

Summary of First Interested Parties Meeting

Regulation Section 25136-2, Market-Based Sourcing Rules for Sales of other than Tangible Personal Property

- I. **Administration:** On January 20, 2017 at 10:00 a.m., at the Franchise Tax Board (FTB) central office in Sacramento, interested members of the public (participants) attended the first Interested Parties Meeting (IPM) on potential amendments to California Code of Regulations, Title 18, section 25136-2 (Regulation). Participants attended in person and by telephone. Participants physically present were asked to register at the entrance and phone participants introduced themselves.

Melissa Williams, FTB Tax Counsel IV, and Amanda Smith, FTB Tax Counsel, served as the IPM Facilitators (Facilitators). Ben Miller, Counsel for Multistate Tax Affairs, also served on the panel to respond to questions from participants. Ms. Smith listed the documents made available as handouts: the IPM announcement and discussion topics to be addressed at the meeting. She also notified participants that the FTB would prepare and make available on the FTB's public website an updated 50 state analysis. Ms. Smith then explained the purpose of the meeting was to provide the public with an opportunity to discuss and provide comments on potential amendments to Regulation section 25136-2. Participants were advised they had 30 days from the date of the IPM to submit written comments, and that this summary of the IPM and comments would thereafter be prepared and published online.

- II. **Discussion:** The IPM discussion was organized by reviewing each discussion topic in the order it appeared in the Discussion Topic paper. However, Topic 6 (Interest Received from Business Entity Borrowers) was merged into the discussion of Topic 4 (Dividend Assignment). The Facilitators made opening remarks to each discussion topic and invited comment.
- III. **Summary:** The opening remarks for each discussion topic are presented below and are followed by a summary of the comments received during the IPM and in writing by the close of the IPM comment period, i.e., February 20, 2017.

Discussion Topic 1 - Asset Management Fee Examples:

Facilitator Remarks

Previous drafts of proposed amendments to the Regulation included examples on how Asset Management Fees are sourced. The FTB is now considering reincorporating the Asset Management Fee examples into the Regulation as part of possible amendments to the Regulation.

Comments

No comments were received on this topic.

Discussion Topic 2 – Reasonably Approximated/Reasonable Approximation:

Facilitator Remarks

Under the existing Regulation, the Taxpayer's method of reasonable approximation will be accepted so long as it is reasonable. Only if the FTB finds the method to be unreasonable will it apply its own method of reasonable approximation to source the sales. Furthermore, the Regulation refers to sourcing foreign sales both by country and by geographic area. In the interest of accurately sourcing sales, the FTB is now considering amending the Regulation to source sales pursuant to geographic area instead of country.

Comments

Some commenters stated it would be useful to clarify the reasonable approximation method position in the language of the regulation.

Other commenters want the Regulation to further clarify the term "reasonable." Facilitators referred commenters to the Supreme Court decision in *Microsoft Corp. v. Franchise Tax Board* (39 Cal.4th 750) as a potential guide for the process of determining what is "reasonable," particularly the process of who decides and the burden of proof.

Some commenters asked that the Regulation ensure certain sourcing methods, such as using a customer's commercial domicile, would be accepted under the reasonable approximation method. The Facilitators reiterated that so long as the method was reasonable, FTB would accept the method.

A commenter asked about the effect of the Regulation on the filing requirements of nonresident individuals. The Facilitators stated that FTB's Market-Based Sourcing Rules Task Force is currently discussing this issue.

Discussion Topic 3 – Benefit of a Service Is Received

The FTB sought input regarding the application of the term "benefit of the service" to certain industries and factual scenarios. Each issue within this discussion topic is discussed separately below.

- a. Regulation subsection dedicated to sourcing receipts from federal government contracts

Facilitator Remarks

The FTB is considering adding a subsection to the Regulation dedicated to providing instruction on assigning sales from government contracts.

Comments

Some commenters welcomed the idea, while others believed that it set a precedent for allowing special rules for different industries.

- b. Services to tangible personal property.

Facilitator Remarks

The FTB is considering whether there is a difference between receipts from services rendered on tangible personal property and receipts from other services such that they should be sourced differently.

Comments

A commenter stated that the proper assignment of services to tangible personal property would be to where the taxpayer's customer used the tangible personal property (as opposed to where the service was performed or where the tangible personal property was delivered to the taxpayer's customer).

c. Long-term contracts.

Facilitator Remarks

For long-term contracts, the FTB is considering adding language to the Regulation modeled after the treatment of long-term contracts under California Code of Regulations, Title 18, section 25137-2 for sourcing receipts from long-term contracts.

