

California – Proposed amendments to market sourcing rules

October 25, 2013

In brief

On October 18, 2013, the Franchise Tax Board (FTB) held an Interested Parties Meeting (IPM) to discuss potential amendments to California Code of Regulations (CCR) Section 25136-2, which provides guidance for the market sourcing of sales of other than tangible personal property.

Substantive proposed changes to CCR Section 25136-2 include clarifying the definition and market sourcing rules for 'marketable securities'; determining the sourcing for sales of interests in start-up corporations and pass-through entities; providing additional examples for asset management companies; and including market sourcing rules for dividends, interest, and goodwill.

California taxpayers that may be affected by the proposals include taxpayers that are asset managers and those taxpayers with: (1) moderate to large amounts of securities transactions, whether traded on an exchange or over-the-counter; (2) significant dividend or interest income; or (3) substantial sales of minority ownership interests in start-up companies or pass-through entities.

The FTB is receptive to public input on these issues. Interested and affected taxpayers should consider getting involved and providing input in the regulatory process.

In detail

The FTB released draft amendments to the market sourcing rules in CCR Section 25136-2 and held an IPM on October 18 to discuss the amendments. The key changes that the FTB is proposing to CCR Section 25136-2 include the following.

Marketable securities

California Revenue and Taxation Code Section 25136 provides that sales of marketable securities are in this state if the customer is in this state, but the existing regulation

did not define a marketable security and did not address how to determine the location of the customer. The proposed amendments provide a definition of marketable securities. Additionally, if the customer is an individual, the sale shall be assigned to the customer's billing address. If the customer is a business entity, the sale is assigned to the customer's commercial domicile.

Observations:

- Marketable securities include all securities traded on an

exchange, and exclude securities not traded on an exchange, i.e., over-the-counter transactions.

- Revenue from sales of securities that do not fall within this narrow definition of marketable securities will be subject to the general sourcing rules for sales of intangibles and assigned to the location where the property is used. There is still no guidance as to how this general rule will apply to

many types of financial instruments.

- Commentators asked if the FTB will address the treatment of derivatives and mortgage-backed securities. The FTB is open to input and commentary in this area.

Asset management fees

Existing CCR Section 25137-14 provides shareholder-based sourcing rules for assigning fees from asset management services, but those rules only apply to taxpayers that provide services to a regulated investment company. The proposed amendments to CCR Section 25136-2 add two examples that essentially extend similar sourcing rules to asset management fees that do not fall within current CCR Section 25137-14.

Under the new examples, an asset manager provides services to pension plans, retirement accounts, and other investment accounts. However, the example states that the services are provided ‘on behalf of’ the shareholders, beneficial owners, and investors. Revenue from such services are assigned to the domicile of the shareholders, beneficial owners, and investors because they are the parties deemed to be receiving the benefit of the services. If the taxpayer cannot reasonably approximate the domicile of those parties, the language of the example currently states that the receipts are thrown out of the sales factor and disregarded. The FTB indicated that language is misstated and will be revised to state that receipts that cannot be reasonably approximated will be disregarded in arriving at the shareholder ratios used to assign such sales, but will not be thrown out of the sales factor altogether.

Sale of corporate or pass-through entities (including start-up entities)

Under the existing regulation, receipts from the sale of an interest in an entity are assigned to the location where the entity operated, measured by either its sales factor, or by its average property and payroll factors. The proposed amendments provide rules for reasonably approximating that location in situations where the taxpayer does not have access to the entity’s property, payroll, or sales data.

Group comments discussed the difficulties in valuing intangible property (IP). Use of cost basis to value IP could present problems when companies develop IP internally as it tends to have a high market value, but a low or zero cost basis.

Observation:

- An entity’s sales factor may be ‘reasonably approximated’ by using a ratio of the taxpayer’s ownership interest. In other words, if the taxpayer owned 20% of the entity, then the entity’s sales factor is approximated to be 20%. Receipts from the sale of the taxpayer’s ownership interest in the entity would then be assigned 20% to California. It’s not clear why this is presumed to be a reasonable approximation. The FTB acknowledged that this is not a strong model for a reasonable approximation and asked for suggestions.

Interest, dividends and goodwill

The proposed amendments state that gross receipts attributable to interest, dividends, and goodwill are sourced in the same manner as sales of an interest in a corporation or pass-through entity. There is no further explanation.

Observations:

- Dividends. Presumably, dividend income will be sourced to the location where the corporation operates, as measured by its sales factor or average property/payroll factors, or as reasonably approximated. If the taxpayer does not have the data for a reasonable approximation, it appears that the default will be the taxpayer’s commercial domicile.
- Interest. The FTB agreed that the rules for sourcing sales of entities are not a good fit for interest. The FTB intends to re-draft the interest sourcing rules to mirror the bank and financial treatment in CCR Section 25137-4.2.
- It appears that these rules may not apply to dividends or interest attributable to marketable securities. Nor do the rules for assigning sales of marketable securities appear to encompass dividends or interest attributable to such securities since there is no apparent ‘customer.’ This issue was not discussed during the IPM.
- Receipts from the sale of goodwill appear to be sourced in the same manner as if an interest in a corporation or pass-through entity was sold. Taxpayers considering a Section 338 election in California will have to consider the impact this may have on the apportionment and sourcing of any deemed gain on the deemed sale of assets.

The takeaway

California taxpayers interested in the sourcing of these receipts or engaged in significant securities transactions should pay special attention to the FTB’s proposed amendments to CCR

Section 25136-2 as well as the insight presented by the commentators on these issues. The FTB is working with industry to draft more appropriate rules for these transactions.

This regulatory project is in initial stages. The FTB is receptive to public input on these issues. As such, interested and affected taxpayers should consider getting involved and providing input in the regulatory process.

Let's talk

If you have any questions or would like to provide any input in this regulatory process please contact one of the following individuals:

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