

**FINAL STATEMENT OF REASONS  
PROPOSED AMENDMENTS TO REGULATION SECTION 25136-2,  
RELATING TO MARKET BASED SOURCING RULES**

**UPDATE OF INITIAL STATEMENT OF REASONS**

*Updates Pertaining to the Proposed Text of the Regulation*

The public notice required by Government Code section 11346.4 was mailed and published in the California Notice Register on August 7, 2015. The hearing was held, as noticed, on September 22, 2015, to consider the adoption of amendments to Regulation section 25136-2, which provides guidance on how to assign sales of other than sales of tangible personal property. There were four (4) attendees at the hearing. One (1) comment was received during the comment period, which ended at 5:00 p.m. on September 22, 2015. The comment involved sourcing of interest from investments, pointing out that the language potentially conflicts with Revenue and Taxation Code (RTC) section 25120. As a result of this comment and additional suggested changes by staff, modifications were made to the proposed amendments to the regulation. These substantial and sufficiently-related changes were noticed in a 15-day change notice, mailed and posted on November 5, 2015. No comments were received during the period the modified text was available to the public during the notice period from November 5, 2015 through November 20, 2015.

In late 2015 after the first 15-day change notice, some members of the public expressed that they had not had the opportunity to provide input on the 45-day notice amendment addition of asset management fee examples, which was part of the original proposed draft amendment language in 2012. In response to this comment, the asset management fee examples were removed from the proposed amendments to the regulation. This substantial and sufficiently-related change was noticed in a second 15-day change notice, mailed and posted on December 30, 2015. No comments were received during the period the modified text was available to the public during the notice period from December 30, 2015 through January 14, 2016.

Since the publication of the amended regulation text on August 7, 2015, the only substantial and sufficiently-related changes to the text are those listed above. The Franchise Tax Board complied with the requirements of Section 44 of Title 1 of the California Code of Regulations.

Following publication of the original 45-day notice for these proposed amendments, the Franchise Tax Board discovered two nonsubstantial and sufficiently-related changes needed to the proposed amendments to the regulation. First, in Regulation section 25136-2(b)(3) in the second to last sentence of that paragraph, the percent sign should be removed, and the word "percent" following the closed parenthetical should be added. This change is an error which is nonsubstantial and non-material and is needed to make the text consistent with the formatting in the rest of the paragraph. Second, the last phrase of Regulation section 25136-2(d)(2)(D)8 was inadvertently underscored in the originally-noticed text of the proposed amendments to the existing regulation. The inadvertently underscored phrase is part of the existing version of Regulation section 25136-2. This means that the inadvertent underscoring of the phrase is an error which is nonsubstantial and non-material. No public comments were received with respect to these inadvertent errors in the regulation text included with the original 45-day notice, so the Franchise Tax Board has removed the percentage sign and added the word percent in Regulation

section 25136-2(b)(3), and removed the underscore under the last phrase of Regulation section 25136-2(d)(2)(D)8.

### *Updates to the Economic Impact Assessment / Analysis*

After the August 7, 2015 publication of the public notice required by Government Code section 11346.4, the Franchise Tax Board made revisions to update the California Form 399 Economic and Fiscal Impact Statement in accordance with instructions from the Department of Finance. As a result of those revisions, the Economic Impact Assessment is now updated as follows:

### ECONOMIC IMPACT ASSESSMENT

#### **Purpose:**

The broad objective of the proposed amendments to Regulation section 25136-2 is to ensure that taxpayers, their representatives, and the State of California have guidance on how to assign certain sales from services and sales from intangible property. By providing additional clarity on the tax treatment of marketable securities, dividends, goodwill and interest, the proposed amendments to the regulation will reduce compliance expenses for taxpayers and reduce administrative expenses for the state. There may be an additional benefit to taxpayers if, because of the clarity provided by the proposed amendments to the regulation, they are able to reduce their reserves for uncertain tax positions on other financial accounting documents.

The Franchise Tax Board estimates that a maximum of 400 businesses may be impacted by the proposed amendments to the regulation. Affected multi-state taxpayers would predominantly experience an increase in taxes while a majority of affected in-state taxpayers would see a reduction in their tax liability. The Franchise Tax Board believe that the economic impact on business, including the ability of California businesses to compete with businesses in other states, will not be significant. The proposal would have no impact the health and welfare of California residents, worker safety or the State's environment.

#### **The Creation or Elimination of Jobs Within the State of California:**

Absent the proposed amendments to the regulation, there could be disputes between taxpayers and the Franchise Tax Board about how to assign certain sales. If the Franchise Tax Board's interpretation of the correct apportionment method is upheld in the absence of the proposed amendments to the regulation, the tax owed by these taxpayers would be the same as if the amended regulation is adopted, so there would be no change in the number of jobs. If the Franchise Tax Board's interpretation of the correct apportionment method is not upheld in the absence of the proposed amendments to the regulation, taxpayers challenging the Franchise Tax Board's interpretation (and other similarly situated taxpayers) would owe less tax. Thus, the amended regulation would result in an increase in tax paid by these taxpayers compared to a world without the amended regulation. The change in interpretation would also apply to taxpayers (with other circumstances) who would pay more in taxes under an alternate interpretation. These taxpayers would owe less tax if the amended regulation is adopted.

