

California FTB Proposes Additional Amendments to Market-Based Sourcing Rules

Overview

On Friday, July 19, 2019, the California Franchise Tax Board ("FTB") will hold its fourth Interested Parties Meeting ("IPM") regarding the proposed amendments to California Code of Regulations, title 18, ("CCR") Section 25136-2.¹ In anticipation of the fourth IPM, the FTB released its third 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 April 25, 2018 ("Prior Draft CCR Section 25136-2").³ Amended Draft CCR Section 25136-2 proposes numerous changes to the existing rules, some of which include:⁴

- Substantially modifies the manner in which receipts from sales of services to business and government entities are assigned, including creation of a new two-step process that requires application of modified "simplifying rules" and new "substantiation rules."
- Clarified the rules for sourcing receipts derived from the sale of corporate stock or pass-through entity interests, dividends, and goodwill.

This Tax Alert summarizes some of the more notable changes made under Amended Draft CCR Section 25136-2 and provides some taxpayer considerations.

Substantial Modifications to the Rules for Assigning Sales of Services to Businesses and Government Entities

Amended Draft CCR Section 25136-2 now proposes a new two-step process by which a taxpayer must first apply the simplifying rules, which presumes 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 rules, 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

Simplifying Rules: In Amended Draft CCR Section 25136-2, the FTB clarified how the presumptions under the simplifying rules should apply. Specifically, if the taxpayer's service relates to:⁷

- *Real property* – the benefit of the service is presumed to be received at the location of the real property.

¹ Franchise Tax Board Meeting Notice and Information, Fourth 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 Cal. Code Regs. tit. 18, § 25136-2 (July 1, 2019) (available [here](#)).

³ See Prior Draft Cal. Code Regs. tit. 18, § 25136-2 (Apr. 25, 2018) (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 May 15, 2018 (available [here](#)).

⁴ Amended Draft CCR Section 25136-2 revamped the rules for assigning receipts derived from asset management services by, among others, introducing a "value of interest" method that is used to determine the location where the benefit of the service is received. Deloitte Tax has issued a separate Multistate Tax Alert, dated July 15, 2019, which focuses specifically on those rules (available [here](#)).

⁵ The FTB first proposed the simplifying rules in Prior Draft CCR Section 25136-2. Prior Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(A).

⁶ Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(B). The FTB has also clarified various examples that illustrate how these rules should apply as well as deleted some examples. Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(D). Through Prior Draft CCR Section 25136-2 and Amended Draft CCR Section 25136-2, the FTB has also deleted the cascading rules under existing CCR Section 25136-2 (e.g., the methods allowing for use of a reasonable approximation, location where the order was placed, and billing address). Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A-D).

⁷ Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)1. Although Prior Draft CCR Section 25136-2(c)(2)(A)5 provided an additional presumption which applied where the service relates to a business, Amended Draft CCR Section 25136-2 deletes this presumption. *Id.*

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- *Tangible personal property* – the benefit of the service is presumed to be received where the tangible personal property is located 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.
- *Intangible property* – the benefit of the service is presumed to be received at the location the intangible property is used by the customer.
- *Individuals* – the benefit of the service is presumed to be received where individuals are physically present at the time the service is received.⁸

Amended Draft CCR Section 25136-2 retains the rule that the taxpayer or the FTB may overcome the presumptions in the simplified rules by showing, based on a preponderance of the evidence, the benefit of the service is received at a location other than the location stated under the presumption.⁹ However, the FTB has expanded this rule by requiring that “[t]he party attempting to the overcome a presumption shall use the taxpayer’s contracts or books and records kept in the normal course of business to provide evidence to overcome the presumption.”¹⁰ If those sources are unavailable or do not provide sufficient detail to overcome the presumption, then “all sources of information to the extent such information is reasonably available to the taxpayer” may be used to overcome the presumption.¹¹

Amended Draft CCR Section 25136-2 also provides a new alternative rule that applies when a presumption does not apply either because the service does not relate to real property, tangible personal property, intangible property, or individuals, or if the presumption was overcome.¹² This alternative rule requires that a taxpayer or the FTB use the taxpayer’s contracts or books and records kept in the normal course of business to identify the location where the benefit of the service is received.¹³ If those sources are unavailable or do not provide sufficient detail to identify the location where the benefit of the service is received, then “all sources of information to the extent such information is reasonably available to the taxpayer may be used to identify the location where the benefit of the service is received.”¹⁴

