

FINAL STATEMENT OF REASONS
FOR PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25136-2

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

Update of Initial Statement of Reasons

The public notice required by section 11346.4 of the Government Code was mailed and published in the California Notice Register on June 17, 2011. The hearing was held, as noticed, on August 10, 2011, to consider the adoption of amendments to Regulation section 25136 (now renumbered 25136-2), which provides guidance on how to assign sales of other than sales of tangible personal property. There were nineteen (19) attendees at the hearing. Sixteen (16) written and oral comments were received during the comment period, which ended at 5:00 p.m. on August 10, 2011, as follows: one commentator made one comment both orally and in writing, another commentator made nine (9) comments in writing and three (3) orally (which three (3) oral comments were redundant of three (3) of the nine (9) written comments), and two (2) commentators made one oral comment each.

As a result of comments received and additional suggested changes recommended by staff, modifications were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on October 7, 2011. Nine (9) comments were received from three (3) commentators regarding the 15-day changes.

As a result of some of the comments received, additional changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on October 27, 2011. Six (6) comments were received from one commentator regarding the 15-day changes. No further changes were made.

On January 12, 2012, the rulemaking file was submitted to the Office of Administrative Law for approval. Subsequent to that submittal, the Office of Administrative Law noted to Department staff that there were two phrases in two separate definitions that had not appeared in the 45-day notice text but which did appear in the first 15-day notice text, however, one without underscore and explanation for its addition and the other without underscore to show its relocation from a provision appearing later in the regulation. As a result, to ensure that the public has had sufficient notice of these changes, a third 15-day notice and accompanying text was published on February 1, 2012 to underscore the two phrases in the two definitions and provide an explanation for one of those changes. No comments were received during the comment period.

Changes were made to the proposed regulation for purposes of clarity and consistency as part of the first two 15-day notice changes (there were no changes made as a result of the third 15-day notice.) The proposed modifications constitute sufficiently related changes (within the meaning of Govt. Code section 11346.8). These modifications are described below and incorporates by reference the Staff Summary of Comments and Responses in Tab 17 of the Table of Contents of the Rulemaking File:

1. The regulation number has been revised to read "25136-2." The regulation number itself was originally titled "25136(b)" to follow the numbering of the underlying statute for market

based rules of assignment of sales. However, in previous regulations, the Franchise Tax Board has used a dash-number system, i.e. California Code of Regulations (CCR) section 25137-1 et seq. This numbering system was adopted to avoid confusion with subsection "(a)" in the number of the regulation itself with a subsection "(a)" immediately following in the body of the regulation. As a result, this regulation number has been renumbered to "25136-2", with the "(b)" deleted. The cost of performance provisions in existing regulation section 25136 will be renumbered to 25136-1 with a Form 100 change. These changes were recommended by several commentators during the 45-day notice process. The amended title reads as follows:

§25136(b)-2. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

2. In a number of places, either a provision has been deleted in its entirety or one has been inserted. For example, the definition of commercial domicile has been deleted (formally subsection (b)(4)). As a result, the numbering and/or lettering of the regulation subsections have changed in some cases. This is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by the two 15-day notices' proposed changes.

3. Many examples have been modified to state the subsection they represent, for instance "Benefit of a Service – Individuals, subsection (c)(1)(A)." This has been done for the purpose of clarity.

4. Subsection (a), In General, has been revised to add Revenue and Taxation Code section 25135 (sales of tangible personal property), and change the reference to Revenue and Taxation Code section "25136" to "25136(a)." Originally, this subsection was intended to define sales as other than those sales of tangible personal property under Revenue and Taxation Code section 25135 and sales determined under income-producing activity/cost of performance rules under Revenue and Taxation Code section 25136, subdivision (a). Instead, when drafted, Revenue and Taxation Code section 25135 was omitted entirely, and the income-producing activity/cost of performance rules were mistakenly referenced as Revenue and Taxation Code section "25136" and not "25136(a)." To clarify that assignment of both type sales (sales of tangible personal property and sales of other than intangible property, cost of performance rules) are not governed by this regulation's market-based rules, a reference to Revenue and Taxation Code section 25135 for sales of tangible personal property was added and Revenue and Taxation Code section 25136 was identified as "25136, subdivision (a)," to reference assignment of sales of other than tangible personal property under the income producing activity/cost of performance rules.

In General. Sales other than those described under Revenue and Taxation Code Sections ~~25136~~ 25135 and 25136, subdivision (a), are in this state if the taxpayer's market for the sales is in this state.

5. Subsection (b) contains the definitions for the regulation's provisions. The terms being defined have been reorganized alphabetically such that "Benefit of the service is received" is (b)(1) and is followed by "Cannot be determined" at (b)(2), "Complete transfer of all property rights" at (b)(3), "Intangible property" at (b)(4), "Reasonably approximated" at (b)(5), "Service"

at (b)(6), "The use of intangible property in this state" at (b)(7) and "to the extent" at (b)(8). Also, as discussed below, one definition has been deleted and another added.

6. Subsection (b)(3) has been added to define the term, "Complete transfer of all property rights." This definition was created because a commentator pointed out that the term "complete transfer of all property rights" in connection with the sale of intangible property was confusing and needed to be defined for clarity. This definition makes it clear that "complete transfer" means a transfer in connection with ownership rights of stock or an interest in a pass-through entity as distinguished from those rights transferred under a license. It is also made clear that "complete transfer" does not mean that a taxpayer's disposition of stock in a corporation or interest in a pass-through entity must be a transfer of 100% of its ownership interest in that entity in order to have its sale assigned under subsections (d)(1)(A)1.a and b. The new subsection reads as follows:

"Complete transfer of all property rights" means the kind of transfer where voting and other rights associated with the ownership of stock or interest in a pass-through entity are transferred to a buyer in connection with the sale of stock or interest in a pass-through entity, as distinguished from a licensing of property where the licensor retains ownership rights in connection with the property licensed to a buyer. "Complete transfer" does not mean that the seller has sold all its stock in the corporation or all its interest in the pass-through entity. For example, a seller may sell sixty (60) percent of its ownership interest in stock of a corporation. The sixty (60) percent ownership interest sold is subject to assignment under subsections (d)(1)(A)1.a and b.

7. Subsection (b)(4), which provided the definition of "commercial domicile," has been deleted. In an earlier draft, commercial domicile appeared as one of the cascading rules. The only place where "commercial domicile" appears in the current draft is in some of the examples for the definition of "benefit of a service is received." The definition of commercial domicile has been deleted because it is no longer necessary and in order to avoid confusion as to whether it is one of the cascading rules.

~~(4) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.~~

8. Subsection (b)(4)(B), which defines "non-marketing and manufacturing intangible," has been revised to include the language "or other non-marketing process" and insert the word "property" after the word "intangible." These changes were made so that the terms are accurately and consistently phrased throughout the regulation. The subsection as amended reads as follows:

(B) A "non-marketing and manufacturing intangible" includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.

9. Subsection (b)(4)(C), which defines "mixed intangible," was revised to list specific types of intangible property, i.e. "a patent, copyright, service mark, trademark, trade name, or trade secrets", and delete the general term, "intangible property that includes both a license of a

marketing intangible and a license of a non-marketing intangible." Listing specific types of intangible property is a preferable way to define intangible property rather than using general terms to define it. Also, the phrase "includes but is not limited to" has been inserted to make it clear that the list is non-exclusive. Finally, originally, only a general definition for that term was provided. However, it was thought that a more precise way to define a "mixed intangible" was to refer to the actual subparagraphs for marketing and manufacturing/non-marketing intangibles which provisions, when combined, created a "mixed intangible." The subsection as amended reads as follows:

(C) A "mixed intangible " includes, but is not limited to, the license of a patent, copyright, service mark, trademark, trade name, or trade secrets intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible where the value lies both in the marketing of goods, services or other items as described in subparagraph (A) and in the manufacturing process or other non-marketing purpose as described in subparagraph (B).

