STAFF REPORT, STAFF RECOMMENDATION, AND REQUEST FOR ADOPTION OF PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 17952, RELATING TO INCOME FROM INTANGIBLE PROPERTY

On July 17, 2006, Natasha Page of the department's Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed amendment to Regulation section 17952. There were 6 attendees at the hearing. Three persons, who each submitted written comments, also presented comments orally at the hearing. Five commentators submitted approximately 40 comments in total, orally and in writing.

In response to the comments raised, staff intends to notice a 15-day "sufficiently related change" within the meaning of Government Code section 11346.8, subdivision (c), to add a parenthetical phrase in the first example provided. The parenthetical phrase clarifies that the business situs exception is still available to nonresident taxpayers. This additional proposed amendment simply seeks to clarify when the sourcing rules should apply, but does not seek to change which sourcing rules are applicable. This additional proposed change can be seen in the attachment in bold double-underlined text.

Although stated in various ways, the comments fell into 7 general categories:

- The examples presented as part of the proposed amendment were read as requiring solely the application of the *mobilia* doctrine and precluding the application of the business situs exception;
- The proposed regulation is seen as incompatible with the repeal of Revenue and Taxation Code (RTC) section 17554 and other changes made pursuant to AB 1115 (Stats. 2001, ch. 920);
- Questions were posed regarding the application of federal or California-only elections out of the installment method;
- There were questions concerning how, particularly, installment sales would be sourced and which intangible property gave rise to the sourcing of income;
- Since this is a clarifying regulation, challenges were made to the FTB's authority to apply this policy prior to the adoption of this amendment;
- A request for the inclusion of further examples; and
- A request for staff to survey how other states handle this issue and the availability of the "Other State Tax Credit" to former nonresidents now living in California for taxes imposed by states where they formerly resided on these types of gains, assuming those states adopt the same timing principle as provided in the proposed amendment.

With respect to the first category of comments, the 15-day change described above will resolve the expressed concern by providing clarification that the business situs exception may apply.

With respect to the second category of comments, staff does not agree with the assertion that the proposed amendment to Regulation section 17952 is incompatible with the repeal of RTC section 17554, nor does staff believe the proposed amendment is contrary to the changes made to sourcing rules by AB 1115. Instead, staff believes the proposed amendments to Regulation section 17952 merely clarify how the sourcing rules already work.

RTC section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. It was repealed, in part, because subsequent to the *Appeal of Money*[1] in 1983, RTC section 17554 was rarely applicable. The *Appeal of Money* decision provided that RTC section 17554 would apply only when two conditions were satisfied: (1) when California's sole basis for taxation is the taxpayer's residency, and (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting. Since the Board of Equalization limited RTC section 17554 to only those cases of California residency, it was not applicable to nonresidents even back to 1983. Therefore, its application or repeal has no bearing on a sourcing rule applied to nonresidents.

As stated in various pronouncements, AB 1115 specifies clear, definitive rules that will be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. Specifically it provides resident taxpayers will be taxed based on residency jurisdiction and carryovers and deferred items will be calculated regardless of source. Nonresident taxpayers will be taxed solely based on sourcing jurisdiction and carryovers and deferred items will be calculated to reflect such approach. This regulation project was begun as part of the AB 1115 implementation. At that time, it was determined by FTB staff that existing sourcing rules did not adequately address the timing of determining the correct sourcing rule to apply in the case of the sale or other disposition of intangible property. The FTB has a broad legislative delegation of rulemaking authority under RTC section 17954 to promulgate necessary rules and regulations in this area. Moreover, it is fundamental that sourcing principles should apply at the moment of realization, since those rules attach jurisdiction to the sale or other disposition and the resulting income, instead of personal jurisdiction to tax the individual.

