

Summary of Interested Parties Meeting
Regulation §25136, Sales of Other than Sales of Tangible
Personal Property

- I. **Administration:** On February 10, 2010 at 1:30 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board central office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Colleen Berwick for later correspondence. Phone participants introduced themselves. The session was tape recorded for reference but there will be no attribution of comments and no transcript.

The Hearing Officer, Melissa Potter, listed the four documents available as handouts: the notice of the meeting, the list of discussion topics, a copy of SB 1750, and a 50 state analysis of other states' similar statutes and regulations in connection with the terms "benefit of the service" and the "location of the use of intangibles." Parties were told they had until March 15, 2010 to submit written comments and that a summary of the interested parties meeting and any written comments would be posted online. The hearing officer explained that the purpose of the meeting was to provide the public with an opportunity to discuss and provide comments on the regulation to implement the market-based rules for sales other than sales of tangible personal property.

- II. **Discussion:** The discussion was organized by subject matter beginning with "benefit of the service" followed by "location of the use of intangibles." The comments are not necessarily replicated in the order spoken but rather are grouped topically. The numbering of the comments is for ease of reference and do not assign any importance to one comment over any other comment. Public comments have been italicized.

A. Benefit of the Service.

1. Definition of customer or purchaser. Georgia has a statute that defines "customer." The statute refers to "customer" in one place and "purchaser" in another. Is there a reason for the two different terms? Customer is preferred over purchaser.
2. Where the purchaser received the benefit.

Other states with similar statutes/regulations. Seven states have rules for where the purchaser received the benefit: Georgia, Illinois, Maine, Minnesota, Iowa, Ohio, and Wisconsin.

3. Example scenarios:
 - a. What if the purchaser is a business purchasing services provided to the employees of the business? Who receives the benefit? The business or the employees?
 - b. There is a contract with an IP company to produce custom software to be used in your business everywhere. What is the seller of the service going to know about that? Is the benefit of the service in the head office or at the location of field offices? Or what about a law firm giving legal advice for something – could be general advice for the corporation itself or a situation that has arisen in a specific office?
4. Possible solutions:
 - a. How sophisticated do you want to be? Address? Commercial domicile? Or more detail? Where the order was placed or where the software was actually used?
 - b. Is assignment to the ultimate customer feasible?
 - i. *Administratively it is difficult to know customer of customer. Prefer the commercial domicile of customer.*
 - c. What about a cascading approach?
 - i. *Minnesota has ordering rules (cascading sourcing rules) that simply look to the person to whom you sold the services and where they received the services. There is no tracking to tiers of customers. If the customer operates in 3 states, do we divide the benefits between 3 states? Yes, if we can, but if we can't, we should use ordering rules: the office where ordered from then the office where the service is received.*
 - d. Billing address v. commercial domicile?
 - i. *Billing address may be more easily manipulated, but it also may be more readily identifiable. Taxpayers don't necessarily know commercial domicile of customer.*
 - ii. Manipulation, however, would require some kind of conspiracy between the seller and purchaser – may be difficult to control where billed. It might be overly narrow to use the billing address. The benefit may be received in a different location than the billing address. We do not want the regulation to conflict with the statute. Not all benefits are necessarily realized by the purchaser; could be split up with others.

