

AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

CALIFORNIA FRANCHISE TAX BOARD ISSUES AMENDED MARKET-BASED SOURCING REGULATIONS FOR THE SOURCING OF DIVIDENDS, INTEREST, AND RECEIPTS FROM SALES OF GOODWILL AND MARKETABLE SECURITIES FOR PURPOSES OF THE CALIFORNIA SALES FACTOR

SUMMARY

On September 15, 2016, the California Office of Administrative Law approved the California Franchise Tax Board's ("FTB") amendments to the FTB's current market-based sourcing regulations, 18 Cal. Code Regs. § 25136-2 (the "amended regulations") and filed the amended regulations with the California Secretary of State. The amended regulations provide sourcing rules for dividends and interest, gross receipts from sales of goodwill, and definitions for marketable securities and sourcing rules for sales of marketable securities. The amended regulations are effective retroactively to taxable years beginning on or after January 1, 2015, and affected taxpayers will have to apply the amended regulations for their 2015 California return on or before October 17, 2016. In addition, and in tandem with California's economic/factor presence nexus statute, the amended regulations could result in income tax nexus for corporations that are currently non-filers with California and other potential California income tax consequences.

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DETAILS

Background

For taxable years beginning on or after January 1, 2011, if the former single sales factor apportionment election was made, and for taxable years beginning on or after January 1, 2013, California has required market-based sourcing for gross receipts from sales of services and intangibles.¹ As a general rule under 18 Cal. Code Regs. § 25136-2, such gross receipts are sourced based on where the “benefit of a service is received” or to the extent an intangible is used in the state.

The FTB’s existing regulations were issued on March 27, 2012, and did not provide sourcing guidance with respect to dividends, interest, and receipts from sales of goodwill or marketable securities. The amended regulations attempt to provide this guidance.

Sourcing of Dividends, Interest, and Receipts from Sales of Goodwill

The amended regulations’ sourcing rule for dividends and receipts from sales of goodwill is the same as the existing rule applicable to sales of stock and pass-through entity interests in 18 Cal. Code Regs. § 25136-2(d)(1)(A).

Dividends and receipts from sales of goodwill are sourced, as follows:

- ▶ If 50 percent or more of the amount of the assets of a corporation or pass-through entity sold are not intangibles (using the original cost basis of the assets), then dividends and goodwill are sourced based on the average of the corporation or pass-through entity’s property and payroll factors for the most recent 12 month taxable year, or the current taxable year if the sale occurs more than six months into the taxable year; or
- ▶ If more than 50 percent or more of the amount of the assets of the corporation or pass-through entity sold are intangibles (using original cost basis), then the dividends and goodwill are sourced based on the sales factor of the corporation or pass-through entity’s most recent 12 month taxable year, or the current taxable year if the sale occurs more than six months into the taxable year

Although the property and payroll factors or sales factor of the corporation whose assets, including goodwill, are sold may be determinable from the taxpayer’s books and records, there will be situations when a taxpayer’s books and records do not contain such information with respect to a corporation that has distributed a dividend to the taxpayer. For example, dividends received from a 50 percent or less owned corporation that is engaged in a unitary business with the taxpayer corporation are dividends that likely are business income and receipts includible in the sales factor; however, it may be problematic to obtain such a payor’s California apportionment and asset information. Under these circumstances, the sourcing of dividends may have to be determined based on a method of reasonable approximation.²

The amended regulations’ sourcing rule for interest income is, as follows:

- ▶ Interest from investments, other than from loans (as defined in California’s bank and financial corporation income apportionment regulation, 18 Cal. Code Regs. § 25136-4.2(b)(7)), is sourced to where the investment is managed.
- ▶ Interest from loans secured by real property is sourced to the location of the real property.
- ▶ Interest from loans not secured by real property is sourced to the borrower’s location.

¹ Cal. Rev. & Tax. Code § 25136.

² 18 Cal. Code Regs. § 25136-2(d)(1)(B). If the taxpayer’s books and records do not contain the property and payroll factors or sales factor information of the dividend distributing corporation, then 18 Cal. Code Regs. § 25136(d)(1)(B) requires a method of reasonable approximation be used to source the dividends. If the sourcing of the dividends is not capable of reasonable approximation, then the regulations direct the taxpayer to use “the billing address of the purchaser” (18 Cal. Code Regs. § 25136-2(d)(1)(C)), which also may be problematic to apply when the intangible receipt being sourced is a dividend from a corporation.