With respect to the remaining five categories of comments received, staff will address them in detail in the rulemaking file, but abbreviated versions of staff's responses are set forth below for convenience:

- With respect to the third category of comments, federal elections remain valid, and California taxpayers may make California-only elections out of the installment method.
- With respect to the fourth category of comments, the intangible property sold or otherwise disposed of gives rise to the sourcing of the income. The installment note itself is a deferral mechanism. Absent that deferral, the income would be recognized at realization.
- With respect to the fifth category of comments, the proposed amendment is a clarification of how the law operates presently and thus no prospective-only application of the change is necessary.
- With respect to the sixth category of comments, the example proposed concerns a California resident. Revenue and Taxation Code sections 17951 through 17955 concern the taxation of nonresidents. Specifically, those sections address sourcing rules that are only relevant to nonresidents. Resident taxpayers are taxable on all income, regardless of source. Staff recommends no change.

With respect to the seventh category of comments, staff is conducting a survey as requested and will include the results in its official responses to comments. The "Other State Tax Credit" remains available to former nonresidents now living in California for taxes imposed by the states where they

[1] *Appeal of Virgil M. and Jeanne P. Money* (December 13, 1983) 83-SBE-267.

formerly resided on these types of gains, assuming those states adopt the same timing principle as provided in the proposed amendment.

Staff also received a request for the Board itself to consider and adopt the amendment to the regulation, as provided under Government Code section 15702, subdivision (b), so that staff now requests that the Board adopt the proposed amendment to Regulation section 17952, including the further modification in the above-described 15-day change, and authorize the Executive Officer to proceed under the Administrative Procedures Act.

Notice of Modifications to Text of
Proposed Regulation Section 17952

On July 17, 2006, 2006, Natasha Page of the department's Legal staff held a hearing at the Franchise Tax Board's central office to receive public comments on the proposed amendment to Regulation section 17952. Both the proposed amendment and the proposed adoption were noticed in the California Regulatory Notice Registry on May 26, 2006. Section 17954 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations apportioning and allocating income of nonresident individuals to sources within and without California.

As a result of the comments received during the hearing process, staff recommends that a change be made to the proposed amendment to Regulation section 17952. This change constitutes a sufficiently related change within the meaning of Government Code section 11346.8. The changes provided by this notice are reflected by double underscore. (The amendment to Regulation section 17952 as initially proposed is reflected by single underscore.)

The proposed amendment seeks to clarify when the sourcing rules should apply, but does not seek to change which sourcing rules are applicable. Accordingly, the proposed change to the amendment is the addition of a parenthetical phrase in the first example provided. The parenthetical phrase clarifies that the business situs exception is still available to nonresident taxpayers.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 pm on [enter date.] The Franchise Tax Board is sending a copy of the proposed amendments to Regulation section 17952 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation section 17952.

All inquiries concerning this notice should be directed to Colleen Berwick at Franchise Tax Board, Legal Department, 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 Natasha Sherwood Page; Tel.: (916) 845-6729. The notice and the proposed amendments will also be made available at the Franchise Tax Board’s website at http://www.ftb.ca.gov/.

December 4, 2006

Section 17952 is amended to read:

§ 17952. Income from Intangible Personal Property.

Note: The 15-day changes are indicated by double underscore for additions and double strikeout for deletions.

(a) Income of nonresidents from rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property is taxable, if such intangible property has a business situs in this State within the meaning of (c) below.

(b) Income of nonresidents from intangible personal property such as shares of stock in corporations, bonds, notes, bank deposits and other indebtedness is taxable as income from sources within this State only if the property has a situs for taxation in this State, except that if a nonresident buys or sells stock, bonds, and other such property in California, or places orders with brokers in California to buy or sell such property, so regularly, systematically and continuously as to constitute doing business in this State, the profit or gain derived from such activity is taxable as income from a business carried on here, irrespective of the situs of the property for taxation.

(c) Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here. Again, if a nonresident maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State, the bank account has a business situs here.

If intangible personal property of a nonresident has acquired a business situs here, the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within this State, taxable to the nonresident.

