

**In the Matter of the Appeal of:
Ronald N. and Jane A. Frazar vs. Franchise Tax Board
Appeal Case No. 494349
BOE Hearing June 16, 2010**

Supplemental Documents

1. FTB Final Regulations Summary from www.ftb.ca.gov/law/Final_Regulations.shtml
2. Notice of Hearing (regarding Regulation 17952)
3. 15 – Day Service (regarding Regulation 17952)
4. Initial Statement Of Reasons for the Adoption of Amendments to California Code of Regulations, Title 18, Section 17952
5. Final Statement Of Reasons for the Adoption of Amendments to California Code of Regulations, Title 18, Section 17952
6. FTB Summary of Comments, Responses and Recommendations Regarding Proposed Amendment to Regulation 17952, Hearing Notice Dated May 26, 2002 (attached to Final Statement of Reasons)
7. Regulation 17952, as amended
8. CA Revenue & Taxation Code § 19503 (power to issue regulations)
9. CA Government Code § 11343.4 (effective date of regulations)
10. Spidell's Newsletter dated March 1, 2003 "Change to Taxation of New Residents and New Nonresidents"
11. Spidell's Newsletter dated January 1, 2007 "Taxing Former Residents on Installment Sales of Intangibles"
12. IRC § 864(c)(6)
13. Joint Committee Explanation on Tax Reform Act of 1986, Act § 1242 (enacting IRC §864(c))
14. Conference Committee Report on Tax Reform Act of 1986, Act § 1242
15. Senate Finance Committee Report on Tax Reform Act of 1986, Act § 1242

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Chronology

- 1941** **Miller vs. McColgan decided establishing *mobilia sequuntur personam***

- 1983** **Enactment of Revenue & Taxation Code § 17554; adopts accrual method in place of *mobilia sequenter personam***

- 2001** **Repeal of Section 17554 per AB 1115; does not include source provision for intangibles**

- 5/19/04** **Taxpayers sell stock in Citizens Development Corporation**

- 12/2/04** **Taxpayers become residents of Montana**

- 5/26/06** **Public hearing on amendment to Regulation 17952(d) announced; FTB describes question of source of installments sale gain *ambiguous, not adequately addressed, and mobilia arguably applies***

- 7/17/06** **Public hearing on amendment to Regulation 17952(d) held**

- 7/2/07** **Amended Regulation 17952(d) filed**

- 8/1/07** **Amended Regulation 17952(d) becomes effective**



FTB Final Regulations

Final regulations are rules or requirements formally approved by the Office of Administrative Law (OAL) and published in the [California Code of Regulations](#).

Due to copyright issues, we cannot publish final regulations on our website. You can access the details of the final regulations from the Office of Administrative Law's website at www.oal.ca.gov.

Regulation Number	Subject	Date Filed with the Secretary of State	Effective Date
25114	Presumptions Arising from Federal Audits Notice of Hearing Initial Statement of Reasons Final Statement of Reasons	May 21, 2009	June 20, 2009
25111 25113	Water's-Edge Election Notice of Hearing Notice of Correction 15 - Day Notice Initial Statement of Reasons Final Statement of Reasons	April 6, 2009	May 6, 2009
23701 23772	Exemption from Taxation and Information Returns and Statements Exempt Organizations Notice of Hearing Initial Statement of Reasons Final Statement of Reasons	March 19, 2009	April 19, 2009
19503	Absence of Regulations - Nonsubstantive Changes Initial Statement of Reasons	June 23, 2008	July 23, 2008
23038(b)-2 23038(b)-3	Business Entities and Definitions and Classification of Certain Business Entities - Nonsubstantive Changes Initial Statement of Reasons	June 4, 2008	July 3, 2008
25137(c)(1) (D)	Special Rules Sales Factor (Applicable to taxable years beginning on or after January 1, 2007.) Notice of Hearing 15 - Day Notice Initial Statement of Reasons Final Statement of Reasons	April 29, 2008	May 29, 2008

17952	Income from Intangible Personal Property	July 2, 2007	<u>August 1, 2007</u>
	Notice of Hearing 15 - Day Notice Initial Statement of Reasons Final Statement of Reasons		
25137-14	Mutual Fund Service Providers and Asset Management Service Providers	June 20, 2007	January 1, 2007
	<u>Notice of Hearing</u> <u>15 - Day Notice</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
25110	Water's-Edge Election Group	January 23, 2007	February 23, 2007
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
19591	Specialized Tax Service Fees	April 24, 2006	January 1, 2006
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
25106.5-11	Election to File a Group Return	December 9, 2005	January 9, 2006
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
20501 20502 20503 20504 20505	Senior Citizens Homeowners and Renters Property Tax Assistance	March 15, 2005	April 15, 2005
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
25130 25137	Property Valuation and Other Apportionment Methods	January 28, 2005	February 28, 2005
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
19133	Penalty for Failure to File Return Upon Notice and Demand	November 23, 2004	December 23, 2004
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u> <u>Final Statement of Reasons</u>		
18001-1	Credit for Taxes Paid to Another State	November 16, 2004	December 16, 2004
	<u>Notice of Hearing</u> <u>Initial Statement of Reasons</u>		

TITLE 18. FRANCHISE TAX BOARD

As required by Government Code section 11346.4, this is notice that a public hearing has been scheduled to be held at 10:00 a.m., on Monday, July 17, 2006, at the Franchise Tax Board, 9646 Butterfield Way, Town Center Golden State Room A/B, Sacramento, California, to consider the amendment of California Code of Regulations, title 18, section 17952. These proposed changes address the timing of the sourcing of gains or losses from the sale or other disposition of intangible personal property.

An employee of the Franchise Tax Board will conduct the hearing, and a report will be submitted to the three-member Franchise Tax Board for its consideration, along with a recommendation as to whether the three-member Board should hold a hearing on the proposed regulatory action. Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action if any person makes such a request in writing. If a written request is received, the three-member Franchise Tax Board will consider the proposed regulatory action prior to adoption.

Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., Monday, July 17, 2006. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer named below.