- iii. What if customer is in dispute with states as to where its commercial domicile is?
- iv. *Commercial domicile makes more sense because in a service context, it goes to where the recipient is being controlled, managed from. Texas works this way in connection with software sales. Texas actually uses legal domicile and not commercial domicile. Commercial domicile may have nothing to do with management or where the benefit is received. For example, what if the corporation is incorporated in Delaware?*
- v. *Does this create an incentive to move out of California? No because it's the tax of the provider, not the purchaser.*
- e. Do we need to define a benefit? It is unlikely that a provider will argue that its services provide no benefit.
- f. What about the Minnesota cascading-end throw-out rule? There should only be a small amount by the time you get through the cascading rules. Similar to the rule for mutual funds. However, the idea was that this would only apply to a very small amount of taxpayers. If you can't assign it, then you shouldn't put it in.
- g. What about benefits received by a company doing business in 3 different states? Do you proportion the benefit between the states? If it can be determined, yes, but if not then default to the ordering rules. What about a payroll processor? The billing address may be CA but the employees (who receive the benefits) are spread out between the states. What then? Location of the benefit of the service would be determinable. However, if there are other facts, then the location may not be determinable. Do we then have a different rule? Would taxpayers be filing their taxes in several ways? The goal is to obtain records and facts using the regulation as a guide.
- h. It is possible that the benefits may be divided between the buyer and seller? It may be difficult to determine extent of the benefits. Should we do something similar to the regulation for the mutual fund industry, based on the shareholders' location, giving latitude if you do not have the shareholder's address? Where is the middle ground of filing the return, but still complying with the law?
- i. What about pro rata assignment? For example, what about a payroll processor with contracts in 30 states, do we assign it all to California? Or health insurance benefits for all of the purchaser's employees in more than one state? We need to find out where the benefit is, according to the statute, and this might require additional

recordkeeping. However, the location may never be determinable. If you have a rule that says "if you can do this, do this", then the people who will benefit from doing so will spend the time and energy to have their recordkeeping match that, and others won't. This will create a system where some use one rule and others another. Not a great thing from the state's angle, but also from a competition view point; competitors would like others in the same industry to be doing taxes the same way.

j. Would people want specific, industry specific, complex rules? Do people want details or general rules?

i. *If you can get simplicity it is better, but the process may necessitate complexity. Lots of businesses seem to disfavor general rules, in favor of more specific rules that give direct guidance on issues.*

ii. Even Ohio leaves out some industries.

k. *May rulings be issued? A possible approach.*

l. *Include cascading rules with examples.*

5. Administration issues:

a. *Administratively, trying to know where your customer's customer is may be tough to identify. So maybe we should consider commercial domicile of purchaser as a default rule – deal with the quirks at the extremes.*

b. *Where the benefit of the service takes place is not something recorded by an accounting department. That information is not readily available. You will need to go to a specific contract, but once executed, the details of the contract as to the benefit of the service will not be kept.*

c. Has any taxpayer or taxpayer representative had any experience in complying with these sophisticated statutes in other states? Do you keep your accounting records accordingly? It might vary by company. Those that are really interested in tracking it will do so.

d. *Large companies will keep info on billing address, but not commercial domicile. Customer may dispute commercial domicile – how does a vendor deal with this? Electronic commerce might not know where the customer is located and perhaps only know the billing address of a customer. This is especially so when selling to individual consumers.*

- e. *We would like a regulation under which, if all the records are available and all facts and circumstances are known, the regulation will provide an answer regarding how to comply. If you can't, what do you do? How do you prove you cannot? Will FTB say, "If you had the right recording system this would have been determinable?" Or is it a safe harbor, where the residual rule is default unless you want to put the effort in to keep better records?*
- f. *Ohio's regulation says that taxpayers do not need to go out and change accounting systems to comply as long as they act in good faith.*
- g. Georgia provides that taxing agency may be able to look at records and find information.
- h. *Size of company may be a factor – large companies may not seek to implement new information systems to track benefit of the service information because they average out the cost across many customers in many states, while a small business may want to look more closely at where its customers are really located, because they don't benefit from the same averaging out.*
- i. Ohio has very specific rules. What does industry prefer – more or less detail? Even Ohio leaves out some industries.
 - i. *Prefer simple rules if we can get it but practically that may be difficult. Industry specific rules often want more details so industries can plan accordingly (FIN 48.)*

B. Location of the Use of Intangibles.

1. Definition of Intangibles:
 - a. *It should be discussed, because there is enough uncertainty right now and it affects taxpayers' compliance position.*
 - b. States with definitions: Georgia and Michigan.
 - c. *What do you do with your property factor for software assets – if you answer this here in these regulations, then you might as well answer it for the property factor, too.*
2. Location of the use:
 - a. Ultimate customer: Is that practicable? 7 states assign sales from intangibles to the ultimate customer: Indiana, Kentucky, Massachusetts, Michigan, Minnesota, North Carolina, Wisconsin.