(d) The source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property. For example, if a California resident sells intangible personal property under the installment method, and subsequently becomes a nonresident, any later recognized gain attributable to any installment payment receipts relating to that sale will be sourced to California **(absent a business situs exception)**. Further, a California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments if the intangible personal property had a business situs in California at the time of the sale.

Note: Authority cited: Section 19503~~19253~~, Revenue and Taxation Code.
Reference: Sections 17041 and 17952, Revenue and Taxation Code.

December 4, 2006

SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS REGARDING PROPOSED AMENDMENT TO REGULATION SECTION 17952 HEARING NOTICED MAY 26, 2006

Comments:

1.1 Enactment of this regulation will erode AB 1115 (Stats. 2001, ch. 920), which sought to clarify and provide equal treatment to taxation of new and former residents. (Lynn Freer, Spidell Publishing, July 28, 2003.)

1.2 And I see that this proposed regulation is circumventing the spirit and the language of Section 17041(i)(3) [of the Revenue and Taxation Code]. (Lynn Freer, Spidell Publishing, Public Hearing held July 17, 2006.)

1.3 [W]e oppose the FTB's proposed amendment to 18 Cal. Code Regs. §17952 because we believe the proposed amendment affects where income is sourced when intangible property is sold under the installment method in violation of AB 1115 (Stats. 2001, ch. 920). (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

1.4 The proposed regulation puts California back under pre-AB 1115 law for sourcing intangibles: The gain on the sale would be sourced to California on the basis that the gain accrued when the taxpayer was a California resident. However, why, then did the legislature so choose to repeal R&TC Sec. 17554 back in 2001? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

1.5 We do agree there may be some ambiguity to the source of gain when layered with residency and non-residency claims as stated in the FTB's *Initial Statement of Reasons for the Adoption of Amendments to California Code if [sic] Regulations, Tile 18, Section 17952*. However, we believe the intent of AB 1115 addressed the ambiguity surrounding these very issues. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

1.6 In my opinion, the proposed regulations… are completely inconsistent with the revised California rules for taxing persons who change residence, as adopted in AB 1115 (Stats. 2001, ch. 920), and are therefore invalid under governing law…. The best way to describe the new system [under AB 1115] is to say that source was deemphasized, and residence at the time income was realized under a normal method of accounting, was emphasized. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 1:

Assembly Bill 1115 (Stats. 2001, ch. 920) specifies clear, definitive rules that will be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. Specifically it provides resident taxpayers will be taxed based on residency jurisdiction, and carryovers and deferred items will be calculated regardless of source. Nonresident taxpayers will be taxed solely based on sourcing jurisdiction, and carryovers and deferred items will be calculated to reflect such approach. This regulation project was begun as part of the AB 1115 implementation. At that time, it was

determined by FTB staff existing sourcing rules did not adequately address the timing of sourcing in the case of the sale or other disposition of intangible property. The FTB has authority under Revenue and Taxation Code section 17954 to promulgate rules and regulations in this area. Moreover, it is fundamental that sourcing principles apply at the moment of realization since they apply to attach jurisdiction to the sale or other disposition and the resulting income, not personal jurisdiction over the individual.

The gain on the sale in comment 1.4 would not be sourced to California on the basis the gain accrued when the taxpayer was a California resident. Although the result may be the same, the policy and method are distinct. Under the repealed RTC section 17554, the source of the gain or loss from the sale or other disposition of intangible property was never examined. Instead, the residency of the taxpayer was determined and section 17554 was applied to determine if the gain had accrued while the taxpayer was a resident. If it had, then the gain was taxed under residency jurisdiction.