10. Subsection (b)(5), which defines "reasonably approximated," a cascading rule for assignment of sales that appears in various subsections throughout this regulation, has been revised in several ways. In general, the definition has been broadened to indicate that reasonable approximation is limited to the jurisdiction or geographic area where the customer receives the benefit of the service or uses the intangible property. Also, if reasonable approximation is by population, it must be determined by U.S. population unless it can be shown by the taxpayer that the benefit is received or the intangible property is used materially in other parts of the world. These limitations originally appeared only in the reasonable approximation provisions for sales of intangible property but not in the definition or in the reasonable approximation provisions for sales of services. Based on a comment by a commentator during the 45-day notice period for this regulation, it was felt that all limitations that appeared in the reasonable approximation provisions for sales of intangible property should appear in the definition of reasonable approximation and apply to the entire regulation. As a result, all limitations now appear in the definition of "reasonable approximation" and have been deleted from the reasonable approximation provisions for sales of intangible property as redundant. The limitations apply when reasonably approximating both sales of services and sales of intangible property. Specific changes to the definition include the following.

First, the word "business" is exchanged for the word "activities." Originally, the term "reasonably approximated" was stated throughout the regulation with the proviso "that is consistent with the *activities* of the customer..." [emphasis added.] However, the definition originally read "that is consistent with the *business* of the customer..." [emphasis added.] Since some customers may not be business entities or a customer's business may be irrelevant to the services rendered, it would be more appropriate to refer to the customer's "activities" in getting to the taxpayer's market.

Second, in other subsections of the regulation, reasonable approximation is to be determined "in a manner that is consistent with the activities of the customer" but limited by the proviso "to the extent such information is available to the taxpayer." This provision was intended to provide fairness to the taxpayer who may or may not have access to such information regarding its customer. However, while that language appeared throughout this regulation's provisions regarding reasonable approximation, that language did not appear in

the definition. It has been inserted into the definition and removed from individual provisions as now redundant.

Third, geographic and/or jurisdictional limitations have been inserted for reasonably approximating where the benefit of the service has been received and the location of the use of the intangible property. The benefit of the service must be "substantially" received and the intangible property "materially" used in other parts of the world if those parts of the world are to be included in the population data for reasonable approximation. The purpose of such limitations is to ensure that only the actual market for the services or intangible property is considered in the reasonable approximation.

Fourth, population has been defined to be determined "by U.S. census data." This addition provides a method of determining population numbers. This change was made to a comment made at the regulatory hearing.

Fifth, at some point during the drafting of the first 15-day notice and accompanying text, the last sentence was inadvertently deleted from the accompanying text although it appears in the 15-day notice itself as an unaltered sentence (without underscore or strikeout) in the subsection discussing changes to the definition. The sentence was *included*:

- in the draft language presented at the November 8, 2010 Interested Parties Meeting (in somewhat different wording),
- in the draft language presented on December 2, 2010 to the three-member Franchise Tax Board which approved the language,
- in the draft language presented along with the Initial Statement of Reasons and Notice of Hearing (45-day notice), and
- in the first 15-day notice mailed on October 7, 2011.

The language was *not* included in the accompanying text to the first 15-day notice mailed on October 7, 2011, nor in the second 15-day notice and accompanying text.

The deletion/omission of this sentence was in error and unintentional. This is obvious when one notes in the 15-day notice mailed on October 7, 2011 that there are several sentences that were inserted prior to the sentence at issue here (see the underscored portion of the definition in the 15-day notice). As discussed above, there were many changes to the definition in the 15-day notice and accompanying text mailed on October 7, 2011. It was during this process of substantially altering the definition that the sentence was inadvertently deleted from the first 15-day notice text that accompanied the first 15-day notice mailed on October 7, 2011. Thereafter, the language remained inadvertently omitted and does not appear in the second 15-day notice and its accompanying text both mailed on October 27, 2011. No changes were made to the definition at the second 15-day notice stage.

No member of the public, since the sentence has appeared in the draft language of the text in October 2010, has made any comments, positive or negative, about this sentence. Indeed, it is common sense that in order to reasonably approximate the seller's market, specific information would be preferred over general information. Furthermore, general information is not being excluded but would be secondary to any available specific information. This provision neither mandates nor prohibits any action

but states a logical preference for types of information. The language has been added back into the final draft.

The subsection as amended reads as follows:

- (5) "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the business activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic area where the customer or purchaser, at the time of purchase, will receive the benefit of the services or use the intangible property, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being received or intangible property is being used materially in other parts of the world, then the populations of those other countries where the benefit of the service is being received or the intangible property is being used materially shall be added to the U.S. population. Information that is specific in nature is preferred over information that is general in nature.

11. Subsection (b)(7), which originally defined the term "Intangible personal property is used," has been revised so that the term being defined is worded exactly as it appears throughout the language in subsection (d). As a result, "intangible personal property is used" has been replaced with "the use of intangible property in this state." In addition, the definition has been expanded to address new provisions, subsections (d)(1)(A)1 and (d)(1)(A)1.a and b which have been added to the sale of intangible property in the case where stock in a corporation or interest in a pass-through entity has been sold. Thus, language has been added to state that the location of the use of the stock or interest is the location of the use of the underlying assets of the stock or interest of the business entity sold. The subsection as amended reads as follows:

~~"Intangible personal property is used"~~ "The use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee. In the case of the complete transfer of all property rights in stock of a corporation or pass-through entity, the location of the use of the stock is the location of the use of the underlying assets of the stock of the corporation or pass-through entity.

12. Subsections (c)(1) and (c)(1)(A) previously provided the first cascading rule for the assignment of sale of services to individuals. Now, (c)(1) has been revised so that it is a segue to the cascading rules for assignment of sales of services to individuals, which now appear below it in subsections (c)(1)(A) and (B). This format is cleaner and clearer: all cascading rule subsections are contained within the same subsection format, i.e. (c)(1)(A) and (c)(1)(B), and not as they were previously set forth, subsections (c)(1) and (c)(1)(A). Also, this format is consistent with those provisions for cascading rules in subsection (d) for sales of intangible property.

As a result, several changes to this subsection have been made. First "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows" has been added to clarify that this subsection is the segue for the cascading rules to come under subsections (A) and (B) in connection with assignment of sales of services to individuals. Third, the language of the first cascading rule has been deleted here (but now appears in subsection (A).) The subsection as amended reads as follows:

- (1) In the case where an individual is the taxpayer's customer, receipt of the benefit of the service shall be presumed to be received at the billing address of the taxpayer's customer, as determined at the end of the taxable year. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment determined as follows:

13. Subsection (c)(1)(A) now contains the first cascading rule of assignment to the customer's billing address, previously set forth in subsection (c)(1). To be consistent with other subsections of this regulation, the subsection starts with "The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer's customer as determined at the end of the taxable year is in this state." Then, the safe harbor provision for that rule is stated. Finally, the original language of subsection (c)(1)(A) is set forth and explains how a taxpayer may overcome the presumption that the billing address, the first cascading rule, is the location where the benefit of the services is received.

