

NOTE: This paper is intended only for purposes of facilitation of discussion at the Interested Parties Meeting (IPM) scheduled for May 18, 2018.

EXPLANATION OF DRAFT LANGUAGE AMENDING CALIFORNIA CODE OF REGULATIONS, TITLE 18, (CCR) SECTION 25136-2

The focus of this Interested Parties Meeting (IPM) will be on the draft language amending CCR section 25136-2, California's market-based sourcing rules. This will be the third IPM for the second round of amendments to CCR section 25136-2. The first IPM for this second round of amendments was held on January 20, 2017. The second IPM for this second round of amendments was held on June 16, 2017.

Available to the public for the May 18, 2018 IPM are the following documents: the Third IPM Notice; the Third IPM Draft Language (Draft Language); and this Explanation of Draft Language. Previously posted to the Franchise Tax Board's website are the Second IPM Summary and the 50 state analyses which address assignment of sales of services and intangible property, assignment of asset management fees, assignment of freight forwarder receipts, and the definition of sales.

In the draft language document, proposed language additions, as presented at the second IPM, are underlined and proposed deletions are ~~struck through~~. New proposed language additions, presented for the first time at the third IPM, are **bolded and underlined**, while new proposed deletions (including deletions to changes presented at the second IPM) are **~~bolded and struck through~~**. All page references are to the page number of the Draft Language document.

Discussion of the second round of proposed amendments to CCR section 25136-2

1. Definition of "Beneficial owner" added at subsection (b)(1) on p.1.

"Beneficial owner" appears in the assignment rules for asset management fees in (c)(4) at p. 16 of the draft language (hereafter, a reference to a page number is a reference to the draft language provided with this explanation). A definition of that term has been proposed to be added, and will provide further guidance to taxpayers for how to assign those type of receipts. This definition is derived from general legal and federal use of the term.

2. Relocated examples formerly under subsection (b)(1) at pp.1-2 to subsection (c)(2)(E) on p. 9

Originally, under subsection (b)(1) "Benefit of a service is received," there were a number of examples: Real Estate Development Corp at subsection (b)(1)(A), Builder Corp at subsection (b)(1)(B), General Corp at subsection (b)(1)(C), and Apartment Corp at subsection (b)(1)(D). The original location was not optimal for the current, modified examples which now indicate how new simplifying rules under subsection (c)(2)(A) operate. Therefore, these modified examples have been proposed to be relocated to subsection (c)(2)(E) on p. 9 to follow the simplifying and cascading rules.

The Contractor example, formerly at subsection (b)(1)(E), has been deleted and a different example under subsection (c)(2)(E)9 has been proposed to replace it. Commentators at the second IPM indicated that the original Contractor example needed greater clarity and should focus on where the value is received. The different example at (c)(2)(E)9 addresses these concerns.

3. Defined "Domicile" at subsection (b)(5) on p.3

"Domicile" appears in the assignment rules for asset management fees at (c)(4) on p.15-16. A definition of that term has been proposed to be added to provide further guidance to taxpayers about how to assign asset management receipts. This definition is derived from general legal principles and CCR section 25137-14.

4. Added language regarding documentation substantiating foreign sales under the definition of "reasonable approximation," at subsection (b)(9) on p.4

Language was proposed to be added to provide that the taxpayer must substantiate their foreign sales. If the taxpayer does not provide such substantiation, then the taxpayer is limited by the ratio of California over U.S. population as a reasonable approximation method. This proposed addition is in response to information provided by interested parties, noting that some taxpayers' worldwide license agreements may generate sales or license fees from some, but not all, countries. Rather than include worldwide population, which would not accurately reflect the taxpayer's less-than-worldwide sales, a better method of reasonable approximation would be to include only those populations from areas or jurisdictions where sales actually occurred and require the taxpayer to substantiate those foreign sales.

5. Added simplifying rules for assignment of sales of services to business and government entities at subsection (c)(2)(A) on p.7

Taxpayers and staff have faced challenges trying to assign sales of services. A number of states, including Wisconsin and Utah, have simplifying rules that provide very specific guidance to determine whether a sale is assignable to that state. For instance, if a service is performed on tangible personal property located in California, then that service sale is assigned to California. If a service is performed on real property located in California, then the service sale is assigned to California. If a service is related to an individual, and the individual is in this state when the service is received, then the sale is assigned to California. If a business is in this state and the service received relates to the in-state business, the sale is assigned to California. Similar rules have been proposed to be added here.

This provision does not impact sales of services to individuals, guidance for which is provided at subsection (c)(1) on p.5. The safe harbor rule for sales of services to individuals is preserved.

6. Added a rule regarding predominant service at subsection (c)(2)(B) on p.8

Language has been proposed to be added in this subsection to explain that to the extent the taxpayer receives one fee for a service that relates to more than one of the simplifying rules, the service shall be characterized by the simplifying rule to which the service predominantly relates.

