

California FTB Proposes Additional Amendments to Market-Based Sourcing Rules

Overview

On July 21, 2020, the California Franchise Tax Board (“FTB”) will hold its fifth Interested Parties Meeting (“IPM”) regarding the proposed amendments to California Code of Regulations, title 18, (“CCR”) section 25136-2.¹ In anticipation of the fifth IPM, the FTB released its fourth version of draft language proposing amendments to the market-based sourcing regulations promulgated under CCR section 25136-2 (“Amended Draft CCR section 25136-2”).² The last version was issued on July 19, 2019 (“Prior Draft CCR section 25136-2”).³ Amended Draft CCR section 25136-2 proposes numerous changes to the existing rules, some of which include:

- Substantially modifies the manner in which receipts from sales of services to individuals, businesses, and government entities are assigned.
- Clarifies the rules for sourcing receipts derived from the sale of corporate stock or pass-through entity interests, dividends, and goodwill.

Importantly, in Amended Draft CCR section 25136-2, **the FTB proposed an effective date for the proposed amendments of taxable years beginning on or after January 1, 2019.**⁴ **Written comments regarding the Amended Draft CCR section 25136-2 are due to the FTB by August 18, 2020.** This Tax Alert summarizes some of the changes made under Amended Draft CCR section 25136-2 and provides some taxpayer considerations.

Substantial Modifications to the Rules for Assigning Sales of Services

In Prior Draft CCR section 25136-2, the FTB proposed a new two-step process that would apply to businesses and government entities where a taxpayer must first apply the simplifying presumptions, which presume the location where the benefit of the service is received based on whether the service relates to real property, tangible personal property, intangible property, or individuals.⁵ Once the method for identifying where the benefit of the service is received has been determined under the simplifying presumptions, the taxpayer must then apply the substantiation rules which specifies the types of documents that should be used to substantiate the precise location (e.g., California) where the benefit of the service is received.⁶

Amended Draft CCR section 25136-2 retains the simplifying presumptions and substantiation rules.⁷ However, in an effort to eliminate the distinction between customers who are individuals and business or government entities, the FTB completely deleted the rules that previously applied only to individual customers and now only uses one set of rules that apply generally to sales of services, including when the customers are individuals, business, or government entities.⁸

¹ FTB Notice of Fifth 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 Amended Draft CCR section 25136-2 (July 21, 2020) (available [here](#)).

³ See Prior Draft CCR section 25136-2 (July 19, 2019) (available [here](#)). The FTB’s prior proposed amendments to CCR section 25136-2 (Prior Draft CCR section 25136-2) are discussed in more detail in our Multistate Tax Alert, dated July 16, 2019 (available [here](#)).

⁴ Amended Draft CCR section 25136-2(j)(3). The proposed amendments also allow a taxpayer to elect to have these amendments apply retroactively to taxable years beginning on or after January 1, 2018, but only if those taxable years are open to adjustment under the applicable statute of limitations. See Amended Draft CCR section 25136-2(j)(5).

⁵ Prior Draft CCR section 25136-2(c)(2)(A).

⁶ Prior Draft CCR section 25136-2(c)(2)(B).

⁷ Amended Draft CCR section 25136-2(c)(1)(A)-(E).

⁸ Amended Draft CCR section 25136-2(c)(1); see also FTB Explanation of Draft Language Amending California Code of Regulations, Title 18, (CCR) section 25136-2 (July 21, 2020) (available [here](#)).

The FTB clarified how the simplifying presumptions should apply. Specifically, Amended Draft CCR section 25136-2(c)(1)(A)(1) provides that “the benefit of the service shall be presumed to be in this state to the extent the service predominately relates to:

- a. Real property that is located in this state.
- b. Tangible personal property and the tangible personal property is located in this state when the service is received. If the tangible personal property is delivered directly or indirectly to the customer after the service is performed, the benefit of the service is received where the property is delivered, regardless of where the service is performed.
- c. Intangible property that is used in this state.
- d. Individuals who are physically present in this state at the time the service is delivered.”⁹

Additionally, Amended Draft CCR section 25136-2(c)(1)(A)(2) retains the rule that the taxpayer or the FTB may overcome the simplifying presumptions by showing, based on a preponderance of the evidence, the benefit of the service is received at a location different from the one stated under the presumption.¹⁰ The FTB also retains the rule requiring that the party attempting to overcome a presumption use the taxpayer’s contracts or books and records, but clarifies that the information contained in the contracts or books and records should first be considered before considering any other source of information to overcome the presumption.¹¹ If the service falls under one of the presumptions, or the presumption is overcome, and the location of the benefit cannot be substantiated through the taxpayer’s contracts or books and records, Amended Draft CCR section 25136-2(c)(1)(B) then allows consideration of “all other sources of information...to substantiate the location of [the] benefit.”¹²

Furthermore, Amended Draft CCR section 25136-2(c)(1)(C) retains the rule that, if the location of the benefit cannot be determined pursuant to the rules discussed above, “the location where the benefit of the service is received shall be reasonably approximated.”¹³ Finally, the FTB reinstates the customer’s billing address as an alternative method if the location of the benefit cannot be determined under the preceding rules or reasonably approximated.¹⁴

In lieu of the “billing address” rule, the FTB provides a different rule that applies only to government contractors. Specifically, Amended Draft CCR section 25136-2(c)(1)(E) provides that, for services provided under U.S. government contracts, if the sale cannot be assigned under subsections (c)(1)(A) through (C), “such as when a contract cannot be disclosed and no information about the service is publicly available, then the benefit of the service is deemed received by the fifty (50) states of the United States” and the receipts shall be assigned based on “the ratio of California population over U.S. population as determined by the most recent U.S. census data as of the beginning of the taxable year.”¹⁵

Modified Rules on Sourcing Receipts Derived from Sale of Corporate Stock and Pass-through Entity Interests, Dividends, and Goodwill

Amended Draft CCR section 25136-2 retains the rule that assigns receipts derived from the sale of corporate stock or an ownership interest in a pass-through entity, dividends, and goodwill based on a look-through approach, whereby receipts are assigned based on the underlying entity’s California property and payroll factors, or California sales factor, depending on whether fifty percent or more of the assets of the underlying entity consists of real and/or tangible personal property, or more than fifty percent from intangible property, respectively.¹⁶ Amended Draft CCR section 25136-2 also

⁹ Amended Draft CCR section 25136-2(c)(1)(A)(1).

