

Summary of Interested Parties Meeting – July 19, 2010
Regulation §25136, Sales of Other than Sales of Tangible
Personal Property

- I. **Administration:** On July, 19, 2010 at 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board 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 3 documents available as handouts: the notice of the meeting, proposed language with notes, and explanation of draft language. Parties were told they had until August 19, 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 proposed regulation language 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. Definitions:

1. *The term "Market" in (a) is defined as sales within this state. It is a conclusory term. Does it apply to sales of services only? What about intangibles? In connection with the term "intangible property" in (d)(1), there appears a list of what is not "intangible property." Define the term "intangible property" rather than listing what is or isn't intangible property as is done in (d)(1). Does the term "market" apply to everything or just services? FTB response: "market" applies to both services and intangibles. FTB should consider defining "intangible property."*

2. *Shouldn't "customer" appear after "taxpayer" in (b)(2). FTB response: yes.*

3. *The word "reasonably" should be placed in front of "developed" in the third sentence of (b)(4) and (b)(4)(A). FTB response: agreed.*

4. *Will FTB consider the cost of compliance? FTB response: yes. FTB patterned the language in (b)(4) after Regulation § 25106.5-10(e)(1).*

5. At one time FTB refers to "purchaser" and at another time "customer." Do they have the same meaning? FTB response: yes. FTB will consistently use the term "customer."

6. Define "intangible" and "use" as used in (d). The term "functional use," [the purpose for which it is intended] as defined by sales tax law might be helpful. Check regulation 1620. For example, noise reduction is being used by the consumer listening to the product using the noise reduction feature. FTB response: We will consider various possible definitions.

B. Benefit of the Service – Individuals:

1. Looking at the contract terms is a good idea. However, the example is confusing. There is an enterprise-wide value. FTB response: We will reword the example so that it is not confusing.

2. Is the location where the service is rendered the same as where the benefit is received? In the cascading rules [(c)(1)(A)1.B], the billing address is where the service is "delivered for use", what does that mean? Intangible property can be delivered, but services are different. Is it where the service is performed or where the benefit is received? "Where the benefit of the service is received" – is there a difference between delivery and where the benefit is received? FTB response: the service can be delivered anywhere but the service must be used at the delivery location for purposes of assignment to the sales factor numerator. The intent is to move away from costs of performance to where the customer is located. In the law firm example, the services are performed out of state, and therefore the sale of the services is assigned out of state because that is where the benefit of the services is received. We can continue to discuss whether there is a difference between delivery and where the benefit is received.

3. 25137 may affect all examples. Does 25136 supersede 25137? Which one [25136 or 25137] would you follow? What about the throwback rules in 25137 special rules? We want more discussion regarding 25137 before we see language. FTB response: the 2 sections should work together because 25137 works to get to the location of the market also. The example in (c)(1)(A)2.C in connection with the cable company is an attempt to reach new fact patterns. We want to keep the special rules under 25137. We can put all of the 25137 sales factor provisions within 25136 but that is not necessary. The financial regulations are a complete scheme so it would be clumsy to move some of them to 25136. We could incorporate the special rules by reference. We can discuss these issues more.

4. Billing address is generally okay? FTB response: yes. Everyone travels so where the calls are received or made tends to balance itself out.

C. Benefit of the Service – Business Entities:

1. Are we looking to the initial customer? FTB response: yes.

2. *Is the concept that if market cannot be reasonably approximated then the sales are assigned to where the order was placed?* FTB response: yes. FTB will show in each example how the cascading rules operate.

3. *In Example B [Law Corp], the services sale is assigned to where the benefit is received. In Example C [Accounting Corp], the services sale is assigned to where the client is located. Service is usually in several states and there is usually no break-down of what service is done in what state.* FTB response: if the location where the benefit is received is not determinable under the contract, then reasonably approximate where the benefit is received and if it cannot be reasonably approximated, then go to the next cascade [the location from which the customer ordered the service], and then if necessary to the next cascade [customer's billing address.] FTB will add all the cascading rules to each example so one can see how they work.

