



## Podcast Transcript

# The Neverending Story: California FTB Regulation Projects

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**Guest:** None, **Host:** Matt Hunsaker

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Hunsaker: Happy New Year's, folks, and welcome back to the State Tax Show. This is Matt Hunsaker. Today we kick off Season 4 of the show by discussing a couple of California Franchise Tax Board regulation projects that are coming up on their fourth anniversary.

Speakers: Seven, six, five, four, three, two, one.

Hunsaker: Welcome back to Season 4 of the podcast. I hope that each of you had a great New Year's. Around the Hunsaker house we mostly tried to just stay awake with our friends and the younger kids and fielded calls throughout the night begging for curfew extensions. I'm excited for the new year, revamping how I approach work, family, and personal development. In fact, right here on my desk in this studio I have a list of nine goals for the week. One of them involves waking up well before the crack of dawn, so if I seem incoherent, that's my excuse.

Over the years I've given you periodic updates on a couple regulation projects that the Franchise Tax Board in California has been kicking around. One of them deals with market-based sourcing for income from services and intangibles. If you're keeping track, that is Section 25136-2. The other deals with how to petition for alternative apportionment, and that one is Section 25137. Now when I say over the years, I mean that literally. These reg projects have been going on since at least 2017, so we are coming up on the four-year anniversary now.

Let's just do a quick status update on where we are at. We won't get into the weeds today. We've done that before, and at this point I just want to wait for them to go final before digging in. Back when the legislature enacted market-based sourcing for sales other than sales of tangible personal property, that is, services and intangibles income. They decided to source sales of services to where the purchaser of the services receives the benefit of those services, and for intangibles they decided to source those, or income from those, to where the intangible property is used.

Now that may sound simple, at least to a legislator who doesn't have to deal with the minutiae, but you and I know that marketplace sourcing introduces tons of difficult questions and frankly is going to be a source of litigation in those states for years to come. And the longevity of this reg project really highlights that fact and how complex these sourcing rules are.

There have been by my count five interested party meetings on the market-based sourcing regulation, and these have been pretty interesting to attend. There's a lot at stake, and the temperature has risen a little at times. I don't want to dig into the details, but basically the current regulation sets up a cascading set of rules for determining where the benefit of a service is received, or as the regulations put it, where the taxpayer's customer has either directly or indirectly received value from delivery of that service. And what I mean by cascading rules is that there's five priorities for how you source this income, and you try and use the first one, and if that doesn't work then you go on to the second, and if that doesn't work you go on to the third and so forth down through the list.

So the current version of the reg project continues to take this cascading rule approach for determining where services and intangible property are received or used, respectively. But the reg project is amending these rules to clarify what a lot of these terms mean, and also to provide some special industry-specific rules. For example, how to source income from asset managers. And the regulations will also include a few more examples.

So the million-dollar question is, when are these things going to be final? Well, I'm hesitant to hazard a guess. But it looks like the FTB intends to finish this up on its 2021 calendar, and when that happens, we will certainly do a show, really dig into the meat of these regulations a little bit more. Now I know a lot of you may not be in California and may not be excited for that, but I wouldn't sleep on this.

Market-based sourcing continues to spread throughout the country, and how this very in-depth California reg project turns out will likely affect how other states approach flushing out their own market-based sourcing regimes. So even if California may not be that important to you, it still is important to understand the concepts that they're kicking around in their regulations.

The second reg project involves changes to the alternative apportionment regulation. This is the regulation that allows a taxpayer to petition to use a

different apportionment formula in those rare circumstances where the statutory one causes impermissible distortion. The problem is, is that the statute and the current version of the regulation, well they don't address the mechanics for how a taxpayer goes about making the petition, and this reg project aims to remedy that. Just like the market-based sourcing project, this one also has been going on since 2017 with at least four interested party meetings.

The regulation addresses a few issues including the ability of the public to access information provided to the FTB in a petition, the right to a hearing, and notice and other procedural issues. Last week the Franchise Tax Board proposed four additional changes to the language and opened up a 20-day comment period. That comment period will close at 5:00 p.m. on January 18th, and after the comment period ends, the expectation is that the Franchise Tax Board staff will present the final draft to the three-member Franchise Tax Board and ask for permission to go ahead and proceed with the formal Administrative Procedures Act process to get the regulation promulgated.

So that is where we are at with California reg projects of interest. Stay tuned for more details as these projects cross the finish lines. But until that happens, if you have any questions about the existing regulations and what to do in the interim, feel free to give me a ring. I'll be back next Monday with a fresh new episode. I don't know what it will be yet, so feel free to send in your requests. Until next time, have yourselves a great week.

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