Substantiation Rules: Once the method for identifying where the benefit of the service is received has been determined under the simplifying rules, the extent to which the benefit of the service is received in California shall be substantiated based on the following rules:

- (1) “[t]he taxpayer shall use its contracts or books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer’s customer, to substantiate the precise location of where the benefit of the service is received. If the taxpayer’s contracts or books and records are not available, or the taxpayer’s contracts or books and records do not provide sufficient detail to substantiate the precise location of where the benefit of the service is received, then all sources of information to the extent such information is reasonably available to the taxpayer may be used to substantiate the precise location of where the benefit of the service is received.”¹⁵
- (2) “[i]f all sources of information reasonably available to the taxpayer cannot be used to substantiate the precise location where the benefit is received, all available information may be used to approximate the location where the benefit is received.”¹⁶

Government Contractors Only: For services provided under U.S. government contracts only, Amended Draft CCR Section 25136-2 still allows sourcing based on U.S. population if the receipts cannot be assigned under the simplifying and substantiation rules discussed above, such as “when a contract cannot be disclosed and no information about the

⁸ Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)1.

⁹ Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)3. Amended Draft CCR Section 25136-2 also retains the rule that provides that, if the taxpayer receives one fee for a service that relates to more than one of the above, the presumption that applies is based on the one to which the service predominantly relates. Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)2. Amended Draft CCR Section 25136-2(e) provides another rule that states that, when the sale is from the provision of a service, and tangible or intangible property, or from the provision of tangible and intangible property, and the value of each portion of the sale is readily ascertainable, then each portion shall be separately assigned using such values. Amended Draft Cal. Code Regs., tit. 18, § 25136-2(e)(1). If the value of each portion is not readily ascertainable, then the principal purpose for entering the contract will determine how to assign the revenue. Amended Draft Cal. Code Regs., tit. 18, § 25136-2(e)(2). For purposes of this rule, the value of gross receipts attributable to tangible personal property includes all of the charges enumerated in CCR Section 25134(a)(1)(A). Amended Draft Cal. Code Regs., tit. 18, § 25136-2(e)(3).

¹⁰ *Id.*

¹¹ *Id.*

¹² Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(A)4.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ Amended Draft Cal. Code Regs., tit. 18, § 25136-2(c)(2)(B)1.

¹⁶ Amended Draft Cal. Code Regs. tit. 18, § 25136-2(c)(2)(B)2.

service is publicly available.”¹⁷ Under those circumstances, “the benefit of the service is deemed received by the fifty (50) states of the United States. The receipt shall be assigned to this state based on the ratio of California population over U.S. population.”¹⁸

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 (50) percent or more of the assets of the underlying entity consists of real and/or tangible personal property, or intangible property.¹⁹ However, Amended Draft CCR Section 25136-2 clarifies that, in applying the fifty (50) percent or more asset calculation, “cash, cash equivalents, prepaid items, and similar items are excluded.”²⁰ Moreover, in Amended Draft CCR Section 25136-2, the FTB also defines the phrases “California payroll factor,” “California property factor,” and “California sales factor” which are used in applying this rule.²¹ Notably, Amended Draft CCR Section 25136-2 retains, but clarifies, the alternative rule that was added in Prior Draft CCR Section 25136-2 that assigns the above-listed receipts to the underlying entity’s commercial domicile if the taxpayer does not have access to the information to enable it to assign receipts under the look-through approach discussed above.²²

Considerations

The FTB has not stated an effective date for the proposed amendments under Amended Draft CCR Section 25136-2. It has also not indicated when the proposed amendments will be finalized. However, 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 fourth IPM which will be held on **Friday, July 19, 2019. Written comments are due to the FTB by August 19, 2019.**

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 business.

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¹⁷ Amended Draft Cal. Code. Regs. tit. 18, § 25136-2(c)(2)(C).

¹⁸ *Id.*

¹⁹ Amended Draft Cal. Code. Regs. tit. 18, § 25136-2(d)(1)(A)1.a-b.

²⁰ *Id.*

²¹ Amended Draft Cal. Code. Regs. tit. 18, § 25136-2(d)(1)(A)1.d.

²² Amended Draft Cal. Code. Regs. tit. 18, § 25136-2(d)(1)(A)1.c.

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