4. *Taxpayer could use client's factors.*

5. *What about out-of-state service providers who had used costs-of-performance and now only 10% is assigned to California? That taxpayer likes the customer's location as the place of assignment.* FTB response: yes, this market-based rule works differently than the costs-of-performance rules.

6. *Example D [Web Corp] delivers content to subscribers. Where is the benefit received? The benefit is received where the taxpayer is earning revenue.* FTB response: the idea is that we get to the market, the "circulation eyeballs" – where people are looking at the advertisement – which is where the benefit is received. The example is consistent with [25137] -8 and -12. The taxpayer in that example is the publisher of the website not the drafter of the advertisement. The market for the advertising is not the DSL provider or the web page. *What about assigning the sales to the taxpayer's commercial domicile?* FTB response: that would be inconsistent with Regulation §§ 25137 -8 and -12. Advertising on the internet is in the middle of those two factual scenarios and so we give an example of an internet situation here in Example D.

D. Location of the Use of Intangibles – Complete Transfer of All Property Rights

1. *(d)(1) is awkward and does not flow.* FTB response: we agree and will reword the subsection.

2. *How is the sale of the stock of a subsidiary "used by the purchaser at the time of purchase"? This situation does not fit within the definition. For example, a domestic parent sells a foreign subsidiary to a domestic purchaser who has both domestic and foreign operations, how does the selling parent know what the domestic purchaser is going to do with the subsidiary? Should we use a proportionate ratio of sales of the unitary subsidiaries? Duplicate the factors? The purchaser/subsidiary could be a holding company.* FTB response: the problem in determining the location of the use of stock of a subsidiary which is sold is that where there is a sale of stock, it usually occurs in one state, but the value of the business is spread across several states. To determine the location of

the use of the intangible property sold, the right answer might be that we use the factors at the time of the sale because we could assume via rebuttable presumption that the subsidiary would be used by the purchaser in the same way that the seller used the subsidiary. We could consider whether a ratio of property or a ratio of sales or a ratio of all the factors of the company sold could be used to determine the sales factor for the sale of stock. We would also have to address the situation where the purchaser uses an intangible corporation, a holding company, to make the purchase. We need either a clear rule for situation of selling stock or we can handle the situation by example.

3. *(d)(1)(B) sounds more like a property factor than a sales factor. The "purchaser's location" vs. the "purchaser's locations everywhere." Why is the purchaser's location relevant? For example, where a patent is sold, how is the purchaser's location relevant?* FTB response: We'll consider changing the wording of this provision to make the relevance clearer.

E. Location of the Use of Intangibles – Licensing Property Rights

1. *Is FTB going to look three or six levels down to that customer? We would like to lock down the default rule.* FTB response: We will look to the customer's customer if that can be determined under the contract or other cascading rule in order of descent. It really depends on the nature of the product produced. Look at *McDonnell Douglas*: the ultimate location is not where the property is picked up. The seller would want to know where the property ends up. The taxpayer should be able to determine the actual location of the underlying sales under the terms of the contract between the taxpayer and its customer. If not, then the taxpayer can use the remaining cascading rules to determine the location of the underlying sales. The "location of the use" should not be the manufacturing location because that is not the market for the intangible property.

2. *Tangible personal property is different than intangible personal property. Assignment of tangible property is based on destination only. Assignment of intangible property is more amorphous.* FTB response: The value of an intangible is in the creating of something else.

3. *Taxpayers do not collect any of the information needed for (d)(2). A taxpayer would have to create this information. A taxpayer could either assign it to the commercial domicile or based on the "sell to" or "bill to" address lines. Taxpayers want a bright-line rule. Under current proposed draft, there are too many choices and the ability to cherry pick among the alternate rules. There will be issues with other states and auditors who will challenge what information the taxpayer has. Auditors will cherry pick the method. There would be ease of administration if there were a bright-line test such as the billing address. The California economy is so large that as long as the rule is a consistent measurement, California will get its fair share. A direct customer address is as good as the ultimate market so why doesn't California make it easier. If, however, FTB decides to keep the cascading rules, "use" must be defined. If "use" is defined, then turn the provisions under (d)(2) into examples.* FTB response: The assignment should relate to the market and not the commercial domicile. If it is unrealistic to use "best data" to obtain actual market location of the use of the intangible property, then we should consider discarding that provision.