3. Example scenarios:
- a. How does industry now deal with the context of royalties? What information is provided in a royalty agreement based on sales to ensure that they give you the right amount? How do you know you are getting the right amount? Can that information be used in this context?
 - b. The problem is that there is such a diverse array of things you are covering. Intangible holding company cases, like *Geoffrey*, were for a trademark percentage of sales within a unitary group. However, many cases are licensing to a third party, and in many cases there are geographic limitations as to where the license applies, but it typically will be the US or foreign countries. If to the US, how do you assign those sales? Illinois assigns the sales to the customer's customer by using a population sample. Assigning the sale to the customer's customer is problematic because the taxpayer doesn't have information as to who the ultimate customer is, so Illinois uses that formula.
 - c. If a patent is in a manufacturing process, then it is a different situation – you know where the factories are that use it, but you wouldn't care who the product was sold to.
 - d. In the case of tangible personal property and you sell to a large distributor, it is going to be the place you ship the goods to, not each individual store. If that distributor services six states, you are not going to try to apportion between the six states, but rather where the warehouse is located.
 - e. Your customer may not be the ultimate customer – you may license to someone who sublicenses to 10 other people – you may not know. Wouldn't you have a prohibition on sublicensing or something? We say where is your ultimate customer, and that is as far down as it needs to go – as long as it is assigned that is good?
 - f. If A creates technology to put in cell phones and licenses it to a large cell phone manufacturer, what do you get from them to tell where they sold it, and does A even care? Maybe there is data, but not data that matches an ultimate customer rule.
 - g. Some licenses are not contingent on sales volume. What do you do with those sales? What do you do with upfront fees before any sales are made?

4. Possible solutions:

- a. California Senate Bill 1750 does a customer's customer kind of analogy regarding royalties and where the underlying sale occurs. If the location of the factory where product is produced is considered the location of the use, then we may not actually find the market that creates the value of the good that is being charged for. The default percentage relates to tangible property sales factor. Caution as to whether the policy of SB 1750 fits this case. In the example given in SB 1750, the entities were affiliated entities and information was likely present within the group. In the context of third party transactions, it might not be practicable to assume that the taxpayer will know where the customers' customer is located and capture the info necessary to apportion under the ultimate customer concept.
 - i. *The history of SB 1750 was crafted for a narrow purpose and may not apply broadly. Not everyone is going to have the sales of tangible personal property be representative of their intangible revenues.*
- b. *What about the McDonnell Douglas case?* Ultimate destination was the answer, but the decision looked through to the ultimate customer. That's why we want the industry perspective.
- c. What is the preference? Cascading rules? Alternatives? Is the preference to capture value added leaving California or is it something else like the ultimate market? What is the available information to the taxpayer?
 - i. *It depends on what the contract says, or how sales are structured, and documents provided.*
- d. The legislation suggests that we are trying to find a California market. What does that mean? If manufacturer in CA uses an intangible in the process – is that the market? Or does it relate to the actual product that may be sold in another state? What are we really trying to find? Assigning to factory location may be a problem because most factories are located overseas.
- e. How about using the language of 25127 for patents and royalties? Manufacturing with throwback and commercial domicile? Should we define "taxpayer" in that context? Patent right is not just right to make but also the right to make and sell.

