

**INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF AMENDMENTS TO CALIFORNIA
CODE OF REGULATIONS, TITLE 18, SECTION 25136-2**

**PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR
CIRCUMSTANCE THAT THE AMENDMENTS TO THE REGULATION ARE INTENDED TO
ADDRESS**

The provisions of former California Revenue and Taxation Code (RTC) section 25136, subdivision (b), were enacted in 2009 and are operative for taxable years beginning on or after January 1, 2011. Currently, subdivision (a) of RTC section 25136 provides the market-based rules for assignment of sales of other than sales of tangible personal property. Subdivision (b) of RTC section 25136 specifically provides that "[t]he Franchise Tax Board may prescribe regulations as necessary or appropriate to carry out the purposes of this section." California Code of Regulations, title 18 (CCR), section 25136-2 was promulgated under this statute. CCR section 25136-2, effective March 27, 2012 and operative for taxable years beginning on or after January 1, 2011, provides cascading rules for sales from services and sales from intangible property.

Subdivision (a)(2) of RTC section 25136 provides that "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." However, CCR section 25136-2 does not currently provide a definition of "marketable securities." Second, CCR section 25136-2 does not address how to assign the sales of marketable securities; in other words, there are no provisions on how to determine whether a customer is in this state. Third, the regulation does not address how to assign asset management fees for those taxpayers who do not come under the provisions of CCR section 25137-14 for mutual fund service providers. Fourth, the regulation does not include assignment rules for receipts such as interest, dividends, and goodwill. Finally, the proposed amendments to the regulation address a number of non-substantive clean-up issues.

BENEFITS ANTICIPATED FROM REGULATORY ACTION

The proposed amendments to CCR section 25136-2 will benefit taxpayers, tax practitioners, and the State of California by providing clarity that does not currently exist in connection with how to assign sales from services and sales from intangible property. This clarity will eliminate uncertainty for taxpayers and tax practitioners, and will facilitate tax administration for the State of California by providing definitions, guidelines, and examples relating to marketable securities, asset management fees, dividends, goodwill and interest. These benefits are the result of goals developed by the Franchise Tax Board based on broad statutory authority. There are no benefits of the proposed amendments to the health and welfare of California residents, worker safety and the state's environment.

SPECIFIC PURPOSE OF THE MODIFICATION OF THE REGULATION

The purpose of proposed amendments to CCR section 25136-2 is to clarify for multistate taxpayers how to assign sales of other than sales of tangible personal property based on the location of the taxpayer's market. The proposed amendments to the regulation will achieve the purpose of defining and making specific provisions in RTC section 25136 related to assignment of sales of other than sales of tangible personal property by providing definitions, guidelines, and examples relating to marketable securities, asset management fees, dividends, goodwill and interest. RTC section 25136 and the current provisions of CCR section 25136-2 do not address these specific issues.

NECESSITY

Subdivision (b) of RTC section 25136 specifically authorizes the Franchise Tax Board to issue necessary or appropriate regulations regarding the assignment of sales of other than tangible personal property based on market rules. Since RTC section 25136 and CCR section 25136-2 lack specificity regarding assignment of sales including sales of marketable securities, asset management fees, interest, dividends, and goodwill, the proposed amendments to CCR section 25136-2 are necessary to define and make specific the provisions of RTC section 25136.

The Franchise Tax Board conducted three Interested Parties Meetings from 2012 to 2014 in order to obtain input from taxpayers and other members of the interested public. Discussion Topics and/or Explanations for draft language and the draft language, itself, were provided in advance of those meetings. The substance of the amendments appears as follows.

