

ORANGE COUNTY BUSINESS JOURNAL

RUTAN

RUTAN & TUCKER, LLP

Changes to California Tax Apportionment Regulations on the Sale of Services and Intangible Property for Multi-State Taxpayers

by Rachel A. Simon, Partner, Rutan & Tucker LLP

The Franchise Tax Board (“FTB”) recently adopted amendments to Regulation Section 25136-2 concerning the calculation of the California sales factor for sales of certain intangible property. The amendments which set forth “market-based” sourcing rules become effective as of January 1, 2017. The amendments are intended to provide additional clarity on the manner in which sales of marketable securities, and intangible property, such as dividends, goodwill, and interest, should be assigned to California for purposes of the California sales factor for apportioning income to California.

Taxpayers are required to source receipts from sales of marketable securities and intangible property using market-based sourcing rules. Intangible property is generally sourced based on where the intangible is used, and marketable securities are sourced based on the location of the customer. However, the current language of the regulations under Section 25136-2 fails to define certain key terms and fails to address the manner in which the location of the customer is determined. The new amendments to Regulation 25136-2 intend to make the rules less murky for taxpayers by including definitions for marketable securities for dealers and non-dealers, and providing assignment rules for marketable securities, interest, dividends, and goodwill.

With respect to the assignment of sales of intangible property, such as ownership interests in business entities (which are not marketable securities), dividends, or good will, the amendments to Regulation 25136-2 provide that if at least half of the assets of the selling entity (or paying entity, as the case may be) consist of real or tangible personal property, the receipts will be assigned by averaging such entity’s payroll and property factors in California for the most recent twelve (12) month taxable year preceding such sale. If the sale occurs more than six (6) months into the current taxable year, then the average of the current year property and payroll factors will be used. However, if at least half of

the assets consist of intangible property, then only the sales factor should be used. Special rules provide for start-up entities that do not have significant operating history.

The amendments to Regulation 25136-2 also provide special rules for the assignment of interest. The rules vary depending on which of three categories the interest falls into. Interest from investments (other than loans) will be assigned to California if the investment is managed in California. Alternatively, interest from loans will be assigned to California if the loan is secured by California real property. Thirdly, interest from loans will be assigned to California if the loan is not secured by real property, but the borrower is located in California.

Regulation 25136-2(b)(5) defines “marketable securities” as “any security that is actively traded in an established stock or securities market and is regularly quoted by brokers or

Rachel A. Simon

Rachel A. Simon is a partner in the firm’s Corporate, Securities and Tax Section, where she provides legal counsel and representation to corporate and business clients, as well as to individuals, in a broad range of legal and tax matters. Ms. Simon handles complex commercial business transactions, strategic tax planning and controversies, corporate law, including mergers and acquisitions, real estate law and numerous other areas pertaining to finance. Ms. Simon provides personalized, sophisticated legal counsel to her clients. Her primary focus is the protection of her clients’ business and personal interests. Ms. Simon can be reached at 714.641.3476 or rsimon@rutan.com.



ORANGE COUNTY BUSINESS JOURNAL

dealers in making a market”, but excludes “securities that are traded in transactions specifically excluded from gross receipts under Revenue and Taxation Code Section 25120”. However, for securities and commodities dealers, a different definition of “marketable securities” is provided, which states, “‘marketable securities’ means any security that is defined in Internal Revenue Code Sections 475(c)(2) or 475(e)(2)(B), (C), or (D), and any contract to which Internal Revenue Code Section 1256(a) applies, which has not been excepted under Internal Revenue Code Section 475(b),” including any interest and dividends associated with such marketable securities. Revenue from sales that do not fall within the definitions provided will be subject to the general sourcing rules for sales of intangibles. Since little guidance is available on the application of such rules to sales that fall outside the narrow definition of “marketable securities”, continuing ambiguities may undermine the FTB’s intention of reducing disputes between taxpayers and the FTB over the application of the assignment rules to these transactions.

With respect to the assignment of sales that fall within the definition of “marketable securities”, the amendments to Regulation 25136-2 provide that if a customer is an individual, then the sale should be sourced to California if the customer’s billing address is in California; whereas, if the customer is a business entity, then the sale should be sourced to California if such entity’s domicile is in California at the end of the taxable year, regardless of the billing address. The amendments create a rebuttable presumption that a customer’s domicile is determined based on customer information contained in the taxpayer’s books and records; however, the taxpayer may rebut this presumption with other documentary evidence.

If the assignment of receipts cannot be determined by the rules summarized above, the taxpayer must use reasonable approximation. For purposes of Regulation 25136-2 “reasonably approximated” means that, considering all sources of information, “the location of the market for the

benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer.” The process for reasonable approximation is not precise, and accordingly, disagreements between taxpayers and the FTB may develop on this issue.

Although the amendments made to Regulation 25136-2 are intended to provide clarity on the manner in which receipts from marketable securities or intangible property should be assigned, it is evident that there continue to remain material ambiguities in the language of the regulation, which may potentially lead to conflicts and disputes between taxpayers and the FTB.

Additionally, while the FTB estimates that the economic impact of the changes will be minimal, it is anticipated that multi-state taxpayers will experience an increase in taxes as a result of the amendments to Regulation 25136-2, while in-state taxpayers may see a reduction. It should be noted that taxpayers may face additional burdens because, although the amended regulation is effective January 1, 2017, the amendments may have certain retroactive implications, since they would be applicable to taxable years beginning on or after January 1, 2015. As such, taxpayers are required to comply with these new rules for such prior tax periods.¹ The FTB has preliminarily indicated that it will abate penalties for taxpayers who underpaid because of the application of the final regulations; however, the FTB has not yet provided details regarding these abatement procedures, creating additional uncertainties and concerns for taxpayers. Taxpayers who are impacted by these changes should consult with tax and legal professionals in order to obtain advice on the proper implementation of these changes.

¹ Taxpayers may elect to have the amendments apply retroactively to periods beginning on or after January 1, 2012, if the statute of limitations remains open on such years.