Other modifications have been made to make the language consistent with other provisions of this regulation as well as other regulations. First, the phrase "in this state" was added to the first sentence of subsection (c)(1)(A) for clarification that the sale would be assigned to this state if the billing address were in this state. This was done to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under Revenue and Taxation Code and Regulation sections, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or any location in general. Second, "by" was replaced with "based on" for consistency with other similar provisions in this regulation. Third, "benefit of the" was added before the word "service" to be consistent with the statutory language. Fourth, "[P]erformed" was replaced by "received" also to be consistent with the statutory language and its market-based intent as well as to make this provision consistent with similar provisions in this regulation. This last change was based on a comment at the hearing. The amended subsection reads as follows:

- (A) The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer's customer as determined at the end of the taxable year is in this state. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment. This presumption may be overcome by the taxpayer by showing, by based on a preponderance of the evidence, that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is performed-received at a location (or locations) in

this state. If the taxpayer believes it has overcome the presumption and uses an alternative method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, the Franchise Tax Board may examine the taxpayer's alternative method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's alternate method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers.

14. Subsection (c)(1)(B) is the second cascading rule for the assignment of sales of services made to individuals. The first point of this second cascading rule is that the presumption in the first cascading rule, that the billing address is presumed to be the location where the benefit of the services are received, must be overcome prior to application of the second cascading rule, and, in addition, that there are no alternate methods that can be determined by looking at the contract with the customer or the taxpayer's books and records. To make the subsection clearer and consistent with the wording of other similar provisions in this regulation, "yet no" has been deleted and replaced with "and an" so that the sentence reads that if the presumption in the first cascading rule is overcome "and an alternate method cannot be determined..." then assignment shall be reasonably approximated. "Determined" is the preferred term in this context and is consistently used throughout this regulation and so replaces "derived." Finally, throughout this regulation when referring to the "taxpayer's contract with its customer or the taxpayer's books and records", the "taxpayer's contract with its customer" is listed first and the "taxpayer's books and records" is listed second. This subsection is modified to reflect that consistent order. The amended subsection reads as follows:

- (B) If the presumption in (c)(1)(A) is overcome by the taxpayer, ~~yet no~~ and an alternative method ~~cannot~~ be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records of the taxpayer kept in the normal course of business ~~or the contract between the taxpayer and its customer~~, then the location where the benefit of the services is received by the customer shall be reasonably approximated.

15. Subsection (c)(1)(C)1 provides an example of the assignment of sales of services to individuals. It has been completely revised to illustrate possible different facts in the case of sales of services within the telecommunications industry, which facts would indicate that for some telecommunication taxpayers the billing address would not reflect the market of its consumers, and the market for telecommunications services might be more accurately determined by the net plant method of assigning sales consistent with the Franchise Tax Board's Multistate Audit Technical Manual section 7805. To provide clarity, the phrase "net plant facilities" is specifically described, and a methodology for how property is valued when using the net plant method is provided. The last sentence was deleted as confusing and unnecessary. These changes were a result of comments made by several commentators during the 15-day notice process beginning October 7, 2011. The amended example reads as follows:

1. ~~Phone Corp provides telecommunications services to individuals in this~~

~~state and other states for a monthly fee billed to the customer's address. Gross receipts from these services are assigned to this state if the billing address of the customer is in this state.~~

Benefit of a Service – Individual, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets that is determined from Phone Corp's books and records. Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

16. Subsection(c)(1)(C)2 is another example for assignment of sales of services to individuals. Originally, the second paragraph of this example had not been numbered or lettered. The second paragraph has now been pulled up into the first paragraph, subsection (c)(1)(C)2. This change was made for clarity and consistency with other examples within this regulation.

In addition, the example has been revised in several other ways. First, the phrase "books and" has been inserted in front of the word "records." This term with the inserted words is consistent with other similar provisions throughout this regulation and other Revenue and Taxation Code and Regulation provisions. Second, after the word "records" the phrase "maintained in the regular course of business" was inserted. The phrase "books and records" usually appears with the modifying phrase "maintained in the regular course of business" when initially referred to in a subsection. This is consistent with other provisions throughout this regulation as well as other Revenue and Taxation Code and Regulation sections. However, when the term "books and records" is mentioned a second time in the same subsection, the modifying term "maintained in the regular course of business" need not appear, as it is generally understood that the books and records are the same books and records identified earlier in the subsection. As a result, the second reference to "maintained in the regular course of business" in this subsection was deleted. The amended example reads as follows:

2. Benefit of the Service – Individual, subsection (c)(1)(A). Travel Support Corp located in this state provides travel information services to its customers, who are individuals located throughout the United States, through a call center located in this state. The contract between Travel Support Corp and its customers provides that for a fee per call, the customer can call Travel Support Corp for information regarding hotels, restaurants and other travel related information. Travel Support Corp's books and records maintained in the regular course of business indicate that fifteen (15) percent of its customers have billing addresses in this state. However, Travel Support Corp's ~~books and records, maintained in the regular course of business,~~ indicate that only seven (7) percent of the calls handled by the call center originate from this state. Because Travel Support Corp's books and records show where the benefit of the services is actually received, the billing address presumption is overcome and the books and records of the taxpayer may be used to assign seven (7) percent of the gross receipts from the support services provided by the call center to this state.

17. Subsection (c)(1)(C)3 is an example of when a taxpayer may not overcome the presumption that the billing address is the location where the benefit was received. This example was revised to provide clarity and give a reason as to why the presumption was not overcome. After the language "The fact that only seven (7) percent of the calls originate from this state does not overcome the presumption that the benefit of the services is received at the billing address", the statement "This is because the charges are not based on a per call basis but rather a flat monthly fee" was added. The amended example reads as follows:

3. Benefit of the Service – Individual, subsection (c)(1)(A). Same facts as Example 2 except the contract between Travel Support Corp and its customers provides for a set monthly fee, regardless of whether the customer actually calls for travel support. This is because the charges are not based on a per call basis but rather a flat monthly fee.

18. Subsection (c)(1)(C)4 was inserted to provide an example as to how the cascading rule of reasonable approximation for sales of services to an individual works. It has been identified as "Benefit of the Service – Individual, subsection (c)(1)(B)." An example of this cascading rule had not been provided in previous drafts. It is the intent of the Franchise Tax Board to provide at least one example for every cascading rule to show how each rule works. The new example reads as follows:

4. Benefit of the Service – Individual, subsection (c)(1)(B). Satellite Music Corp has a contract with Car Dealer Corp to provide satellite music service to Car Dealer Corp's retail customers who buy Make and Model X car. Car Dealer Corp's customers pre-pay for a two (2) year service plan at a discounted rate as part of the purchase price of the Brand X car. While Satellite Music Corp requires an email address for Car Dealer Corp's customers who receive the benefit of the service, Satellite Music Corp does not have access to information as to the billing address or physical location of Car Dealer Corp's customers. Satellite Music Corp may reasonably approximate the location where Car Dealer Corp's customers receive the benefit of its satellite music service by a ratio of the number of Car Dealer Corps that offer the two (2) year service plan with Satellite Music Corp to its customers in this state to the number of Car Dealer Corps that offer the two (2) year service plan with Satellite Music Corp to its customers located everywhere.

19. Subsections (c)(2) and (c)(2)(A) originally provided the first cascading rule for sales of services to business entities. Now (c)(2) has been revised so that it is a segue to the cascading rules for assignment of sales of services to business entities that appear below it in (A) through (D). This type of format is cleaner and clearer: all cascading rule subsections are contained within the same subsection, i.e. (A) through (D) and not as they were previously set forth in subsection (c)(2), i.e. (2) and (2) (A) through (C). Also, this format is consistent with the provisions for cascading rules in (d), sales of intangible property.

In subsection (c)(2), several changes have been made. First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection is the segue for the cascading rules to come under subsections (A) through (D) in connection with assignment of sales of services to business entities. Third, the language of the first cascading rule that assignment will be determined by the contract with the customer or the taxpayer's books and records has been deleted.

The subsection is amended as follows.