These changes in taxes could, in theory, induce a change in the number of jobs. In practice, however, these changes are likely to be too small to induce significant changes in jobs.

**The Creation of New Businesses or the Elimination of Existing Businesses Within the State of California:**

Absent the proposed amendments to the regulation, there could be disputes between taxpayers and the Franchise Tax Board about how to assign certain sales. If the Franchise Tax Board's interpretation of the correct apportionment method is upheld in the absence of the proposed amendments to the regulation, the tax owed by these taxpayers would be the same as if the amended regulation is adopted, so there would be no change in the number of businesses. If the Franchise Tax Board's interpretation of the correct apportionment method is not upheld in the absence of the proposed amendments to the regulation, taxpayers challenging the Franchise Tax Board's interpretation (and other similarly situated taxpayers) would owe less tax. Thus, the amended regulation would result in an increase in tax paid by these taxpayers compared to a world without the regulation. The change in interpretation would also apply to taxpayers (with other circumstances) who would pay more in taxes under an alternate interpretation. These taxpayers would owe less tax if the amended regulation is adopted. These changes in taxes could, in theory, induce a change in the number of businesses. In practice, however, the change in taxes is likely to be too small relative to these taxpayers' profits to generate entry and exit. If the proposed amendments to the regulation were to cause a small amount of entry and exit, it would likely result in an increase in the number of taxpayers based inside California and a decrease in the number of taxpayers based outside of California.

**The Expansion of Businesses Currently Doing Business Within the State of California:**

The proposed amendments to the regulation might result in tax changes for some businesses. The Franchise Tax Board estimates that for most of these affected businesses the tax changes will be small relative to their reserve cash balances, so there would not be a significant change in taxpayers' real economic activities. Consequently the Franchise Tax Board does not estimate a significant change in the expansion of businesses currently doing business within the State of California as a result of the amended regulation.

**Benefits of the Regulations to the Health and Welfare of California Residents, Worker Safety, and the State's Environment:**

The proposed amendments to the regulation would clarify certain calculations of corporate franchise and income tax. The Franchise Tax Board estimates there will be no impact to the health and welfare of California residents, worker safety, or the State's environment as a result of the amended regulation.

**COMMENTS RECEIVED DURING THE PERIOD THE TEXT WAS AVAILABLE TO THE PUBLIC DURING THE NOTICE PERIOD FROM August 7, 2015 THROUGH September 22, 2015**

One comment was received during this comment period. Pursuant to Government Code section 11346.9(a)(3) and (a)(5), the summary and response to this comment is as follows:

**Comment (see Hearing Transcript pp. 6-7):** "My comment relates to proposed regulation 25136-2(d)(1)(A)(2). It involves the sourcing of interest from investments to the state if they are managed in the state. My comment relates to the fact that 25120 defines (f)(2)(K) – excludes from the definition of gross receipts enhanced sales treasury investments, the gains and the income from such investments. But [sic] the way, this 25136 [sic] provision reads – it says that where gross receipts from intangible property is interest, even if the underlying transaction is excluded from the gross receipts and a sales factor under the provisions of 25120, the interest shall be assigned as follows. That conflicts with the underlying statute of 25120 and we note the regulation has to be in conformity with the statute. So our suggestion is that the term "investments" must be made to exclude the working capital investments."

**Accept in part/reject in part:** Rather than making the change suggested by the commenter, this provision in the proposed language of Regulation section 25136-2 was deleted altogether for clarity purposes, and because of the potential conflict with RTC section 25120. The commentator's suggested "fix" was not adopted because it could also potentially cause confusion. In addition, RTC section 25120 speaks for itself and need not be restated in this regulation.

**COMMENTS RECEIVED DURING THE PERIOD THE MODIFIED TEXT WAS AVAILABLE TO THE PUBLIC DURING THE NOTICE PERIOD FROM November 5, 2015 THROUGH November 20, 2015**

No comments were received.

**COMMENTS RECEIVED DURING THE PERIOD THE MODIFIED TEXT WAS AVAILABLE TO THE PUBLIC DURING THE NOTICE PERIOD FROM December 30, 2015 THROUGH January 14, 2016**

No comments were received.

**ALTERNATIVES DETERMINED**

The Franchise Tax Board has determined that no alternative to the proposed amendments to the regulation it considered would be more effective in carrying out the purpose of the proposed amendments to the regulation or would be as effective and less burdensome to affected private persons than the adopted amendments, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law, in accordance with Government Code section 11346.9, subdivision (a)(4). The proposed amendments to the regulation is the only text identified by or proposed to the Franchise Tax Board that accomplishes the intent of the regulation and no alternatives have been identified or proposed that would reduce costs to those regulated.

**ALTERNATIVE THAT WOULD LESSEN ADVERSE ECONOMIC IMPACT ON SMALL BUSINESS**

Because the proposed amendments to the regulation do not increase or decrease the amount of tax collected, the Franchise Tax Board has determined the proposed amendments to Regulation section 25136-2 will not have a significant impact on small businesses.

**LOCAL MANDATE DETERMINATION**

The proposed regulations do not impose any mandate on local agencies or school districts.