AUTHORITY AND REFERENCE

Revenue and Taxation Code section 19503 authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001). Revenue and Taxation Code section 17954 specifically authorizes the Franchise Tax Board to prescribe regulations to allocate and apportion gross income from sources within and without this state. The proposed regulatory action interprets, implements, and makes specific Revenue and Taxation Code section 17952.

INFORMATIVE DIGEST/ POLICY STATEMENT OVERVIEW

This proposed amendment to California Code of Regulations, title 18, section 17952, adds a new subsection (d) to directly state that sourcing of gains or losses from the sale or other disposition of intangible property is determined at the time of such sale or other disposition. Any applicable deferral of tax provisions does not affect the sourcing rules for the gain or loss realized.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandate on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: The Board is not aware of any cost impacts that a private person or business would necessarily incur in reasonable compliance with the proposed action.

Significant effect on the creation or elimination of jobs in the state: None.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of businesses currently doing business within the state: None.

Effect on small business: This regulation may affect small business.

Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board must determine that no reasonable alternative it considered or that has otherwise been identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

The Franchise Tax Board has prepared an initial statement of the reasons for the proposed regulatory action. The express terms of the proposed regulatory action, the initial statement of the reasons for the regulatory action, and all the information upon which the proposed regulatory

action is based are available upon request from the agency officer named below. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website at <http://www.ftb.ca.gov>.

CHANGE OR MODIFICATION OF ACTIONS

The three-member Franchise Tax Board may adopt the proposed regulatory action after consideration of any comments received during the comment period. Government Code section 15702, subdivision (b), provides for consideration by the three-member Board of any proposed regulatory action if any person makes such a request. If a request is received, the three-member Board will consider the proposed regulatory action prior to adoption.

The regulations and amendments may also be adopted with modifications if the changes are nonsubstantive or the resulting regulations are sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulations as modified could result from that originally proposed. The text of the regulations as modified will be made available to the public at least 15 days prior to the date on which the regulations are adopted. Requests for copies of any modified regulations should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing, who is in need of a language interpreter, including sign language should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Natasha Sherwood Page; Tel.: (916) 845-6729. This notice, the initial statement of reasons and express terms of the proposed regulations are also available at the Franchise Tax Board's website at www.ftb.ca.gov.

TITLE 18. FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO REGULATION SECTION 17952

On July 17, 2006, Natasha Page of the department's Legal Staff held a hearing at the Franchise Tax Board's central office to receive public comments on the proposed amendment to Regulation section 17952. Both the proposed amendment and the proposed adoption were noticed in the California Regulatory Notice Registry on May 26, 2006. Section 17954 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations apportioning and allocating income of nonresident individuals to sources within and without California.

As a result of the comments received during the hearing process, staff recommends that a change be made to the proposed amendment to Regulation section 17952. This change constitutes a sufficiently related change within the meaning of Government Code section 11346.8. The changes provided by this notice are reflected by double underscore. (The amendment to Regulation 17952 as initially proposed is reflected by single underscore.)

The proposed amendment seeks to clarify when the sourcing rules should apply, but does not seek to change which sourcing rules are applicable. Accordingly, the proposed change to the amendment is the addition of a parenthetical phrase in the first example provided. The parenthetical phrase clarifies that the business situs exception is still available to nonresident taxpayers.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 pm on February 12, 2007. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation 17952 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation 17952.

All inquiries concerning this notice should be directed to Colleen Berwick at Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Natasha Sherwood Page; Tel.: (916) 845-6729. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.

**INITIAL STATEMENT OF REASONS FOR THE
ADOPTION OF AMENDMENTS TO
CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 17952**

PUBLIC PROBLEM THAT THE REGULATION IS INTENDED TO ADDRESS

Revenue and Taxation Code section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency.

The proposed amendment to California Code of Regulations, title 18, section 17952, is intended to provide clarification and guidance to the taxpayer community and audit staff concerning when the source of income from the sale or other disposition of intangible property is determined. Under the *mobilia* doctrine, absent a business situs, intangible property is sourced to the state of residence of the owner. If a California resident sells intangible property, the gain is taxable under a residency theory. If a California nonresident sells intangible property, the gain would be sourced to the nonresident's state of residence and California would not tax the gain, unless the intangible property had acquired a California business situs.

However, if a California resident sells intangible property under the installment method (or employs another type of deferral mechanism) and subsequently moves away, there may be some ambiguity as to the source of the gain. Arguably, the *mobilia* doctrine already provides that the source of the gain is in California because that is where the taxpayer resided when the property was sold. The source could not have moved with the taxpayer because he or she no longer owned the property.

This has not been an issue in the past because California would have applied Revenue and Taxation Code section 17554 to assert that the gain had already accrued prior to the move.

SPECIFIC PURPOSE OF THE REGULATION

This proposed amendment to the regulation adds subsection (d) to directly state that sourcing of gains or losses from a sale or other disposition of intangible property is determined at the time of that sale or other disposition. Deferral of the gain realized does not affect the sourcing rules for the income realized when that gain is ultimately recognized.

NECESSITY

Revenue and Taxation Code section 17954 provides that gross income from sources within and without this state shall be allocated and apportioned under rules and regulations prescribed by the Franchise Tax Board. Especially since the repeal of Revenue and Taxation Code section 17554, it is presently not clear how the sourcing rules apply with respect to the sale or transfer of intangible property.

The proposed regulation is needed in order to clarify to the taxpayer community and Franchise Tax Board audit staff that the income sourcing rules apply regardless of the accounting method of the taxpayer. It is realization, not recognition, of income that controls sourcing.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS RELIED UPON

The Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

In accordance with Government Code section 11346.5, subdivision (a)(12), the Franchise Tax Board has determined that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulatory action.

Minimal impact to private persons or businesses is foreseen as a result of this regulation. The proposed regulation would only affect individual taxpayers who realize a gain from the sale of intangible property but defer recognition of that gain until after a change in residency. The only businesses that would be impacted would be "flow-through" entities, including partnerships, limited liability companies and S corporations, to the extent that their individual partners, members or shareholders, respectively, would be impacted. The proposed amendment to the existing regulation may make it easier for a taxpayer to anticipate the tax consequences when the deferral of tax liability is involved.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The proposed regulatory action will not have a significant adverse economic impact on business. The proposed regulation does not provide any new reporting requirements.

