

## California FTB amends market sourcing regulation for sales of intangible property and marketable securities

### Overview

On September 15, 2016, the California Franchise Tax Board (FTB) filed with the California Secretary of State amendments to California Code of Regulations, Title 18, Section 25136-2 (Regulation 25136-2). The changes to Regulation 25136-2 provide guidance on the manner in which sales of intangible property and marketable securities should be assigned to California for purposes of the California sales factor.<sup>1</sup> Specifically, Regulation 25136-2 provides:

- Definitions for marketable securities in general and for securities and commodities dealers,
- Assignment rules for marketable securities, and
- Assignment rules for interest, dividends, and goodwill.

This Tax Alert summarizes the changes to Regulation 25136-2 and provides taxpayer considerations. The changes generally apply to taxable years beginning on or after January 1, 2015.<sup>2</sup>

### Definitions for marketable securities

Other than for securities dealers or commodities dealers, "marketable securities" is defined to mean "any security that is actively traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market."<sup>3</sup> Securities that are traded in transactions that are excluded from gross receipts under California Revenue & Taxation Code (CRTC) Section 25120 are not considered marketable securities for purposes of Regulation 25136-2.<sup>4</sup> An "established stock or securities market" generally includes both i) "a national securities exchange that is registered under Section 78f of the Securities Exchange Act of 1934 (15 U.S.C. Section 78a to 78pp,)" or ii) "a foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized."<sup>5</sup>

For a taxpayer who is a securities dealer under Internal Revenue Code (IRC) Section 475(c)(1) or a commodities dealer who has made an election under IRC Section 475(e), "marketable securities" means "any security that is defined in [IRC] Sections 475(c)(2) or 475(e)(2)(B), (C), or (D), and any contract to which [IRC] Section 1256(a) applies, which has not been excepted under [IRC] Section 475(b)."<sup>6</sup> For these taxpayers, marketable securities also includes interest and dividends associated with the marketable securities, but excludes the types of securities that are traded in transactions excluded from gross receipts under CRTC Section 25120(f)(2)(L).<sup>7</sup>

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<sup>1</sup> The final text for amended Regulation 25136-2 is available [here](#).

<sup>2</sup> Cal. Code Regs., tit. 18, § 25136-2(i)(2). In addition, "any taxpayer may elect to have the amendments apply retroactively to taxable years beginning on or after January 1, 2012, but only if those taxable years are open to adjustment under applicable statutes of limitations." Cal. Code Regs., tit. 18, § 25136-2(i)(3).

<sup>3</sup> Cal. Code Regs., tit. 18, § 25136-2(b)(5).

<sup>4</sup> *Id.* Some examples of securities that are traded in transactions excluded from gross receipts under CRTC Section 25120 generally include amounts received from transactions in intangible assets held in connection with a treasury function, repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument, and proceeds from issuance of the taxpayer's own stock or from the sale of treasury stock. Cal. Rev. & Tax Code § 25120(f)(2)(A), (C), (K).

<sup>5</sup> *Id.*

<sup>6</sup> Cal. Code Regs., tit. 18, § 25136-2(b)(6).

<sup>7</sup> *Id.*

### Assignment rules for marketable securities

The amended regulation provides rules for assigning gross proceeds from sales of marketable securities to the location of the customer.<sup>8</sup> If the customer is an individual, then the sale is sourced to California if the customer's billing address is in California.<sup>9</sup> If the customer is a corporation or other business entity, then the sale is sourced to California if the customer's commercial domicile is in California.<sup>10</sup>

If the taxpayer's books and records kept in the normal course of business indicate that the customer's commercial domicile is in California, the customer's commercial domicile shall be presumed to be in California and the FTB will accept this assignment method.<sup>11</sup> However, the taxpayer may overcome this presumption by showing by a preponderance of the evidence that other credible documentation provides that the customer's commercial domicile is in another state. The FTB may examine the taxpayer's alternative method to determine if the presumption was in fact overcome and whether this alternative method reasonably reflects the location of the customer's commercial domicile.<sup>12</sup>