With the repeal of RTC section 17554 and the adoption of other changes under AB 1115, the State no longer relies on jurisdiction over its residents to tax former residents. If a taxpayer is a nonresident, the State must now rely only on sourcing jurisdiction to tax income. So the initial question (once nonresidency is established) must always be whether or not the income in question is sourced in California. If the income arose from the sale or other disposition of intangible property, the sourcing rules to be employed to determine if that income is indeed California-sourced are the mobilia doctrine and the business situs exception. As provided in the response to comment 3, below, the character of income from an installment note *retains* the character of the income underlying the note. According to the U.S. Supreme Court in 1955 in *Commissioner v. Glenshaw Glass* (348 U.S. 426), income consists of "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Since income occurs at the point of realization, the sourcing of that income should also then occur. Applying the mobilia sourcing rule at the time of the realization is distinguishable from applying residency jurisdiction to tax income. (If the business situs exception is appropriate, it must also be applied at the time of the realization event.)

The FTB maintains this is merely a clarifying regulation. Staff believes income is indeed sourced at realization and this regulation does not provide that rule but rather seeks to make it unambiguous. AB 1115 did not directly address sourcing rules. It did, however, elevate the importance of sourcing and, thus, demanded that sourcing rules be made clearer. An effort to make sourcing rules clearer does not erode or contradict the intent of AB 1115. Although the FTB cannot determine the intent of the legislature, response 4, below, discusses the repeal of RTC section 17554.

Recommendation: Staff recommends no change.

Comments:

2.1 This regulation does not follow the doctrine of *mobilia sequuntur personam* (movables follow the law of the person) in its application today. (Lynn Freer, Spidell Publishing, July 28, 2003.)

2.2 And it would be easy to say if it was sourced, if it was realized in California, it should always be taxed to California, but I think the business situs issue is really the key point which will always have to be determined on a case-by-case basis. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

2.3 With these excerpts in mind, it appears that Proposed Reg. §17952(d) moves away from 17952(c), which calls for the interpretation on a case-by-case basis of any claims to California taxation of intangible personal property due to business situs. Proposed §17952(d) is an attempt to make a rule out of something that must be decided on a case-by-case basis. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

2.4 Whether income from an intangible asset has a business situs in California cannot be decided through application of the *mobilia* doctrine, because that would indicate that unequivocally in every case the taxpayer's income had a business situs in the state. When in fact, sometimes it would, and sometimes it wouldn't. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

2.5 I think it would be very negative for us to mess with what we have gained already through AB 1115 in trying to solve a lot of these issues. And I think the mobilia doctrine is really a sidestep of the issue. The real issue is determining on a case-by-case basis when does intangible income have business situs in the state of California, not trying to make an easy solution by saying we are going to turn to where the intangible income was realized -- where and when -- and to make that the ruling factor. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

2.6 But I really think the only way, when it comes to an intangible asset which is normally sourced to your state of residency, would be to source it somewhere else based on the business situs issue, and to move the argument from “did the intangible income have a source in this state or not” over to “let’s look at point of realization versus point of recognition” was maybe not the right answer to the problem. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 2:

This regulation is intended to clarify sourcing rules are applied at the time of realization. Aside from the mention in the examples, the regulation does not address which sourcing rules are applicable. The two primary sourcing rules applicable to gains or losses from the sale or other disposition of intangible property are: the mobilia doctrine (intangible property is located at the residence of the owner) and the business situs exception (intangible property may be located somewhere other than the residence of the owner if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so its substantial use and value attach to and become an asset of the business, trade or profession in this State). Both sourcing principles will continue to be applied on a case-by-case basis.

Comment 2.4 is incorrect in that the *mobilia* doctrine will apply in the absence of showing a business situs exception. The application of the *mobilia* doctrine does not determine the business situs. These are two distinct sourcing rules. For further discussion on these two rules, see response 5 below.

The proposed regulation seeks to clarify how to answer the question, "Did the intangible income have a source in this state or not?" To determine that source, the answer of when sourcing rules are applied should be clarified.

Recommendation: Staff recommends the addition in the first example of the parenthetical phrase: (absent a business situs exception).

Comments:

3.1 This regulation assumes that the property at issue is the asset that was sold, not the note taken out of state. (Lynn Freer, Spidell Publishing, July 28, 2003.)