**FINAL STATEMENT OF REASONS FOR THE
ADOPTION OF AMENDMENTS TO
CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 17952**

The proposed regulations do not impose any mandate on local agencies or school districts.

UPDATE OF INITIAL STATEMENT OF REASONS

The public Notice required by Section 11346.4 of the Government Code was mailed and published in the California Notice register on May 26, 2006. The hearing was held, as noticed, on July 17, 2006, to consider the adoption of proposed amendments to regulation section 17952 that address when the source of income from the sale or other disposition of intangible property is determined. There were six attendees at the hearing and oral testimony was received from three individuals representing various interests. Forty written comments were received during the comment period, which ended on July 17, 2006. A summary of and responses to the comments received was prepared and is included in the rulemaking file as Tab 11.

As a result of comments received, non-substantial, sufficiently related changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on January 26, 2007. No comments were received regarding the 15-day changes.

The final version of the regulation was presented to the Franchise Tax Board for its approval at its December 4, 2006, public meeting. The Board was provided with all of the comments received during the regulatory process as well as responses to the comments. The Board approved the regulation by a vote of 3-0. A transcript of that meeting is included in the rulemaking file as Tab 11.

Although stated in various ways, the comments fell into 7 categories:

- The examples presented as part of the proposed amendment were read as requiring solely the application of the mobilia doctrine and precluding the application of the business situs exception;
- The proposed regulation is seen as incompatible with the repeal of Revenue and Taxation Code section 17554 and other changes made pursuant to AB 1115 (Stats. 2001, ch. 920);
- Questions were posed regarding the application of federal or California-only elections out of the installment method;
- There were questions concerning how, particularly, installment sales would be sourced and which intangible property gave rise to the sourcing of income;
- Since this is a clarifying regulation, challenges were made to the FTB's authority to apply this policy prior to the adoption of this amendment;
- A request for the inclusion of further examples; and
- A petition for staff to survey how other states handle this issue and the availability of the Other State Tax Credit to former nonresidents now living in California for taxes imposed

by states where they formerly resided on these types of gains, assuming those states adopt the same approach as provided in the proposed amendment.

First, as provided in the 15-day notice, staff recommended a change to the proposed language to resolve the first category of comments.

Next, staff does not agree the proposed amendment to regulation section 17952 is incompatible with the repeal of Revenue and Taxation Code section 17554 or contrary to the changes made under AB 1115. Staff believes the proposed amendments to regulation section 17952 are merely clarifying how the sourcing rules already work.

Revenue and Taxation Code section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. It was repealed, in part, because subsequent to the *Appeal of Money* in 1983, section 17554 was rarely applicable.¹ The *Appeal of Money* provided Revenue and Taxation Code section 17554 would apply only when two conditions were satisfied: (1) when California's sole basis for taxation is the taxpayer's residency, and (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting. Since the Board of Equalization limited section 17554 to only cases of California residency, it was not applicable to nonresidents even back to 1983. Therefore, its application or repeal has no bearing on a sourcing rule applied to nonresidents.

As stated in various pronouncements, AB 1115 specifies clear, definitive rules that will be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. Specifically it provides resident taxpayers will be taxed based on residency jurisdiction and carryovers and deferred items will be calculated regardless of source. Nonresident taxpayers will be taxed solely based on sourcing jurisdiction and carryovers and deferred items will be calculated to reflect such approach. This regulation project was begun as part of the AB 1115 implementation. At that time, it was determined by FTB staff that existing sourcing rules did not adequately address the timing of sourcing in the case of the sale or other disposition of intangible property. The FTB has authority under Revenue and Taxation Code section 17954 to promulgate rules and regulations in this area. It is fundamental that sourcing principles apply at the moment of realization since they apply to attach jurisdiction to the sale or other disposition and the resulting income, not personal jurisdiction over the individual.

Staff responses to the remaining comments can be found in the rule-making file as Tab 11.

Briefly,

- Federal elections remain valid and California taxpayers may make California-only elections out of the installment method.
- The intangible property sold or otherwise disposed of gives rise to the sourcing of the income. The installment note itself is a deferral mechanism. Absent that deferral, the income would be recognized at realization.

¹ *Appeal of Money* (December 13, 1983) 83-SBE-267.

- The proposed amendment is a clarification of how the law operates presently.
- The example proposed concerns a California resident. Revenue and Taxation Code sections 17951 through 17955 concern the taxation of nonresidents. Specifically they address sourcing rules that are only relevant to nonresidents. Resident taxpayers are taxable on all income, regardless of source. Staff recommends no change.
- Staff conducted a survey as requested and included the results in its official responses to comments. The Other State Tax Credit remains available to former nonresidents now living in California for taxes imposed by the states where they formerly resided on these types of gains, assuming those states adopt the same approach as provided in the proposed amendment.

No other major concerns were raised, and technical changes made through a 15-day notice received no comments.

ALTERNATIVES DETERMINED

The Franchise Tax Board has not received any proposed alternatives that would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome than the proposed regulation.

STAFF REPORT, STAFF RECOMMENDATION, AND REQUEST FOR ADOPTION OF
PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS, TITLE 18,
SECTION 17952, RELATING TO INCOME FROM INTANGIBLE PROPERTY

On July 17, 2006, Natasha Page of the department's Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed amendment to Regulation section 17952. There were 6 attendees at the hearing. Three persons, who each submitted written comments, also presented comments orally at the hearing. Five commentators submitted approximately 40 comments in total, orally and in writing.

In response to the comments raised, staff intends to notice a 15-day "sufficiently related change" within the meaning of Government Code section 11346.8, subdivision (c), to add a parenthetical phrase in the first example provided. The parenthetical phrase clarifies that the business situs exception is still available to nonresident taxpayers. This additional proposed amendment simply seeks to clarify when the sourcing rules should apply, but does not seek to change which sourcing rules are applicable. This additional proposed change can be seen in the attachment in bold double-underlined text.