7. Added a presumption for applying the simplifying rules at subsection (c)(2)(C) on p.8

Some services cannot be sourced accurately with the simplifying rules. Therefore, to provide taxpayers and the Franchise Tax Board with the ability to accurately source services, and to be consistent with the Regulation's other provisions, language has been proposed to be added to the simplifying rules at this subsection, to provide a presumption which may be overcome.

8. Simplifying rules incorporate existing cascading rules, and a reasonable approximation method rule for government contracts is added at subsection (c)(2)(D) on p.8

The simplifying rules incorporate existing cascading rules for assignment of sales to business or government entities. The cascading rules guide taxpayers and the Franchise Tax Board to use the best evidence when assigning sales pursuant to the simplifying rules.

Additional language has been proposed to be added to this subsection to provide that if the taxpayer's services are provided under a U.S. government contract, and the location where the benefit of the service was received cannot be determined by contract or books and records, or if the contract cannot be disclosed, and the location cannot be reasonably approximated by any other method, the taxpayer may reasonably approximate the location by using the ratio of California over U.S. population. The rationale for this proposed addition is that U.S. government services are predominantly intended to benefit the interests of U.S. citizens.

9. Contractor Corp (tank) example added at subsection (c)(2)(E)5 on p.10

This example has been proposed to be added to address a military service contract with the U.S. government, and applies the simplifying rules to assign the sale of services related to tangible personal property.

10. Logistics Corp examples added at subsections (c)(2)(E)6 and 7 on p.10

Taxpayers have expressed that they seek guidance on how to assign sales of services in the logistics industry. These examples have been proposed to be added to show how the simplifying rules work to assign sales in this industry.

11. Research and Development (R&D) example added at subsection (c)(2)(E)7 on p.10

Taxpayers with R&D expenses have requested guidance on how to assign sales of services related to intangible property. This example has been proposed to be added to show how the simplifying rules work to assign sales of services predominantly related to intangible property.

12. Contractor Corp (military field support) example added at subsection (c)(2)(E)8 on p.10

Taxpayers have requested guidance on how to assign a sale of services to the U.S. government when the taxpayer must reasonably approximate the location where the benefit of the service was received. This example has been proposed to be added to demonstrate application of the new reasonable approximation method related to U.S. government contracts at subsection (c)(2)(D).

13. Call Center Corp (fly fishing) examples added at subsections (c)(2)(E)11, 12 and 13 on pp.11-12

Taxpayers have requested guidance on how to assign sales of services for the call center industry. These examples have been proposed to be added to show how the simplifying and cascading rules work in conjunction with one another to assign sales of services in the call center industry.

14. Payroll Services Corp example modified and moved to subsection (c)(2)(E)16 on p.13

For better clarity, this example has been proposed to be modified and relocated to indicate the measure of the benefit of the service is where the employees are located.

15. Web Corp example, formerly at subsection (c)(2)(E)5, has been deleted as not specific enough. See p.13

16. Painting Corp example, formerly at subsection (c)(2)(E)6, has been deleted. See p.13

Commentators expressed concerns that the example did not provide enough facts to be useful. The example has been deleted.

17. Contractor Corp (field support services) example, formerly at subsection (c)(2)(B)8, has been deleted as unclear. See p.14

This example has been proposed to be replaced with example (c)(2)(E)8 at p.10, which has additional facts and therefore provides clearer guidance.

18. Research Corp example, formerly at subsection (c)(2)(E)9, has been deleted at p.14

This example has been proposed to be deleted because interested parties felt it did not contain enough facts to provide meaningful guidance. A new R&D example has been drafted using the new simplifying rules under intangibles provisions, (c)(2)(E)8 at p.10.

19. Research Corp example, formerly at subsection (c)(2)(E)10, has been deleted as unnecessary. See p.14

This example has been proposed to be deleted because interested parties felt it did not contain enough facts to provide meaningful guidance to affected taxpayers. Also, with the addition of a new example at subsection (c)(2)(E)7, staff determined this example would be duplicative.

20. Window Washing Corp example, formerly at subsection (c)(2)(E)11, has been deleted as duplicative of other examples. See p.14

21. Forwarding Corp examples, formerly at subsection (c)(2)(E)12, have been deleted as immaterial. See pp.14-15

For this industry, two new examples that use the new simplifying rules to assign logistic sales have been proposed to be added at (c)(2)(E)7 at p.10. As a result, staff determined that the Forwarding Corp examples, proposed at the previous Interested Parties Meeting and located at subsection (c)(2)(E)12 were no longer necessary.

22. Asset Management Corp examples, formerly at subsections (c)(2)(E)13 and 14, have been deleted. See p.15

These examples were intended to provide guidance to taxpayers on how to assign asset management fees. However, staff determined that assignment rules would be more appropriate. As a result, assignment rules were developed to provide guidance for assignment of asset management fees in place of the examples which have now been proposed to be deleted. The new assignment rules are proposed to be added at (c)(4) on p.16.

