

NOTE: This paper is intended only for purposes of facilitation of discussion at the Interested Parties Meeting scheduled for July 19, 2019.

DISCUSSION TOPICS AND 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 for sales of other than tangible personal property. This will be the fourth IPM for the second round of amendments to CCR section 25136-2. The first IPM was held on January 20, 2017, the second was held on June 16, 2017, and the third was held on May 18, 2018.

Available to the public for the July 19, 2019 IPM are the following three documents: the Fourth IPM Notice; the Fourth IPM Draft Language (Draft Language); and this Discussion Topics and Explanation of Draft Language.

Part I of this document contains discussion topics for consideration. These topics are not tied to specific provisions of the Draft Language. Part II of this document contains the explanation of the Draft Language. Language proposed at previous IPMs but no longer proposed is not included in Part II. However, proposed language which has been modified from proposed language presented at the third IPM is noted. All page references are to the page number of the Draft Language document.

Please note that the following proposed changes appearing in the Draft Language are not discussed in this document: internal reference changes intended to reflect newly-proposed or relocated subsections; proper formatting for references to the California Revenue and Taxation Code, the California Code of Regulations, and the Internal Revenue Code; and proper formatting for percentages, calculations, and numerical values.

Part I: Discussion Topics for Consideration

1. Do the proposed rules assigning sales of services and sales of intangibles provide sufficient guidance to source sales of digital products such as music and eBook downloads, streaming services, and access to online digital products such as cloud-based programs and storage? If not, are additional provisions or examples needed?
2. For taxpayers providing a high-volume of identical services to business customers, should the Franchise Tax Board consider providing a safe harbor provision which allows these taxpayers to source such sales to the billing addresses or commercial domiciles of their customers?

The potential benefits of a safe harbor provision include decreased administrative and compliance burdens for taxpayers and the Franchise Tax Board, and a higher likelihood of taxpayers having high-quality substantiating documentation. Furthermore, the Multistate Tax Commission model regulations have incorporated a safe harbor provision for high-volume sales of professional services.

Potential drawbacks to a safe harbor provision include decreased accuracy when determining the location of the benefit of the service being provided. Also, a safe

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harbor will, in effect, provide an election to taxpayers who qualify to use it that is not available to other service providers.

Other options may be used to address high-volume sales other than a safe harbor provision. For instance, the Draft Language provides for efficiency without the drawbacks of providing an election or sacrificing accuracy. Proposed presumptions at subsection (c)(2)(A)1 of the Draft Language make the "benefit of the service" analysis more efficient, and a special rule at subsection (i)(1) requires that the Franchise Tax Board consider the effort and expense required to obtain the necessary information. An example could be proposed demonstrating the application of these rules to a service provider with a high-volume of identical sales.

Another option for dealing with high-volume, identical sales is to provide a general assignment rule that taxpayers are required to apply.

Part II: Explanation of Draft Language

1. Defined "beneficial owner" at subsection (b)(1) on pp.1-2

Staff now proposes to add a definition for "beneficial owner" at subsection (b)(1). The definition is required to properly apply the proposed rule for assignment of asset management service receipts at subsection (c)(3). The definition was developed after discussion with professionals in the asset management industry. The intent of the definition is to limit the application of who is a beneficial owner for purposes of assigning asset management service receipts. It is conceptually similar to the definition provided in the Code of Federal Regulations, at title 17, section 240.13d-3 in that it defines "beneficial owner" in reference to a person's ability to control the asset that is ultimately invested. However, the proposed definition is not meant to incorporate the federal definition.

Certain individuals and entities are intrinsically not beneficial owners and are explicitly excluded from the definition. The excluded persons include "master funds," "feeder funds," and similar entities; shareholders of publicly-held corporations; and participants in defined benefit plans. These persons are explicitly excluded from the definition for clarity purposes, given questions raised regarding these types of entities and individuals in the context of assigning asset management fees under the "beneficial owner" assignment scheme.

