

Explanation of Second Discussion Draft for Proposed Amendments to Regulation Section 25136-2

For taxable years beginning on or after January 1, 2011, Revenue and Taxation Code (RTC) Section 25136 provides the rules for assignment of sales of other than personal property for taxpayers that file a combined report and elected to apportion their income pursuant to a single sales factor apportionment formula.

Staff proposed initial draft language at the initial Interested Parties Meeting (IPM) held in October 2013. First, the language provided clarification of the statutory version referenced in the "In General" subsection. Second, a general definition of "marketable securities" and accompanying assignment rules for the sale of marketable securities were added. Third, examples for those taxpayers who are asset managers but who do not come under the provisions of California Code of Regulations (CCR), title 18, Section 25137-14 were proposed. Fourth, assignment provisions for receipts in the form of dividends, interest, and goodwill were provided. Fifth, methods were proposed for reasonably approximating the market for the sale of an interest in a corporation or pass-through entity where the taxpayer does not have access to the factor information of the corporation or pass-through entity whose stock or interest was sold, such as where the taxpayer held a minority interest in a corporation or pass-through entity or has an interest in a startup corporation or startup pass-through entity.

For the July 8, 2014 IPM, a second discussion draft is being presented. The second discussion draft includes additional amendments as well as changes to and deletions of those amendments provided in the initial discussion draft for the IPM of October 2013. First, the language now includes a stand-alone definition of "marketable securities" for registered broker-dealer type taxpayers. This definition is in addition to the definition for all other taxpayers presented in the initial discussion draft for the October 2013 IPM. Second, assignment of interest has been removed from the sale of stock rules, and a stand-alone definition for assignment of interest has been provided following the receipt assignment provisions for interest under CCR Section 25137-4.2. Third, methods for reasonably approximating assignment of the sale of an interest in a corporation or pass-through entity where the taxpayer does not have access to the factor information of the corporation or pass-through entity whose stock or interest was sold, such as where the taxpayer has a minority interest in a corporation or pass-through entity or has an interest in a startup corporation or startup pass-through entity, have been deleted. Likewise, the proposed definition for a startup entity was deleted.

As stated above, a second discussion draft is provided with this Explanation. The draft attempts to take into account the comments and concerns of various interested parties raised during and subsequent to the IPM held in October 2013. However, due to competing considerations decisions had to be made that resulted in not all the parties' recommendations being adopted. The key revisions for *all* amendments, including those that are unchanged since the IPM of October 2013, are set forth with explanations below.

1. In General Section.

For the October 2013 IPM, clarification was made that RTC "[Section] 25136(a)" refers to "former" Section 25136(a) "as applicable for taxable years beginning on or after January 1, 2011 and before January 1, 2013." No changes have been made to this language since the October 2013 IPM. CCR Section 25136-2(a).

2. General Definition Section.

In the initial discussion draft for the October 2013 IPM, a general definition for the term "marketable securities" as used in RTC Section 25136(a)(2) was provided. That definition remains in the current draft. It provides that "marketable securities" are securities that are "actively traded" in an established securities market. "Established securities market" is defined as a market registered under the Securities Act or a foreign exchange that is similar to one registered under the Securities Act. No changes have been made to this language since the October 2013 IPM. CCR Section 25136-2(b)(5).

New for the July 8, 2014 IPM is a stand-alone definition for the term "marketable securities" as used in RTC Section 25136(a)(2) for registered broker-dealer type taxpayers. The definition provides that "marketable securities" is based on definitions contained in Internal Revenue Code Sections 475(c)(2) or 475(e)(B),(C), or (D) which security has not been excepted under IRC Section 475(b). CCR Section 25136-2(b)(6).

For the October 2013 IPM, a definition for the term "startup corporation or startup pass-through entity" was provided, but in this second draft that definition has been deleted. The definition was deleted because the public had objections at the October 2013 IPM to the proposed language for methods of reasonable approximation for the sale of a startup corporation or startup pass-through entity, but provided no alternate language. As a result, those proposed methods of reasonable approximation were deleted, as discussed below, and a definition for the term "startup corporation or startup pass-through entity" is now unnecessary.

