EXPLANATION OF DRAFT TEXT

The purpose of this Interested Parties Meeting (IPM) is to receive input from the taxpayer community regarding proposed amendments to Title 18 of the California Code of Regulations (CCR), at Section 17951-5, which would clarify that the regulation applies only to compensation paid in consideration of employment to an employee for California income sourcing purposes. Input is also being sought regarding the proposed adoption of a new regulation at Title 18, CCR Section 17971-8, to provide a sourcing rule for compensation paid to nonresident, nonemployee, and independent directors of corporations. This will be the first IPM for this topic.

The following documents are available to the public for the October 8, 2020 IPM: the IPM Notice; Draft Text; and this Explanation of Draft Text.

Discussion of the proposed amendment to CCR section 17951-5

Currently, CCR Section 17951-5 contains language which may lead to misinterpretations as to whether the regulation section applies only to compensation paid in consideration of employment to an employee, or whether it may also apply to compensation paid to independent contractors, sole proprietors, or other business entities. The proposed amendments would clarify that the regulation applies only to compensation paid in consideration of employment to an employee. Given the provision of sourcing rules for sole proprietors as well as proceeds from other business entities under CCR Section 17951-4, the added specification that the rules provided in CCR Section 17951-5 apply only to income from employment is necessary.

Discussion of proposed addition of CCR section 17951-8

Compensation paid to an independent, nonemployee director, who is a nonresident of California, would not be sourced pursuant to CCR Section 17951-5, to the place where the director performs services for the company for which they serve, because the independent director is not, by definition, an employee. As set forth in Chief Counsel Ruling 2019-03, the independent director "is providing a service to the Company and its shareholders that is unique – to act, with the other directors, to govern the Company." Given this highly nuanced role, which includes fiduciary duties, it is appropriate to create a new sourcing rule to specifically source compensation paid to a nonresident nonemployee independent director. The proposed new regulation section would provide that the fees or other compensation received by a nonresident nonemployee independent director for serving on a company's Board of Directors should be sourced to the commercial domicile, where the highest-ranking corporate officers carry out the Board's directions for the benefit of the company.