Although stated in various ways, the comments fell into 7 general categories:

- The examples presented as part of the proposed amendment were read as requiring solely the application of the *mobilia* doctrine and precluding the application of the business situs exception;
- The proposed regulation is seen as incompatible with the repeal of Revenue and Taxation Code (RTC) section 17554 and other changes made pursuant to AB 1115 (Stats. 2001, ch. 920);
- Questions were posed regarding the application of federal or California-only elections out of the installment method;
- There were questions concerning how, particularly, installment sales would be sourced and which intangible property gave rise to the sourcing of income;
- Since this is a clarifying regulation, challenges were made to the FTB's authority to apply this policy prior to the adoption of this amendment;
- A request for the inclusion of further examples; and
- A request for staff to survey how other states handle this issue and the availability of the "Other State Tax Credit" to former nonresidents now living in California for taxes imposed by states where they formerly resided on these types of gains, assuming those states adopt the same timing principle as provided in the proposed amendment.

With respect to the first category of comments, the 15-day change described above will resolve the expressed concern by providing clarification that the business situs exception may apply.

With respect to the second category of comments, staff does not agree with the assertion that the proposed amendment to Regulation section 17952 is incompatible with the repeal of RTC section 17554, nor does staff believe the proposed amendment is contrary to the changes made to sourcing rules by AB 1115. Instead, staff believes the proposed amendments to Regulation section 17952 merely clarify how the sourcing rules already work.

RTC section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. It was repealed, in part, because subsequent to the *Appeal of Money*¹ in 1983, RTC section 17554 was rarely applicable. The *Appeal of Money* decision provided that RTC section 17554 would apply only when two conditions were satisfied: (1) when California's sole basis for taxation is the taxpayer's residency, and (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting. Since the Board of Equalization limited RTC section 17554 to only those cases of California residency, it was not applicable to nonresidents even back to 1983. Therefore, its application or repeal has no bearing on a sourcing rule applied to nonresidents.

As stated in various pronouncements, AB 1115 specifies clear, definitive rules that will be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. Specifically it provides resident taxpayers will be taxed based on residency jurisdiction and carryovers and deferred items will be calculated regardless of source. Nonresident taxpayers will be taxed solely based on sourcing jurisdiction and carryovers and deferred items will be calculated to reflect such approach. This regulation project was begun as part of the AB 1115 implementation. At that time, it was determined by FTB staff that existing sourcing rules did not adequately address the timing of determining the correct sourcing rule to apply in the case of the sale or other disposition of intangible property. The FTB has a broad legislative delegation of rulemaking authority under RTC section 17954 to promulgate necessary rules and regulations in this area. Moreover, it is fundamental that sourcing principles should apply at the moment of realization, since those rules attach jurisdiction to the sale or other disposition and the resulting income, instead of personal jurisdiction to tax the individual.

With respect to the remaining five categories of comments received, staff will address them in detail in the rulemaking file, but abbreviated versions of staff's responses are set forth below for convenience:

- With respect to the third category of comments, federal elections remain valid, and California taxpayers may make California-only elections out of the installment method.
- With respect to the fourth category of comments, the intangible property sold or otherwise disposed of gives rise to the sourcing of the income. The installment note itself is a deferral mechanism. Absent that deferral, the income would be recognized at realization.
- With respect to the fifth category of comments, the proposed amendment is a clarification of how the law operates presently and thus no prospective-only application of the change is necessary.
- With respect to the sixth category of comments, the example proposed concerns a California resident. Revenue and Taxation Code sections 17951 through 17955 concern the taxation of nonresidents. Specifically, those sections address sourcing rules that are only relevant to nonresidents. Resident taxpayers are taxable on all income, regardless of source. Staff recommends no change.

With respect to the seventh category of comments, staff is conducting a survey as requested and will include the results in its official responses to comments. The "Other State Tax Credit" remains available to former nonresidents now living in California for taxes imposed by the states where they

¹ *Appeal of Virgil M. and Jeanne P. Money* (December 13, 1983) 83-SBE-267.

formerly resided on these types of gains, assuming those states adopt the same timing principle as provided in the proposed amendment.

Staff also received a request for the Board itself to consider and adopt the amendment to the regulation, as provided under Government Code section 15702, subdivision (b), so that staff now requests that the Board adopt the proposed amendment to Regulation section 17952, including the further modification in the above-described 15-day change, and authorize the Executive Officer to proceed under the Administrative Procedures Act.

Notice of Modifications to Text of
Proposed Regulation Section 17952

On July 17, 2006, 2006, Natasha Page of the department's Legal staff held a hearing at the Franchise Tax Board's central office to receive public comments on the proposed amendment to Regulation section 17952. Both the proposed amendment and the proposed adoption were noticed in the California Regulatory Notice Registry on May 26, 2006. Section 17954 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations apportioning and allocating income of nonresident individuals to sources within and without California.

As a result of the comments received during the hearing process, staff recommends that a change be made to the proposed amendment to Regulation section 17952. This change constitutes a sufficiently related change within the meaning of Government Code section 11346.8. The changes provided by this notice are reflected by double underscore. (The amendment to Regulation section 17952 as initially proposed is reflected by single underscore.)

The proposed amendment seeks to clarify when the sourcing rules should apply, but does not seek to change which sourcing rules are applicable. Accordingly, the proposed change to the amendment is the addition of a parenthetical phrase in the first example provided. The parenthetical phrase clarifies that the business situs exception is still available to nonresident taxpayers.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 pm on [enter date.] The Franchise Tax Board is sending a copy of the proposed amendments to Regulation section 17952 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation section 17952.

All inquiries concerning this notice should be directed to Colleen Berwick at Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: Colleen.Berwick@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Natasha Sherwood Page; Tel.: (916) 845-6729. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.

Section 17952 is amended to read:

§ 17952. Income from Intangible Personal Property.