- (2) In the case where a corporation or other business entity is the taxpayer's customer, receipt of the benefit of the service shall be presumed to be received ~~at the location (or locations) indicated by the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records, notwithstanding the billing address of the taxpayer's customer~~ determined as follows:

20. Subsection (c)(2)(A) now contains the first cascading rule of assignment based on the contracts with the customer or the taxpayer's books and records previously set forth in (c)(2). In addition, this rule was modified so that the language is consistent with other provisions in this regulation and other regulations. Hence, the provision starts with "The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business ... indicate the benefit of the service is in this state." Then appears the original language of (c)(2)(A) of how a taxpayer may overcome the presumption that the contract or the taxpayer's books and records indicates the location where the benefit of the services is received. Lastly, for consistency with other similar provisions of this regulation, "upon an evidentiary showing" was deleted and inserted after "by" is "showing based on" also to be consistent with other similar provisions of the regulation. Commas were added where appropriate in that same sentence. The subsection is amended as follows:

- (A) ~~To the extent that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records (notwithstanding the billing address of the taxpayer's customer) kept in the normal course of business provide the location (or locations) where the benefit of the services is received, such location (or locations) will be presumed to be where the benefit of the service is actually received.~~ The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding

the billing address of the taxpayer's customer, indicate it is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board ~~upon an evidentiary showing~~ by showing based on a preponderance of the evidence that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

21. Subsection (c)(2)(C), the third cascading rule for assignment of sales of services to business entities, has been revised to insert the phrases "in this state if" and "is in the state" to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under the Revenue and Taxation Code and other Regulations, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or any location in general. Insertion of the phrase, "is in this state", at the end of the sentence completes the sentence. The subsection is amended as follows:

- (C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

22. Subsection (c)(2)(E)3 provides an example for the first cascading rule for sales of services to business entities and provides guidance on how either the contract between the taxpayer and its customer or a taxpayer's books and records can determine the location where the benefit of the services was received by a business entity customer. The word "its" was exchanged for the term "Client Corp's" so that it is clearer as to which corporation is being referred. The example is amended to read as follows:

- 3. Benefit of the Service – Business Entity, subsection (c)(2)(A). Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as ~~its Client Corp's~~ internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B according to the taxpayer's books and records which indicate time spent in each state by each staff member.

23. Subsections (c)(2)(E)4 and 5 are examples based on similar facts exhibiting how the books and records cascading rule and the reasonable approximation cascading rule works for sale of services to business entities. Originally, the first paragraph under (c)(2)(E)4 was numbered 4.a and the second paragraph was numbered 4.b. To be consistent with other examples throughout the regulation, the provision "a" was moved up into 4, making 4 and 4.a one example. Then, "b" was renumbered "5" as its own example. Because "5" is now its own example, the language "Same facts as in Example 4 except" was added to the

beginning of the example. This format is also consistent with other examples in this regulation. Secondly, since for purposes of this particular example the term "viewers" is more accurate than "subscribers", "subscribers" was substituted for "viewers". The amended example reads as follows:

4. Benefit of the Service – Business Entity, subsection (c)(2)(A). Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. Web Corp's contracts with other businesses do not indicate the location (or locations) where the benefit of the service is received. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. a. If Web Corp, through its books and records kept in the normal course of business, can determine the location from which the advertisement is viewed and/or clicked on by viewers of the website, then gross receipts from the advertising will be assigned to this state by a ratio of the number of viewings and/or clicks of the advertisement in this state to the total number of viewings and/or clicks on the advertisement.
- b.5. Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 4. If Web Corp cannot determine the location from which the advertisement is viewed and/or clicked on through its books and records, it shall reasonably approximate the location of the receipt of the benefit by assigning its gross receipts from advertising by a ratio of the number of its viewers in this state to the number of its ~~subscribers~~viewers everywhere.

24. Subsection (c)(2)(E)6 and 7 are examples with the same facts that show how the third and fourth cascading rules for sales of services to business entities work in the event the first cascading rule (the contract between the taxpayer and the customer or the taxpayer's books and records) and the second cascading rule (reasonable approximation) do not provide a method for determining where the location of the receipt of the benefit of the service, i.e. where the customer has received value from delivery of the service (see definition of "Benefit of a service is received" subsection (b)(1).) Several changes have been made to these examples.

First, what used to be subsection (c)(2)(E)6.a has been brought into what is now subsection (c)(2)(E)6, making the subsections of 6 and 6.a one example. What used to be subsection (c)(2)(E)6.b has been renumbered to 7 and made its own example. Because "7" is now its own example, the phrase "Same facts as Example 6" has been added to the beginning of the example. These changes were made for clarity and consistency with the other examples throughout the regulation.

Second, to make it clearer in this example that the first two cascading rules do not provide a method for determining how much value Western Corp received from Painting Corp's painting services delivered in this state, additional critical factors (shape and surface of the buildings to be painted, and materials used) have been added as necessary facts which are

missing so that determination of this state's receipt of its pro-rata portion of value of the painting service under the first two cascading rules is not possible. The "number" factor was deleted because that fact would be known since the location of the buildings is known. "At each location" was deleted as unnecessary. These facts were added or deleted based on comments received for this regulation during the 45-day notice process.

Third, while it is stated in the example that neither the contract between Painting Corp and Western Corp nor Painting Corp's books and records (the first cascading rule) indicate any method for determination of the extent that the benefit of the services was received in this state, the example failed to specifically mention that there is also no method of reasonable approximation (the second cascading rule) of the extent the benefit of the services was received in this state. It is important that it is clearly stated that the first two cascading rules do not determine assignment of the sale because only then does the next cascading rule apply. As a result, the language "In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received" has been added to the example. The phrase "or reasonably approximating" has been deleted because reasonable approximation is not based on the contract between a taxpayer and its customer or a taxpayer's books and records, and the sentence as it was originally written confuses that point. The fact that reasonable approximation is not available in this example is stated in a separate sentence below. These changes make it clear that application of the third cascading rule (the place from which the order was made), is appropriate because the first two cascading rules are unavailable. This is the purpose of example of (c)(2)(E)6.

If a taxpayer cannot assign the sale to the place from which the order was made (the third cascading rule) then it is assigned to the customer's billing address (the fourth cascading rule) which is the purpose of the example (c)(2)(E)7. The example has been modified to state "subsection (c)(2)(C)" instead of "subparagraph a" to reflect how it is currently numbered.

The amended example reads as follows:

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp ~~a~~ contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining ~~or reasonably approximating~~ the extent that the benefit of the service is received in this state, i.e. the size, shape, or number surface of each buildings, or the materials used for each buildings to be painted ~~at each location~~. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. ~~a.~~ Since neither the contract nor Painting Corp's books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

~~b.7.~~ Benefit of the Service – Business Entity, subsection (c)(2)(D). Same facts as Example 6– If except the sale cannot be assigned under ~~subparagraph a-~~ subsection (c)(2)(C), then the sale shall be assigned to this state if Western Corp's billing address is in this state.

25. Subsection (d)(1), the segue for the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been revised to be consistent with the underlying statute, which provides that assignment of sales of intangibles shall be based on the location of the use of the intangible property. As a result, the phrase "location of the use of the" has been inserted before "the intangible property" for purposes of being consistent with the underlying statute. Consequently, the phrase "in this state" has been deleted as unnecessary as it appears in the cascading rules below. This is consistent with other provisions in this regulation.