- f. Is throwback/throwout appropriate in the regulation if the language is not in the statute?
 - i. *Throwback doesn't go with statutory intent of market place.*
 - g. 25137 sales factor rules: Income-producing activity/costs of performance did not work well. What do we do with those now that we have market-based rules? Should we move those rules to the new 25136 standard rules?
 - i. *Yes, because the normal rules didn't work and that's why 25137 sales factor rules were developed. It is logical to move those rules to 25136.*
 - ii. We might want to consult with each industry involved.
 - iii. Wisconsin. Location of the use. Number of license sites, etc.
5. Administrative Issues:
- a. *Records available: depends on the structure of the contract with customer and the documents provided.*
 - b. *Invoice elements: sale to/bill to/shipping address/legal domicile is easier. Customer location is hardest to find.*
 - c. Cell phone and software: information would be the number of cell phones manufactured at a location. Actual tangible personal property is not tracked to where it goes to end retailer customer. Software follows tangible personal property rules under 25135.
 - d. Taxpayer's direct customer. Purchaser: could go out further (customer of customer).
 - e. OEM manufacturing states would know where manufacturer is. Illinois uses population for where tangible personal property goes. Formula in lieu of actual information.
 - f. *Can't determine ultimate destination for 25135, so why try to in 25136?*
 - g. How do you verify the royalties received as correct? Do you use the number of cell phones manufactured?
 - h. *Some licenses are a fixed amount based on access to the technology and are not based on number of units.*

- i. Michigan, North Carolina, Massachusetts and Kentucky all have different approaches.

III. Written Comments Received by March 15, 2010

A. First Commentator:

1. Consider incorporating Legal Ruling 97-1.
2. Transfer existing 25137 regulations to 25136 where appropriate.
3. Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.
 - a. The easiest, available information for taxpayers is probably the billing address, address in contract, etc, especially if it is the type of business that has thousands in customers vs. a business that only sells to a few.
 - b. Define Service. Are there different kinds of services, i.e. personal service vs. other types of services? Should they be treated differently? What is service vs. intangible property?
 - c. Define Purchaser. What if purchaser is different from who received the benefit? For example, Corp X is the purchaser who then turned around and "gave" the service to Corp Y affiliate in CA who is not the purchaser? Could the taxpayer then argue that purchaser did not receive benefit in the state even though its affiliate did?
 - d. Should different types of services be distinguished? What about a service that can be performed in one place but received in other locations (membership fee) vs. services that could only be received where the service was performed (concert sales)? Would the personal service be assigned based on where the service was performed?
 - e. Should there be a rule that says that if the purchaser is an individual consumer, then the sales will be assigned to this state if the customer is located/resides in this state? If the purchaser is a business entity with multiple locations, should the sale be assigned to X (i.e., commercial domicile)?
 - f. Define what level to look at in determining whether the benefit was received in this state. For example, a service provider (Corp X) to purchaser (Corp Y) subcontracts with a third party (individual or Corp Z). For purposes of determining how to assign sales of Corp X, clarify if the determination of whether the benefit is received in this state should be done at the purchaser (Corp Y) level or the third party (Corp Z) level. (NOTE: There was a lot of discussion during the IPM about

Corp Y not having the information as to where Corp Z received the benefit. Someone made a comment that if 25136 is supposed to reflect the market state, do we make this determination at Corp Y level or at Corp Z level if we're trying to capture the true market)

- g. Address how to determine where the benefit is received, i.e. commercial domicile, billing address, where actual service by taxpayer's employees or independent contractors are performed, or cascading rules. NOTE: This would only apply if it's not for personal services. If a personal service, would we just assign to the state where the service was performed because most likely, that's where the benefit was received?
 - h. Address how to assign sales when benefit is received in multiple states.
 - i. Do we need special rules for things like advertising? Where is the benefit of advertising received?
4. Examples of types of sales from services that may need to be specifically addressed:
- a. Management fee – benefit could be received in multiple states if purchaser is located in multiple states.
 - b. Membership fee/Association fee – primarily received in one state but could be used in multiple states.
 - c. Commissions – should be assigned to the state where the service that generated the commission was performed.
 - d. Production and distribution of information, transmission or management fee – benefit could be received in multiple states if purchaser is located in multiple states.
 - e. Membership fee/Association fee – primarily received in one state but could be used in multiple states.
 - f. Commissions – should be assigned to the state where the service that generated the commission was performed.
 - g. Production and distribution of information, transmission or distribution or communication of data, data processing – the taxpayer will have billing/contract address, but the benefit is received by whomever is using the information.

