). Subsection (g)(4)(B) states that CCR section 25137(c)(1)(C) [Special Rules. Sales Factor] is not applicable. Subsection (g)(4)(C) states that the provisions in CCR section 25137-3 [Franchisors] that relate to the taxpayer not being taxable in a state are not applicable. Subsection (g)(4)(D) states that the provisions in CCR section 25137-4.2 [Banks and Financials] that relate to income-producing activity and costs of performance and throwback are not applicable. Subsection (g)(4)(E) states that the provisions in CCR section 25137-12 [Print Media] that relate to a taxpayer not being taxable in another state and the sale's inclusion in the sales factor numerator if the property had been shipped from this state is not applicable.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandates on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: The Board is not aware of any cost impacts that a representative, private person or business would necessarily incur in reasonable compliance with the proposed action.

Significant effect on the creation or elimination of jobs in the state: The Board is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of existing businesses, and the expansion of businesses currently operating in the state. The Board has made an initial determination that the proposed regulation will not have an effect on any of the above, but invites interested parties to comment on this issue.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of business currently doing business within the state: None.

Effect on small business: The department has made an initial determination that the adoption of the proposed regulation will not affect small businesses as generally multi-state corporations are not considered small businesses and this proposed regulation will apply only to multi-state corporations. However, the Board invites public comments on the question of economic impact on small businesses.

Significant effect on housing costs: The Board is not aware of any significant effect on housing costs that will be incurred by reasonable compliance with the proposed regulation.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board has determined that no reasonable alternative considered by the Board or that has otherwise been identified and brought to the attention of the Board would be more effective in carrying out the purpose of this proposed regulation or would be as effective and less burdensome to affected private persons than the proposed action.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation, the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website identified below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantial or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen.berwick@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Melissa Potter; Telephone (916) 845-7831. This notice, the initial statement of reasons and express terms of the proposed regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.