3.2 To treat the note differently than a note on the sale of real property would not be in keeping with either the doctrine of mobilia sequuntur personam or the spirit of the elimination of R&TC §17554. If this regulation is enacted, is it the first step toward taxing nonresidents on sales of non-California source real property? We believe that it is. (Lynn Freer, Spidell Publishing, July 28, 2003.)

3.3 I do not agree with the FTB conclusion that the installment note itself does not create a property right. (Kathleen K. Wright, June 29, 2006.)

3.4 What is the basis for the FTB's conclusion that the installment note itself does not create a property right? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

3.5 Is the FTB opining that the note itself is the asset in question and is a movable asset? (Gina Rodriguez, Spidell Publishing, July 7, 2006, and Public Hearing held July 17, 2006.)

3.6 If the note is given economic substance, then the mobilia doctrine would place the deferred gain in the taxpayer's state of residence. But what is the FTB's authority for giving the note economic substance? (Gina Rodriguez, Spidell Publishing, July 7, 2006, and Public Hearing held July 17, 2006.)

3.7 The FTB analysis, however, looks through the intangible asset to the property sold. So, again, we want to know what is the basis for the FTB’s conclusion that the installment note itself does not create a property right. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 3:

The property at issue is the asset sold, not the note. This is the same as sourcing the gain or loss from the sale or other disposition of real property located in California under the installment method. The principal/gain portion of installment proceeds arises from that

sale of California property. The principal/gain portion will continue to be sourced to California, regardless of the residency of the seller, since the real property sold is located in California.

The notes are not treated differently depending on the property sold. It is not the note that gives rise to the income or loss. AB 1115 seeks to tax income from California source gains the same way, regardless of whether a deferral of tax is employed. Absent the use of the installment method (or another deferral mechanism), income or loss is recognized upon realization. If a deferral mechanism is employed, the income is still sourced at the time of its realization. Deferral mechanisms are available to defer, not avoid, taxation. Contrary to the contention in comment 3.2, this is not a step toward taxing nonresidents on sales of non-California source real property.

The FTB has not concluded the installment note itself does not create a property right. Internal Revenue Code section 453 sets forth the "installment method." "Consistent with the policy of spreading gain over the life of the payments, the character of the gain recognized is governed by the character of the gain which would have been recognized if the property had been sold for its full fair market value in cash." Fundamentals of Federal Income Taxation, Cases and Materials, Tenth Edition, by James J. Freeland, Stephen A. Lind and Richard B. Stephens, Chapter 24 (The Interrelationship between Timing and Characterization), Pg. 853, citing IRC section 453(i). The character of the note is not part of the rationale for sourcing the gain or loss from the property sold. The note is the deferral mechanism. Absent that deferral, the income would be recognized at realization. In other words, the taxpayer has a realization event upon the sale or other disposition of the intangible property; the taxpayer defers that income through the installment method. The note is given economic substance such that the interest income is not sourced to California when earned by a nonresident since it is realized periodically under the taxpayer's regular method of accounting (cash or accrual). Further, if the note itself were later sold, the value of the note above the initial gain from the sale or other disposition of the intangible would be distinctly sourced.

Whether or not the note is given economic substance has no effect on the sourcing of the gain or loss from the sale or other disposition of the underlying intangible property.

Recommendation: Staff recommends no change.

Comment:

4.1 This regulation is counter to the intent of the repeal of R&TC §17554. (Lynn Freer, Spidell Publishing, July 28, 2003.)

Response 4:

Revenue and Taxation Code section 17554, prior to its repeal, provided:

When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this state, as the case may be, income and deductions accrued prior to the change of status

even though not otherwise includable in respect of the period prior to that change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

Revenue and Taxation Code section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. It was repealed, in part, because subsequent to the *Appeal of Money*, section 17554 was rarely applicable.[1] The *Appeal of Money* provided Revenue and Taxation Code section 17554 would apply only when two conditions were satisfied: (1) when California's sole basis for taxation is the taxpayer's residency, and (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting. Since the Board of Equalization limited section 17554 to only cases of California residency, it was not applicable to nonresidents even back to 1983. Therefore, its application or repeal has little bearing on a sourcing rule applied to nonresidents.