Reasonable approximation should only be used if "best data" were not available. We would appreciate examples of controversies with auditors and other states so we can avoid those controversies. Stepping-down cascade rules are used to combine foreign activities. We, however, want to understand the controversies that taxpayers fear including aggressive auditors in connection with these cascading rules. A better reflection of what the rules mean can lead to less controversy.

4. *What about fees for monthly services?* FTB response: For example, is a coupon tangible or intangible property? For another example, is a billing service tangible or intangible property? These issues will ultimately be case law driven but will take time.

5. *Should we simplify the election to go to population unless that would not be materially correct? How about permitting the use of the method of accounting (unless the taxpayer is granted permission to no longer elect the method of accounting)?* FTB response: To elect, would taxpayers petition for the election or would there be a default rule, a rebuttable presumption for a safe harbor, that of population? We need to further discuss these various options.

6. *Example (d)(2)(E)1 needs to be taken out.* FTB response: we will consider this point of view.

F. Special Rules

1. *Regarding (g)(1) [related entities], are intercompany receipts excluded?* FTB response: yes.

III. Comments Received as of October 8, 2010

A. First commentator. *The Accounting Corp example's "reasonable approximation" is not attainable. Accountants would have difficulty gathering that information for every client. The example assumes that public information is readily available. The commentator suggests a presumption that the accounting corporation's method is reasonable. Billing address would also work. The commentator also recommends examples to show how the cascading rules work from top to bottom.*

B. Second commentator. *25136 should not supersede Regulation § 25137-8 since it was recently updated with the cooperation of industry. Where the primary revenue source is not apportioned under Regulation § 25137-8, the proposed regulation is appropriate. Regarding the licensing of intangibles, apportionment should stop at the customer's information because the industry does not have access to state-level data on where these intangibles are used. Secondly, the volume of tangible personal property is not available to taxpayers because not all licensing arrangements are measured by the sale of tangible personal property. Thirdly, there would be potential conflicts with auditors over the hierarchy of the cascading apportionment methodologies. With "reasonable approximation," how would sales ever be assigned to the lower cascade of commercial domicile? Fourthly, the market for the license of the likeness of cartoon characters is the manufacturer not the ultimate retail consumer of the apparel. Looking through to the customer's customer is at*

odds with the market concept. Lastly, the commentator disagrees that "population" is a proxy for "market" because "population" assumes that everyone uses the product.

C. Third commentator. Telecommunications should be allowed to continue to use the "net plant" method of assigning sales to the sales factor per the provisions in the MATM. This method fairly represents the "market" of this particular industry.

D. Fourth commentator. The provisions for contract terms should be in the form of a rebuttable presumption in case where the benefit of the services are received and the location of the use of the intangibles are different than what the contract says. What is the process for choosing "reasonable approximation"? What if there are two equally "reasonable approximations"? What if the taxpayer will not provide the contract? The language needs to be stronger so that taxpayers cannot "cherry pick" which cascading rule they want.

E. Fifth commentator. The language needs to be clear that either FTB or the taxpayer may rebut any of the presumptions contained in the regulation. Regarding the provisions of the complete transfer of all property rights in intangibles, the first and second provisions assume that the buyer is the current user. It seems unreasonable to make a taxpayer predict how and to the extent the buyer is using the intangible. Regarding the provisions of the licensing of intangibles, licensees and licensors do not share information because they may potentially become competitors. "Population" is a fair proxy for "market."

F. Sixth commentator. Accounting Firms should be allowed to continue to use the time spread method of calculating the sales factor. This method, with only a few exceptions, fairly represents where the benefit of the services is received.