

Summary of Third Interested Parties Meeting

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

- I. **Administration:** On May 18, 2018 at 10:00 a.m., at the Franchise Tax Board (FTB) central office in Sacramento, interested members of the public (Participants) attended the third Interested Parties Meeting (IPM) on potential amendments to California Code of Regulations (CCR), 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 (Facilitator(s)). Ms. Smith listed the documents made available as handouts: the IPM announcement, draft language, and a draft language explanation document. Ms. Smith explained the purpose of the IPM was to provide the public with an opportunity to discuss and provide comments on draft amendments to the Regulation. Participants were advised they had until July 18, 2018 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 the proposed amendments in their numerical order.
- III. **Summary:** Facilitator remarks for each set of proposed Regulation amendments 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.

Discussion Topic 1 – "Beneficial owner" definition.

Facilitator Remarks

A definition of beneficial owner was proposed at Regulation section (b)(1) to ensure all taxpayers that assign asset management fees under proposed Regulation section (c)(4) do so uniformly.

No Comments Received

Discussion Topic 2 – Relocated examples.

Facilitator Remarks

In the current Regulation, certain examples are placed under the definition of "benefit of a service is received." The draft language proposes to move the examples to Regulation section (c)(2)(E).

No Comments Received

Discussion Topic 3 – "Domicile" definition.

Facilitator Remarks

A definition of "domicile" was proposed at Regulation section (b)(5) to ensure all taxpayers that assign asset management fees under proposed Regulation section (c)(4) do so uniformly.

No Comments Received

Discussion Topic 4 – Foreign sales and reasonable approximation.

Facilitator Remarks

Language was proposed requiring substantiation of foreign sales where a taxpayer is using a reasonable approximation method based on population.

Comments

A commenter noted that requiring a taxpayer to substantiate sales in order to use foreign population as a reasonable approximation method creates a circular problem. Under this proposed rule, a taxpayer will never be able to use foreign population in its reasonable approximation method because the very reason they must use reasonable approximation is because they can't substantiate their foreign sales with their books and records. Thus, by default, taxpayers will always be limited to reasonably approximating using United States (U.S.) population.

Another commenter stated that the definition as written does not address the licensing of marketing intangibles wherein the taxpayer is required to look to the location of the customer's customer.

Discussion Topic 5 – Simplifying rules at Regulation 25136-2(c)(2)(A).

Facilitator Remarks

Rules were proposed to be added at Regulation section (c)(2)(A) to simplify the determination of where a taxpayer's business or government entity customer receives the benefit of a service.

General Comments

One commenter stated that the simplifying rules seem to look to property and employees as opposed to market, which is taking a position inconsistent with the clear intent of the statutory provisions. Taking this position could expose the FTB to litigation that would be costly to both taxpayers and the state. Because of this concern, one commenter suggested the simplifying rules be removed.

Comments regarding the proposed second simplifying rule at Regulation 25136-2(c)(2)(A)(2)

Multiple commenters expressed concern that the second simplifying rule strays from the original intent behind market-based sourcing. These commenters noted that the rule reverts to a methodology very similar to cost of performance, which was a methodology explicitly rejected by the market-based sourcing approach. The commenters stated that the rule, and its related examples at Section (c)(2)(E)(5) and (c)(2)(E)(11), should be modified because they are completely contrary to the new market-based sourcing method.

One commenter stated that the second simplifying rule makes sense only if the place where the service is performed is also the place where the service (or the tangible personal property to which the service relates) is used by the taxpayer's customer. Otherwise, the rule will not reflect a taxpayer's market because it will source the sale of a service to a temporary location of property that does not relate to the location of a customer.

A few commenters pointed out that there is no basis for the provision in the statute.

Multiple commenters stated that the second simplifying rule should be changed to reflect that the benefit of a service is received where the customer uses the service, or the item to which the services relates. These commenters noted that sourcing to where the tangible personal property is used is consistent with the third proposed simplifying rule which focuses on the location of "use" of the intangible to which the service relates.

Comments regarding the proposed fifth simplifying rule at 25136-2(c)(2)(A)(5)

A few commenters stated that is unclear what "business in state" means. They opined that if this rule is kept, guidance should be provided regarding the definition of "business in state."

One commenter stated that the fifth simplifying rule is too broad. The commenter stated that it could be interpreted almost any way by FTB audit staff, such that the taxpayer could never overcome the presumption that the rule does not reflect where the benefit of the service is received.

Discussion Topic 6 – Predominant service.

