

California FTB proposes amendments to market-based sourcing rules

Overview

On May 18, 2018, the California Franchise Tax Board (FTB) will hold its third Interested Parties Meeting (IPM) regarding proposed amendments to California Code of Regulations, Title 18 (CCR), Section 25136-2.¹ In anticipation of the third IPM, the FTB released revised draft regulations on April 25, 2018 (Draft CCR Section 25136-2).²

The FTB has proposed revisions to the existing CCR Section 25136-2, which most notably include:

- Simplifying rules for assigning receipts from sales of services to businesses and government entities.
- Rules and examples on how government contractors should determine the location where the benefit of the service is received including how to source receipts when a reasonable approximation method is used.
- Guidance on how to source receipts where the sale involves both services and tangible or intangible personal property.
- Assignment rules for receipts derived from asset management services.
- Guidance for sourcing receipts derived from the sale of pass-through entity interests and corporate stock or from dividends or goodwill.
- Special rule requiring the FTB to accept the taxpayer's reasonable approximation method unless the FTB shows by a preponderance of the evidence that the taxpayer's method is unreasonable.

This tax alert summarizes the notable FTB changes made to Draft CCR Section 25136-2 and provides some taxpayer considerations.

Simplifying rules for assignments of sales of services to businesses

California generally sources receipts derived from services to California to the extent the taxpayer's customer receives the benefit of service in California.³ Depending on whether the taxpayer's customer is an individual or business entity, California applies a particular set of cascading sourcing rules to determine where the benefit is received.⁴ Under Draft CCR Section 25136-2, for business entities, the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the taxpayer's customer's billing address, shall be presumed to indicate the extent to which the benefit of the service is received in California to the extent the services relates to: (1) real property that is located in California; (2) tangible personal property that is located in California when the service is provided; (3) intangible property that is used in California; (4) individuals that are physically present in California at the time the service is received; or (5) a California business that receives a service that relates to a California business.⁵ In the event that the taxpayer receives one fee for a service that relates to more than one of the simplified rules (i.e., (1) through (5) above), the service shall be characterized based on the simplified rule to which the services predominantly relates.⁶ To rebut this presumption, the FTB or the taxpayer, must demonstrate by a preponderance of the evidence that the benefit of the service is not received in California.⁷

¹ Franchise Tax Board Meeting Notice and Information, Third Interested Parties Meeting Market-Based Rules for Sales Other Than Sales of Tangible Personal Property – California Code of Regulations, Title 18, Section 25136-2 (available [here](#)).

² See Draft Cal. Code Regs. tit. 18, § 25136-2 (Apr. 25, 2018) (available [here](#)).

³ Cal. Code Regs. tit. 18, § 25136-2(c).

⁴ *Id.*

⁵ See Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(A)1.-5.

⁶ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(B). Draft CCR Section 25136-2(c)(3) also adds specific rules to determine how to characterize receipts where the contract includes both the sale of services and the sale of tangible or intangible property and provides an example on how these new rules should apply.

⁷ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(C).

If the contract or the books and records do not provide the location where the benefit is received under the simplified rules or the presumption is overcome, then the location where the benefit was received shall be reasonably approximated.⁸ If the taxpayer is still unable to determine the location of the benefit of the service, then the location where the benefit of service is received is presumed to be California if the location from which the taxpayer's customer placed the order for the service is in California.⁹ Lastly, if the location still cannot be determined under any of the above rules, then the location of the benefit is in California if the taxpayer's customer's billing address is in California.¹⁰

Draft CCR Section 25136-2 also provides new examples to illustrate application of the market-based sourcing rules, including examples which address services relating to product transportation, warehousing and repackaging, research and development services, and call center services.¹¹

Sourcing for government contractors

Draft CCR Section 25136-2 extends the above-stated cascading and simplifying rules that apply to services provided to business entities to services provided to government entities.¹² Additionally, for purposes of reasonably approximating the location where the benefit is received, Draft CCR Section 25136-2 provides a new rule that applies to services provided under U.S. government contracts. This new rule states that, if the taxpayer's services are provided under a U.S. government contract, and the location where the benefit of the service under the simplifying rules is not provided in the taxpayer's contracts or books and records or cannot be disclosed, and the location cannot be reasonably approximated by any other method, the taxpayer may reasonably approximate the location by using the ratio of California population over U.S. population.¹³ The FTB's rationale for this proposed language is because U.S. government services are predominantly intended to benefit the interests of U.S. citizens.¹⁴ Draft CCR 25136-2 also provides two new examples to illustrate how these rules should apply to government contractors – one involving the shipment of military tanks to California for repair and returned to the field once completed; the other involving maintenance of software for a military computer network where the location is unknown or cannot be disclosed.¹⁵