23. Rule added on mixed sales at subsections (c)(3)(A) and (B) and Example 1 on pp.15-16

Additional language has been proposed to be added to create a new rule and example addressing the situation where a contract includes both the sale of a service and the sale of tangible or intangible property. If the sale of the service and the sale of the property are separately stated, they will be assigned according to the separate statements. If, however, they are not separately stated, and the property portion of the sale is incidental to the service portion of the sale, the sale will be assigned as a service. If the service portion of the sale is incidental to the property portion of the sale, then the sale will be assigned as a sale of property.

24. Added asset management fee assignment rules at subsection (c)(4) on p.16

Rules for sourcing asset management fees are proposed to be added to this subsection. The assignment rules for asset management fees are patterned after the CCR section 25137-14 provisions. The benefit of asset management services is received by the shareholders or investors of the assets unless the shareholder or investor is holding title for a beneficial owner. If the shareholder or investor is holding the asset for a beneficial owner, the benefit is received by the beneficial owner of the asset. These new proposed rules also provide that the asset management fees be assigned to the domicile of the shareholder, beneficial owner, or investor. In addition, the asset management cascading rules, provided at subsection (c)(4) on p.16, now include a second method of reasonable approximation that uses the ratio of California population over U.S. population.

Commentators have requested adoption of the reasonable approximation method of assigning the sale to the first tier entity below the asset managers in situations where the shareholders or investors appear in multi-layers below the first tier and are not known to the asset managers. Assigning the asset management fees to the first tier would, in most cases, not represent the market of asset managers because the shareholders or investors who received the benefit of the asset management service are not located in, and in many cases are far removed from, that first tier. Staff believes that a ratio of California over U.S. population reasonable approximation method is a fairer reflection of the market.

25. Added provision for alternative method of assignment for sale of stock rules at subsection (d)(1)(A)1.c. on p.18

An additional sale of stock rule has been proposed to be added to this subsection. The sale of stock rules provide that if more than 50 percent of the assets of the underlying corporation are comprised of tangible/real property, then the sale of stock is assigned based on the average of the payroll and property factors of that corporation. If more than 50 percent of the assets of the underlying corporation are comprised of intangible property, then the sales factor of the underlying corporation is used to assign the sale of stock. Taxpayers expressed concerns that if they held and sold only a minority interest of stock in a corporation they would probably not be privy to the factor information of that corporation. This newly proposed provision provides that if a taxpayer does not have access to information to enable it to assign the sale of stock pursuant to the corporation's factors, then the sale is assigned to the payor's domicile.

26. Twelve-month reasonable approximation method, formerly under (d)(1)(A)1, relocated to reasonable approximation provisions for the complete transfer of intangible property at (d)(1)(B)1 on p.18.

Additional revised language has been proposed to be relocated from subsection (d)(1)(A)1 to the reasonable approximation assignment rules at (d)(1)(B)1. at p.18.

Taxpayers expressed concerns that the original location of this provision in the intangibles assignment rules caused confusion. A reasonable approximation method was included in the first cascading rule, including contracts or books and records, which was in direct contradiction to the remaining provisions of the regulation which separate the contract and books/records provision from the reasonable approximation provision.

27. Deleted five-percent de minimis rule for assignment of sales of marketing intangibles at subsection (d)(2)(A)4 on p. 21.

The de minimis rule has been proposed to be deleted because staff determined that any fixed amount was arbitrary.

28. Corrected Cartoon Corp example at subsection (d)(2)(D)3 at p.23.

"Cartoon Corp" has been proposed to be replaced with "Wholesale Corp" in the last sentence of this subsection. The use of "Cartoon Corp" was a clerical error.

29. Added R&D example under intangible property at subsection (d)(2)(D)7 on p.24

An additional example providing guidance for R&D activities was proposed to be added to this subsection. Taxpayers have requested guidance for R&D activities, noting that they were having issues how to assign lump-sum payments. This example has been proposed to be added to explain that if the lump sum was for past R&D, and the R&D was done in this state, then the lump sum payment should be assigned to this state.

30. Deleted the word "smaller" at subsection (h)(1) on p.26

The intent of this provision is to allow businesses of any size the ability to be able to show that necessary data cannot be developed from financial records maintained in the regular course of business. As a result, "smaller" was proposed to be deleted from the rule at this subsection so that there is no implication that the size of the business mattered in this provision.

31. Changed the burden of proof at subsection (h)(2)(C) on p.27

This subsection has been proposed to be changed to reflect a "preponderance of the evidence" standard for the reasonableness of a taxpayer's offered approximation, consistent with the evidence standard in the remainder of the regulation's provisions. Taxpayers have inquired as to whose reasonable approximation would be accepted if both the taxpayer's and the Franchise Tax Board's method were reasonable. Staff agreed that the taxpayer's method of reasonable approximation is the one that must be chosen unless the Franchise Tax Board could show by a preponderance of the evidence that the taxpayer's method was unreasonable. Initially, the burden of proof was "clear and convincing" for the Franchise Tax Board to overturn the taxpayer's method of reasonable approximation.