

Summary of Second Interested Parties Meeting

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

- I. **Administration:** On June 16, 2017 at 10:00 a.m., at the Franchise Tax Board (FTB) central office in Sacramento, interested members of the public (Participants) attended the second 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)). 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 draft language 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 draft amendments to the Regulation. Participants were advised they had until August 15th 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:** The opening 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, i.e., August 15, 2017.

Discussion Topic 1 – Government Contract Example at Regulation subsection (b)(1)(E): Facilitator Remarks

The Facilitator noted that at the first IPM, participants made comments regarding situations involving contracts that involve servicing property that is used by the military. The Facilitator stated the FTB is now considering an example which clarifies sourcing of government contracts.

Comments

Commenters discussed the possible inclusion of an example where a machine is repaired in California, but is used elsewhere, and suggested this example would be an example of a service that results in a "deliverable".

A comment was received suggesting greater clarity could be provided as to where "field support" is provided in the example.

A comment was received suggesting that greater clarity could be provided on what "proportionally" means.

A comment was received suggesting the existing example could apply to similar situations that did not involve government contracts.

Commenters stated that the regular rules are sufficient for government contracts and that examples may not be necessary or helpful.

Staff received a comment stating that the current government contract examples did not provide helpful guidance.

Staff received a comment stating that government contract examples should focus on where value is received.

Discussion Topic 2 – Long-Term contracts

Facilitator Remarks

The Facilitator noted that the FTB will not consider CCR, Title 18, section 25137-2 for sourcing receipts from long-term contracts.

Comments

A commenter suggested clarifying that cost of performance does not apply to CCR, Title 18, section 25137-14 as well as other 25137 provisions, like those relating to long-term contracts.

Discussion Topic 3 – Receipts from Government and Long-Term R&D contracts

Facilitator Remarks

The Facilitator indicated that the FTB will not be proposing special rules for these areas, because the normal rules work fine. However, the Facilitator suggested that some examples in this area would be included.

No Comments Received

Discussion Topic 4 – Definition of Reasonably Approximated at Regulation subsection (b)(7)

Facilitator Remarks

The Facilitator indicated that proposed Regulation amendments would modify the regulatory language in this subsection currently stating "other countries" to "foreign jurisdictions or geographic areas."

Comments

Several commenters suggested providing more clarity around what these terms mean, noting that providing an example demonstrating how the terms operate would be helpful.

Discussion Topic 5 – Government Contract Example at Regulation subsection (c)(2)(E)(8) *Facilitator Remarks*

The Facilitator indicated that the FTB added an example regarding a government contract in which reasonable approximation is used. The Facilitator also mentioned that population spread is not a default rule.

Comments

A commenter suggested that the Regulation should provide for sourcing confidential government contracts according to similar non-confidential government contracts or based on taxpayer affidavits attesting to the proper sourcing.

Another commenter suggested changing "will be" to "could be" within this Regulation subsection, to add more flexibility for taxpayers.

Discussion Topic 6 – Research and Development Example at Regulation subsection (c)(2)(E)(9) *Facilitator Remarks*

The Facilitator stated that the FTB is considering whether the proposed example in this subsection is useful.

Comments

Several commenters stated the example as drafted is not helpful and seems to only restate the rule.

A commenter stated that explaining more clearly what CCR, Title 18, section 25136(c)(2)(A) means would be helpful.

Discussion Topic 7 – Research and Development Example at Regulation subsection (c)(2)(E)(10) *Facilitator Remarks*

The Facilitator requested input from the public on the Research and Development Example.

No Comments Received

Discussion Topic 8 – Window Washing Example at Regulation subsection (c)(2)(E)(11) *Facilitator Remarks*

The Facilitator noted this example was added to clarify instances in which contractual obligations are not honored.

Comments

A commenter suggested that this example may not work as well where the service is delivered to a place that is different from where the service is performed.

Discussion Topic 9 – Freight Forwarder Example at Regulation subsection (c)(2)(E)(12) *Facilitator Remarks*

The Facilitator noted that this example addresses freight forwarders, and provides two possible methods for assignment.

Comments

A comment was received stating the proposed language is a step in the right direction, and that the 50/50 example does not reflect the reality of the industry. Commenters also noted their view that the benefit received by the customer is timeliness, reducing loss, efficiencies, and managing handoffs, and should be sourced to the commercial domicile of the customer.

One commenter stated that the freight forwarding examples proposed should use a place of order approach, which focuses on the location where the customer is relieved of performing the services themselves, and further noted that the pickup/delivery approach does not reflect where the benefit is received.

A commenter stated that the taxpayer's books and records and contracts will typically have information as to the place of order, as well as, pickup and delivery, thus freight forwarding examples should be in Regulation subsection (c)(2)(A) not Regulation subsection (c)(2)(B).

Discussion Topic 10 – Asset Management Examples at Regulation subsection (c)(2)(E)(13) and (14)

Facilitator Remarks

The Facilitator noted that this example addresses asset management companies.

Comments

Several commenters stated that in many instances it is very difficult to obtain information as to the ultimate beneficiary, and that because the information is coming from a third party, its accuracy is difficult or impossible to verify.

Another commenter suggested that management fees could be sourced to the fiduciary entity domicile rather than the ultimate shareholders.

A commenter noted a desire to change the proposed Regulatory language in this subsection from "should" to "may" based on facts and circumstances.

Several commenters noted that in many instances it is very difficult to determine the ultimate beneficiaries of asset management services.

Commenters also noted that the normal rules in the Regulation work for asset management, and that special rules are not necessary.

Discussion Topic 11 – Change to Rule for Intangible Property at Regulation subsection (d)(1)(A)

Facilitator Remarks

The Facilitator noted that this rule addresses sourcing for intangible property.

Comments

A commenter suggested that "the most recent 12 months" might be better than "tax year."

Discussion Topic 12 – Change to Geographic Reference at Regulation subsection (d)(2)(A)(3)

Facilitator Remarks

The Facilitator noted a proposed Regulation change in this subsection from "other countries" to "foreign jurisdictions or geographic areas."

Comments

Several commenters suggested the proposed regulatory text needs more clarity about what these terms mean, including determining whether "foreign" means another US state outside California.

Another commenter sought clarity on whether the "U.S. population" includes U.S. territories like Puerto Rico.

Discussion Topic 13 – Addition of De Minimis rule at Regulation subsection (d)(2)(A)(4)

Facilitator Remarks

The Facilitator noted that this language was added to address situations where a jurisdiction has a de minimis amount of sales.

Comments

A commenter stated that the Multistate Tax Commission, which has a similar rule, has a 3.3% threshold.

Discussion Topic 14 – Cleanup changes to Regulation subsection (e) and (e)(3)(A)

Facilitator Remarks

The Facilitator noted that this clarifies language and removes reference to a paragraph that no longer exists.

No Comments Received

Discussion Topic 15 – Clarifying Reasonable Approximation at Regulation subsection (h)(2), (h)(2)(A), and (h)(2)(C)

Facilitator Remarks

The Facilitator explained that there are proposed Regulation changes to reflect the reasonable approximation for marketable securities. In addition, the Facilitator noted that there are proposed Regulation changes at subsection (h)(2)(C), to modify the "clear and convincing" standard to a "preponderance of evidence" standard.

No Comments Received

Discussion Topic 16 – Effective Date Language at Regulation subsection (i)

Facilitator Remarks

The Facilitator noted that FTB plans to update to language to reflect proper effective dates.

No Comments Received

- 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.