Subsection (a) of the regulation states the general rule that sales of other than tangible personal property are in this state if the taxpayer's market is in this state. The proposed amendments to this subsection clarify that RTC "[Section] 25136 subdivision (a)" refers to "former Section "25136 subdivision (a) "as applicable for taxable years beginning on or after January 1, 2011 and before January 1, 2013." These amendments are necessary because there was confusion as to which sales this regulation encompassed. Sales of tangible personal property under RTC section 25135 and sales of other than tangible personal property in former RTC section 25136 are assigned under the cost of performance rules and are *not* covered by this regulation. Thus, these amendments eliminate any ambiguity by referring to sales under RTC section 25135 and sales of other than tangible personal property under subdivision (a) of *former* RTC section 25136 as not subject to the provisions of this regulation.

Subsection (b) defines terms contained within the regulation. Subsection (b)(5) has been added to define the term "marketable securities." RTC section 25136(a)(2) refers to "marketable securities" but provides no definition of that term. Numerous comments received at the first Interested Parties Meeting indicated that stakeholders wanted to know with a degree of certainty the definition of the term "marketable securities." As a result of many comments from the public, the proposed definition of "marketable securities" is based

on a combination of various federal definitions including the Securities Exchange Act of 1934.

Proposed subsection (b)(6) has been added to define the term "marketable securities" specifically for dealer-type taxpayers. This proposed subsection also provides that dealer-type taxpayers include securities and/or commodities dealers. At all three Interested Parties Meetings and in conversations with staff, stakeholders pointed out that both a stand-alone definition for "securities dealers" and "commodities dealers," and a corresponding definition of "marketable securities" for those dealer-type taxpayers were necessary. Stakeholders considered the "marketable securities" definition provided in subsection (b)(5) for general population taxpayers to be too narrow for securities and commodities dealers. After much discussion between staff and securities and commodities dealers and their representatives, it was ultimately decided that for purposes of being consistent with federal tax law on the same subject, the best definition to use in CCR 25136-2 for these type taxpayers would be to incorporate by reference the definitions of "securities dealer" and "commodities dealer" in Internal Revenue Code section 475(a)(1) and (e), respectively. Also for purposes of being consistent with federal law on the same subject, it was decided for these type taxpayers to incorporate by reference into CCR 25136-2 the definition of "marketable securities" located in Internal Revenue Code sections 475(c)(2) or 475(e)(2)(B),(C),(D), and to include any contract to which Internal Revenue Code Section 1256(a) applies but which has not been excepted under Internal Revenue Code section 475(b). These IRC provisions are proposed to be incorporated by reference in the definitions contained in Subsection (b)(6). Also, "Receipts" under this proposed definition include any interest and dividends associated with such marketable securities. Finally, in the proposed subsection the term "marketable securities" does not include any transactions specifically excluded from gross receipts under RTC section 25120(f)(2)(L). The states of Texas and New York reference (either fully or partially) IRC section 475 for their definitions of sales of "marketable securities." Originally, this proposed subsection defined "securities dealer" as one who "purchases and sells intangible assets of the type defined in Internal Revenue Code Sections 475(c) or (e), such as a registered broker-dealer." However, this language was eliminated when later in the discussion process stakeholders suggested that a broader definition of "securities dealers" would be more appropriate for dealer-type taxpayers. The eliminated language appears in strike-out in the draft language of the proposed definition of "marketable securities" contained in subsection (b)(6).

Subsection (c) addresses assignment of sales from services to the extent that the benefit of the service is received in this state by the taxpayer's customer. There are two different sets of cascading rules: one for individual customers located in subsection (c)(1) and one for corporate or other business entity customers located in subsection (c)(2). Subsection (c)(2)(C) provides examples illustrating how the cascading rules in subsection (c)(2) operate. The examples in subsections (c)(2)(E)6 and 7 indicate how asset management fees should be assigned. Stakeholders at Interested Parties Meetings and in contact with staff have been concerned about the lack of guidance in either RTC section 25136 or CCR section 25136-2 for assignment of asset management fees when the taxpayer falls outside of the provisions of CCR section 25137-14 for mutual fund service providers. Stakeholders felt that asset management fees should be assigned in the same manner as asset management fees are assigned under the provisions of the mutual fund providers in CCR section 25137-

14 because CCR section 25137-14 rules reflect the location where the benefit of the service was received. The proposed examples, therefore, provide guidance for taxpayers that asset management fees are assigned pursuant to the assignment rules for asset management fees for mutual fund service providers under CCR section 25137-14(b)(1)(B).