Staff proposed a definition for beneficial owner at the third IPM. Staff changed the Draft Language in response to feedback from interested parties, who suggested the Franchise Tax Board refer to federal definitions of "beneficial owner" for guidance.

2. Deleted examples under subsection (b)(2) on p.2

There are four examples under existing regulation subsection (b)(1). All the examples are proposed to be deleted. They are no longer relevant because of the Draft

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Language changes with respect to assigning sales from services to business entity and government customers.

3. Modified the definition of "reasonably approximated" at subsection (b)(8) on p.4

Staff proposes to delete the phrase "foreign countries" and replace it with "foreign jurisdictions or geographic areas." The purpose of this proposed change is to more accurately reflect the taxpayer's market when using population as a reasonable approximation method.

Also staff proposes to change the word "shown" to "substantiate" in the definition. "Substantiate" more clearly reflects the purpose of the definition to limit assignment of sales to foreign jurisdictions and geographic areas where the taxpayer actually has sales. This limitation applies when the taxpayer uses population as a reasonable approximation method.

Staff previously proposed additional language at the third IPM requiring taxpayers to substantiate foreign sales in geographic areas they sought to include when using population as a reasonable approximation method. This language was deleted as duplicative.

4. Added language for consistency at subsection (c)(1) on p.5

Staff proposes to add the phrase "the location of the" to the phrase introducing rules for sourcing service receipts from individuals. Inserting the phrase will make language used in the introductory phrase and language used in the rules consistent.

5. Substantially modified rules for assigning receipts from services provided to business entity and government entity customers at subsection (c)(2) on pp.6-9

Taxpayers and staff faced challenges assigning sales of services to business and government entity customers under the current regulation. For the third IPM, staff proposed the concept of using simplifying presumptions to streamline assignment of these service receipts. Draft Language now modifies the simplifying presumptions in response to feedback from interested parties.

Staff proposes to modify the presumption that applies to services related to tangible personal property to better reflect the location of the taxpayer's market. Staff also proposes to delete the fifth presumption proposed at the third IPM because comments received suggested it was confusing and did not provide additional guidance beyond what the basic benefit of the service rule provides.

Furthermore, staff proposes to substantially restructure the rules as follows:

- a. Staff proposes to modify rules for assigning sales from services to business and government entity customers. The rules assign service receipts pursuant

to a two-step process provided at subsections (c)(2)(A) and (c)(2)(B), as follows:

First, the method for locating the benefit of the service is determined and applied pursuant to subsection (c)(2)(A). Applying the method shall direct the taxpayer to the type of location to which the sale should be sourced. For example, if the service relates to real property, the sale should be sourced to the location of that real property pursuant to the presumption method at subsection (c)(2)(A)1.a.

Second, the assignment of sales pursuant to the applicable method is substantiated under subsection (c)(2)(B). For example, after the taxpayer determines that the type of location the service should be sourced to is the location of the real property, the taxpayer shall substantiate the precise location of that real property by using its contracts and books and records kept in the normal course of business, pursuant to subsection (c)(2)(B)1. If contracts or books and records are not available or do not provide sufficient detail to substantiate the precise location of the real property, then all other sources of information reasonably available to the taxpayer shall be used to substantiate the precise location. If all other sources of information cannot substantiate the precise location of the real property, then the location of the real property may be approximated under subsection (c)(2)(B)2.

