



TaxNewsFlash

United States



No. 2019-385
July 26, 2019

California: Proposals considered, addressing changes to market-based sourcing rules

The California Franchise Tax Board (FTB) in July 2019 held its fourth “interested parties meeting” to discuss proposed amendments to the market-based sourcing provisions under California Code of Regulations, title 18, (CCR) section 25136-2. Only amendments proposed by the FTB since the third interested parties meeting (May 2018) were discussed.

The currently proposed changes to CCR section 25136-2 include, but are not limited to:

- Introducing a new term and definition of “beneficial owner”
- Modifying the definition of “reasonably approximated”
- Modifying the assignment rules for sales of services provided to a business entity or government entity customers, asset management gross receipts, and receipts from the sale of intangible property, and “mixed sales” (i.e., sales of services and property or sales of different types of property)

Two FTB representatives conducted the meeting, and the FTB will continue to solicit public comments on the proposed changes until August 19, 2019.

KPMG observation

The proposed regulations do not specify an application date, and it is unclear whether the FTB will allow taxpayers to elect to apply the rules retroactively.

Definition of beneficial owner

Under the current version of the proposed regulation, “beneficial owner” is defined as “any person who made an independent decision to invest assets.” For purposes of this definition, “independent decision to invest assets” means a decision to invest assets made by a person who was not required or committed to do so by contract, agreement, or any other arrangement, understanding, or relationship, except pursuant to law. Excluded from the definition of “beneficial owner” are: (1) master

funds, feeder funds, and similar entities that pool investors' assets; (2) a shareholder of a publicly traded corporation whose board decides to invest excess capital into an investment vehicle; and (3) a participant of a defined benefit plan.

Public comments during the interested parties meeting

- There was a suggestion that master feeder funds be excluded.
- Some confusion appeared to exist relating to the use of the terms “purchaser,” “customer” and “beneficial owner.”
- It was suggested that examples of a fund holding title for a beneficial owner be added.

Language added regarding documentation substantiating foreign sales under “reasonable approximation”

The proposed language provides that a taxpayer may not use jurisdiction or geographic area population as a method of reasonably approximating sales in those geographic areas, unless the taxpayer provides substantiation that it had sales in those specific geographic areas. If the taxpayer does not provide that substantiation, then the taxpayer is limited to using U.S. population as its reasonable approximation method.

Public comments during the interested parties meeting

- There were concerns that this would result in sourcing a disproportionate amount of income to California by virtue of excluding foreign sales.
- It became clear that, based on the discussion, “reasonable approximation” is still available for these sales. Accordingly, to the extent that a taxpayer has sufficient data to support its foreign sales, it appears that the FTB would accept reasonable approximation.

Simplifying rules for assigning receipts from services provided to business and government entities would incorporate existing “cascading” rules and “reasonable approximation” for government contracts

The proposed simplifying rules incorporate the existing cascading rules for assigning sales to business or government entities. The cascading rules guide taxpayers and the FTB to use the best evidence when assigning sales pursuant to the simplifying rules.

The presumed benefit of the service will be based on the type of service performed.

- Services related to real property will be received at the location of the real property.
- Services related to tangible personal property will be presumed to be received where the tangible personal property is located when the service is received.
- Concerning tangible personal property delivered directly or indirectly to a 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.
- Concerning services related to intangible property, the benefit of the service is presumed to be received at the location the intangible property is used by the customer. However, if the taxpayer’s

service relates to individuals, then the benefit of the service is presumed to be received where the individuals are physically present at the time the service is received.

The proposed amendments would delete provisions related to the “location of order” and customer’s billing address as separate rules for assignment of service receipts from a business or government entity. The proposed amendments would also delete the term “reasonably approximated” from the rules for assignment of service receipts from business and government entities.

Additional language has been proposed to provide that, if the taxpayer's services are provided under a U.S. government contract, and the location where the benefit of the service was received cannot be determined by contract or books and records, or if the contract cannot be disclosed, and the location cannot be reasonably approximated by any other method, the taxpayer may “reasonably approximate” the location by using the ratio of California over U.S. population. The rationale for this proposed addition is that U.S. government services are predominantly intended to benefit the interests of U.S. citizens.

Public comments during the interested parties meeting

- It was requested that the FTB clarify how receipts are sourced in instances when the taxpayer provides services for a “customer’s” customer.
- It was observed that more guidance and examples are needed to determine the location of services “related to individuals.”

Assignment of “mixed” sales (services, property or different types of property)

Proposed language would assign “mixed” sales to the extent that the value of each portion of the sale is readily ascertainable. If the value of each portion of a sale can be determined, each portion of the sale will be separately assigned using such values. If the value is not ascertainable, the principal purpose for entering the contract will determine assignment of the receipt.

Assignment of management receipts related to asset management services

Proposed language would assign receipts from asset management services in proportion to the “average value of interest” in the asset(s) held by the asset's investors or beneficial owners domiciled in the state. In cases when the taxpayer does not know the “average value of interest” in the asset(s) held by the asset's investors or beneficial owners domiciled in the state, the receipts will be assigned to the extent the “average value of interest” in the asset(s) held by the asset's investors or beneficial owners domiciled in the state is approximated to be in the state.

Public comments during the interested parties meeting

- There was a request to clarify the definition of “beneficial owner.”
- There was a request to provide an example of investor holding title to the asset(s) for a beneficial owner.

Assignment of dividends, goodwill, and sales of intangibles (including corporate stock or interest in a pass-through entity)

Proposed amendments would clarify that in the case of a complete transfer of all property rights in intangible property, it is the purchaser’s use of the intangible after the sale that determines the assignment of sales receipts. However, in the case of dividends or the sale of goodwill, corporate stock or interest in a pass-through entity, the receipts are assigned based on the assets and related factors of the underlying entity.

Proposed language would also provide for an assignment of gross receipts related to intangibles if the taxpayer does not have access to information to enable it to assign gross receipts. The amendments would provide that gross receipts that are dividends will be assigned to California if the dividend payor's commercial domicile is in California, and receipts from the sale of shares of stock in a corporation, interest in a pass-through entity, or goodwill will be assigned to California if the entity whose stock, interest, or goodwill was sold has its commercial domicile in the state.

Mileage ratio methodology eliminated for freight forwarders

Proposed language would eliminate the mileage ratio for the freight forwarder industry and would, instead, assign such receipts to where the tangible personal property is delivered.

Sourcing methodology disclosure

The FTB intimated that it will require taxpayers to establish a sourcing "method" and provide disclosure on the return in situations when the taxpayer deviates from its established method. The format of the disclosure is unclear. Suggestions were offered—ranging from a simple disclosure on the return to a description on the Schedule R.

What's next?

The FTB has given consideration to comments from the business community, tax practitioners, and taxpayers, and it has been observed that many of the current rules are a result of such feedback.

For a more information, contact a tax professional with KPMG's State and Local Tax practice in Sacramento:

Gina Rodriquez | +1 (916) 551-3132 | grodriguez@kpmg.com

Oksana Jaffe | +1 (916) 554-1119 | ojaffe@kpmg.com

Eric Drew | +1 (916) 448-4700 | ericdrew@kpmg.com

The information contained in TaxNewsFlash is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230, as the content of this document is issued for general informational purposes only, is intended to enhance the reader's knowledge on the matters addressed therein, and is not intended to be applied to any specific reader's particular set of facts. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

Direct comments, including requests for subscriptions, to [Washington National Tax](#). For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.

To unsubscribe from TaxNewsFlash-United States, reply to [Washington National Tax](#).

[Privacy](#) | [Legal](#)