In addition, the language has been modified to reference the definition of "complete transfer of all property rights" in subsection (b)(3). The amended subsection reads as follows:

- (1) In the case of the complete transfer of all property rights as defined in subsection (b)(3) in intangible property as defined in subsection (b)(~~3-4~~) for a jurisdiction or jurisdictions, the location of the use of the intangible property in this state shall be determined as follows:

26. Subsection (d)(1)(A), the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been modified.

First, the phrase "location of the use of the intangible property shall be presumed to be in this state to the extent the" was added to the beginning of the subsection to be consistent with the wording of similar presumptive language in the provisions for assignment of sales of services in subsection (c). Further down in the same sentence, the phrase "shall be presumed to provide where the purchaser will use the intangible at the time of the purchase" was deleted accordingly. Also in the first sentence, the word "indicate" replaces the word "provide" to be consistent with the wording of the provisions for assignment of sales of services in subsection (c). For clarity, the phrase "that the intangible property is used" was inserted before "in this state", and "at the time of sale" was added to the end of the sentence.

In the second sentence, the two words "books and" were added before the word "records" to complete the phrase as it is generally known and so that the term is consistently worded throughout this regulation. Also, "for the most recent twelve (12) month taxable year" was added in order to identify the time period for determining the extent of the use of the intangible property in this state by the taxpayer prior to the sale.

In the third sentence, to be consistent in the wording with other similar provisions in this regulation, the phrase "showing based on" was added prior to the phrase "preponderance of the evidence, and "showing" was deleted immediately after "preponderance of the evidence."

In the final sentence, for clarity, the term "actual location of the use" was put in place of "purchaser's use" and the phrase "property by the purchaser" was added after the word

"intangible" so it now reads "the actual location of the use of the intangible property by the purchaser..." The term "intangible property" was originally referred to here as only "intangible", hence the word "property" was added to "intangible" to complete the term as it is generally known. Commas have been added where appropriate. As a result of rephrasing this sentence, "showing" and "purchaser's use" were deleted.

The amended subsection reads as follows.

- (A) The location of the use of the intangible property shall be presumed to be in this state to the extent that the contract between the taxpayer and the purchaser, or the taxpayer's books and records kept in the normal course of business, shall be presumed to indicate provide where the purchaser will use the intangible at the time of purchase that the intangible property is used it is in this state at the time of the sale. This may include books and records providing the extent that the intangible property is used in this state by the taxpayer for the most recent twelve (12) month taxable year prior to the time of the sale of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, showing that the actual location of the use purchaser's use of the intangible property by the purchaser at the time of purchase is not consistent with the terms of the contract or the taxpayer's books and records.

27. Subsections (d)(1)(A)1, (d)(1)(A)1.a and (d)(1)(A)1.b are assignment rules for sales of intangible property in the event of a sale of an interest in a corporation or a pass-through entity. Subsection (d)(1)(A)1.a was originally set out as an example for assignment of the sale of stock (see original subsection (d)(1)(D)(1), ~~strikeout version.~~)

At the 45-day hearing for the regulation, comments were received that (1) it is better tax policy to set forth the law in statutory or regulatory provisions instead of by example, (2) sales of interests in pass-through entities should be included, (3) a separate provision should be created for sales of stock or interests where the underlying assets consist of more than 50% intangible property and assignment of the sale of the stock or interest should be based on the principles in Revenue and Taxation Code section 25125, subdivision (d), and (4) in calculating the assignment of the sale, the average of the factors referred to in subsection (d)(1)(A)1.a and the sales factor referred to in subsection (d)(1)(A)1.b should be determined by the most recent 12-month taxable year prior to the time of the sale. As a result of the comments, assignment mechanism rules for a sale of stock in a corporation or an ownership interest in a pass-through entity were created in subsections (d)(1)(A)1.a and (d)(1)(A)1.b.

Subsection (d)(1)(A)1 was created as a segue for the rules set forth in (d)(1)(A)1.a and (d)(1)(A)1.b. This is consistent with the provisions in subsection (c). In response to a comment received during the 15-day notice period beginning October 7, 2011, to make it clear that a seller need not own one hundred percent of the stock of an entity, nor sell all one hundred percent of its interest in order for the assignment rules of (d)(1)(A)1 to apply, the phrase "shares of stock" was used. Also, in order to reflect and be consistent with the language of the underlying statute, Revenue and Taxation Code section 25136, subdivision (b)(2), which states that sales of marketable securities are assigned to this state if the

purchaser is in this state, the subsection specifically excludes sales of marketable securities.

Subsection (d)(1)(A)1.a reflects the principles of the example originally set out in (d)(1)(D)1 and incorporates the comments received. That subsection states that in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where 50% or more of the amount of the assets of the corporation or pass-through entity, determined using the original cost basis, consist of real and/or tangible personal property, the sale will be assigned by averaging the California payroll and property factors of the entity sold. The average of the factors will be determined by the most recent 12-month taxable year prior to the time of sale according to the taxpayer's books and records. It is felt that the payroll and property factors reflect the value and location of where the intangible property, the underlying assets of the entity sold, was employed (see definition of "the use of the intangible property," subsection (b)(7)) at the time of the sale and therefore is an appropriate way to assign the sale of intangible property where 50% or more of the underlying assets consist of real and/or tangible personal property.

Subsection (d)(1)(A)1.b was created to provide for assignment of a sale of stock in a corporation or an ownership interest in a pass-through entity where more than 50% of the amount of the corporation's or pass-through entity's underlying assets, determined by using the original cost basis, consist of intangible property. This subsection states that the sale will be assigned by using the California sales factor of the entity sold for the most recent 12-month tax period prior to the time of sale according to the taxpayer's books and records. This subsection is based on comments received at the 45-day hearing. Here, the sales factor reflects the value and location of where the intangible property, such as goodwill, was employed (see definition of "the use of intangible property," subsection (b)(7)) at the time of sale, and, as a result, is an appropriate way to determine assignment of sale of stock or ownership interest where the majority of the underlying assets consist of intangible property.

In both subsections (d)(1)(A)1.a and (d)(1)(A)1.b, determination of whether the underlying assets consist of 50% or more of real and/or tangible personal property or 51% intangible property is to be made on the date of the sale. Also, to address the issue where the stock or interest is sold more than six (6) into the current taxable year, language has been included in both subsections that where the stock or interest at issue is sold more than six (6) months into the current taxable year, the average of the current taxable year's payroll and property or sales factors shall be used. These changes were made pursuant to comments received during the 15-day notice period beginning October 7, 2011.

The new subsections read as follows:

1. Where the sale of intangible property is the sale of shares of stock of a corporation or of an interest in a pass-through entity, other than sales of marketable securities, the following rules:
 - a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the

payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business. If, however, the sale occurs more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records. If, however, the sale occurs more than six (6) months into the current taxable year, then the current taxable year's sales factor shall be used.

28. Subsection (d)(1)(B), the second cascading rule of reasonable approximation for sales of intangible property where there has been a complete transfer of all property rights, has been modified to delete the conditions and limitations for reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximation at subsection (b)(5), thereby making them applicable to all provisions in this regulation. The amended subsection reads as follows:

(B) If the extent of the use of the intangible property in this state cannot be determined under subparagraph (A) or the presumption under subparagraph (A) is overcome, the location where the intangible property is used shall be reasonably approximated. ~~by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser, at the time of purchase, will use the intangible, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.~~

29. Subsection (d)(1)(C) is the third cascading rule. This rule provides that if the taxpayer cannot apply the rules in (d)(1)(A) or (d)(1)(B), that the location of the customer's billing address will be used to assign sales of intangible property where there has been a complete transfer of all property rights. This rule has been modified to reflect the standard assignment language found in other sections of the Revenue and Taxation Code and Regulations. Typically, assignment will be made "to this state" as opposed to "California" or any location in general. As a result, the words "this state if" were inserted after the phrase "the gross receipts shall be assigned to". Secondly, after the phrase "the billing address of the purchaser" the phrase "is in this state" was added. The amended subsection reads as follows:

- (C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subparagraphs (A) or (B), then the gross receipts shall be assigned to this state if the billing address of the purchaser is in this state.