- b. Under the Draft Language, location of order and customer's billing address are no longer included as separate rules to assign service receipts from business entity and government customers.
- c. Staff proposes deleting the term "reasonably approximated" from subsection (c)(2). The definition "reasonably approximated" requires taxpayers to engage in an analysis to determine the location of the taxpayer's market. The newly-proposed rules already provide guidance at subsection (c)(2)(A) on how to engage in such an analysis. Therefore, to reduce confusion and ensure the applicable method at (c)(2)(A) is applied, and not the method in the "reasonably approximated" definition, staff now proposes to delete "reasonably approximated" from the section. Taxpayers, under certain circumstances, are still able to approximate the location of the benefit of the service when substantiating the location of their sales under subsection (c)(2)(B)2.
- d. Staff proposes additional language at subsection (c)(2)(C) to assign sales of services provided under U.S. government contracts that cannot be assigned under the two-step process provided in subsections (c)(2)(A) and (c)(2)(B). In these cases, the benefit of the service is deemed received by the fifty states of the United States and will be assigned to this state based on the ratio of California population over U.S. population. Generally, the proposed rule would apply when a taxpayer's contracts cannot be disclosed and/or no information about the service it provides to the U.S. government is publicly available. The

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rationale for this proposed rule is that services provided to the U.S. government are predominantly intended to benefit the interests of U.S. citizens.

6. Added, deleted, and modified examples to demonstrate restructured rules for assigning sales of services to business entity and government customers at subsection (c)(2)(D) on pp.9-13

Examples 1 through 7 demonstrate how the method for locating the benefit of the service provided at subsection (c)(2)(A) is determined in various instances. Examples 3 and 5 also demonstrate how to substantiate the precise location of the benefit of service pursuant to subsection (c)(2)(B)1. after the method for locating the benefit is determined under subsection (c)(2)(A). Example 7 demonstrates how to substantiate the location of the benefit of the service through approximation pursuant to subsection (c)(2)(B)2. after the method for locating the benefit is determined under subsection (c)(2)(A).

Example 8 provides an example of how to overcome a presumption method pursuant to subsection (c)(2)(A)3.

Example 9 provides an example demonstrating application of the special rule for U.S. government contracts at subsection (c)(2)(C).

7. Added asset management receipt assignment rules and examples at subsection (c)(3) on pp.13-16

Staff proposes rules to assign asset management service receipts. The rules provide that the benefit the customer receives for the asset management services is located where the investor is domiciled. However, if the investor is holding title to an asset for a beneficial owner, the customer receives the benefit at the domicile of the beneficial owner of the asset.

Staff also proposes to add presumed meanings of the term "domicile" to subsection (c)(3). The presumed meanings are derived from general legal principles and CCR section 25137-14. The meanings are intended to ease the administrative burden of applying the asset management rules. Staff originally proposed to add the presumed meanings at the third IPM under subsection (b), but now proposes to move them to subsection (c)(3) because they are not strictly definitions. Furthermore, they have been changed from those presented at the third IPM because the term "shareholder" was removed. Staff determined that the term "investor" as used in the meanings and rule includes "shareholder," so using the term was not necessary.

The proposed rule outlines how to assign receipts based on investor and/or beneficial owner domicile. The proposed rule uses a "value of interest" method, whereby receipts are assigned to a location in proportion to the amount of managed assets held by the investors or beneficial owners domiciled in that location. Staff proposes a specific calculation for determining the "average value of interest" held by

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investors or beneficial owners domiciled in this state. To demonstrate the assignment of asset management service receipts pursuant to the rule, staff now proposes examples in the Draft Language at subsection (c)(3)(C).

Staff previously proposed a rule to source asset management service receipts at the third IPM. The current proposed rule differs from the previous version because it includes instructions for calculating the benefit of the service received in this state and because it does not contain a default rule that would source asset management fees to this state based on population if no other reasonable approximation method applied.

8. Modified language to clarify subsection (d)(1)(A) on p.16

Staff proposes to move the phrase "at the time of the sale" to clarify that it modifies the word "kept". Also, staff proposes to change the verb "is" to "will be," and to add the phrase "by the purchaser". Together, these changes clarify that it is the purchaser's use of the intangible post-sale which is the relevant use to consider when assigning receipts of intangibles pursuant to subsection (d)(1)(A).