Note: The 15-day changes are indicated by double underscore for additions and double strikeout for deletions.

(a) Income of nonresidents from rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property is taxable, if such intangible property has a business situs in this State within the meaning of (c) below.

(b) Income of nonresidents from intangible personal property such as shares of stock in corporations, bonds, notes, bank deposits and other indebtedness is taxable as income from sources within this State only if the property has a situs for taxation in this State, except that if a nonresident buys or sells stock, bonds, and other such property in California, or places orders with brokers in California to buy or sell such property, so regularly, systematically and continuously as to constitute doing business in this State, the profit or gain derived from such activity is taxable as income from a business carried on here, irrespective of the situs of the property for taxation.

(c) Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here. Again, if a nonresident maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State, the bank account has a business situs here.

If intangible personal property of a nonresident has acquired a business situs here, the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within this State, taxable to the nonresident.

(d) The source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property. For example, if a California resident sells intangible personal property under the installment method, and subsequently becomes a nonresident, any later recognized gain attributable to any installment payment receipts relating to that sale will be sourced to California (absent a business situs exception). Further, a California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments if the intangible personal property had a business situs in California at the time of the sale.

Note: Authority cited: Section 19503+9253, Revenue and Taxation Code.
Reference: Sections 17041 and 17952, Revenue and Taxation Code.

December 4, 2006

**SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
REGARDING PROPOSED AMENDMENT TO REGULATION SECTION 17952
HEARING NOTICED MAY 26, 2006**

Comments:

- 1.1 Enactment of this regulation will erode AB 1115 (Stats. 2001, ch. 920), which sought to clarify and provide equal treatment to taxation of new and former residents. (Lynn Freer, Spidell Publishing, July 28, 2003.)
- 1.2 And I see that this proposed regulation is circumventing the spirit and the language of Section 17041(i)(3) [of the Revenue and Taxation Code]. (Lynn Freer, Spidell Publishing, Public Hearing held July 17, 2006.)
- 1.3 [W]e oppose the FTB's proposed amendment to 18 Cal. Code Regs. §17952 because we believe the proposed amendment affects where income is sourced when intangible property is sold under the installment method in violation of AB 1115 (Stats. 2001, ch. 920). (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)
- 1.4 The proposed regulation puts California back under pre-AB 1115 law for sourcing intangibles: The gain on the sale would be sourced to California on the basis that the gain accrued when the taxpayer was a California resident. However, why, then did the legislature so choose to repeal R&TC Sec. 17554 back in 2001? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)
- 1.5 We do agree there may be some ambiguity to the source of gain when layered with residency and non-residency claims as stated in the FTB's *Initial Statement of Reasons for the Adoption of Amendments to California Code of Regulations, Title 18, Section 17952*. However, we believe the intent of AB 1115 addressed the ambiguity surrounding these very issues. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)
- 1.6 In my opinion, the proposed regulations... are completely inconsistent with the revised California rules for taxing persons who change residence, as adopted in AB 1115 (Stats. 2001, ch. 920), and are therefore invalid under governing law.... The best way to describe the new system [under AB 1115] is to say that source was deemphasized, and residence at the time income was realized under a normal method of accounting, was emphasized. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 1:

Assembly Bill 1115 (Stats. 2001, ch. 920) specifies clear, definitive rules that will be applied consistently to all taxpayers for calculating loss carryovers, deferred deductions, and deferred income. Specifically it provides resident taxpayers will be taxed based on residency jurisdiction, and carryovers and deferred items will be calculated regardless of source. Nonresident taxpayers will be taxed solely based on sourcing jurisdiction, and carryovers and deferred items will be calculated to reflect such approach. This regulation project was begun as part of the AB 1115 implementation. At that time, it was

determined by FTB staff existing sourcing rules did not adequately address the timing of sourcing in the case of the sale or other disposition of intangible property. The FTB has authority under Revenue and Taxation Code section 17954 to promulgate rules and regulations in this area. Moreover, it is fundamental that sourcing principles apply at the moment of realization since they apply to attach jurisdiction to the sale or other disposition and the resulting income, not personal jurisdiction over the individual.

The gain on the sale in comment 1.4 would not be sourced to California on the basis the gain accrued when the taxpayer was a California resident. Although the result may be the same, the policy and method are distinct. Under the repealed RTC section 17554, the source of the gain or loss from the sale or other disposition of intangible property was never examined. Instead, the residency of the taxpayer was determined and section 17554 was applied to determine if the gain had accrued while the taxpayer was a resident. If it had, then the gain was taxed under residency jurisdiction.

With the repeal of RTC section 17554 and the adoption of other changes under AB 1115, the State no longer relies on jurisdiction over its residents to tax former residents. If a taxpayer is a nonresident, the State must now rely only on sourcing jurisdiction to tax income. So the initial question (once nonresidency is established) must always be whether or not the income in question is sourced in California. If the income arose from the sale or other disposition of intangible property, the sourcing rules to be employed to determine if that income is indeed California-sourced are the mobilia doctrine and the business situs exception. As provided in the response to comment 3, below, the character of income from an installment note *retains* the character of the income underlying the note. According to the U.S. Supreme Court in 1955 in *Commissioner v. Glenshaw Glass* (348 U.S. 426), income consists of "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Since income occurs at the point of realization, the sourcing of that income should also then occur. Applying the mobilia sourcing rule at the time of the realization is distinguishable from applying residency jurisdiction to tax income. (If the business situs exception is appropriate, it must also be applied at the time of the realization event.)

The FTB maintains this is merely a clarifying regulation. Staff believes income is indeed sourced at realization and this regulation does not provide that rule but rather seeks to make it unambiguous. AB 1115 did not directly address sourcing rules. It did, however, elevate the importance of sourcing and, thus, demanded that sourcing rules be made clearer. An effort to make sourcing rules clearer does not erode or contradict the intent of AB 1115. Although the FTB cannot determine the intent of the legislature, response 4, below, discusses the repeal of RTC section 17554.

Recommendation: Staff recommends no change.

