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10.07.2019

Chief Counsel Ruling 2019-03

RE: Chief Counsel Ruling Request for the Independent Directors of ***** Co.

Dear *****,

This letter is in response to your request for guidance with respect to the sourcing of income paid by ***** Co. to its independent directors for California tax purposes.

FACTS

***** Co., a ***** corporation (the "Company"), represents that it is commercially domiciled outside of California, in the State of *****.

The business of the Company is managed under the direction of its Board of Directors. Pursuant to the requirements of the New York Stock Exchange (NYSE), of which the Company is a member, a majority of the members of the Board of Directors must be independent, as defined by the NYSE rules. NYSE Rule 303A.02 provides, in pertinent part:

- (b) In addition, a director is not independent if:
 - (i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.
 - (ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

**** of the Company's ***** directors are independent directors. The Company represents that its independent directors, sometimes referred to as nonemployee directors or outside directors, are not employees under state or federal law.

Directors are primarily elected to represent shareholders, but also govern a company with all stakeholders in mind. A board's obligation is to establish policies for corporate management and oversight; making decisions on major company issues and providing oversight of the highest levels of management. The Company has attendance guidelines for the directors which require a certain level of participation in both board of directors and shareholder meetings, which are conducted both within and without *****.

ISSUE

Whether compensation paid to an independent director, who is a nonresident of California, is sourced to California if the Company holds a shareholder meeting or board of directors meeting in California which the director attends?

HOLDING

No. The fees or other compensation received from the Company by the independent director of the Company for services performed in California will be sourced to where the highest-ranking corporate officers carry out the Board's directions.

DISCUSSION

California Revenue and Taxation Code ("CRTC") section 17951 specifies:

- (a) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, in the case of nonresident taxpayers the gross income includes only the gross income from sources within this state.

California Code of Regulations, title 18, section ("Regulation section") 17951-2 provides that income from sources within California includes income from a trade, business or profession and income from personal services performed in California.¹

However, Regulation section 17951-5 only sources compensation of employees. In this case, the Company has represented the directors are not employees under state or federal law.

Therefore, the appropriate California regulation to apply is Regulation section 17951-4. The amount of income of a nonresident independent director derived from California sources shall be determined in accordance with the provisions of the apportionment rules of the Uniform Division of Income for Tax Purposes Act (UDIPTA), sections 25120 to 25139, inclusive. Specifically, the source of income is determined by applying these market-based sourcing rules.²

¹ See Regulation sections 17951-4 and 17951-5.

² Regulation sections 25136-2. (See also Regulation section 17951-4(c)(2).)

CRTC section 25136 states, in pertinent part:

- (a)(1) Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state.

The benefit of a service is received in the location where taxpayer's customer has either directly or indirectly received value from delivery of that service.³

Here, the independent director is providing a service to the Company and its shareholders that is unique – to act, with the other directors, to govern the Company. One role of the Board of Directors is to oversee management's assessments of major risk factors facing the Company and review options to mitigate such risks. Directors also serve on Board committees which require their independence to meet best practices and NYSE requirements with respect to audit policies, compensation practices and other corporate governance requirements.

The benefit of that service is received where the Company received value from the delivery of that service.⁴ The value of an independent director's services does not derive from the place from which the Board of Directors confers and makes decisions, but rather from that place the decisions and actions of the Board detailed above are executed. Unlike consulting or similar services, these services do not merely recommend actions that may be taken by management. Independent directors are in a very distinct class of service-providers. The Board of Directors, acting as a body, gives authority to and directs management to take action. Since these services go to the core of the governance of the Company and the implementation of any such decisions are taken by the highest echelons of management, the location of that benefit is the place where the highest-ranking corporate officers carry out these directions.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayers and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the CRTC. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Very truly yours,

Natasha S. Page
Tax Counsel IV

³ Regulation section 25136-2(b)(1).

⁴ Regulation section 25136-2(b)(1).