If the individual customer's billing address or the corporate or other business entity's commercial domicile cannot be determined pursuant to the above rules, the customer's location must be reasonably approximated.<sup>13</sup> Regulation 25136-2(e)(3)(A) provides an example of what constitutes a reasonable approximation. Based on that example, the customer's billing address may constitute a reasonable approximation of the customer's location.<sup>14</sup>

### Assignment rules for interest, dividends, and goodwill

Gross receipts from intangible property are generally assigned to California to the extent the intangible property is used in California.<sup>15</sup> Generally, the amended regulation applies the same assignment rules that would apply to sales of shares of stock in a corporation or an ownership interest in a pass-through entity (other than sales of marketable securities) to dividends or goodwill.<sup>16</sup> That rule generally provides that, if 50 percent or more of the underlying entity's assets (e.g., the payor of the dividends) consist of real or tangible personal property, the receipts will be assigned by averaging the payroll and property factors in California of the entity for the most recent 12-month taxable year preceding the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business.<sup>17</sup> If the sale occurred more than six months into the current taxable year, then the average of the current year property and payroll factors will be used.<sup>18</sup> However, if 50 percent or more of the assets consist of intangible property, then only the sales factor is used in the computation consistent with the rules discussed above.<sup>19</sup>

Where the gross receipts from intangible property is interest, the amended regulation provides a different set of rules. Specifically, interest from loans, as defined under CRTS Section 25137-4.2(b)(7),<sup>20</sup> is assigned to California if the loan is i) secured by real property that is located in California, or ii) not secured by real property, but the borrower is located in California.<sup>21</sup> Interest from investments (other than the loans described above) is assigned to California if the investment is managed in California.<sup>22</sup>

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<sup>8</sup> Cal. Code Regs., tit. 18, § 25136-2(e).

<sup>9</sup> Cal. Code Regs., tit. 18, § 25136-2(e)(1).

<sup>10</sup> Cal. Code Regs., tit. 18, § 25136-2(e)(2).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Cal. Code Regs., tit. 18, § 25136-2(e)(3). The meaning of "reasonably approximated" remains unchanged. However, the definition is now found under Regulation Section 25136-2(b)(7).

<sup>14</sup> Cal. Code Regs., tit. 18, § 25136-2(e)(3)(A).

<sup>15</sup> Cal. Code Regs., tit. 18, § 25136-2(d).

<sup>16</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)1.

<sup>17</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)1.a.

<sup>18</sup> *Id.*

<sup>19</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)1.b. Similar to the rules where 50 percent or more of the assets consist of real or tangible personal property, where 50 percent or more consists of intangible property, the sales factor of the entity for the most recent 12-month taxable year preceding the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business should be used, but if the sale occurred more than six months into the current taxable year, then the current year's sales factor is used. *Id.*

<sup>20</sup> CRTS Section 25137-4.2(b)(7) provides, in part, that "loan" means "any extension of credit resulting from direct negotiations between the taxpayer and its customer, and/or the purchase, in whole or in part, of such extension of credit from another person. Loans include participations, syndications, and leases treated as loans for federal income tax purposes."

<sup>21</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)2.b.-c.

<sup>22</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(A)2.a.

Where the receipts from dividends, goodwill, and interest cannot be assigned pursuant to the above-stated rules, the taxpayer would move to the next prong, the rules of which remain the same and were not amended in this specific regulatory action. Specifically, if the gross receipts cannot be assigned under the rules above, then the location where the intangible property is used is reasonably approximated.<sup>23</sup> If the location cannot be reasonable approximated, then these gross receipts are assigned to the purchaser's billing address.<sup>24</sup> However, as noted below, there are some ambiguities with the way these amended rules are currently drafted.

## Considerations

Although the amendments made to Regulation 25136-2 provide much needed guidance on the manner in which receipts from marketable securities or intangible property (such as dividends, goodwill, or interest) should be assigned, open questions remain. For example, although a prior draft version of the amended regulation included examples which provided guidance on how receipts from asset management services should be assigned to California, these examples were subsequently deleted,<sup>25</sup> and the final text of the amended regulation does not include any guidance on how these types of receipts should be assigned. Although the examples were excluded from the final version of the amended regulation, the examples may be re-visited if the FTB undertakes another regulatory project relating to Regulation Section 25136-2.