The amended regulations do not define where a borrower is deemed located with respect to interest on a loan not secured by real property. California's bank and financial corporation income apportionment regulation also sources interest from loans not secured by real property according to the borrower's location. 18 Cal. Code Regs. § 25137-4.2(c)(3)(D). Under the bank and financial corporation income apportionment regulation, a borrower's location is the borrower's commercial domicile in the case of a business borrower or the borrower's billing address in the case of a borrower that is not engaged in business.³ As with the sourcing of dividends, the amended regulations lack clarity for determining the borrower's location. If the borrower's location cannot be determined, then the interest is sourced using a method of reasonable approximation, and if the source of the interest still cannot be reasonably approximated, then the borrower's billing address is used to source.⁴

Sales of Marketable Securities

The amended regulations provide two definitions for marketable securities. One for securities and commodities dealers, and another for everyone else. For non-dealers, a marketable security is generally any security traded on an established securities market that is quoted by brokers and dealers. However, a marketable security for this purpose does not include "those types of securities that are traded in transactions specifically excluded from gross receipts under Revenue and Taxation Code Section 25120."⁵ As a result, investments and securities held as part of the management of a corporation's treasury function whose gross receipts are excluded from the California sales factor by Cal. Rev. & Tax. Code § 25120(f)(2)(K) are excluded from the definition of marketable security for non-dealers.

For a securities dealer or a commodities dealer, a marketable security includes stock, pass-through entity interests, notes, bonds, debentures, notional principal contracts, derivatives, commodities, and any other "security" as defined in Sections 475(c)(2), (e)(2)(B), (C), and (D), and 1256(a) of the Internal Revenue Code of 1986, as amended. Notably, the definition of marketable security for dealers does not include that the security must be traded on an established securities market. The gross receipts from marketable securities for such dealers includes dividends and interest.⁶ However, receipts from hedging transactions are excluded as gross receipts from marketable securities.⁷

Gross receipts from sales of marketable securities so defined are sourced by 18 Cal. Code Regs. § 25136-2(e), as follows:

- ▶ Gross receipts from the sale of a marketable security to an individual customer are sourced to the customer's billing address.
- ▶ Gross receipts from the sale of a marketable security to a business customer is sourced to the state of that customer's commercial domicile based on the taxpayer's books and records. Based on the preponderance of the evidence, the taxpayer may use other credible information to determine the business customer's commercial domicile and source the receipts to that state.
- ▶ If the individual customer's billing address or the business customer's state of commercial domicile cannot be determined, then the location of the customer may be reasonably approximated.

As addressed above, for a securities or commodities dealer, gross receipts from marketable securities include the dividends and interest thereon. The amended regulations do not define the location of the customer for dividends or interest paid with respect to a marketable security. As a result, dividends or interest received on a marketable security may be sourced to California if the payor's commercial domicile is in California.

³ 18 Cal. Code Regs. § 25137-4.2(b)(2).

⁴ 18 Cal. Code Regs. § 25136-2(d)(1)(B), (C).

⁵ 18 Cal. Code Regs. § 25136-2(b)(5).

⁶ Thus, dividends and interest of a securities dealer or commodities dealer are sourced according to 18 Cal. Code Regs. § 25136-2(e) and not according to 18 Cal. Code Regs. § 25136-2(d)(1)(A).

⁷ 18 Cal. Code Regs. § 25136-2(b)(6). See also Cal. Rev. & Tax. Code § 25120(f)(2)(L). The "treasury function" exclusion from gross receipts includible in the California sales factor under Cal. Rev. & Tax. Code § 25120(f)(2)(K) does not apply to securities or commodities dealers, because they would be "principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function."