By the time AB 1115 was being considered, there were very few fact situations that would result in the application of RTC section 17554. When AB 1115 sought to simplify the rules to provide nonresidents are taxed through jurisdiction gained through sourcing concepts, it became apparent RTC section 17554 was superfluous. As a result, RTC section 17554 was repealed with the adoption of the changes made by AB 1115.

This regulation provides clarification of when sourcing rules should apply. The timing of sourcing other types of income, such as income from the performance of services or from the sale or other disposition of real property, also occurs at the time of realization. Therefore this regulation is consistent with when sourcing rules apply in other circumstances.

Recommendation: Staff recommends no change.

Comments:

5.1 The proposed regulation under 17952 … duplicates the examples included in regulations promulgated under (now repealed) Rev. and Tax. Code sec. 17554. This code section was repealed by AB 1115 and therefore it would be a logical result that to put back part of that code section would require legislative action. (Kathleen K. Wright, June 29, 2006.)

5.2 Finally, please see Example 3 of former 18 CCR 17554 (the regulation was repealed on Dec. 10, 2002 due to the passage of AB 1115). While the example deals with the sale of real property, and not intangibles, it clearly shows that a nonresident was subject to California tax because the right to receive the income on the sale accrued before the taxpayer changed residency. Proposed regulation 17952 is attempting to apply the same tax policy as promulgated in a regulation that has been repealed. What is the FTB's authority for this action? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

[1] *Appeal of Virgil M. and Jeanne P. Money* (December 13, 1983) 83-SBE-267.

5.3 In Example 3 of former regulation section 17554, it deals with the sale of real property, not intangibles. However, it clearly shows that a nonresident was subject to California tax because the right to receive income on the sale accrued before the taxpayer changed residency. So the proposed regulation attempts to apply the same tax policy promulgated in this regulation, a regulation that has been repealed. So we want to know again, what is FTB's authority for this action? (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 5:

The examples in Regulation 17554 (Title 18, California Code of Regulations 17554) did not address the sale or other disposition of intangible property.

In light of the repeal of RTC section 17554 and the regulations thereunder, the facts under example 3 would lead to a different result. As explained above, the first question would be whether or not the income in question is sourced to California. In the example, the real property is located in Nevada and, therefore, the income from the sale of that property is not subject to California tax in the hands of a nonresident. Please note the example says the "payments are subject to California tax even though they were not derived from a California source…" With the repeal of RTC section 17554, the payments would only be subject to California tax if they were derived from a California source.

The sourcing rule for income from the sale or other disposition of intangible property is distinct from the sourcing rule for income from the sale of real property. Although both sources are determined by reference to the location of the property, the location of real property is readily determinable. Intangible personal property has no actual situs.

The situs problem is explained well by Frank M. Keesling, former Counsel to the Franchise Tax Commissioner of California, in the 1950 treatise, Allocation of Income in State Taxation on page 35:

> Because of this the law has for tax purposes indulged in fictions. One of these fictions is represented by the maxim mobilia sequunter personam – that the association of intangibles with the person of the owner gives them a situs at the domicile of the owner… A contrary fiction, however, is that of "business situs," under which intangibles which are an integral part of a business carried on at a place are given situs at that place… The situs attributed is still a fiction, however.

The amendments to regulation section 17952 are consistent with both AB 1115 and the repeal of RTC section 17554.

Recommendation: Staff recommends no change.

Comment:

6.1 The guidance would be more useful if the example dealt not only with the sale of intangible personal property by a resident under the installment method who subsequently becomes a nonresident, but also with the sale under the installment method by a nonresident of intangible personal property without a business situs in California, and the nonresident subsequently becomes a resident of California. Otherwise, a reader might incorrectly interpret the last sentence of the proposed addition (which can be interpreted as limited to the business situs exception) as inferring that no tax is due where a nonresident sells intangible personal property on an installment basis prior to becoming a resident of California, and receives an installment payment after becoming a California resident. (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 6:

This regulation is being promulgated under Revenue and Taxation Code 17952. Revenue and Taxation Code sections 17951 through 17955 concern the taxation of nonresidents. Specifically they address sourcing rules that are only relevant to nonresidents. Resident taxpayers are taxable on all income, regardless of source.

