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California: Final regulation, sourcing of sales other than tangible personal property

California's Franchise Tax Board (FTB) finalized revisions to Cal. Code Regs. § 25136-2 concerning the sourcing rules for sales other than sales of tangible personal property. The regulation (approved September 15, 2016, by the Office of Administrative Law) provides guidance on how to source certain types of receipts that were not covered in the original iteration of the regulation.

The amendments to the regulation are effective for tax years beginning on or after January 1, 2015. However, a taxpayer may elect to apply the amendments retroactively to tax years beginning on or after January 1, 2012, if those years are open under the statute of limitations.

Marketable securities

The revised regulation adopts a definition of "marketable securities" and provides guidance on assigning sales of marketable securities to the location of the customer.

The term "marketable securities" is generally defined as any security that is actively traded on an "established stock or securities market" and regularly quoted by brokers or dealers in making a market. There is a second definition for taxpayers that are securities dealers under IRC section 475(c)(1) or commodities dealers that have elected to use the mark-to-market rules under IRC section 475. Receipts from marketable securities (as defined in the subsection of the regulation addressing securities and commodities dealers) includes any interest and dividends associated with such marketable securities.

"Marketable securities" under this subsection does not include securities traded in certain hedging transactions, as defined under Cal. Rev. & Tax Code § 25120(f)(2)(L).

Where sales of marketable securities will be assigned depends on whether the customer is an individual or business entity.

- If the customer is an individual, the sale will be assigned to California if the customer's billing address is in California.

- If the customer is a business entity, the sale will be assigned to California if the customer's commercial domicile is in California.

Commercial domicile is presumed to be in California if the taxpayer's books and records provide that this is the case. The presumption may be overcome by showing that, based on a preponderance of the evidence, other credible documentation provides that commercial domicile is in another state. If an individual's billing address or business entity's commercial domicile cannot be determined under these rules, the location of the customer must be "reasonably approximated."

Interest

Under California's sourcing rules, receipts from sales of intangible property are generally assigned to California to the extent the intangible property is used in the state. The revised regulation now specifically addresses how to source interest as a gross receipt from intangible property.

- Interest from investments other than loans (as defined under the California regulation addressing apportionment for banks and financial corporations) will be assigned to California if the investment is managed in California.

- Interest from loans that are secured by real property will be assigned to California to the extent the real property is located within the state.

- Interest from loans that are not secured by real property will be assigned to California if the borrower is located in California.

Dividends and goodwill

The final version of the revised regulation includes a new reference to dividends and goodwill in a provision (a subclause) that addresses the sourcing of sales of intangible property—specifically sales of stock or ownership interests in a pass-through entity. This rule provides that the source of a sale of stock or ownership interest in a pass-through entity is determined by looking through to the underlying location of the sold entity's assets and depends on whether the majority of those assets are intangible property or real and/or tangible personal property.

KPMG observation

The placement of the reference to dividends and goodwill creates some confusion, as it appears to require dividends and goodwill to be sourced by looking at the types of assets owned by a corporation whose stock has been "sold." The payment of a dividend is not dependent on stock being "sold," and therefore, it could be presumed that this reference was made in error. However, the intent behind inserting a reference to dividends and goodwill in this subclause was likely to provide that dividends and goodwill are sourced using the same sourcing rules that apply to sales of stock. Thus, under the revised regulation, it appears a dividend (that is classified as business income) will be sourced based on the location of the payor corporation's assets and the type of assets owned by such corporation.

Asset management fees

The final version of the regulation is somewhat different than earlier proposed iterations of the regulation. One of the items addressed in an earlier proposed version was how the market-based sourcing provisions apply to fees earned by asset managers. However, last year the FTB withdrew two examples in the proposed version that indicated that receipts from asset management services are sourced to the location of the investors in the fund (i.e., sourced using a "look-though" approach).

KPMG observation

It is not entirely surprising that the FTB adopted such an approach because there are "look-through" rules in another California regulation that addresses fees received by asset managers from performing services for regulated investment companies (RICs). The FTB has communicated that the asset manager examples will be reintroduced in a future regulation, but the examples are not included in the version that was recently finalized. This leaves the sourcing of fees received by asset managers somewhat unclear.

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