Complications of Economic/Factor Presence Nexus for Current Non-filers

For taxable years beginning on or after January 1, 2011, Cal. Rev. & Tax. Code § 23101(b) was added. Section 23101(b) established an economic/factor presence nexus standard for an out-of-state corporation. To be considered doing business in California, among other factor-presence criteria, an out-of-state corporation with more than \$536,446 of gross receipts for its 2015 taxable year (or 25 percent of its total sales) sourced to California under California's sales factor sourcing rules is deemed doing business in California and subject to income/franchise tax.⁸

As a result of the amended regulations, a corporation, which was not a California taxpayer because it had no receipts from California other than dividends or interest from stock, securities or investments, and loans in or to one or more corporations with commercial domiciles in California could now have nexus with California. Since dividends and interest are treated as gross receipts from marketable securities for a dealer, the sourcing rule for marketable securities receipts of dealers has a bias in favor of the payor's commercial domicile. Further, for non-dealers dividends received from payors having California apportionment factors or interest on loans or investments from California borrowers also could have such receipts sourced to California which could result in a California income tax return filing obligation. Therefore, there could be situations where a dividend paid by a U.S. subsidiary of a foreign parent corporation or a U.S. subsidiary paid interest on an intercompany loan from a foreign affiliate could result in California nexus for the foreign corporation. It is FTB's position that receipts from intercompany transactions are included in determining whether the sales factor threshold of the California economic/factor presence statute is satisfied.

In addition to these California nexus consequences for current California non-filing corporations, there could be California water's-edge election implications as well resulting from the FTB's recent Notice 2016-02. See the BDO SALT Alert [LINK: [https://www.bdo.com/insights/tax/state-and-local-tax/state-and-local-tax-alert-september-2016-\(1\)](https://www.bdo.com/insights/tax/state-and-local-tax/state-and-local-tax-alert-september-2016-(1))]

Effective Dates

The amended regulations are effective for taxable years beginning on and after January 1, 2015. A taxpayer may elect to apply the amended regulations to open tax years beginning on or after January 1, 2012.

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- ▶ For calendar year taxpayers currently on extension for their 2015 taxable year, the amended regulations will apply to 2015 California Form 100 or Form 100-W tax returns having an extended due date of October 17, 2016.
- ▶ Likewise, since the amended regulations apply to taxable years beginning on or after January 1, 2015, California taxpayers should assess what, if any, impact the amended regulations may have on their existing deferred tax balances, and adjust accordingly as of the effective date.
- ▶ The amended regulations in conjunction with California's economic/factor presence nexus statute could have the consequence of rendering a non-California corporate income/franchise tax filer a filer, particularly dealers in marketable securities and other corporations receiving dividends or interest from California corporations or borrowers.
- ▶ Given the FTB's position that intercompany receipts count toward the economic/factor presence nexus sales factor threshold, an intercompany loan by a foreign affiliate excluded from the water's-edge group to a California subsidiary or affiliate that results in interest sourced under the amended regulations to California, could result in California nexus for the foreign affiliate if the interest sourced to California exceeds the sales factor threshold. The amended regulations sourcing rules for dividends, receipts from sales of goodwill, and receipts from marketable securities could have similar California nexus consequences for current non-filers.

⁸ California's economic/factor presence nexus statute is indexed for inflation. Cal. Rev. & Tax. Code § 23101(b)(2), (c). California's sales factor presence threshold was \$500,000, \$509,500, \$518,162, \$529,562, and \$536,446 for 2011, 2012, 2013, 2014, and 2015, respectively.

- ▶ A partnership, including LLCs classified as a partnership for federal and California income tax purposes, must file a California Form 565 (partnership information return) if it is doing business in or has any income from California sources. Cal. Rev. & Tax. Code §§ 18633(a) and 18633.5(a). As with a corporation that has not previously had a California income/franchise tax return filing obligation, a partnership or LLC similarly may now have a California information return filing requirement. California imposes a “per partner/per month” failure to file a partnership information return of \$18 for a 12 month maximum or \$216 maximum penalty per partner.⁹
- ▶ Especially with respect to receipts from sales of marketable securities, taxpayers must apply the statutory exclusions from the definition of gross receipts contained in Cal. Rev. & Tax. Code § 25120(f)(2) before applying the new sourcing rules provided by the amended regulations. For example, for taxpayers that are not securities or commodities dealers, gross receipts in connection with the management of investments by their treasury function are excluded from the California sales factor under Cal. Rev. & Tax. Code § 25120(f)(2)(K). In addition, dividends, interest, and especially receipts from sales of goodwill will also be subject to exclusion from the sales factor if they constitute substantial gross receipts from an occasional sale or transaction under 18 Cal. Code Regs. § 25137(c)(1)(A) and Appeal of Imperial, Inc., Nos. 472648 and 477927 (Cal. State Bd. Equal., July 13, 2010).

⁹ Cal. Rev. & Tax. Code § 19172.

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