3. Benefit of the Service Section.

In the initial discussion draft presented at the October 2013 IPM, two examples were included to show how to assign asset management fees earned from providing administration, distribution, and management services for pension plans, retirement accounts, or other investment accounts on behalf of shareholders, beneficial owners or investors of the pension plan, retirement account or other investment account, which fees are not subject to assignment under CCR Section 25137-14. For purposes of maintaining consistency between similarly situated taxpayers, these examples follow the assignment rules of CCR Section 25137-14, including the provisions for determining 1) the domicile of the shareholders, beneficial owners, or investors, and 2) assignment of the receipts based on the ratio of shareholders, beneficial owners, or investors in this state over the

shareholders, beneficial owners, or investors everywhere. The examples provide that if the domicile of the shareholders, beneficial owners, or investors cannot be determined, the domicile may be reasonably approximated, but if the domicile cannot be reasonably approximated then those receipts will be disregarded. No changes have been made to these examples since the October 2013 IPM, except to move them to the business entities section. CCR Section 25136-2(c)(1)(C)5. and 6.

4. Sales from Intangible Property Section.

The only changes to this section are to the sale of intangible property section where there has been a complete transfer of all property rights.

For the IPM of October 2013, language was added to provide that where gross receipts from intangible property are dividends, interest or goodwill, the sale of stock rules apply, consistent with *Mobil Oil Corp. v. Commissioner of Taxes of Vt.* (1980) 445 U.S. 425. The provision for assignment of dividends and goodwill has not been changed since the initial discussion draft presented at the October 2013 IPM. However, the term "interest" has been deleted from this subsection since the October 2013 IPM, and a stand-alone provision for the assignment of interest has been provided in the second discussion draft and is explained below. CCR Section 25136-2(d)(1)(A)1.

At the October 2013 IPM and subsequent to that IPM, concern was expressed that the sale of stock rules would be difficult to apply in assigning interest receipts. Several commentators suggested that interest be assigned using the receipts factor assignment rules under CCR Section 25137-4.2 [special industry rules for banks and financial corporations]. As a result, in the second discussion draft a stand-alone rule for assignment of interest incorporating the receipts factor assignment provisions for interest under CCR Section 25137-4.2 has been provided. Those provisions under CCR Section 25137-4.2 relating to income-producing activities, costs of performance, and throwback are not applicable to the assignment rules for interest receipts. CCR Section 25136-2(d)(1)(A)2.

For the IPM of October 2013, a minor change was made to (d)(1)(A)1.b. to add "kept in the normal course of business" to "taxpayer's books and records." This is consistent with similar language throughout the regulation. No changes have been made to this language since the October 2013 IPM. CCR Section 25136-2(d)(1)(A)1.b.

For the IPM of October 2013, cascading rules were added to provide a method of reasonable approximation in the event a taxpayer does not have access to data enabling it to determine the necessary factor information for assignment of either the sale of a minority interest in a corporation or pass-through entity or sale of an interest in a startup corporation or startup pass-through entity. However, at the IPM, staff received negative feedback without proposed alternative language from several stakeholders in connection with those provisions. As a result, it was ultimately determined to delete these rules from the second draft discussion. The deletion of these specific rules means that the general provision for reasonable approximation in this subsection, CCR Section 25136-2(d)(1)(B), applies to such sales in the event they cannot be assigned under CCR Section 25136-2(d)(1)(A).

5. Assignment of Marketable Securities Section.

For the IPM of October 2013, a section was added to address how to determine "if the customer is in this state" for purposes of assigning the sale of marketable securities under RTC Section 25136(a)(2). If the customer is an individual, then the sale is assigned to this state if the customer's billing address is in this state. If the customer is a corporation or other business entity, then the sale is assigned to this state if the customer's commercial domicile is in this state. If the billing address or commercial domicile cannot be determined, then each one may be reasonably approximated. There have been no changes to these provisions since the October 2013 IPM. Possible examples should be discussed. CCR Section 25135-2(e).