

NOTE: This paper is intended only for purposes of facilitation of discussion at the Interested Parties Meeting scheduled for July 21, 2020.

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 title 18, California Code of Regulations, (CCR) section 25136-2, California's market-based sourcing rules for sales of other than tangible personal property. This will be the fifth IPM for the second round of amendments to CCR section 25136-2. The first IPM was held on January 20, 2017, the second on June 16, 2017, the third on May 18, 2018, and the fourth on July 19, 2019.

Available to the public for this fifth IPM are the following three documents: the Fifth IPM Notice; the Fifth IPM Draft Language (Draft Language); and this Explanation of Draft Language.

This document contains the Explanation of Draft Language. Language proposed at previous IPMs but no longer proposed is not included. However, proposed language which has been modified from proposed language presented at the previous IPMs is noted. All page references are to the page number of the Draft Language document.

To facilitate reading, 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.

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 stakeholders 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, it is not intended that the proposed definition incorporate the federal definition.

Certain individuals and entities are intrinsically not beneficial owners and are explicitly excluded from the definition. The excluded persons are "master funds," "feeder funds," and similar entities; shareholders of publicly-held corporations; and participants in defined benefit plans. Due to comments from the public, 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 revised 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 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.

Staff additionally proposes to substitute the term "shown" with the term "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 material amounts of sales. This limitation applies when the taxpayer uses population as a reasonable approximation method.

Staff also proposes to add language clarifying the cutoff date for the use of census data. The purpose of this change is to account for the length of time that can pass between the beginning of a taxable year and the ultimate filing date.

4. Deleted subsection (c)(1) on pp.4-6.

Staff proposes to eliminate the distinction between entities and individuals in the sourcing rules for services in order to provide similar treatment to taxpayers.

5. Substantially modified rules for assigning receipts from services provided to business entity and government entity customers at subsection (c)(1) on pp.6-7

Assigning sales of services under the existing language of the regulation could be challenging. Staff previously 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. In particular, it removes the term "approximated," which was causing confusion because of its similarity to the defined term "reasonably approximated."

- a. Subparagraph (A) requires that the Taxpayer first consult its contracts and books and records when identifying and substantiating the location where the benefit is received.

- i. Section (A)(1) provides presumptions for determining the location of the benefit involved that the taxpayer must apply if the service predominantly relates to one of the enumerated items (real property, tangible personal property, intangible property, or individuals). Section (A)(2) states that the presumptions in (A)(1) may be overcome by either the FTB or Taxpayer based on a preponderance of the evidence standard. The party attempting to overcome the presumption must first consider the Taxpayer's books and records for information before it may consider any other information.
 - b. Subparagraph (B) provides Taxpayer or FTB may use all other sources of information to substantiate the location of benefit if the service falls under a presumption or the presumption has been overcome and the location of benefit cannot be identified or substantiated by books and records.
 - c. Subparagraph (C) provides that if the service did not initially fall under a presumption, and the benefit of the service cannot be determined under the contract or the taxpayer's books and records, the location where the benefit is received shall be reasonably approximated.
 - d. Subparagraph (D) provides that if the service cannot be assigned pursuant to subparagraphs (A) through (C), the sale shall be assigned to the location of the customer's billing address.
 - e. Staff proposes additional language at subsection (c)(1)(E) to assign sales of services provided under U.S. government contracts that cannot be assigned under the two-step process provided in subsections (c)(1)(A) and (c)(1)(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 there is no publicly available information. The rationale for this proposed rule is that services provided to the U.S. government are exclusively intended to benefit the interests of the people of the United States.
6. Added, deleted, and modified examples to demonstrate restructured rules for assigning sales of services to business entity and government customers at subsection (c)(1)(D) on pp.8-12

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

Example 8 provides an example demonstrating application of the special rule for U.S. government contracts at subsection (c)(1)(C).

Example 9 provides an example of how to overcome a presumption method pursuant to subsection (c)(1)(A)3.

Example 10 provides an additional example of how to substantiate the location of the benefit of service pursuant to subsection (c)(1)(B)1. once the method for locating the benefit is determined under subsection (c)(1)(A).