Comments:

- 2.1 This regulation does not follow the doctrine of *mobilia sequuntur personam* (movables follow the law of the person) in its application today. (Lynn Freer, Spidell Publishing, July 28, 2003.)

- 2.2 And it would be easy to say if it was sourced, if it was realized in California, it should always be taxed to California, but I think the business situs issue is really the key point which will always have to be determined on a case-by-case basis. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)
- 2.3 With these excerpts in mind, it appears that Proposed Reg. §17952(d) moves away from 17952(c), which calls for the interpretation on a case-by-case basis of any claims to California taxation of intangible personal property due to business situs. Proposed §17952(d) is an attempt to make a rule out of something that must be decided on a case-by-case basis. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)
- 2.4 Whether income from an intangible asset has a business situs in California cannot be decided through application of the *mobilia* doctrine, because that would indicate that unequivocally in every case the taxpayer's income had a business situs in the state. When in fact, sometimes it would, and sometimes it wouldn't. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)
- 2.5 I think it would be very negative for us to mess with what we have gained already through AB 1115 in trying to solve a lot of these issues. And I think the *mobilia* doctrine is really a sidestep of the issue. The real issue is determining on a case-by-case basis when does intangible income have business situs in the state of California, not trying to make an easy solution by saying we are going to turn to where the intangible income was realized -- where and when -- and to make that the ruling factor. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)
- 2.6 But I really think the only way, when it comes to an intangible asset which is normally sourced to your state of residency, would be to source it somewhere else based on the business situs issue, and to move the argument from "did the intangible income have a source in this state or not" over to "let's look at point of realization versus point of recognition" was maybe not the right answer to the problem. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 2:

This regulation is intended to clarify sourcing rules are applied at the time of realization. Aside from the mention in the examples, the regulation does not address which sourcing rules are applicable. The two primary sourcing rules applicable to gains or losses from the sale or other disposition of intangible property are: the *mobilia* doctrine (intangible property is located at the residence of the owner) and the business situs exception (intangible property may be located somewhere other than the residence of the owner if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so its substantial use and value attach to and become an asset of the business, trade or profession in this State). Both sourcing principles will continue to be applied on a case-by-case basis.

Comment 2.4 is incorrect in that the *mobilia* doctrine will apply in the absence of showing a business situs exception. The application of the *mobilia* doctrine does not determine the business situs. These are two distinct sourcing rules. For further discussion on these two rules, see response 5 below.

The proposed regulation seeks to clarify how to answer the question, "Did the intangible income have a source in this state or not?" To determine that source, the answer of when sourcing rules are applied should be clarified.

Recommendation: Staff recommends the addition in the first example of the parenthetical phrase: (absent a business situs exception).

Comments:

- 3.1 This regulation assumes that the property at issue is the asset that was sold, not the note taken out of state. (Lynn Freer, Spidell Publishing, July 28, 2003.)
- 3.2 To treat the note differently than a note on the sale of real property would not be in keeping with either the doctrine of *mobilia sequuntur personam* or the spirit of the elimination of R&TC §17554. If this regulation is enacted, is it the first step toward taxing nonresidents on sales of non-California source real property? We believe that it is. (Lynn Freer, Spidell Publishing, July 28, 2003.)
- 3.3 I do not agree with the FTB conclusion that the installment note itself does not create a property right. (Kathleen K. Wright, June 29, 2006.)
- 3.4 What is the basis for the FTB's conclusion that the installment note itself does not create a property right? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)
- 3.5 Is the FTB opining that the note itself is the asset in question and is a movable asset? (Gina Rodriguez, Spidell Publishing, July 7, 2006, and Public Hearing held July 17, 2006.)
- 3.6 If the note is given economic substance, then the *mobilia* doctrine would place the deferred gain in the taxpayer's state of residence. But what is the FTB's authority for giving the note economic substance? (Gina Rodriguez, Spidell Publishing, July 7, 2006, and Public Hearing held July 17, 2006.)
- 3.7 The FTB analysis, however, looks through the intangible asset to the property sold. So, again, we want to know what is the basis for the FTB's conclusion that the installment note itself does not create a property right. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 3:

The property at issue is the asset sold, not the note. This is the same as sourcing the gain or loss from the sale or other disposition of real property located in California under the installment method. The principal/gain portion of installment proceeds arises from that

sale of California property. The principal/gain portion will continue to be sourced to California, regardless of the residency of the seller, since the real property sold is located in California.

The notes are not treated differently depending on the property sold. It is not the note that gives rise to the income or loss. AB 1115 seeks to tax income from California source gains the same way, regardless of whether a deferral of tax is employed. Absent the use of the installment method (or another deferral mechanism), income or loss is recognized upon realization. If a deferral mechanism is employed, the income is still sourced at the time of its realization. Deferral mechanisms are available to defer, not avoid, taxation. Contrary to the contention in comment 3.2, this is not a step toward taxing nonresidents on sales of non-California source real property.

The FTB has not concluded the installment note itself does not create a property right. Internal Revenue Code section 453 sets forth the "installment method." "Consistent with the policy of spreading gain over the life of the payments, the character of the gain recognized is governed by the character of the gain which would have been recognized if the property had been sold for its full fair market value in cash." Fundamentals of Federal Income Taxation, Cases and Materials, Tenth Edition, by James J. Freeland, Stephen A. Lind and Richard B. Stephens, Chapter 24 (The Interrelationship between Timing and Characterization), Pg. 853, citing IRC section 453(i). The character of the note is not part of the rationale for sourcing the gain or loss from the property sold. The note is the deferral mechanism. Absent that deferral, the income would be recognized at realization. In other words, the taxpayer has a realization event upon the sale or other disposition of the intangible property; the taxpayer defers that income through the installment method. The note is given economic substance such that the interest income is not sourced to California when earned by a nonresident since it is realized periodically under the taxpayer's regular method of accounting (cash or accrual). Further, if the note itself were later sold, the value of the note above the initial gain from the sale or other disposition of the intangible would be distinctly sourced.

Whether or not the note is given economic substance has no effect on the sourcing of the gain or loss from the sale or other disposition of the underlying intangible property.