9. Clarified rules for assigning receipts from certain intangibles (sales from shares of stock in a corporation or interest in a pass-through entity, dividends, and goodwill) under (d)(1)(A)1. on pp.16-18

Rules for assigning receipts from certain intangibles (sales from shares of stock in a corporation or interest in a pass-through entity, dividends, and goodwill) provide that if more than 50 percent of the assets of the underlying entity 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 entity. If more than 50 percent of the assets of the underlying entity are comprised of intangible property, then the sales factor of the underlying entity is used to assign the sale of stock.

Staff proposes to modify the language of these provisions to clarify the meaning of "property factor," "payroll factor," and "sales factor" as used in this subsection. Furthermore, staff proposes to add language to clarify that items such as cash, cash equivalents, and prepaid items are not included in the asset calculation because such items do not have a cost basis.

10. Added a provision to assign receipts from certain intangibles at subsection (d)(1)(A)1.c. on p.17

Staff proposes a rule to allow taxpayers to assign receipts from certain intangibles (sales from shares of stock in a corporation or interest in a pass-through entity, dividends, and goodwill) to the underlying entity's commercial domicile if a taxpayer does not have access to information to enable it to assign the receipt pursuant to the underlying entity's factors.

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

Staff proposes to relocate the 12-month reasonable approximation method from subsection (d)(1)(A)1 to the reasonable approximation assignment rules at (d)(1)(B)1. Taxpayers expressed concerns that the original location of this provision caused confusion since it was included in the first cascading rule, which was in direct contradiction to the remaining provisions of the regulation which separate reasonable approximation provisions into the second cascading rule.

12. Deleted the third cascading rule at current subsection (d)(1)(C) at p.19 and its related example at proposed subsection (d)(1)(C)4. on p.20

The third cascading rule at existing CCR Section 25136-2 subsection (d)(1)(C) provides that if a receipt from intangible property cannot be assigned pursuant to the taxpayer's contracts and books and records, and cannot be reasonably approximated, then the gross receipt from the intangible property shall be assigned to this state if the billing address is in this state. Staff proposes to delete this rule and its associated example. Reasonable approximation allows consideration of "all other information," therefore creating a special cascading rule addressing billing address is not necessary. Furthermore, deleting the rule will conform to the proposed deletion of the billing address assignment rule under subsection (c)(2).

13. Replaced "countries" with "foreign jurisdictions or geographic areas" and "shown" with "substantiated" at subsection (d)(2)(A)3. on p. 21

Staff proposes to delete the phrase "countries" and replace it with "foreign jurisdictions or geographic areas." The purpose of this proposed change is to more accurately reflect the taxpayer's market when using population as a reasonable approximation method under the conditions set forth under subsection (d)(2)(A)(3). Also staff proposes to change the word "shown" to "substantiate." "Substantiate" more clearly reflects the purpose of the rule to limit assignment of sales of marketing intangibles to foreign jurisdictions and geographic areas where the taxpayer actually has sales.

14. Corrected Cartoon Corp example at subsection (d)(2)(C)3. on p.23

Staff proposes to replace "Cartoon Corp" with "Wholesale Corp" in the last sentence of this subsection. The use of "Cartoon Corp" was a clerical error.

15. Added Research and Development example at subsection (d)(2)(D)7 on p.24

Staff proposes an example to provide guidance for sourcing receipts from licensed non-marketing and manufacturing intangibles related to research and development activities. This example demonstrates that if a lump sum payment is for the use of licensed drug compounds, and the licensed drug compounds are used in this state in

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connection with research and development activities, then the lump sum payment should be assigned to this state.

16. Added rule for assigning mixed sales at subsection (e) on pp.24-25

Staff proposes adding a subsection to assign mixed sales, (i.e., sales of services and property or sales of different types of property.) The Draft Language provides that the part of the receipt attributable to each portion of the sale will be assigned differently if the values of each portion are readily ascertainable. If the value of each portion is not readily ascertainable, the principal purpose for entering the contract will determine the sourcing of the sale. For instance, if the principal purpose of entering into a mixed sale of tangible personal property and services was to obtain tangible personal property, then the sale will be sourced as a sale of tangible personal property. The Draft Language also clarifies that the value of gross receipts attributable to tangible personal property includes all of the charges enumerated in CCR section 25134(a)(1)(A).