30. Subsection (d)(1)(D)1 is an example showing the application of the cascading rule for assigning a sale of an interest in a corporation or pass-through entity where 50% or more of the amount of the underlying assets, determined by using the original cost basis, are real or tangible personal property. Language was added to indicate that this example addresses the provision where the underlying assets of the corporation or entity sold consist of predominantly tangible personal property. "[A]t the time of sale" was moved to the beginning of the sentence to address both the new language and the first sentence. The phrase "in its most recent 12-month taxable year preceding the sale" has been inserted to define the time period that the payroll and property factors are to be averaged for determining assignment of the sale of stock. The amended example reads as follows:

~~(1)~~ 1. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells all of the of stock of Subsidiary Corp. At the time of sale, the predominant value of Subsidiary Corp's assets consists of tangible personal property and Subsidiary Corp, at the time of sale, had locations in this state and three (3) other states. Taxpayer's books and records indicate Subsidiary Corp had payroll and property in this state of 15% and 25%, respectively, in its twelve (12) month taxable year preceding the sale. In assigning the receipt from the sale of Subsidiary Corp. Taxpayer may average the property and payroll percentages and assign 20% of the receipt from the sale to this state.

31. Subsection (d)(1)(D)2 has been inserted as an example of the cascading rule in subsection (d)(1)(A)1.b of assigning the sale of stock of a corporation or an interest in a pass-through entity where more than 50% of the amount of the underlying assets, determined by using the original cost basis, is intangible property. The new example reads as follows:

~~(2)~~ 2. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells an interest in Target Entity. At the time of the sale, the predominant value (over 50%) of Target Entity's assets consists of intangible property. Target Entity's books and records indicate that 30% of Target Entity's sales were assigned to California during the most recent full tax period preceding the sale. Parent Corp may assign 30% of the receipt from the sale of the interest in Target Entity to this state.

32. Subsection (d)(1)(D)3 is an example of the second cascading rule of reasonable approximation for assigning sales of intangible property where a complete transfer of all property rights has been made. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp", and "Buyer" has been replaced with

"Manu." Also, because this example is intended to show how a taxpayer may reasonably approximate the location of the use of the intangible property, the words "may reasonably approximate the location of the use by assigning" have been inserted in place of the word, "assigns" for clarity. The amended example reads as follows:

~~(3)~~ 3. Intangible Property – Complete Transfer, subsection (d)(1)(B). ~~Taxpayer R&D Corp~~ sells a patent to ~~Buyer Manu~~ Corp that will be used by ~~Buyer Manu~~ Corp to manufacture products for sale in the United States. The contract between ~~Taxpayer R&D Corp~~ and ~~Buyer Manu~~ Corp indicates that ~~Buyer Manu~~ Corp will have the exclusive rights to the patent for exploitation in the United States. At the time of the purchase, ~~Taxpayer R&D Corp~~ knows that ~~Buyer Manu~~ Corp has three factories that will use the patented process in manufacturing, one of which is located in this state. In the absence of specific information as to the amount of manufacturing ~~Buyer Manu~~ Corp does at each of the three locations, ~~Taxpayer R&D Corp~~ may reasonably approximate the location of the use by assigning assigns the receipts from the sale equally among the three states where ~~Buyer Manu~~ Corp has manufacturing plants, assigning 33% of the sale to this state.

33. Subsection (d)(1)(D)4 is an example of the third cascading rule. This rule provides that the customer's billing address shall be used for assigning sales of intangible property in the case of a complete transfer of all property rights. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp" and "Buyer" has been replaced with "Manu." Also, the word "facts" has been added for clarity. "[S]hall" replaces "may" and "except" replaces "but" to be consistent with other similar provisions in this regulation. The amended example reads as follows:

~~(1)~~ 4. Intangible Property – Complete Transfer, subsection (d)(1)(C). Same facts as Example ~~(3)~~, but ~~Taxpayer~~ except R&D Corp has no information regarding ~~Buyer Manu~~ Corp's activities. ~~Taxpayer R&D Corp~~ may shall assign the receipt to the billing address of ~~Buyer Manu~~ Corp.

34. Subsection (d)(2)(A)1 is the provision for assignment of sales where the intangible property sold is a "marketing intangible." A commenter at the 45-day hearing for this regulation suggested that the language was duplicative, and, therefore by implication, also unclear. As a result, changes have been made based on those comments, to clearly articulate the 3 prongs of this marketing intangible provision. The three prongs are: (1) sales are assigned to this state to the extent the ultimate customer of the goods or services to which licensing fees are attributed is in this state, (2) the contract between the taxpayer and licensee or the taxpayer's books and records are presumed to indicate the method for determination of the ultimate customer in this state, and (3) the presumption of the contract or books and records may be overcome based on a preponderance of the evidence.

In connection with the first prong (sales are assigned based on location of ultimate customer), there have been several changes made for clarity. First, the subsection originally contained one long sentence which included the provisions for both the first prong and the second prong. Now, the two prongs have been divided into two separate sentences. The first prong is the first sentence of this subsection and provides the general rule for

assignment of sales for marketing intangibles. The second prong is the second sentence and provides the presumptive first cascading rule on how to assign such sales (discussed infra). In the first sentence, the word "ultimate" was added preceding "customer" to make it clear that it is the ultimate customer that determines the location of assignment of the sale. Also, the phrase "presumed to be" was deleted as unnecessary because the first cascading rule (contract or books and records are presumed to indicate the method of location of the ultimate customer) to which the presumption was intended to attach is now in the second sentence.

In connection with the second prong (the contract or books and records are presumed to indicate the method of location of the ultimate customer), the presumption language itself has been rephrased so that it is clearer and consistent with other similar provisions in this regulation. In addition, language clearly stating that the contract or books and records "are presumed" to provide a method for determination of the location of the ultimate customers has been inserted. Also, as in the previous sentence, the word "ultimate" is inserted before "customers" for purposes of clarity. This prong is represented in the second sentence of this subsection.

In connection with the third prong (overcoming the presumption), previously there was no language as to how the presumption could be overcome (thereby allowing application of the second cascading rule of reasonable approximation which appears in the following subsection). Language as to how to overcome the presumption was added as the third sentence to this subsection. It is now consistent with other similar provisions in this regulation.

The amended subsection reads as follows:

1. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) ~~are presumed to be~~ attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by ~~this state's~~ ultimate customers in this state, ~~as is provided for by the terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business. If~~ The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of this state's the ultimate customers in this state for the purchase of goods, services, or other items in connection with the use of the intangible property; ~~then the contract's terms or the taxpayer's books and records shall be used to determine this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property. This~~ presumption may be overcome by the taxpayer or the Franchise Tax Board by showing based on a preponderance of the evidence that the ultimate customers in this state are not determinable under the contract or the taxpayer's books and records.

35. Subsections(d)(2)(A)2 provides the second cascading rule for assignment of "marketing intangibles" which states that if assignment cannot be made under the previous provision, then assignment shall be done by reasonable approximation. This subsection was reworded to be consistent with other similar provisions in the regulation, including the addition that if the presumption in the preceding paragraph is overcome, then the location of the use of the intangible property shall be reasonably approximated. This subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been inserted into the general definition of reasonable approximation in subsection (b)(5), thereby making them applicable to all provisions in this regulation. (This is discussed above under the discussion of the changes to the definition of reasonable approximation beginning on page 3.)