Subsection (d) addresses sales from intangible property and provides that sales from intangible property are assigned to this state to the extent the intangible property is used in this state. Subsection (d)(1) addresses assignment of sales from intangible property where there has been a complete transfer of all property rights. Neither RTC section 25136 nor CCR section 25136-2 provide guidelines as to how gross receipts such as dividends or goodwill should be assigned. Stakeholders at the Interested Parties Meetings expressed that dividends and goodwill should be assigned according to the sale of stock rules contained in subsection (d)(1)(A)1. This assignment position is based on *Mobil Oil Corp. v. Commissioner of Taxes of Vt.* (1980) 445 U.S. 425. Thus, in the proposed modifications to CCR section 25136-2 dividends and goodwill are assigned according to the sale of stock rules under subsection (d)(1)(A)1.

Subsection (d)(1)(A)2 addresses assignment of sales from intangible property where the gross receipt is interest. At the Interested Parties Meetings and in conversations with staff, stakeholders made several recommendations that have been incorporated in the proposed modifications to the regulation. First, interest from investments (other than loans as defined under the banks and financials special apportionment formula in CCR section 25137-4.2) is assigned to California if the investment was managed in California. Second, interest from loans (other than those defined under the banks and financials special apportionment formula in section 25137-4.2) secured by real property are assigned to California to the extent that the real property is located here. Lastly, interest from loans (other than those defined under the banks and financials special apportionment formula in CCR section 25137-4.2) not secured by real property are assigned to California if the borrower is located in this state. Stakeholders felt that the assignment rules for interest under CCR section 25137-4.2 for banks and financial corporations would not be appropriate for general taxpayers as those assignment rules are specifically and exclusively designed for banks and financial corporations. Stakeholders and staff felt these assignment rules most closely reflect the location of the use of the intangible property, as required by RTC section 25136(a)(2).

Proposed subsection (e) provides the assignment rules for the sales of marketable securities. Proposed subsection (e)(1) provides that where the customer of the sale of a marketable security is an individual, the sale is assigned to California if the customer's billing address is in California. Staff and stakeholders concur that this rule reflects the location of the use of the intangible property, marketable securities, as mandated by RTC section 25136(a)(2).

Proposed subsection (e)(2) provides the rules for assignment of sales of marketable securities to corporations or other business entities. If the customer's commercial domicile is in California, then the sale is assigned to California. Stakeholders felt that this assignment rule reflected the location of the use of the intangible property. In addition, there is a safe harbor provision that if a taxpayer uses its books and records to determine

commercial domicile of the customer, then the Franchise Tax Board will accept that method of assignment. The language is based on the safe harbor rule that appears in the assignment of sales from services to individuals in subsection (c)(1)(A). This presumption can be overcome based on a preponderance of evidence that other credible documentation indicates that the commercial domicile is in a state other than California. If the taxpayer feels the presumption is overcome and assigns the sale to a state other than California, the Franchise Tax Board may examine the alternate method and determine if it reasonably reflects the location of the customer's commercial domicile. Stakeholders felt that a safe harbor rule would be fair, because it would mean that taxpayers would not be required to do a time-consuming and expensive exhaustive facts and circumstances analysis to determine the customers' commercial domiciles, but the methodology would still reflect of the location of the use of the intangible property as required under RTC section 25136(a)(2) .

Proposed subsection (e)(3) provides that if the billing address of the customer of the sale of the marketable security cannot be determined under subsection (1) or (2), then the location of the customer shall be reasonably approximated. This is consistent with other provisions within the regulation.

