Explanation of Discussion Draft for Proposed Amendments to
Regulation Section 25136-2

For taxable years beginning on or after January 1, 2011, Revenue and Taxation Code (RTC) section 25136 provides the rules of assignment of sales of other than personal property for taxpayers that file a combined report and elected to apportion their income pursuant to a single sales factor apportionment formula. As enacted by Section 8 of Proposition 39, approved by the voters at the November 6, 2012 general election, application of this section became mandatory for most taxpayers that file a combined report for taxable years beginning on or after January 1, 2013.

RTC Section 25136(a)(2) provides that receipts from marketable securities are to be assigned to this state if the customer is in this state. However, there is no definition for "marketable securities" and no guidance for determining the location of a customer in this state. The discussion draft provided with this Explanation proposes a definition for "marketable securities" and guidance for determining the location of a customer in this state.

California Code of Regulations (CCR), title 18, Section 25136-2, effective March 27, 2012, and operative for taxable years beginning on or after January 1, 2011, provides a series of cascading rules for assigning sales of services and sales of intangible property. Under those rules, there are specific provisions for assignment of sales of stock in a corporation or interest in a pass-through entity and for the incorporation of the special industry rules under CCR Section 25137, including those for mutual fund providers under CCR Section 25137-14. Currently, there are no provisions for assignment of dividends, interest or goodwill under CCR section 25136-2. In the discussion draft provided with this Explanation, examples for those taxpayers who are asset managers but who do not come under the provisions of CCR Section 25137-14 are proposed. The discussion draft also proposes a method for reasonable approximation for assigning a sale of an interest in a corporation or pass-through entity where the taxpayer does not have access to the factor information of the corporation or pass-through entity whose stock or interest was sold such as where the taxpayer has a minority interest in a corporation or pass-through entity or has an interest in a startup corporation or startup pass-through entity. A definition of a startup entity is provided in the discussion draft. In addition, the discussion draft provides that dividends, interest, and goodwill are subject to the sale of stock rules.

As stated above, a discussion draft is provided with this Explanation. The draft attempts to take into account the comments and concerns of various interested parties raised during and subsequent to the Interested Parties Meeting held in March 2012. However, decisions had to be made that resulted in not all the parties' recommendations being adopted. The key revisions are set forth with explanations below.

1. In General Section.

Clarification has been made that RTC "[Section] 25136(a)" refers to "former" Section 25136(a) "as applicable for taxable years beginning on or after January 1, 2011 and before January 1, 2013." There has been some confusion about which version of RTC Section

25136(a) the regulation addresses because the statute was amended subsequent to the drafting of the regulation. CCR Section 25136-2(a).

2. General Definition Section.

A definition for the term "marketable securities" as is used in California Revenue and Taxation Code Section 25136(a)(2) has been provided. It states that "marketable securities" are securities that are "actively traded" in an established securities market. "Established securities market" is defined as one registered under the Securities Act or a foreign exchange that is similar to one registered under the Securities Act. This language is based on definitions of "marketable securities" of the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Internal Revenue Code, Treasury Regulations, Hawaii, Idaho and Utah. CCR Section 25136-2(b)(5).

A definition for the term "startup corporation or startup pass-through entity" has been provided. A corporation or pass-through entity is a startup entity when it 1) has no more than five million dollars ($5,000,000) in annual gross receipts, 2) has been actively engaged in a trade or business for no longer than five (5) years, and 3) is not publicly traded on a registered stock exchange. This proposed language is designed to begin a discussion of the characteristics of a startup corporation or startup pass-through entity, which discussion will ultimately lead to the final definition of a "startup corporation or startup pass-through entity." CCR Section 25136-2(b)(8).

2. Benefit of the Service Section.

Two examples have been added to show how to assign asset management fees earned from providing administration, distribution, and management services for pension plans, retirement accounts, or other investment accounts on behalf of shareholders, beneficial owners or investors of the pension plan, retirement account or other investment account, which fees are not subject to assignment under CCR Section 25137-14. For purposes of maintaining consistency between similarly situated taxpayers, these examples follow the assignment rules of CCR Section 25137-14 including the provisions for determining 1) the domicile of the shareholders, beneficial owners, or investors, and 2) assignment of the receipts based on the ratio of shareholders, beneficial owners, or investors in this state over the shareholders, beneficial owners, or investors everywhere. The examples provide that if the domicile of the shareholders, beneficial owners, or investors cannot be determined, the domicile may be reasonably approximated, but if the domicile cannot be reasonably approximated then those receipts will be disregarded. CCR Section 25136-2(c)(1)(C)5. and 6.

3. Use of Intangible Property Section.

The only changes to this section are to the sale of intangible property section where there has been a complete transfer of all property rights.

Language has been added to provide that where gross receipts from intangible property are dividends, interest or goodwill, the sale of stock rules apply. This is consistent with *Mobil Oil Corp. v. Commissioner of Taxes of Vt.* (1980) 445 U.S. 425. CCR Section 25136-2(d)(1)(A)1.

A minor change is made to (d)(1)(A)1.b. to add "kept in the normal course of business" to "taxpayer's books and records." This is consistent with similar language throughout the regulation. CCR Section 25136-2(d)(1)(A)1.b.

Cascading rules were added to provide a method of reasonable approximation in the event a taxpayer does not have access to data enabling it to determine the necessary factor information for assignment of either the sale of a minority interest of a corporation or pass-through entity or sale of an interest in a startup corporation or startup pass-through entity. These rules attempt to provide a fair and practical method of reasonably approximating the standard rules for the sale of stock or interest in a pass-through entity for these two specific situations. CCR Section 25136-2(d)(1)(A)1.c. and d.

4. Assignment of Marketable Securities Section [New].

A section was added to address how to determine "if the customer is in this state" for purposes of assigning the sale of marketable securities. If the customer is an individual, then the sale is assigned to this state if the customer's billing address is in this state. If the customer is a corporation or other business entity, then the sale is assigned to this state if the customer's commercial domicile is in this state. If the billing address or commercial domicile cannot be determined, then each one may be reasonably approximated. There are no examples set forth in the draft language. Possible examples, particularly for reasonable approximation methods, will be explored at the upcoming Interested Parties Meeting. CCR Section 25135-2(e).