Finally, the last sentence provides factors to consider in determining the customer's or licensee's use of "marketing intangibles." This provision was originally located under "Special Rules" in subsection (g)(2) and applicable to the regulation as a whole. However, the rule is specific to assignment of sales of "marketing intangibles" and therefore was relocated to the provision for the first cascading rule for assignment of "marketing intangibles." The phrase "including population" was deleted as unnecessary. For clarity, other changes were made and include replacing "intangible property" with "marketing intangibles" and deleting "for use of marketing intangibles".

The amended subsection reads as follows:

2. If the location of the use of the intangible property is not determinable under subparagraph 1 or the presumption under subparagraph 1 is overcome, the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's licensee customer to the extent such information is available to the taxpayer. Reasonable approximation of the location of the use of the intangible property includes, but is not limited to, the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items, to the extent such information is available to the taxpayer. To determine the customer's or licensee's use of intangible property marketing intangibles in this state under subsection (d)(2)(A)2 for use of marketing intangibles, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data including population that reflects the relative usage of the intangible property in this state.~~

36. Subsection (d)(2)(A)3 is a population assignment provision specific for marketing intangibles sold at the wholesale level. The assignment language was modified to be consistent with the language for the use of population as a method of assignment in the definition of reasonable approximation in subsection (b)(5) The amended subsection reads as follows:

3. Where the license of a marketing intangible property is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the taxpayer may be

unable to develop information regarding the location of the ultimate use of the intangible property. If this is the case, then the taxpayer may attribute the receipt to this state based solely upon the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items. ~~Only the populations of those countries where the intangible is being materially used shall be taken into account.~~ The population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible property is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.

37. Subsection (d)(2)(B)1 is the first cascading rule regarding non-marketing or manufacturing intangibles. For consistency purposes, the provision was changed to mirror the first cascading rule of marketing intangibles in subsection (d)(2)(A)1. Thus, the first sentence provides the general rule for assignment of non-marketing/manufacturing sales, and the second sentence contains the presumptive first cascading rule on how to assign such sales. The third sentence is now consistent with marketing intangibles and other similar provisions in the regulation and provides language on overcoming a presumption. Thus, "by a preponderance of the evidence" was deleted and "by showing, based on a preponderance of the evidence, that the extent of the use for which the fees are paid are not determinable under the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records" was inserted in its place. The amended subsection reads as follows:

(B) Non-marketing and manufacturing intangibles.

1. Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are ~~presumed to be~~ attributable to this state to the extent that the use for which the fees are paid takes place in this state, ~~as is provided for by.~~ The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to. ~~If the contract or the taxpayer's books and records provide a method for determination of the extent of the use of the intangible property in this state, then the contract's terms or the taxpayer's books and records will be presumed to properly indicate the extent of the use of the intangible property in this state. This presumption may be overcome by a preponderance of the evidence by the taxpayer or the Franchise Tax Board~~ by showing, based on preponderance of evidence, that the extent of the use for which the fees are paid are not determinable under the contract or the taxpayer's books and records.

38. Subsection (d)(2)(B)2 provides the second cascading rule for the assignment of sales of non-marketing and manufacturing intangibles. The phrase "for which the fees are paid" was deleted as unnecessary and inconsistent with the language of similar provisions in the

regulation. Finally, this subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximations at subsection (b)(5), making them applicable to all provisions of this regulation. The amended subsection reads as follows:

2. If the location of the use of the intangible property ~~for which the fees are paid~~ cannot be determined under subparagraph 1 or the presumption in subparagraph 1 is overcome, then the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's customer, to the extent such information is available to the taxpayer.~~

39. Subsection (d)(2)(C)1 is the first cascading rule for assignment of sales of mixed intangibles. For clarity, the single word "Where" was replaced with the phrase "Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and..." in the last sentence "or manufacturing" was added to "non-marketing" to complete the term, mixed intangibles, as it is defined in subsection (b)(4)(C). The amended subsection reads as follows:

(C) Mixed intangibles.

1. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and the fees to be paid in each instance are separately stated in the licensing contract, the Franchise Tax Board will accept such separate statement for purposes of this section if it is reasonable. If the Franchise Tax Board determines that the separate statement is not reasonable, then the Franchise Tax Board may assign the fees using a reasonable method that accurately reflects the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible.

39. Subsection (d)(2)(C)2 is the second cascading rule for assignment of sales of mixed intangibles. The phrase "a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible" is unnecessary as the definitional language of a mixed intangible already appears immediately above in subsection (d)(2)(C)1. Since this second rule immediately follows the first rule, it is unnecessary to define the term again. Finally, the language on how to overcome the presumption has been added to the end of this provision. This is consistent with other similar subsections of this regulation. The amended subsection reads as follows:

2. ~~Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or the Franchise Tax Board can reasonably establish otherwise. This presumption may be overcome, by a preponderance of the evidence, by the taxpayer or the Franchise Tax Board, that the~~

licensing fees are paid for both the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible, and the extent to which the fees represent the marketing intangible and the non-marketing or manufacturing intangible.

40. Subsection (d)(2)(D)2 is an example for reasonable approximation for assigning sales of marketing intangibles." "Sports" replaces "Whole" to give the corporation in the example a clearer identity so that the example is easier to understand. In addition, to make it clear that the taxpayer could not determine assignment based on the first cascading rule (the contract or the taxpayer's books and records), language is inserted to state that fact: "Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks." Finally, to make it clear that this is a reasonable approximation example, the word "determined" is replaced with the term "reasonably approximated." The amended example reads as follows:

2. Intangible Property – Marketing Intangible, subsection (d)(2)(A)1. Marketing intangible. Moniker Corp enters into a license agreement with Whole Sports Corp where Whole Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment that is to be manufactured by Whole Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is ~~determined~~ reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total population in the specified geographic region in which the retail sales are made.

42. Subsection (d)(2)(D)3 is an example for the assignment of sales of a marketing intangible where the sale is to a wholesaler. The previous draft did not contain a wholesale example. As stated above, it is the intent to provide an example to show how each rule in this regulation works. The new example reads as follows:

3. Intangible Property - Marketing Intangible, Wholesale, subsection (d)(2)(A)3. Cartoon Corp enters into a license agreement with Wholesale Corp where Wholesale Corp is granted the right to use Cartoon Corp's cartoon characters in the design and manufacture of tee shirts and sweatshirts which will be sold to various retailers who will in turn sell them to members of the public. Cartoon Corp is unable to develop information regarding the location of the ultimate customer of the products designed and manufactured in connection with Cartoon Corp's cartoon characters. Cartoon Corp shall assign the licensing fee by multiplying the fee by the percentage of this state's

population over the total population in the geographic area in which Cartoon Corp markets its goods, services or other items.

43. Subsection (d)(2)(D)5 is an example of the second cascading rule of reasonable approximation for assignment of a sale of a non-marketing or manufacturing intangible property. The previous draft did not contain an example for reasonable approximation in connection with assignment of the sale of non-marketing or manufacturing intangibles, and as stated above, it is the intent to provide an example to show how each rule in this regulation works. The new example reads as follows:

5. Intangible Property - Non-marketing or Manufacturing Intangible, subsection (d)(2)(B)2. Mechanical Corp enters into a license agreement with Spa Corp where Spa Corp is granted the right to use the patents owned by Mechanical Corp to manufacture mechanically operated spa covers for spas that Spa Corp manufactures. Neither the terms of the contract nor the taxpayer's books and records indicate the extent of the use of the patent in this state. However, there is public information that Spa Corp has 3 manufacturing locations in this state and an additional 6 manufacturing locations in various other states. Mechanical Corp may reasonably approximate the location of the use of the intangible property and assign 33% of the licensing fees to this state.