Additionally, although it appears that the intent for adding the phrase "where the gross receipts from intangible property are dividends or goodwill" to the rules that apply to the assignment of sales of stock or an ownership interest (under Regulation Section 25136-2(d)(1)(A)1.) was merely to apply similar assignment rules to dividends and goodwill,<sup>26</sup> the FTB inserted that language under Regulation Section 25136-2(d)(1) which technically should only apply to a "complete transfer of all property rights." The same issue exists for the rule setting forth how interest should be assigned under Regulation Section 25136-2(d)(1)(A) 2.<sup>27</sup>

If the FTB undertakes another regulatory project relating to Regulation 25136-2, the FTB may address the ambiguities in the current version of the amended regulation discussed above as well as others. For example, with respect to receipts derived from dividends and goodwill, it appears the sourcing rule was intended to focus on the dividend payor's assets and apportionment factors (and not on the assets and apportionment factors of a corporation sold, as the current version of this amended regulation seems to imply). However, until the FTB completes a new regulation project, it is uncertain how the current version will change and to what extent (if any) the FTB will address either the various ambiguities that exist in the current version of the amended regulation or the issues associated with the assignment of receipts from asset management services as noted above.

Finally, the FTB recently issued its October 2016 "Tax News" publication<sup>28</sup> in which it acknowledged that an entity may now have a California tax filing requirement as a result of applying the amended regulation (when considered in conjunction with California's economic nexus standard.<sup>29</sup>) In addition, entities that have already filed their original California tax returns, but did not apply these new rules, may need to amend those returns to reflect the new rules. Although the amended regulation is effective January 1, 2017, because the amendments generally apply to taxable years beginning on or after January 1, 2015, taxpayers are required to comply with these new rules for any taxable year beginning on or after January 1, 2015. For taxpayers who find themselves underpaid because of the application of the final regulations, the "Tax News" indicates that the FTB will abate applicable penalties as allowed by law and

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<sup>23</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(B).

<sup>24</sup> Cal. Code Regs., tit. 18, § 25136-2(d)(1)(C).

<sup>25</sup> The deletion of these examples was discussed in our prior Multistate Tax Alert, available [here](#).

<sup>26</sup> See Franchise Tax Board Initial Statement of Reasons for the Adoption of Amendments to California Code of Regulations, Title 18, Section 25136-2 ("Initial Statement of Reasons"), p.4 (stating that "Subsection (D)(1) addresses assignment of sales from intangible property where there has been a complete transfer of all property rights. Neither [CRTC] section 25136 nor [Regulation] section 25136-2 provide guidelines as to how gross receipts such as dividends or goodwill should be assigned. Stakeholders at the Interested Parties Meetings expressed that dividends and goodwill should be assigned according to the sale of stock rules contained in subsection (D)(1)(A)1. This assignment position is based on *Mobile Oil Corp. v. Commissioner of Taxes of Vt.* (1980) 445 U.S. 425. Thus, in the proposed modifications to [Regulation] section 25136-2 dividends and goodwill are assigned according to the sale of stock rules under subsection (d)(1)(A)1").

<sup>27</sup> The FTB's Initial Statement of Reasons, p.4, stated that "Subsection (d)(1)(A)2 addresses assignment of sales from intangible property where the gross receipt is interest" and explained that the rules in the amended regulation for interest from investments and loans reflected recommendations made at Interested Parties Meetings and FTB staff.

<sup>28</sup> FTB Tax News, *Amended Rules on Market-Sourcing for Intangible Property Finalized* (Oct. 2016).

<sup>29</sup> In 2015, for example, an entity was "doing business" in California if its sales into California exceeded the lesser of \$536,446 or 25% of the taxpayer's total sales. Cal. Rev. & Tax Code § 23101(b)(2).

## External Multistate Tax Alert

that it will issue a Notice discussing this at a later date.<sup>30</sup> Notwithstanding, business organizations should consider the possible imposition of penalties when deciding how these rules potentially impact them.

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<sup>30</sup> *Id.*