Application of 25136-2 to fees derived from asset management services

In prior versions of the proposed amendments to this regulation, the draft language included examples to illustrate how to source receipts derived from asset management services. Draft CCR Section 25136-2 deletes those examples and replaces them with actual rules that will apply to asset management services.¹⁶ Generally, Draft CCR Section 25136-2(c)(4) provides that, for receipts derived from asset management services (that are not subject to CCR, title 18, section 25137-14 which apply to services provided to regulated investment companies), the benefit of the services is received by the shareholder or the investor, unless the shareholder or the investor is holding title for the beneficial owner. "Beneficial owner" is defined to mean "a person or entity who has an interest in the property that is distinct from title ownership, is the owner of the income derived from the property for tax purposes and for whose ultimate benefit the title holder maintains the property."¹⁷ If it is determined that the investor or the shareholder is holding the property for a beneficial owner, the benefit is received by the beneficial owner of the asset.¹⁸

To determine the location where the benefit of the asset management service is received, Draft CCR Section 25136-2(c)(4) provides the following cascading rules: (1) if the taxpayer knows the domicile of the shareholders, beneficial owners, or investors, then the receipts are to be assigned to California to the extent their domicile is in California;¹⁹ (2) if the taxpayer does not know the domicile of the shareholders, beneficial owners, or investors, then the receipts are assigned to California to the extent the domicile can be reasonably approximated to be in California;²⁰ (3) if the taxpayer cannot assign the

⁸ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(D)2.

⁹ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(D)3.

¹⁰ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(D)4.

¹¹ See Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(E).

¹² Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2).

¹³ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(D)2.a.

¹⁴ Franchise Tax Board Explanation of Draft Language Amending California Code of Regulations, Title 18, Section 25136-2, at p.3. (available [here](#))

¹⁵ See Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(E)5.;11.

¹⁶ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(4) (Apr. 25, 2018).

¹⁷ Draft Cal. Code Regs. tit. 18, § 25136-2(b)(1).

¹⁸ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(4).

¹⁹ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(4)(A).

²⁰ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(4)(B).

receipts based on (1) or (2) above, the receipts are assigned to California based on the ratio of California population to U.S. population.²¹ With respect to the domicile of shareholders, investors, or customers, the domicile is presumed to be the billing address on the records of the taxpayer, unless the taxpayer has actual knowledge that the principal place of business is different than the billing address.²² With respect to the domicile of a beneficial owner of assets managed by an asset manager, the domicile is presumed to be the beneficial owner's billing address on the records of the entity that received the service, or on the records of the asset manager, unless either have actual knowledge that the beneficial owner's primary residence or principal place of business is different than the beneficial owner's billing address.²³

Sourcing of receipts derived from the sale of pass-through entity interests and corporate stock, dividends, and goodwill.

Draft CCR Section 25136-2 adds a new rule to the existing provisions.²⁴ The current rule provides that if 50 percent or more of the underlying corporation or pass-through entity is comprised of tangible property/real property, then the sale is assigned based on the average of the payroll and property factors of underlying entity.²⁵ If more than 50 percent of the assets of the underlying corporation or pass-through entity is comprised of intangible property, then the sales factor of the underlying entity is used to assign the sale.²⁶ The new rule provides that, if a taxpayer does not have access to the above information, then the sale is assigned to the payor's domicile.²⁷

Special rules relating to reasonable approximation

CCR 25136-2(h)(2) currently contains special rules related to reasonable approximation for the location of the benefit of services and the location of the use of intangible property. Draft CCR 25136-2 expands these special rules to sales from marketable securities.²⁸ Significantly, the FTB has added a new special rule that provides that a taxpayer's reasonable method of approximation shall be used unless the FTB shows by a preponderance of the evidence that such method is not reasonable.²⁹

Considerations

The changes proposed by the FTB in Draft CCR Section 25136-2 would, if adopted, represent a significant change to California's market-based sourcing rules impacting service providers in general as well as contracts involving asset management services, government entities, and research and development services. These changes also impact receipts derived from sales of corporate stock or pass-through entity interests, dividends, and goodwill. Taxpayers interested in these regulations may wish to attend the third IPM to be held on May 18, 2018, to provide comments. Written comments are due to the FTB by July 19, 2018.

Taxpayers with sales derived from services or intangible personal property should consult their tax practitioners to evaluate how the FTB's proposed amendments to CCR Section 25136-2 may impact their businesses.

Contacts:

²¹ Draft Cal. Code Regs. tit. 18, § 25136-2(c)(4)(C).

²² Draft Cal. Code Regs. tit. 18, § 25136-2(b)(5)(A).

²³ Draft Cal. Code Regs. tit. 18, § 25136-2(b)(5)(B).

²⁴ Draft Cal. Code Regs. tit. 18, § 25136-2(d)(1)(A)1.c.

²⁵ Draft Cal. Code Regs. tit. 18, § 25136-2(d)(1)(A)1.a.

²⁶ Draft Cal. Code Regs. tit. 18, § 25136-2(d)(1)(A)1.b.

²⁷ Draft Cal. Code Regs. tit. 18, § 25136-2(d)(1)(A)1.c.

²⁸ Draft Cal. Code Regs. tit. 18, § 25136-2(h)(2).

²⁹ Draft Cal. Code Regs. tit. 18, § 25136-2(h)(2)(C).

If you have questions regarding the proposed changes to CCR Section 25136-2 or other California tax matters, please contact any of the following Deloitte Tax professionals:

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