Comments

A commenter asked if the Regulation would conform to federal accounting treatment.

Commenters suggested sourcing milestone payment receipts for the development of a product to the customer's eventual market for that product or to the location where the product would ultimately be manufactured by the customer.

d. Subcontractors.

Facilitator Remarks

Pursuant to the Regulation, receipts a subcontractor receives from a customer that is a contractor for the government are assigned to the location of the contractor.

Comments

A comment was received stating that the relative population spread should be used to source the subcontractor's receipt if it is clear from the contract that the subcontractor's customer is a federal contractor.

e. Throwback of sales to the federal government.

Facilitator Remarks

The FTB is considering adding language to the Regulation to provide that sales of services to the federal government should be thrown back to where the taxpayer rendered the services. This method would parallel the throwback method used to source sales of tangible personal property to the federal government under California Revenue and Taxation Code section 25135(a)(2)(A).

Comments

Commenters stated that taxpayers do not like the throwback idea because it replicates cost of performance methodology and California is now a market-sourcing state.

One commenter rejected a throw-out or throw-back rule, claiming neither is allowed by Revenue and Taxation Code section 25136.

Other commenters voiced their support for sourcing sales to the federal government based on relative population spread, in lieu of the four cascading rules provided in Regulation section 25136-2(c)(2)(A)-(D).

f. Confidential contracts.

Facilitator Remarks

To account for instances where a taxpayer's contract with its customer cannot be reviewed due to confidentiality, the FTB is considering possible amendments to the Regulation where a "deemed numerator percentage" would be used, whereby sales to California would be assigned to California based on a fixed percentage included in the Regulation.

Comments

Commenters provided mixed feedback, some amenable to the idea of a deemed numerator based on population, others withholding an opinion because they had not yet considered the idea.

g. Assigning sales of intangible property under Regulation (d)(1)(A)

Facilitator Remarks

The FTB is considering proposed amendments to the Regulation's general rule assigning sales of intangible property under (d)(1)(A) to clarify that these sales are sourced to the location where the buyer uses the intangible and that only if the taxpayer does not know the customer's location of use is a sale sourced to where the taxpayer used the intangible within the previous 12 months (as determined at the time of a sale).

Comments

Commenters expressed approval for the clarification.

Discussion Topic 4 – Dividend Assignment.

Facilitator Remarks

Currently the Regulation assigns dividends and interest receipts. The FTB is considering possible amendments to the Regulation removing these sourcing provisions because feedback received from the public suggests that non-financial taxpayers generally do not receive either dividend or interest income from a market.

Comments

Commenters generally stated that dividends should be left in the sales factor if they represent business income, and one commenter suggested these receipts be sourced to the state of the payor.

No comments were received regarding whether interest income should be assigned pursuant to the regulation.

Discussion Topic 5 – Freight Forwarding Example:

Facilitator Remarks

FTB is considering amendments to the Regulation to incorporate rules for freight forwarders, either by way of an example or as a stand-alone rule. The substance of the examples provided in the [Discussion Paper](#) reflect how sales for the industry are currently sourced, and will be continued to be sourced under the possible additional amendments.

Comments

A comment was received suggesting that the examples do not properly reflect the nature of the freight forwarding business. The commenter indicated that because freight forwarders are brokers, sourcing sales according to the location of the freight would return California to a cost of performance sourcing methodology and does not reflect where the customer receives the benefit of the service. The benefit received by the customer is increased efficiency in shipping, and should be sourced to where the customer would have had to organize for the shipment itself, or to the customer's commercial domicile.

Discussion Topic 6 – Interest Received from Business Entities Borrowers:

The assignment of interest from business entities was discussed above, with Discussion Topic 4. Please see the notes to that Discussion Topic. No comments were received with respect to this topic.

Discussion Topic 7 – Marketing Intangibles:

Facilitator Remarks

The FTB is considering how well-known a marketing intangible must be for the Regulation's marketing intangible sourcing rules to apply.

Comments

Comments were received stating that the popularity of a particular marketing intangible should be irrelevant when determining when the sourcing rules apply. Instead, the contract between the taxpayer and its customer should control the sourcing of marketing intangibles; that is, if the contracting parties identify marketing value in the intangible, the FTB should not override the determination.

Other commenters stated that any inquiry into how "well-known" a marketing intangible is would be very difficult to administer.

Discussion Topic 8 – Various Clean Up Issues:

No discussion was held on this topic.

- IV. **Next Steps:** The Facilitator indicated that staff would review comments received and schedule a future IPM at which draft language would be presented.