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California: Proposed amendments, FTB's revised market-sourcing regulation for asset managers

The California Franchise Tax Board (FTB) will hold its second "interested parties meeting" tomorrow, June 16, 2017, to discuss the second round of proposed amendments to CCR 25136-2—the regulation that addresses "sourcing for sales other than sales of tangible personal property."

Read the [proposed amendments](#) [PDF 182 KB] to CCR 25136-2

Background

The FTB—in a lengthy process—already amended the original regulation once and on January 1, 2017, the revised CCR 25136-2 became effective applicable for tax years beginning on or after January 1, 2015.

However, there were certain issues left unresolved in revised CCR 25136-2, and the FTB announced the second round of amendments shortly after the regulation was finalized. Details on the recently released draft amendments are provided below.

Management fees for asset managers

The draft amendments to CCR 25136-2 include examples providing that asset managers generally are to source management fees to the location of the ultimate investors in the funds they advise, based on the relative value of those investors' investments in the funds.

Examples addressing such fees were pulled from the first revised regulation before it was finalized, and this resulted in much confusion for affected taxpayers.

The example in the recently released draft amendments involves an asset manager corporation that provides administration, distribution, and management services by

contracting with third-party entities to provide these services on behalf of shareholders, beneficial owners or investors in pension plans, retirement accounts or other investment accounts. The example provides that because the benefit of the service provided is received by the shareholders, beneficial owners or investors, the sale of these services is assigned to the location of the shareholders, beneficial owners or investors in a fund. The example clarifies that management fees are sourced, based on the relative value of each investor's interest as opposed to the number of investors in the fund.

A second example addressing the same facts clarifies that if the asset manager cannot determine the location of the ultimate investors through its books and records kept in the normal course of business, the asset manager is to source its fees using a method of reasonable approximation based on "zip codes or other statistical data."

Reasonable approximation "special rules"

The current version of CCR 25136-2 provides "special rules" that must be used when reasonably approximating service receipts and receipts from intangibles. The draft amendments extend these "special rules" of reasonable approximation to determining customer location when reasonably approximating receipts from the sale of marketable securities.

The "special rules" are also expanded to provide that a taxpayer's reasonable approximation method is to be used unless the FTB shows, by clear and convincing evidence, that such method is not reasonable. If the FTB shows that the taxpayer's approximation method is not reasonable, the FTB is to reasonably approximate the location of the receipt of the benefit of the services, the location of the use of the intangible property or the location of the customer for sales from marketable securities.

Sales to U.S. government contractors

Certain new examples specific to government contractors are included in the draft amendments to CCR 25136-2. Under one example, if a contractor provides field support under a contract with an agency of the U.S. government and support is provided to locations in California and another state, the benefit of the services are received in both states, and the receipts from the contract are assigned proportionally to both states. If the books and records of the contractor do not indicate where the field support services are received (which is highly likely if the project is classified or deals with national security), a reasonable approximation of the location where the field support services are received will be based upon the percentage of the population in California compared to the population of the U.S. overall.

Another example provides that the same method of reasonable approximation will be used when a company is providing research and development services to the U.S. government and does not know where the benefit of the research and development services are received.

Next steps

The draft amendments would be effective retroactively to tax years beginning on or after January 1, 2015. It is unclear how quickly the regulatory process will progress during this second round of amendments to CCR 25136-2. As mentioned above, the second “interested parties meeting” will be held Friday June 16, 2017, and after that meeting, there may be a better sense of the issues and concerns associated with the FTB’s proposed amendments.

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