- h. Electric power, natural gas, steam supply, water supply, and sewage removal (which includes generation, transmission and distribution) – taxpayer will have billing address, the benefit is most likely received at that address.
 - i. Finance, insurance and underwriting – taxpayer will have billing address/contract address – benefit may be received in multiple locations, but the purchase is most likely done by corporate headquarters.
 - j. Professional, scientific and technical service (accounting, bookkeeping, and payroll services; architectural, engineering, and specialized design services; computer services; consulting services; research services; advertising services; photographic services; translation and interpretation services; veterinary services.)
 - k. Arts, recreation and entertainment (promotion and producing) – will be assigned to this state if the customers are in this state.
 - l. Internet sales, i.e., travel, music, downloadable movies – if customer billing address is in California, then sales are assigned to California.
 - m. Internet related sales, i.e., advertising, commission, – who is benefiting from advertising? Example: Corp A advertises on Corp X's website. Corp A pays Corp X for every customer that visits their website as a result of the advertisement.
5. 25136(2) Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
- a. Define intangible property. Is it income other than income from services (a)(1) and sale/lease/licensing of real and tangible personal property ((a)(3) and (a)(4))?
 - b. Address similar issue in III (A)(C)(iv) above.
 - c. How is the property assigned if the property is used in multiple states? Is the answer different than assigning sales from service (a)(1) when the benefit is received in multiple states?

NOTE: unlike "sales from services" above, where the purchaser is assumed to be receiving the benefit, this does not assume that the purchaser is the user because it does not refer to the customer or the purchaser, rather, it only refers to whether the property was used in this state.

6. Examples of types of sales of intangible property that might need to be addressed:
 - a. Royalties, trademarks, patents, or goodwill -- property is considered used in multiple states if taxpayer is in multiple states.
 - b. Radio and TV Broadcasting, cable and other program subscription -- use customer billing address.
 - c. Mortgage and loan brokerage, clearinghouse and reserve services, and check cashing services. -- these do not fall under marketable securities but should these be assigned to California if the customers are in this state?
7. 25136 (4) Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state:
 - a. Located in this state when, i.e., at the end of the year regardless of where it was in the beginning of the year? What happens when the property is within and without the state during the taxable year?

B. Second Commentator:

1. Taxpayers need to be able to comply without unreasonable effort, and FTB auditors need enough guidance to perform audits without forcing taxpayers to develop additional records that the taxpayer did not have readily available at the time of filing the return.
 - a. Recommends that California adopt Ohio's provision that taxpayers are not required to upgrade their systems to comply as long as the taxpayer makes a good faith effort to "situate" receipts from services in a reasonable, consistent, and uniform method that is supported by the taxpayer's business records as they existed at the time the service was provided or within a reasonable time thereafter.
2. Flexibility should be provided to taxpayers to file on a reasonable and consistent approach. One size does not fit all. Companies in different industries of different sizes will have different information available. Regulations should provide guidance as to how to handle these different situations. The rules should be flexible enough that taxpayers using good faith efforts to comply using methods that are reasonable and consistent over time should not be subject to an auditor's point of view that the taxpayer should have established different records. Because of taxpayer complexity, there should be as much guidance as possible including specific approaches for different industries for categories of intangible income including royalties and services.

- a. Concern is raised where the only information a seller has is the billing address associated with a credit card. The seller may know where the product is being manufactured but not where it is ultimately used.