Facilitator Remarks

A rule was proposed stating that a service related to more than one simplifying rule shall be assigned according to the simplifying rule to which the service predominantly relates.

Comments

One commenter stated that the "predominant" rule should be eliminated because it results in not sourcing a benefit received by a taxpayer's customer.

One commenter expressed concern that, under the proposed rule, a service, if a standalone service, could be sourced to one location, but if part of a larger service with a more predominant element, could be sourced to a different location.

Another commenter suggested the rule should also apply to situations in which a service has two elements that relate to the same simplifying rule but would each nevertheless be sourced to a different geographic location. In these instances, the commenter stated that the entire service should be sourced by the predominant element.

Discussion Topic 7 – Simplifying rules presume the location where the customer's benefit is received.

Facilitator Remarks

Because some services may not be able to be sourced accurately with the simplifying rules, language has been proposed to be added to provide that the simplifying rules are a presumption which may be overcome by a preponderance of the evidence.

Comments

A few commenters expressed concern that, in practice, it will be difficult for a taxpayer to overcome the presumption because FTB staff will rely too strongly on the presumption.

Discussion Topic 8 – Modified cascading rules at Regulation 25136-2(c)(2)(D).

Facilitator Remarks

While the simplifying rules presume the location where a taxpayer's customer receives the benefit of a service, the cascading rules, as modified in the proposed language, guide taxpayers and the FTB to use the best evidence when determining that location.

Comments

Multiple commenters stated that the relationship between the cascading rules and the proposed simplifying rules is unclear. Some commenters stated that this is because the simplifying rules and the cascading rules present conflicting presumptions. They suggested that to clarify the relationship, the presumption language from subsection 25136-2(c)(2)(D) should be deleted.

Discussion Topic 9 – Reasonable approximation rule for government contracts.

Facilitator Remarks

A rule was proposed stating that if services are provided to the U.S. government, and the location of 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 shall reasonably approximate the location by using the ratio of California population over U.S. population.

Comments

One commenter agreed that population spread is a useful reasonable approximation method for confidential government contracts because U.S. government services are predominantly intended to benefit the interests of U.S. citizens.

Some commenters stated that using U.S. population for reasonable approximation is outside the legislative intent of market-based sourcing for services. The statute does not suggest there is a default rule for U.S. population.

Another commenter stated that even if a contract is confidential, sometimes the taxpayer may know that the services relate to a certain country, region, or foreign area of conflict. In these cases, using California over U.S. population would be arbitrary and unsupported by a clear factual relationship to the business transaction.

Another commenter suggested that a more direct and appropriate ratio for services provided by defense contractors would be based on military population, such as military active and reserve personnel in California compared to everywhere. The commenter suggested, alternatively, that the receipt be removed from the sales factor.

Another commenter stated that if the United States has treaties with foreign countries, and that when the taxpayer's contract relates to United States activities in those other countries, the populations of those countries should factor into the sourcing analysis if using population as a reasonable method.

One commenter stated the language used in this paragraph should be consistent with the "reasonable approximation" definition language at section 25136-2(b)(9). The definition allows for inclusion of foreign jurisdictions or geographic areas where taxpayer can show it maintains a market. Currently, the proposed language in this paragraph is inconsistent with that portion of the definition.

Discussion Topic 10 – Examples at Regulation 25136-2(c)(2)(E).

Facilitator Remarks

Many examples were proposed to be added, deleted, or modified based on the proposed simplifying rules. Other examples were proposed to be moved to Regulation section (c)(2)(E) from their current location under Regulation section (b)(1).

Comments

One commenter expressed concern that the examples for sourcing fees from freight forwarding services at Regulation 25136-2(c)(2)(E)6 and 7 do not demonstrate that logistics services add value beyond the mere movement of goods.

Discussion Topic 11 – Gross receipts from a mixed sale of services and property.

Facilitator Remarks

A rule was proposed to address how to source a gross receipt from a contract that includes both the provision of a service and of tangible or intangible property. If the fees for each are separately stated, then each portion of the sale will be separately assigned pursuant to those fees. If the fees are not separately stated, and the provision of the service is incidental to the provision of property, then the entire sale will be sourced as a sale of property. Similarly, if the provision of the property is incidental to the provision of the service, the entire sale will be sourced as a sale of a service.

Comments

Commenters noted that it is overly formalistic to source a service based on separately stated fees. Applying such a rule could lead to similarly-situated taxpayers being taxed very differently based on different fee structures.

Discussion Topic 12 – Asset management fee sourcing rules.