Proposed subsection (e)(3)(A) is an example for overcoming the safe harbor rule in subsection (e)(2) by using the customer's billing address as a proxy for the commercial domicile of the customer. Stakeholders felt that this alternate assignment rule would also reflect the location of the use of the intangible property as required by RTC section 25136(a)(2).

Proposed subsection (i), Effective date, provides that this regulation applies on or after January 1, 2011, but only if the taxpayer has made a single sales factor apportionment election, and is applicable to all taxpayers beginning on or after January 1, 2013. The proposed amendments to the regulation in subsections (a); (b)(5) and (6); (c)(2)(E)6 and 7; (d)(1)(A)1 and 2; and (e)(1), (2) and (3) are applicable for taxable years beginning on or after January 1, 2015. This proposed subsection also provides that any taxpayer may elect to have the amendments apply retroactively to taxable years beginning on or after January 1, 2012 but only if those taxable years are open to adjustment under applicable statutes of limitation. Staff felt that the first notice of the first Interested Parties Meeting did not "substantially" identify all the amendments. As a result, the proposed amendments could not be retroactive for all taxpayers. In order to be fair to all taxpayers, the proposed amendments are effective January 1, 2015 for all taxpayers except for those taxpayers that elect to have the amendments retroactive to January 1, 2012.

Miscellaneous proposed clean-up fixes include:

- (b)(3): the addition of "sixty." The spelling of a number before the number itself is consistent with similar language throughout the regulation.
- (d)(1)(A)1.b.: addition of "kept in the normal course of business." This is consistent with similar language throughout the regulation.
- (d)(2)(D)7: the deletion of "the taxpayer" and insertion of "Biker Corp." The example originally incorrectly identified "taxpayer" when it should have identified "Biker Corp." With this change, the example now makes sense.

- (d)(2)(D)8: the addition of "the licensing fee constitutes sales in this state." This phrase completes the last sentence in the example. With the addition, the sentence now makes sense.
- (h)(3)(F): the addition of [Mutual Fund Service Providers and Asset Management Service Providers]. The title of the special industry apportionment formula for CCR section 25137-14 was inadvertently left out during the drafting the original provisions of CCR section 25136-2. The title addition to the section number is consistent with similar language throughout the regulation.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting the proposed amendments to CCR section 25136-2, the Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ECONOMIC IMPACT ASSESSMENT/ANALYSIS

The Franchise Tax Board has no reason to believe that the proposed amendments will result in an increase or decrease in the number of employees or businesses subject to CCR 25136-2 because the modifications are intended only to provide clarity that does not currently exist in connection with how to assign sales from services and sales from intangible property. Therefore, it is anticipated that these regulations will not affect the creation or elimination of jobs within California.

The Franchise Tax Board has no reason to believe that the proposed amendments will increase or decrease the cost of doing business or the number of businesses doing business in the State of California because the regulation is already in place, and the modifications will assist businesses by providing clarity that does not currently exist in connection with how to assign sales from services and sales from intangible property. The proposed amendments to the regulation clarify existing Franchise Tax Board practices for sales from services and sales from intangible property. Providing clearer administrative guidance may reduce the cost of taxpayer compliance but is not expected to result in any additional costs. Therefore, it is anticipated that these regulation will not affect the creation of new businesses, elimination of existing businesses and the expansion of businesses currently doing business within California.

EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS

The Franchise Tax Board has determined that the proposed amendments to CCR section 25136-2 will not have a significant adverse economic impact on business. The proposed amendments to CCR section 25136-2 provide clarity that does not currently exist in connection with how to assign sales from services and sales from intangible property, by

providing definitions, guidelines, and examples relating to marketable securities, asset management fees, dividends, goodwill and interest.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed amendments to CCR section 25136-2, or would be less burdensome with respect to affected private persons or small businesses than the proposed regulation. The proposed amendments to CCR section 25136-2 pertain only to corporate taxpayers and therefore do not affect private individuals. In addition, CCR section 25136-2 pertains only to multistate and multinational businesses and therefore will have little or no impact on small business.