Recommendation: Staff recommends no change.

Comment:

7.1 Comment: What is the effect of a federal election [pursuant to Internal Revenue Code section 453(d)] to be taxed at the time of sale? (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 7:

California conforms to Internal Revenue Code section 453. If a taxpayer elects to be taxed at the time of sale, then there would be no deferral of income tax. The source of the income is unaffected by the taxpayer's accounting method or the choice to employ a deferral mechanism. The source of the gain or loss would be determined at the time of the sale or other disposition.

Recommendation: Staff recommends no change.

Comment:

8.1 Comment: May a nonresident taxpayer make a California-only election out of installment treatment? (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 8:

A properly filed federal election to report the gain in the year of sale, rather than on the installment method, is a proper election for California purposes. However, the taxpayer is not required to make the same election for California tax purposes. To elect out of the installment method for California purposes, the taxpayer reports the gain on the sale of the property in the year of sale on their California tax return. The election must be made by the extended due date of the return. However, a federal election (or lack of an

election) made by an individual before he or she becomes a California taxpayer is binding for California purposes. (See RTC section 17024.5(e).)

Recommendation: Staff recommends no change.

Comments:

9.1 Comment: [T]he FTB has been applying its policy to taxpayers for the 2002 and subsequent taxable years, and has published its substantive application in FTB Pub. 1100 since that time. What is the FTB's authority to apply the policy set for [sic] in the proposed regulation for the last four years (taxing nonresidents who sell intangibles on the installment basis)? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

9.2 We would like to know what is the FTB's authority to apply the policy set forth in the proposed regulation for the last four years in that they are taxing nonresidents who sell intangibles on an installment basis. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 9:

The FTB maintains this is merely a clarifying regulation. Staff believes income is indeed sourced at realization and this regulation does not provide that rule but rather seeks to make it unambiguous. AB 1115 did not directly address sourcing rules. It did, however, elevate the importance of sourcing and, thus, demanded that sourcing rules be made clearer. As explained in response 1 above, it is fundamental that sourcing occurs at realization.

Recommendation: Staff recommends no change.

Comment:

10.1 An auditor would no longer have the disagreeable task of trying to prove residency. Nonetheless, such statutory changes still have to pass constitutional muster and survive analysis under the Due Process Clause and the Commerce Clause, which limit a state's power to tax nonresidents unless that income is derived from sources within the state. (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

Response 10:

Both the taxpayer and auditor will be faced with determining the source of the income. This regulation sets forth the analysis of whether "income is derived from sources within the state" occurs at realization. The requirements of the Due Process and Commerce Clauses are bound up in whether the income is sourced to California.

Recommendation: Staff recommends no change.

Comment:

11.1 Comment: As a professional membership organization representing over 4,000 tax professionals, we disagree [with the FTB's analysis there would be minimal impact to

private persons or businesses as a result of this regulation]. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

Response 11:

This regulation clarifies existing law and, as such, is not expected to have any significant fiscal impact. The economic estimates are based on the data available as well as discussion with the Audit Division and Legal Department regarding how often these cases are encountered.

Recommendation: Staff recommends no change.

Comment:

12.1 The proposed regulations create potential problems for financial institutions, such as private equity funds, which may have reporting and withholding obligations for former California residents that they are not well-equipped to administer. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 12:

This regulation is only solidifying current principles and is not creating new reporting or withholding obligations. In fact, by promulgating the regulation the FTB hopes to assist taxpayers and their financial representatives in understanding and complying with the California Revenue and Taxation Code.

Recommendation: Staff recommends no change.