44. Subsection (d)(2)(D)6 is an example of the third cascading rule of the customer's billing address for assignment of a sale of a non-marketing or manufacturing intangible. The previous draft did not contain an example for customer's billing address, and as stated above, it is the intent to provide an example to illustrate how each rule in this regulation works. The new example reads as follows:

6. Intangible Property - Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)3. Same facts as Example 5 except that Spa Corp is a small, privately held manufacturing corporation that has no publicly available information as to its manufacturing locations, Mechanical Corp shall assign all of the licensing fees to this state if Spa Corp's billing address is in this state.

45. Subsections (d)(2)(D)7 and 8 provide examples of how the two cascading rules for mixed intangibles work. Inadvertently, the facts of the two examples originally appeared in reverse order for application of the cascading rules. The examples' facts have been modified so that they appear in the same order as the cascading rules for mixed intangibles. Thus subsection (d)(2)(D)7's facts refer to where there is a separate and reasonable statement of fees and how the sale would be assigned under those facts, and subsection (d)(2)(D)8's facts refer to where there is no separate statement of fees and how the sale would be assignment under those facts. The amended examples read as follows:

47. Intangible Property – Mixed Intangible, subsection (d)(2)(C)1. Mixed intangible. Axel Corp enters into a two-year license agreement with Biker Corp in which Biker Corp is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were

manufactured using the special technology. The scooters are manufactured outside this state, but the taxpayer is granted the right to sell the scooters in a geographic area in which this state's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible, to this state. The licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.

~~58. Intangible Property – Mixed Intangible, subsection (d)(2)(C)2. Mixed intangible. Same facts as Example 47, except that the license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible to this state. The licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.~~

46. Subsection (g)(1) provides that the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information to comply with these regulations. The reference is to "assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136." It should reference Revenue and Taxation Code section 25136, subdivision (b), which is the underlying statutory provision for the market-based

rules of assigning sales other than sales of tangible personal property. This change has been made. The amended subsection reads as follows:

- (1) In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business.

47. Subsection (g)(1)(A) is an example under "Special Rules" to indicate facts when a taxpayer would not be required to alter its recordkeeping method to comply with the provisions of this regulation. A comment was made at the 45-day hearing for this regulation that the example gave the impression that only a small corporation would be able to qualify within this provision. As a result, the name of the corporation in the example has been changed to "Misc". The amended example reads as follows:

- (A) Example. ~~Small~~ Misc Corp, a corporation located in this state, provides limited bookkeeping services to clients both within and outside this state. Some clients have several operations among various states. For the past ten (10) years, ~~Small~~ Misc Corp's only records for the sales of these services have consisted of invoices with the billing address for the client. ~~Small~~ Misc Corp's records have been consistently maintained in this manner. If the FTB determines that ~~Small~~ Misc Corp cannot determine, pursuant to financial records maintained in the regular course of its business, the location where the benefit of the services it performs are received under the rules in this regulation, then ~~Small~~ Misc Corp's sales of services will be assigned to this state using the billing address information maintained by the taxpayer. ~~Small~~ Misc Corp will not be required to alter its recordkeeping method for purposes of this regulation.

48. Subsection (g)(2) used to list factors for the determination of the location of the use of marketing intangibles. This was moved to the provisions regarding marketing intangibles as subsection (d)(2)(A)2.a. It was determined that this was not a general rule that applied to the entire regulation and so has been deleted under the Special Rules section of the regulation.

- ~~(2) To determine the customer's or licensee's use of intangible property in this state under subsection (d)(2)(A)2. for use of marketing intangibles, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data including population that reflects the relative usage of the intangible property in this state.~~

49. Subsection (g)(2) is now segue to special rules for reasonable approximation of the location for receipt of the benefit of the services or the location of the use of the intangible property. The phrase "the receipt of" was inserted to match the language of the underlying statute and other provisions of this regulation. The amended subsection reads as follows:

- (32) The following special rules shall apply in determining the method of reasonable approximation of the location for the receipt of the benefit of the services or the location of the use of the intangible property:

50. Subsection (g)(2)(A) provides that once a reasonable approximation method is used, the taxpayer must continue to use that method unless the Franchise Tax Board gives permission for a change to the method. To match the language of the underlying statute and remain consistent with other provisions of this regulation, "receipt of the" was inserted before "benefit of the services." In addition, it has been determined that in fairness to taxpayers, once the Franchise Tax Board has examined the taxpayer's reasonable approximation method and accepted it, the Franchise Tax Board will continue to accept that method until facts and circumstances change such that the method no longer reasonably reflects the market. This is consistent with other provisions of the Revenue and Taxation Code and other Regulations. As a result, language to that effect has been added to this provision. The amended subsection reads as follows:

- (A) Once a taxpayer has used a reasonable approximation method to determine the location of the market for the receipt of the benefit of the services or the location of the use of the intangible property, then the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation may not be made without the permission of the Franchise Tax Board. Where the Franchise Tax Board has examined the reasonable approximation method and accepted it in writing, the Franchise Tax Board will continue to accept that method, absent any change of material fact such that the method no longer reasonably reflects the market for the receipt of the benefit of the services or the location of the use of the intangible property.

51. Subsection (g)(3)(A) refers to Revenue and Taxation Code section 25136 and Regulation section 25136. "RTC" is changed to "Revenue and Taxation Code". "CCR" is changed to "Regulation" to be consistent with other provisions of this regulation and other regulations. Also, to reflect that the reference is to the market-based rules, it now reads, where appropriate, "Revenue and Taxation Code section 25136, subdivision (a), and Regulation section 25136-2." The amended subsection reads as follows:

- (A) All references to ~~RTC~~ Revenue and Taxation Code section and ~~CCR~~ Regulation section 25136 shall refer to RTC Revenue and Taxation Code section 25136(b) and CCR Regulation section 25136-2 as they are operative beginning on and after January 1, 2011.

52. Subsection (g)(3)(C) refers to the incorporation of special industry rules for franchisors. A comment on this regulation was received that, based on the wording of the subsection, there might be confusion as to whether or not throwout rules apply. To avoid any confusion that throwback or throwout rules apply, language has been inserted indicating that the taxability of a taxpayer in a state is not relevant under the market-based rules. Neither throwback nor throwout rules apply under these market-based rules. The amended subsection reads as follows:

- (C) The provisions in Regulation section 25137-3 [Franchisors] that

relate to the taxpayer being, or not being, taxable in a state shall not be applicable.

53. Subsection (g)(3)(F) relates to the incorporation of special industry rules for mutual fund providers and specifically refers to assignment of receipts to the location of income-producing activity in the event the taxpayer is not taxable in a state. Those provisions are not applicable under the market-based rules of this regulation and the underlying statute. There is no statutory authority for assignment of a receipt to the location of the income-producing activity if it is not the market state. Therefore, the taxability of a taxpayer in a state which triggers the assignment to the location of the income-producing activity is immaterial and should be eliminated to avoid confusion. This language should have been included in the draft that was presented to the public under the 45-day Notice of Hearing, but was inadvertently overlooked. A commentator at the hearing brought this to the attention of the hearing officer and the following language is now included in the regulation. The amended subsection reads as follows:

- (F) The provisions in Regulation section 25137-14 that relate to the taxpayer not being taxable in a state and assign the receipts to the location of the income-producing activity that gave rise to the receipts shall not be applicable.

The final version of the regulation was presented to the Franchise Tax Board for its approval at its December 1, 2011 public meeting. The Board was provided with all of the comments received during the regulatory process as well as responses to the comments. The Board approved the regulation by a vote of 3-0.

Nonsubstantive changes were made including technical, punctuation, and grammar errors during OAL's review process.

Alternatives Determined

The Franchise Tax Board has not received any proposed alternatives that would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.