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## *California Franchise Tax Board proposes amendments to market-based sourcing regulations, holds public hearing*

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The California Franchise Tax Board (FTB) has proposed amendments to California Code of Regulations section 25136(b), regarding sales of other than tangible personal property, which would set rules for determining assignment of sales for purposes of single sales factor apportionment. A hearing on the proposed regulations was held on August 10, 2011. [[Proposed Cal. Code of Reg. Section 25136\(b\)](#); [Click here](#) for the hearing notice]

### *Background*

Effective for tax years beginning on or after January 1, 2011, taxpayers may elect to apportion their income to California using a single sales factor formula. If a taxpayer makes this election, sales of other than tangible personal property are assigned to California based upon the location where the benefit of the services was received or the location of the use of the intangibles.

### *Benefits of services received by individuals*

In general, the proposed regulation would provide a cascading approach to determining where the benefit is received. If the person receiving the benefit is an



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individual, the benefit is presumed received at the billing address of the customer. This presumption may be overcome by the taxpayer showing by a preponderance of the evidence that either the contract between the taxpayer and its customer, or other books and records kept by the taxpayer in its normal course of business, provide the extent to which the service is performed at a location within California. If the taxpayer believes it has overcome the presumption and uses this alternative sourcing method, the FTB may determine whether the alternative method reasonably reflects where the benefit of the service was received.

However, if the taxpayer overcomes the billing address presumption but no alternative sourcing method can be derived from reference to the books and records or the contract, the location where the benefit of the services is received by the customer must be reasonably approximated.

### *Benefits of services received by business entities*

If the customer receiving the benefit is a business entity, the benefit of the service is presumed to be received at the location indicated by the contract between the taxpayer and the customer or by the books and records of the taxpayer or the customer, notwithstanding the billing address of the customer. However, this presumption may be rebutted by showing by a preponderance of the evidence that the location indicated by the contract or the books and records was not the actual location where the benefit was received. In this case, the location of where the benefit was received must be reasonably approximated.

If the location of where the benefit is received cannot be reasonably approximated, then the location is presumed to be the location from which the customer placed the order for the service. Otherwise, the benefit of the service shall be in California if the customer's billing address is in the state.

### *All property rights to intangible are transferred*

The proposed regulations also provide a cascading approach to determining where sales from intangible property are assigned. If all property rights to the intangible are transferred, the intangible is presumed to be used at the location indicated in the contract between the taxpayer and the purchaser or the books and records kept by the taxpayer in its normal course of business. However, this presumption may be overcome by showing that the purchaser's use of the intangible at the time of purchase is inconsistent with the terms of the contract or other books and records.

If the location of use of the intangible cannot be determined by the contract, or the presumption is overcome, the location of where the intangible property is used must be reasonably approximated by reference to the activities of the purchaser. Otherwise, the location of the use of the intangible will be assigned to the billing address of the purchaser.

### *Marketing intangibles*

A "marketing intangible" is an intangible used in connection with the marketing of goods, services or other items to customers in California, such as a trademark. If the intangible is licensed, leased, rented, or otherwise used, and is a marketing intangible, the royalties or other licensing fees are attributable to the location of the

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retail customer who purchased the goods or services marketed in connection with the intangible property, first determined by the contract. If insufficient information exists to assign sales pursuant to retail customer location, a reasonable approximation may be made by the taxpayer, including the use of a population proxy in limited circumstances. If the sale of the purchased good or service is at the wholesale level rather than directly to retail customers, the taxpayer may use the percentage of California's population to the total population of the geographic area in which the licensee markets its goods.

### *Non-marketing and manufacturing intangibles*

A "non-marketing" or "manufacturing" intangible is an intangible used in a manufacturing process or for another non-marketing purpose, such as a patent. If the license is granted for the use of intangible property other than in connection with the sale, lease or license of goods services or other items, receipts are assigned to the location where the intangible property is used (e.g., the manufacturing plant) determined first by the contract or records. If insufficient information exists to assign to the location of use, a reasonable approximation to the activities of the taxpayer's customer may be made. Otherwise, the location of use will be assigned to the licensee's billing address.

### *Mixed intangibles*

Where the intangible is "mixed," i.e., a license is granted for the right to use for a marketing and for a non-marketing and manufacturing purpose, if the fees are separately stated then they shall be assigned based upon that separate statement. If a separate statement is not reasonable, then the FTB may assign the fees using a reasonable method that accurately reflects the marketing and non-marketing intangible.

### *Note*

If a taxpayer uses a reasonable approximation to determine the location of the market for the benefit of a service or the location of the use of intangible property, then the taxpayer must continue to use that same method in subsequent tax years. A change in method cannot be made without specific FTB permission.

### *Other sourcing rules*

The proposed regulation also provides additional sourcing rules, including for real and personal property to the extent such property is located within California.

### *PwC observes*

"Based upon comments provided at and leading up to the hearing held on August 10, 2011, the FTB is planning to release a revised draft of the proposed regulation," notes Ligia Machado, Managing Director with PwC in Sacramento, CA. "I'm expecting quite a few changes in that draft, including an example for every sourcing rule. When the new draft is issued, the FTB plans to provide only a 15-day comment period. That means that it will be critical for people to review the draft right away to see whether there is anything that they need to address before the regulation is promulgated. Final approval from the 3-member Franchise Tax Board is anticipated at their December meeting. That means that there will not be much time for give and take

with the FTB - taxpayers should expect that when the next draft comes out, it may be the last opportunity to try to get changes made to the regulation," warns Machado.

"Once the draft regulation is approved by the three-member FTB, it will go to the Office of Administrative Law. OAL has 30 working days to finalize, and once finalized the regulation will be effective retroactive to January 1, 2011," adds Elaine Segarra Warneke, PwC Director in Sacramento, CA.

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