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Quarterly California Tax Legislation Update

October 2013 - December 2013

Dear Friends & Clients,

The purpose of this Quarterly California Tax Legislative Update is to provide our clients and prospective clients with timely and meaningful updates that affect both their personal income and business taxes.

The 4th Quarter of 2013 was a relatively quiet time in California from a tax legislative perspective. The Franchise Tax Board ("FTB") held interested party meetings for potential amendments to its sales factor market sourcing rules and to clarify the treatment of a corporate partner's interest in a partnership for income/franchise tax purposes. Additionally, California clarified the existing treatment of gain or loss generated from the sale of qualified small business stock and taxpayers continued to prevail in court on the treatment of technology transfer agreements as being exempt from California sales and use tax.

The FTB Proposes Amendments of Market Sourcing Rules and Corporate Partner Income Treatment

On October 18, 2013, the FTB held two interested parties meetings. The first was to discuss draft amendments to the income tax apportionment market sourcing rules in California Code of Regulations ("CCR") Section 25136-2. Specifically this code section provides guidance on sales of other than tangible personal property. The following items were discussed at the meeting:

- The proposed amendments of CCR Section 25136-2 define marketable securities to include all securities traded on an exchange. Under the proposed market sourcing amendments, marketable securities would be sourced based on where the buyer is located. Sales of securities outside of the definition of marketable securities are subject to general intangible sourcing rules, sourcing to the location where the securities are used. More guidance will be necessary as to how to apply the market sourcing rules to other financial instruments including hedging and derivative transactions.

- Asset management fees paid for services provided on behalf of shareholders, investors, and beneficial owners shall be sourced to the domicile of these beneficial parties. If it cannot be reasonably determined where the domicile of these parties is, the FTB plans to have these receipts disregarded in determining shareholder ratios assigning such sales.

The second interested parties meeting held discussed possible amendments to CCR Section 25137-1. This code section provides guidance on apportioning corporate partners' share of distributive partnership income. The FTB discussed the following nine possible amendments:

1. Clarification that non-unitary partnership business income is to be treated as income from a separate trade or business. Apportionment and classification of income is to be based on the partnership's apportionment and treatment as business or non-business income, respectively.

2. Non-business income produced by an asset of a partnership should be reclassified at the partner level as business income if it would have produced business income had the corporate partner directly owned the asset.

3. Intercompany sales between a member of the partner's unitary combined reporting group and the partnership should be eliminated.

4. Including some sort of definition (e.g. capital or equity ownership) to determine percentage of partnership interest used in assigning partnership property, payroll and sales to a unitary partner.

5. Deleting certain language matching partnership accounting periods to the partner. In instances where these accounting periods do not match, use of this code section can resolve any resulting distortion.

6. Confirming both corporations and individuals should treat partnership apportionment in the same manner.

7. In tiered partnership structures, giving guidance in applying safe-harbor rule under CCR Section 17951-4, which gives exemption from unitary combination for partnerships less than 20 percent owned. The FTB believes the test should be aggregate ownership, including indirect interested owned through the tiered partnership.

8. Replacing the word "taxpayer" with the word "partner" to avoid confusion in instances where the "partner" is a partnership, and therefore cannot be a "taxpayer."

Another interested parties meeting is expected to be announced later this month or in February. The FTB plans to issue draft amendments by the end of the year.

Affected taxpayers should note the FTB is open to public input as it continues with the regulatory process in both of these matters.

FTB Provides Guidance on Qualified Small Business Stock Gain Exclusion/Deferral Legislation

Last quarter we discussed the legislation enacted in response to the Cutler decision, which found unconstitutional qualified small business stock ("QSBS") gain exclusions and deferrals for taxpayers who invested in businesses predominately based in California. Enacted legislation A.B. 1412 removed the in-state requirement, allowing QSBS deferrals and exclusions for certain investments. Refund claims for the 2008 tax year can be filed until June 30, 2014, for taxpayers who realized gains because of the in-state requirement.

Specifically, A.B. 1412 allows taxpayers to exclude 50 percent of the gain from sale or exchange of QSBS. A qualified small business is defined as a domestic C corporation that meets the following criteria:

- At all times on or after July 1, 1993, before the issuance of stock, and immediately after the issuance of stock, the aggregate gross assets of the corporation (or its predecessor) did not exceed $50 million, and

- At the time of stock issuance, at least 80 percent of the corporation's payroll was attributable to California employment.

Although the requirements for no more than 20 percent of the corporation's payroll to be attributable to outside California during the holding period of the stock and the in-state requirement for the corporation's assets were eliminated, it seems that the FTB will still enforce this second requirement.

The final date under which the QSBS gain exclusion/deferral can be claimed is December 31, 2015.

As mentioned in last quarter's update, taxpayers who were assessed additional tax, penalties and interest after the Cutler decision can ignore these assessments. For those who have already paid the assessment, the FTB is issuing refunds. Anyone who has not yet received a refund should contact the FTB at 916.845.3030.

Technology Transfer Agreements and Exemption from Sales and Use Tax

AT&T Corp. and Lucent Technologies, Inc. ("the taxpayers") manufactured and sold switching equipment allowing customers to provide telecommunication services to end customers. Pursuant to written agreements, AT&T and Lucent provided software required by the switching equipment. The taxpayers filed for refund claims with the position that the written agreements were technology transfer agreements, exempt from sales and use tax. The Board of Equalization ("BOE") denied the refund and the taxpayers filed complaint with a trial court.

Intangible personal property transferred with tangible personal property in a technology transfer agreement is generally exempt from sales and use tax. In a technology transfer agreement, a person who holds a copyright or patent interest licenses or assigns the right to another person, who then uses a process subject to these copyright or patent interests or makes and sells a product. A 2011 appellate court decision in *Nortel Networks, Inc. v. California State Board of Equalization* found that prewritten software could not be excluded from the definition of a technology transfer agreement.

In the case of AT&T and Lucent, the BOE argued that the physical storage medium of the software gave the software itself a physical presence. The court disagreed, seeing the storage medium as a convenient means to transmit software. The BOE asked that the taxpayers prove copyright and patent infringements that would result from violations of each agreement. The court dismissed this request as it was beyond the scope of the case. The taxpayers provided general evidence to support interest in the copyrights and patents licensed to the customer. The court transferred the burden of proving the nonexistence of these interests to the BOE. Since the facts of the case were essentially the same as Nortel, a motion for summary judgment in favor of the taxpayers was made.

Although the result in the two technology transfer agreement cases was the same, the most recent case highlights the requests that the BOE might demand and what the courts actually require as factual support. Companies buying and selling software should discuss the application of this court case with their tax advisors to see if any portion could be treated as a technology transfer agreement exempt from California sales and use tax. &

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