Facilitator Remarks

Rules were proposed to source receipts from asset management services. The rules source receipts to the domicile of the asset's shareholder or investor unless the shareholder or investor holds title for a beneficial owner. In that case, the receipts are sourced to the domicile of the beneficial owner. If the relevant domiciles are not known or cannot be reasonably approximated, the receipts are sourced to this state based on the percentage of California's population over the population of the United States.

Comments

Commenters noted that the proposed rules for sourcing asset management receipts appear to source sales to the location of the customer's customer, which is inconsistent with the Regulation's approach elsewhere. Multiple commenters suggested FTB should consider sourcing based on the billing addresses of the asset manager's private fund customers. This would ensure equal treatment of asset managers, reduce risk of manipulation, and be simple to comply with and enforce.

In addition, multiple commenters stated that sourcing asset management receipts based on the domicile of the beneficial owners is not realistic in the private fund setting because private funds seldom know the identities of beneficial owners. When many in an industry are unlikely to have the information necessary to assign their receipts under a proposed rule, that rule shouldn't be adopted. Furthermore, many commenters stated that most asset managers will be required to use the California population spread to source their sales, which will create a profound risk of overstating California sales due to the increasingly international investor base in the industry. One commenter suggested that the population spread rule provide a mechanism for reflecting international investors.

One commenter, however, stated that the proposed rules for sourcing asset management receipts are reasonable because the beneficial owners effectively bear the economic burden of paying for the service and funds are, in effect, merely agents for the underlying beneficiaries. The commenter noted that other states source asset management fees to the domicile of the beneficial owner.

Some commenters stated that California's proposed rule is unique and would create significant compliance costs.

Commenters stated that proposed Regulation 25136-2(c)(4)(c) is arbitrary and could potentially subject asset managers to California's economic nexus provisions even though those asset managers do not have substantial nexus with California. Another commenter added that a substantial risk of international multiple taxation would exist if California attempted to subject to tax under Regulation 25136-2(c)(4)(c) foreign asset managers that are engaged in commerce entirely outside of the state.

One commenter expressed concern that the asset management rules do not address how to source income asset managers receive from their interest in funds, which in some instances may serve as amounts paid for managing assets for their customers.

Another commenter noted that though FTB stated it was using Regulation 25137-14 treatment as a model for the asset management fee rules, using a population spread rule is inconsistent with Regulation 25137-14. Other commenters stated that rules appropriate for Regulated Investment Company (RIC) asset managers (like those found in Regulation 25137-14) are not appropriate for the private fund setting because the relationship is very different between investors and asset managers in RIC settings and private fund settings.

Other commenters expressed concern that the rule would adversely affect California investors. Particularly, asset managers may increase fees to funds with California

beneficiaries, diluting net returns for those investors and causing funds to avoid California beneficiaries. Similarly, asset managers may simply avoid doing business with funds with California beneficiaries.

Commenters noted that the proposed rules create an uneven playing field because similarly-situated asset managers could pay significantly different tax solely based on the beneficial owner information they happen to receive from their customers.

Another commenter stated that the proposed asset management rules allow for tax planning. Asset managers can request not to be provided with resident information if they suspect a fund has a high number of California beneficiaries, or may cooperate with its customer to structure its investments through special-made entities to avoid California tax.

Several commenters suggested that FTB further study the impact of the Regulation on certain funds in California. In instances where the services are provided to public pension funds, for example, FTB should delay the implementation of the amendments, or exclude them from the scope of the rule either temporarily or permanently.

Discussion Topic 13 – Gross receipts from dividends, goodwill, and sales of interest in pass-through entities and of stock (except marketable securities).

Facilitator Remarks

Currently, the Regulation provides an asset test to determine how to source receipts from dividends, goodwill, and sales of interest in pass-through entities and of stock (except marketable securities). If more than fifty percent of the target entity's assets consist of intangible property, the gross receipt is sourced pursuant to the target's sales factor. If more than fifty percent of the target entity's assets consists of real property and tangible property, the gross receipt is sourced pursuant to the target's property and payroll factors. The proposed rule states that if a taxpayer does not have access to the target's factors, the sale shall be sourced to the target's domicile.

Comments

Commenters noted that sourcing receipts from dividends, goodwill, and sales of interest in pass-through entities and of stock to the target's domicile is inconsistent with other proposed provisions in the Regulation. Specifically, it is inconsistent with the proposed asset management rule which sources receipts based on population spread. Commenters suggested domicile be used for both rules.