Recommendation: Staff recommends no change.

Comment:

4.1 This regulation is counter to the intent of the repeal of R&TC §17554. (Lynn Freer, Spidell Publishing, July 28, 2003.)

Response 4:

Revenue and Taxation Code section 17554, prior to its repeal, provided:

When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this state, as the case may be, income and deductions accrued prior to the change of status

even though not otherwise includable in respect of the period prior to that change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

Revenue and Taxation Code section 17554 was repealed in 2002, operative for taxable years beginning on or after January 1, 2002. That section provided for the accrual of income under certain circumstances upon a change of residency. It was repealed, in part, because subsequent to the *Appeal of Money*, section 17554 was rarely applicable.¹ The *Appeal of Money* provided Revenue and Taxation Code section 17554 would apply only when two conditions were satisfied: (1) when California's sole basis for taxation is the taxpayer's residency, and (2) when that taxation would differ depending on whether the taxpayer used the accrual or the cash method of accounting. Since the Board of Equalization limited section 17554 to only cases of California residency, it was not applicable to nonresidents even back to 1983. Therefore, its application or repeal has little bearing on a sourcing rule applied to nonresidents.

By the time AB 1115 was being considered, there were very few fact situations that would result in the application of RTC section 17554. When AB 1115 sought to simplify the rules to provide nonresidents are taxed through jurisdiction gained through sourcing concepts, it became apparent RTC section 17554 was superfluous. As a result, RTC section 17554 was repealed with the adoption of the changes made by AB 1115.

This regulation provides clarification of when sourcing rules should apply. The timing of sourcing other types of income, such as income from the performance of services or from the sale or other disposition of real property, also occurs at the time of realization. Therefore this regulation is consistent with when sourcing rules apply in other circumstances.

Recommendation: Staff recommends no change.

Comments:

- 5.1 The proposed regulation under 17952 ... duplicates the examples included in regulations promulgated under (now repealed) Rev. and Tax. Code sec. 17554. This code section was repealed by AB 1115 and therefore it would be a logical result that to put back part of that code section would require legislative action. (Kathleen K. Wright, June 29, 2006.)
- 5.2 Finally, please see Example 3 of former 18 CCR 17554 (the regulation was repealed on Dec. 10, 2002 due to the passage of AB 1115). While the example deals with the sale of real property, and not intangibles, it clearly shows that a nonresident was subject to California tax because the right to receive the income on the sale accrued before the taxpayer changed residency. Proposed regulation 17952 is attempting to apply the same tax policy as promulgated in a regulation that has been repealed. What is the FTB's authority for this action? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

¹ *Appeal of Virgil M. and Jeanne P. Money* (December 13, 1983) 83-SBE-267.

5.3 In Example 3 of former regulation section 17554, it deals with the sale of real property, not intangibles. However, it clearly shows that a nonresident was subject to California tax because the right to receive income on the sale accrued before the taxpayer changed residency. So the proposed regulation attempts to apply the same tax policy promulgated in this regulation, a regulation that has been repealed. So we want to know again, what is FTB's authority for this action? (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 5:

The examples in Regulation 17554 (Title 18, California Code of Regulations 17554) did not address the sale or other disposition of intangible property.

In light of the repeal of RTC section 17554 and the regulations thereunder, the facts under example 3 would lead to a different result. As explained above, the first question would be whether or not the income in question is sourced to California. In the example, the real property is located in Nevada and, therefore, the income from the sale of that property is not subject to California tax in the hands of a nonresident. Please note the example says the "payments are subject to California tax even though they were not derived from a California source..." With the repeal of RTC section 17554, the payments would only be subject to California tax if they were derived from a California source.

The sourcing rule for income from the sale or other disposition of intangible property is distinct from the sourcing rule for income from the sale of real property. Although both sources are determined by reference to the location of the property, the location of real property is readily determinable. Intangible personal property has no actual situs.

The situs problem is explained well by Frank M. Keesling, former Counsel to the Franchise Tax Commissioner of California, in the 1950 treatise, Allocation of Income in State Taxation on page 35:

Because of this the law has for tax purposes indulged in fictions. One of these fictions is represented by the maxim *mobilia sequuntur personam* – that the association of intangibles with the person of the owner gives them a situs at the domicile of the owner... A contrary fiction, however, is that of "business situs," under which intangibles which are an integral part of a business carried on at a place are given situs at that place... The situs attributed is still a fiction, however.

The amendments to regulation section 17952 are consistent with both AB 1115 and the repeal of RTC section 17554.

Recommendation: Staff recommends no change.

Comment:

6.1 The guidance would be more useful if the example dealt not only with the sale of intangible personal property by a resident under the installment method who subsequently becomes a nonresident, but also with the sale under the installment method by a nonresident of intangible personal property without a business situs in California, and the nonresident subsequently becomes a resident of California. Otherwise, a reader might incorrectly interpret the last sentence of the proposed addition (which can be interpreted as limited to the business situs exception) as inferring that no tax is due where a nonresident sells intangible personal property on an installment basis prior to becoming a resident of California, and receives an installment payment after becoming a California resident. (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 6:

This regulation is being promulgated under Revenue and Taxation Code 17952. Revenue and Taxation Code sections 17951 through 17955 concern the taxation of nonresidents. Specifically they address sourcing rules that are only relevant to nonresidents. Resident taxpayers are taxable on all income, regardless of source.

Recommendation: Staff recommends no change.

Comment:

7.1 Comment: What is the effect of a federal election [pursuant to Internal Revenue Code section 453(d)] to be taxed at the time of sale? (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 7:

California conforms to Internal Revenue Code section 453. If a taxpayer elects to be taxed at the time of sale, then there would be no deferral of income tax. The source of the income is unaffected by the taxpayer's accounting method or the choice to employ a deferral mechanism. The source of the gain or loss would be determined at the time of the sale or other disposition.

Recommendation: Staff recommends no change.

Comment:

8.1 Comment: May a nonresident taxpayer make a California-only election out of installment treatment? (Roy E. Crawford, Heller Ehrman, LLP, June 6, 2006.)