Comments:

13.1 The Board should not adopt the proposed regulations before conducting a study, and coordinating with major states (such as New York, Illinois, and Massachusetts) which impose personal income taxes and to and from which California residents frequently move, to determine whether the proposed rules are likely to lead to double taxation. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

13.2 The Board should make clear that former nonresidents now living in California will be able to claim credits for taxes imposed by the states where they formerly lived on gains of the type we are concerned with here, assuming that those states adopt the same approach as that provided in the proposed regulations. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 13:

Staff is presently conducting such a study, including a survey of state tax administrators. The results of the study will be included in the rule-making file for this regulation.

The "Other State Tax Credit" (provided under RTC section 18001) remains available to former nonresidents now living in California for taxes imposed by the states where they formerly resided on these types of gains, since the "Other State Tax Credit" is determined with reference to California sourcing rules.

Recommendation: Staff recommends no change.

Comment:

14.1 [T]he seller who is now a nonresident may still have a financial interest in the intangible which is exercisable if the provisions of the contract are not fulfilled. And I know in the regulation's filings there seem to be a lot of documents and cases on fixed and determinable amounts, so we're questioning that the note may not be fixed and determinable as the FTB purports. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 14:

The rule set forth in this regulation provides sourcing will be determined at the time of realization. If the seller still has a financial interest in the intangible property, it may be realization has not occurred. The regulation does not attempt to address under which circumstances realization occurs. It only provides when the sourcing rules shall be applied – upon realization.

Recommendation: Staff recommends no change.

Comment:

15.1 A taxpayer's method of accounting should affect the sourcing of his or her income. Under former Section 17554, a taxpayer converted to accrual when they moved into or out of state, and on that basis, the income from the installment note was artificially accelerated on the date of the move. Yet we no longer apply the accrual method to a cash-basis taxpayer when they move. And, therefore, the accounting method should govern when the income is recognized – under the installment method and cash method, when received – and then the sourcing rule should apply. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 15:

The definition of income, rules to source such income and right to tax such income involve distinct policy considerations from the choice by the State to offer alternative accounting methods, conform to federal taxation law and defer the collection of tax due. The State's ability to tax should not be driven by a taxpayer's choice of accounting method.

Recommendation: Staff recommends no change.

Comment:

16.1 Finally, I want to point out that the proposed regulation does not address two different types of tax effects. Number one, the sale of an intangible without a California business situs [sic] under the installment method, and, number two, a California-only election out of the installment method at the time of the sale. And those two things should be clarified if we are moving forward with this regulation. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 16:

This regulation clarifies when the sourcing rules should be applied to determine the source of income. It does not attempt to address the tax impacts on the sale of an intangible without a California business situs under the installment method. The sourcing of the income from the sale of the intangible property in the hypothetical would depend on whether or not the property sold had a business situs outside California. This regulation would merely provide that the sourcing rules would be determined at the time of realization. Please see response 8 for information on a California-only election.

Recommendation: Staff recommends no change.

Comment:

17.1 And so I don't think trying to re-source it to California, which will even further confuse all the issues of AB 1115, is really the answer. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 17:

This regulation clarifies source is determined at realization. There is no re-sourcing.

Recommendation: Staff recommends no change.

Comment:

18.1 And just as you may lose some tax on intangible income that is not going to be received prior to a person becoming a nonresident, you also receive tax by those who move into this state and receive some intangible income from something sold in another state. So it all just comes out in the wash, doesn't it? (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 18:

The proposed amendment to this regulation seeks to clarify when sourcing rules apply so taxpayers and their representatives may comply with the state tax law.

Recommendation: Staff recommends no change.

Comment:

19.1 Lastly, Lynn and I do respectfully request that this regulation be returned to the Board for review and that you answer the questions that we posed here today. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 19:

This item is expected to be considered by the Board at its meeting on December 4, 2006.

Recommendation: Staff recommends no change except the addition in the first example of the parenthetical phrase: (absent a business situs exception).