Staff previously proposed a rule for mixed sales at the third IPM. The language was modified to ensure the provision is consistent with CCR section 25134(a)(1)(A) and in response to feedback from interested parties, who suggested that relying on separately stated fees to assign mixed sales was too formalistic and could result in treating similarly-situated taxpayers differently.

17. Modified language related to marketable securities at subsections (f), (i)(2), (i)(2)(A), and (i)(2)(C) on pp.25 and 27

At subsection (f), staff proposes to replace "sales of marketable securities" with "sales from marketable securities." Using "from" in lieu of "of" parallels language describing other sales throughout the regulation.

Also, because the location of a customer may be reasonably approximated under subsection (f)(3), staff proposes to add the phrase "sales from marketable securities" to subsections (i)(2), (i)(2)(A), and (i)(2)(C) which address application of reasonable approximation rules.

18. Clarified Securities Dealer Corp example at subsection (f)(3)(A) on pp. 25-26

Staff proposes to modify the example at subsection (f)(3)(A) to clarify that Securities Dealer Corp's receipts are from selling marketable securities on its own account.

19. Deleted the word "smaller" and added "approximation" to subsection (i)(1) on p.26

The intent of this provision is to allow businesses of any size the ability to indicate that necessary data cannot be reasonably developed from financial records maintained in the regular course of business. As a result, staff proposes to delete "smaller" from the rule at this subsection so that there is no implication that the size of the business matters when applying this rule.

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Furthermore, staff proposes insertion of the word "approximation" in addition to "reasonable approximation." The addition of "approximation" would allow this rule be applicable to approximations made under proposed subsection (c)(2)(B)2.

20. Added burden of proof at subsection (i)(2)(A) on p.27

Taxpayers have inquired whose reasonable approximation would be accepted if both the taxpayer's and the Franchise Tax Board's preferred methods were reasonable. Staff agrees that the taxpayer's method of reasonable approximation is the one that must be used unless the Franchise Tax Board shows by a preponderance of the evidence that the taxpayer's method was unreasonable, and has proposed modifying the Draft Language to add a burden of proof provision. This provision was proposed at the third IPM as subparagraph (C) of that subsection.

21. Modified language regarding how a taxpayer may change its reasonable approximation method at subsection (i)(2)(C) on pp.26-27

Staff proposes to add additional language which details that, notwithstanding subsection (i)(2)(A), the rule that once a taxpayer uses a reasonable approximation method, it must continue to use that method and cannot change it unless the Franchise Tax Board provides written permission, still applies.

Staff also proposes language to require that taxpayers notify the Franchise Tax Board when they are using a new reasonable approximation to provide a brief description of that method in the form and manner prescribed by the Franchise Tax Board.

In addition to the language modifications provided above, staff proposes to move this subparagraph to subparagraph (C) of its section because it describes rules to be applied notwithstanding proposed rule (A).

22. Corrected applicability date clerical errors at subsections (j) and (j)(2) on p.28

Staff proposes to change the subsection title from "Effective date" to "Applicability dates" because the subsection concerns dates that the original regulation and its various amendments are applicable, not effective. The effective dates for adoption of amendments to this regulation are controlled by statute pursuant to Government Code section 11343.4.

Furthermore, the current regulation language references non-existent examples in subsection (j)(2). Staff proposes to delete these references.

23. Added applicability date placeholder language to subsection (j)(3) on p.28

Staff proposes language to indicate the applicability dates of the amendments currently proposed in the Draft Language. Since the Draft Language is still proposed

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as opposed to final, and the respective sections to update are undefined, this section provides placeholder language at this time.

24. No change to retroactive application election under subsection (j)(4) on p.28

Staff has not yet decided whether to provide for a retroactive application election for the new amendments proposed in the Draft Language document.