¹⁰ Amended Draft CCR section 25136-2(c)(1)(A)(2).

¹¹ *Id.*

¹² Amended Draft CCR section 25136-2(c)(1)(B). The FTB also added a new example that illustrates how subsection (c)(1)(B) applies in the context of commissions earned from selling marketable securities on behalf of customers. See Amended Draft CCR section 25136-2(c)(1)(F)(10).

¹³ Amended Draft CCR section 25136-2(c)(1)(B). In Prior Draft CCR section 25136-2, the FTB had used the word “approximate” under this rule. However, in Amended Draft CCR section 25136-2, the FTB changed this to “reasonably approximated.”

¹⁴ Amended Draft CCR section 25136-2(c)(1)(C). As background, existing CCR section 25136-2 allows a taxpayer to use the customer’s billing address if the location where the benefit of the service is received cannot be determined under the other preceding rules. Prior Draft CCR section 25136-2 had deleted use of billing address as an alternative method. Amended Draft CCR section 25136-2 reinstates this rule and allows use of this method if the taxpayer cannot determine the location where the benefit of the service is received under any of the preceding rules in the cascading set of rules.

¹⁵ Amended Draft CCR section 25136-2(c)(1)(E).

¹⁶ Amended Draft CCR section 25136-2(d)(1)(A)1.a-b.

retains the clarification that, in applying the fifty percent or more asset calculation, “cash, cash equivalents, prepaid items, and accounts receivable are excluded.”¹⁷

However, the FTB added new default rules that address the circumstance where the taxpayer does not have access to information to enable it to apply the above-stated rules. Specifically, if the taxpayer does not have access to information to allow it to determine if its assets are comprised more of real and tangible personal property or intangible property, the taxpayer “shall nevertheless assign gross receipts using payroll and property factor information.”¹⁸ If the taxpayer does not have access to payroll and property factor information, but has access to sales factor information, the taxpayer shall use the sales factor information to assign the gross receipts.¹⁹ Similarly, if the taxpayer does not have access to sales factor information, but has access to payroll and property factor information, the taxpayer will use the payroll and property factor information to assign the gross receipts.²⁰

Moreover, the FTB proposes a new rule that applies if the taxpayer does not have any information relating to the property, payroll, or sales factor. Specifically, if the gross receipts are dividends, such receipts shall be assigned to the state that is the commercial domicile of the dividend payor.²¹ For gross receipts from the sale of stock in a corporation, interest in a pass-through entity, or goodwill, the receipts shall be assigned to the commercial domicile of the entity whose stock, interest, or goodwill was sold.²²

Finally, in Amended Draft CCR section 25136-2, the FTB retains the definitions for the phrases “California payroll factor,” “California property factor,” and “California sales factor” which are used in applying this rule.²³

Considerations

The amendments contained in Amended Draft CCR section 25136-2 are applicable for taxable years beginning on or after January 1, 2019 which effectively applies these proposed amendments retroactively to taxable year 2019. However, these proposed amendments are not yet final, and the FTB has not indicated when they will be finalized. The changes proposed by the FTB in Amended Draft CCR section 25136-2 would, if adopted, represent a significant change to California’s market-based sourcing rules that may impact service providers, including government contractors. These proposed amendments may also impact how receipts derived from sales of corporate stock or pass-through entity interests, dividends, and goodwill are sourced to California. Taxpayers interested in these proposed amendments may want to consider attending the fifth IPM which will be held on **Tuesday, July 21, 2020.** **Written comments are due to the FTB by August 18, 2020.**

Taxpayers with sales derived from services or intangible personal property should consult with their tax advisors to evaluate how the FTB’s proposed amendments to CCR section 25136-2 may impact their business.

¹⁷ *Id.* In Prior Draft CCR section 25136-2(d)(1)(A)1.a-b, the FTB had originally used the phrase “and similar items” in place of “accounts receivable” in Amended Draft CCR section 25136-2, thereby specifically indicating and narrowing the types of assets that should be considered in the 50 percent asset test.

¹⁸ Amended Draft CCR section 25136-2(d)(1)(A)1.c.

¹⁹ Amended Draft CCR section 25136-2(d)(1)(A)1.d.

²⁰ *Id.*

²¹ Amended Draft CCR section 25136-2(d)(1)(A)1.e.

²² *Id.*

²³ Amended Draft CCR section 25136-2(d)(1)(A)1.f. The FTB also reinstated the “billing address” method as an alternative method when the location where the intangible was used cannot be determined under the presumption under subsection (d)(1)(A) or reasonably approximated under subsection (d)(1)(B) (except if the sale involves the sale of shares of stock in a corporation or an interest in a pass-through entity (other than sales of marketable securities), or from dividends, goodwill, or interest). See Amended Draft CCR section 25136-2(d)(1)(C).

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