7. Added asset management receipt assignment rules and examples at subsection (c)(2) on pp.12-14

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 beneficial owner is the customer and receives the benefit of the service at its domicile.

Staff also proposes to explain what constitutes "domicile" for purposes of subsection (c)(2). The explanation is derived from general legal principles and CCR section 25137-14. The explanation is intended to ease the administrative burden of applying the asset management rules. Staff originally proposed to add the explanation at the third IPM under subsection (b), but now proposes to relocate it to subsection (c)(2) because it is not necessarily a definition. Furthermore, the explanation has been revised from that presented at the third IPM because the term "shareholder" was eliminated. Staff determined that the term "investor" as used in the meanings and rule includes "shareholder," so using the term "shareholder" 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 investors or beneficial owners domiciled in this state. To demonstrate the assignment of asset management service receipts pursuant to the rule, staff proposes two examples in the Draft Language at subsection (c)(2)(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 guidance for calculating the benefit of the service received in this state, whereas the previous version contained 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 pp.14-15

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.15-17

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 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.

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. Staff proposes to add language to clarify that certain 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.

In addition, Staff proposes additional rules to govern situations where information is lacking to perform the asset test, or to apply the selected apportionment factors from the asset test.

10. Added a provision to assign receipts from certain intangibles at subsection (d)(1)(A)1.e. on p.16

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 enabling it to assign the receipt pursuant to the underlying entity's factors.

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.17-18

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. Commentators expressed concerns that the original location of this provision caused confusion since it was included in the first cascading rule, which was in contrast to the remaining provisions of the regulation which include reasonable approximation provisions in the second cascading rule.

12. Replaced "countries" with "foreign jurisdictions or geographic areas" and "shown" with "substantiated" at subsection (d)(2)(A)3. on pp.19-20

Staff proposes to substitute the phrase "countries" with the phrase "foreign jurisdictions or geographic areas." The purpose of this proposed revision 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 substitute "shown" with "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.

13. Corrected Cartoon Corp example at subsection (d)(2)(C)3. on p.22

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.

14. Added Research and Development example at subsection (d)(2)(D)7 on p.22

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

15. Added rule for assigning mixed sales at subsection (e) on p.23

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 commentators, who suggested that relying on separately stated fees to assign mixed sales was too formalistic and could result in treating similarly-situated taxpayers differently.

16. Modified language related to marketable securities at subsections (f), (i)(2), (i)(2)(A), and (i)(2)(C) on pp.24-26

At subsection (f) staff proposes to add a definition for the term "customer" applicable to the subsection.

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.

17. Clarified Securities Dealer Corp example at subsection (f)(4) on p.24

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.

18. Deleted the word "smaller" and added "alternative sources of information" to subsection (i)(1) on p.25

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 magnitude of the business controls when applying this rule.

Furthermore, staff proposes insertion of the phrase "alternative sources of information" in addition to "reasonable approximation." The addition of would allow this rule be applicable to proposed subsection (c)(2)(B)2.

19. Added burden of proof at subsection (i)(2)(A) on pp.25-26

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 controls unless the Franchise Tax Board proves by a preponderance of the evidence that the taxpayer's method was unreasonable. Therefore, staff proposes 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.

20. Modified language regarding how a taxpayer may change its reasonable approximation method at subsection (i)(2)(C) on p.26

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, will continue to apply.

Staff also proposes language to require that taxpayers notify the Franchise Tax Board when they are using a new reasonable approximation and 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 relocate this subparagraph to subparagraph (C) of its section because it describes rules to be applied notwithstanding proposed rule (A).

21. Corrected applicability date clerical errors at subsections (j) and (j)(2) on p.27

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.

22. Added applicability date placeholder language to subsection (j)(3) on p.27

Staff proposes language to indicate an applicability date for the new amendments proposed in the Draft Language document, of taxable years beginning on or after January 1, 2019.

23. Retroactive application election under subsection (j)(5) on p.27

Staff has proposed elective retroactive application for the new amendments proposed in the Draft Language document to taxable years beginning on or after January 1, 2018.