DISCUSSION TOPIC PAPER

The focus of this Interested Parties Meeting will be to discuss the following issues regarding the market-based sourcing rules under title 18, California Code of Regulations (CCR) section 25136-2. (Regulation.)

1. Asset Management Fee Examples. Previous drafts of the Regulation included the following examples on how to source asset management fees:

   Benefit of the Service – Business entity, subsection (c)(2)(A). Asset Management Corp, which is not subject to California Code of Regulations section 25137-14 because the taxpayer is not providing services to at least one Regulated Investment Company, provides administration, distribution and management services for pension plans, retirement accounts, or other investment accounts, by contracting with third party entities to provide these services on behalf of shareholders, beneficial owners, or investors of the pension plans, retirement accounts or other investment accounts. Since the benefit of the services is received by the shareholders, beneficial owners, or investors, the sale of these services shall be assigned to the location of the shareholders, beneficial owners, or investors.

   Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 5 except that Asset Management Corp cannot determine through its books and records kept in the normal course of business the domicile of the shareholders, beneficial owners, or investors. Asset Management Corp shall assign the sales by reasonably approximating the domicile of the shareholder, beneficial owner, or investor by utilizing information based on zip codes or other statistical data. If Asset Management Corp cannot reasonably approximate a method for determining the domicile of the shareholders, beneficial owners, or investors, then those receipts shall be disregarded for purposes of the sales factor.

The Franchise Tax Board (FTB) requests the public's input on the language of these examples.

2. Reasonably approximated/reasonable approximation. The Regulation states that under certain scenarios, the location of the benefit received from a service shall be "reasonably approximated." That term is defined at subparagraph (b)(7) and is used in subparagraphs (c)(1)(B), (c)(2)(B), (d)(2)(A)2, (d)(2)(B)2, and (e)(3), and paragraph (h). In October 2016, at the California Tax Policy Conference in San Diego, a number of taxpayers and representatives requested additional clarification of the term "reasonable approximation." They also wanted clarification to know whether the taxpayer or FTB determines which "reasonable approximation" method may be used, and what the process is for making that decision. FTB requests the public's input on the term "reasonable approximation" as used in the paragraphs noted above, as well as its input on the best process for determining the appropriate method of "reasonable approximation."
3. "Benefit of a service is received." Many taxpayers and taxpayer representatives have requested clarification of the term "benefit of the service," which is defined in subparagraph (b)(1). Currently, the Regulation provides that when the taxpayer's customer is a business entity, determination of the location where the benefit of the service is received is determined by the language of the contract between the taxpayer and the customer and/or the taxpayer's books and records. If these materials do not indicate where the benefit of the service is received, the taxpayer may use reasonable approximation. These rules are not in dispute. The following paragraphs set forth the various views that have been expressed in connection with these rules.

a. Timing. Is there a distinction between an immediate benefit of a service and an ultimate benefit of a service that would require altering the timing of assigning the benefit of service received? What if the provision of a service is abandoned before the full benefit of the service is received? Various rules that address the sale of intangible property state that the sale should be assigned "within 12 months of the sale." (See, e.g., subparagraph (d)(1)(A).) Should we apply the same 12 month rule to sale of services?

b. Government Contracts. Often, the general rules work well to assign sales of other than tangible personal property made pursuant to government contracts. However, FTB recognizes that certain industries with government contracts may require special rules. What are the most common industries affected by CCR Section 25136-2 that require special consideration for the sourcing of government contract revenue? For these industries, what rules should be considered in determining the location of the benefit of the service received?

c. Research and Development Contracts. FTB requests input on how sales should be assigned for research and development ("R&D") projects that take multiple years to complete, never "get off the ground," or are not completed as originally intended. Similarly, how should upfront and milestone payments for R&D projects be treated?

d. Sales of intangible property. How does a taxpayer assign the sale of a patent when it has little information on how that patent will be used after the sale? What if the location of where that intangible was used by the seller cannot be reasonably approximated to what the buyer will do with the patent? How should such sales be assigned?

4. Dividend Assignment. Should dividends be taken out of the Regulation, because they are not true sales? Should dividends be considered true sales for the purpose of the Regulation where they represent functional business income? If the dividends continue to be incorporated into the Regulation, should there be different rules for taxpayers with minority ownership?

5. Freight Forwarding Example. Freight forwarding companies arrange for the shipment of goods by air, sea, rail or truck common carriers, and receive fees for their services. In addition, many forwarders provide their customers with truck trailers that may be transported by independent highway haulers or rail piggyback services. FTB tentatively plans to include an example of the location of the benefit of the service for freight
forwarding companies under subparagraph (c)(2)(E). The following example is not in final language, but reflects its planned substance:

When the freight forwarding company does not provide trailers but only arranges transportation by a common carrier, the benefit of the service is received at both the point of origination and point of destination. The revenue will be assigned 50 percent to each location.

When the freight forwarding company provides trailers in which to transport its customers' freight, the benefit of the service is received in those locations where the loaded freight car travels in addition to the points of origination and destination. In these instances, the receipts will be sourced to the various locations (i.e. states) pursuant to a mileage ratio.

The FTB requests the public's input regarding the substance of the above example.

6. **Interest Received from Business Entity Borrowers.** How should interest received from a borrowing business entity be sourced? Does the borrower's commercial domicile represent the location of the benefit of the service?

7. **Marketing Intangibles.** How "well known" must a marketing intangible be for the regulation to apply? Must it be known worldwide? Locally? Industry-wide? Could the geographic area vary for a particular marketing intangible, so that the regulation applies to some sales of the intangible but not to others? What level of proof would be required to show that the regulation applies or does not apply?

8. **Various Clean-Up Issues.** Amending the Regulation will likely require FTB to address certain clean-up issues, such as clarifying effective dates for any amendments and changing internal references.

In order to encourage private sector participation and input in this project, staff is not proposing draft language at this time. Instead, the interested parties meeting will include discussion of the above-listed items.