Discussion Topic 14 – Using the location of the taxpayer's prior use of an intangible to source receipt of that intangible's sale.

Facilitator Remarks

The current Regulation requires a taxpayer to source certain sales of intangibles to the location of its own prior use, as indicated in the taxpayer's books and records. This provision is included in the first cascading rule at Regulation 25136-2(d)(1)(A). However, the rule's placement has caused confusion because sourcing the sale to the taxpayer's prior location of use is a reasonable approximation method. The proposed language relocates this rule under the reasonable approximation provisions at proposed Regulation 251363-2(d)(1)(B)1.

No Comments Received

Discussion Topic 15 – Five percent *de minimis* rule deleted from Regulation 25136-2(d).

Facilitator Remarks

The *de minimis* rule previously proposed has been removed because feedback from various interested parties suggested that any fixed amount was arbitrary.

No Comments Received

Discussion Topic 16 – "Smaller" deleted from Regulation 25136-2(h)(1).

Facilitator Remarks

The term "smaller" was proposed to be deleted from Regulation 25136-2(h)(1). The intent of this provision is to allow businesses of any size the ability to show that necessary data can't be developed from financial records maintained in the regular course of business.

No Comments Received

Discussion Topic 17 – "Preponderance of the evidence" standard at Regulation 25136-2(h)(2)(C).

Facilitator Remarks

The 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.

Comments

Multiple commenters stated that the evidence standard should be defined, and the Regulation should provide examples in plain English demonstrating how the burden of proof could be met. One commenter suggested using objective standards from recognized general, legal or financial sources that are reasonably easy to follow.

Another commenter stated that using a "preponderance of the evidence" standard instead of the previously proposed "clear and convincing evidence" standard will make taxpayers nervous. Under the preponderance standard, auditors may more easily second-guess the taxpayer's reasonable approximation methodology, which may ultimately lead to a proposed change at audit that exposes taxpayers to California's Large Corporate Understatement Penalty.

Another commenter noted that the lower standard of "preponderance of the evidence" will create more disputes between the taxpayers and the FTB, leading to higher costs for taxpayers. FTB should use a higher standard consistent with its policy of minimizing taxpayers' costs.

Discussion Topic 18 - Applicability dates.

Facilitator Remarks

As a general rule, regulation amendments are prospective, though in some cases they can be retroactive. Once the substantive amendments are relatively finalized, the applicability dates for each amendment will be determined.

Comments

Commenters suggested that amendments that were not part of any prior Regulation projects be prospective, but taxpayers should be allowed to elect to apply amendments retroactively to open years.

Another commenter stated that proposed amendments should be applied prospectively only.

Additional Comments Received.

Comments on the definition of "benefit of the service is received"

One commenter suggested that the Regulation should include factors to help determine where the benefit of a service is received, e.g., the intent or purpose of the contract, historical data, industry practice, what the service relates to and what it will be operationally used for, etc. These factors should be considered when evaluating the taxpayer's contracts and books and records.

Comments on the definition of "reasonable approximation"

A commenter stated that changing from "other countries" to "other foreign jurisdictions and geographic areas" prevents a small, localized market in a very populated country from diluting a taxpayer's sales factor denominator to a point where the factor no longer fairly represents the sales attributable to California. However, this same risk is present when using California's entire population over U.S. population when the market is only in a small portion of the state, and the regulation does not address this.

Another commenter noted that the language in the "reasonably approximated" definition that references foreign jurisdiction or geographic population should be incorporated in every instance in which Regulation 25136-2 refers to population being used as a basis for sourcing receipts. Currently, the Regulation uses different language in different subsections unnecessarily.

Comments on Government Contracts

A commenter stated that services to the U.S. government which enhance conceptual ideas and existing technology should be sourced where the government plans to use that technology or idea, per the contracts. An example should address this situation.

Comments on Safe Harbor for high volume sales

Some commenters stated that a safe harbor rule should be provided for taxpayers with a high volume of customers to which they provide substantially similar services. To comply with the proposed rules as written, such taxpayers would have to manually review all existing contracts because these taxpayers typically don't maintain the location where the benefit is received in their electronic records. Commenters suggested including a safe harbor rule similar to the marketable securities rule at California Revenue and Taxation Code section 25136(e), the Code of Massachusetts Regulations at 830 CMR 63.38.1(9)(d)4.d.iii(A)(3), or as adopted by the Multistate Tax Commission in 2017 in its Model General Allocation and Apportionment Regulations.

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