Response 8:

A properly filed federal election to report the gain in the year of sale, rather than on the installment method, is a proper election for California purposes. However, the taxpayer is not required to make the same election for California tax purposes. To elect out of the installment method for California purposes, the taxpayer reports the gain on the sale of the property in the year of sale on their California tax return. The election must be made by the extended due date of the return. However, a federal election (or lack of an

election) made by an individual before he or she becomes a California taxpayer is binding for California purposes. (See RTC section 17024.5(e).)

Recommendation: Staff recommends no change.

Comments:

9.1 Comment: [T]he FTB has been applying its policy to taxpayers for the 2002 and subsequent taxable years, and has published its substantive application in FTB Pub. 1100 since that time. What is the FTB's authority to apply the policy set for [sic] in the proposed regulation for the last four years (taxing nonresidents who sell intangibles on the installment basis)? (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

9.2 We would like to know what is the FTB's authority to apply the policy set forth in the proposed regulation for the last four years in that they are taxing nonresidents who sell intangibles on an installment basis. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 9:

The FTB maintains this is merely a clarifying regulation. Staff believes income is indeed sourced at realization and this regulation does not provide that rule but rather seeks to make it unambiguous. AB 1115 did not directly address sourcing rules. It did, however, elevate the importance of sourcing and, thus, demanded that sourcing rules be made clearer. As explained in response 1 above, it is fundamental that sourcing occurs at realization.

Recommendation: Staff recommends no change.

Comment:

10.1 An auditor would no longer have the disagreeable task of trying to prove residency. Nonetheless, such statutory changes still have to pass constitutional muster and survive analysis under the Due Process Clause and the Commerce Clause, which limit a state's power to tax nonresidents unless that income is derived from sources within the state. (Gina Rodriguez, Spidell Publishing, July 7, 2006.)

Response 10:

Both the taxpayer and auditor will be faced with determining the source of the income. This regulation sets forth the analysis of whether "income is derived from sources within the state" occurs at realization. The requirements of the Due Process and Commerce Clauses are bound up in whether the income is sourced to California.

Recommendation: Staff recommends no change.

Comment:

11.1 Comment: As a professional membership organization representing over 4,000 tax professionals, we disagree [with the FTB's analysis there would be minimal impact to

private persons or businesses as a result of this regulation]. (Kim Kastl, California Society of Enrolled Agents, July 12, 2006.)

Response 11:

This regulation clarifies existing law and, as such, is not expected to have any significant fiscal impact. The economic estimates are based on the data available as well as discussion with the Audit Division and Legal Department regarding how often these cases are encountered.

Recommendation: Staff recommends no change.

Comment:

12.1 The proposed regulations create potential problems for financial institutions, such as private equity funds, which may have reporting and withholding obligations for former California residents that they are not well-equipped to administer. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 12:

This regulation is only solidifying current principles and is not creating new reporting or withholding obligations. In fact, by promulgating the regulation the FTB hopes to assist taxpayers and their financial representatives in understanding and complying with the California Revenue and Taxation Code.

Recommendation: Staff recommends no change.

Comments:

13.1 The Board should not adopt the proposed regulations before conducting a study, and coordinating with major states (such as New York, Illinois, and Massachusetts) which impose personal income taxes and to and from which California residents frequently move, to determine whether the proposed rules are likely to lead to double taxation. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

13.2 The Board should make clear that former nonresidents now living in California will be able to claim credits for taxes imposed by the states where they formerly lived on gains of the type we are concerned with here, assuming that those states adopt the same approach as that provided in the proposed regulations. (Norman Lane, Greenberg Traurig, in his individual capacity, July 14, 2006.)

Response 13:

Staff is presently conducting such a study, including a survey of state tax administrators. The results of the study will be included in the rule-making file for this regulation.

The "Other State Tax Credit" (provided under RTC section 18001) remains available to former nonresidents now living in California for taxes imposed by the states where they formerly resided on these types of gains, since the "Other State Tax Credit" is determined with reference to California sourcing rules.

Recommendation: Staff recommends no change.

Comment:

14.1 [T]he seller who is now a nonresident may still have a financial interest in the intangible which is exercisable if the provisions of the contract are not fulfilled. And I know in the regulation's filings there seem to be a lot of documents and cases on fixed and determinable amounts, so we're questioning that the note may not be fixed and determinable as the FTB purports. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 14:

The rule set forth in this regulation provides sourcing will be determined at the time of realization. If the seller still has a financial interest in the intangible property, it may be realization has not occurred. The regulation does not attempt to address under which circumstances realization occurs. It only provides when the sourcing rules shall be applied – upon realization.

Recommendation: Staff recommends no change.

Comment:

15.1 A taxpayer's method of accounting should affect the sourcing of his or her income. Under former Section 17554, a taxpayer converted to accrual when they moved into or out of state, and on that basis, the income from the installment note was artificially accelerated on the date of the move. Yet we no longer apply the accrual method to a cash-basis taxpayer when they move. And, therefore, the accounting method should govern when the income is recognized – under the installment method and cash method, when received – and then the sourcing rule should apply. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 15:

The definition of income, rules to source such income and right to tax such income involve distinct policy considerations from the choice by the State to offer alternative accounting methods, conform to federal taxation law and defer the collection of tax due. The State's ability to tax should not be driven by a taxpayer's choice of accounting method.

Recommendation: Staff recommends no change.

Comment:

16.1 Finally, I want to point out that the proposed regulation does not address two different types of tax effects. Number one, the sale of an intangible without a California business situs [sic] under the installment method, and, number two, a California-only election out of the installment method at the time of the sale. And those two things should be clarified if we are moving forward with this regulation. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 16:

This regulation clarifies when the sourcing rules should be applied to determine the source of income. It does not attempt to address the tax impacts on the sale of an intangible without a California business situs under the installment method. The sourcing of the income from the sale of the intangible property in the hypothetical would depend on whether or not the property sold had a business situs outside California. This regulation would merely provide that the sourcing rules would be determined at the time of realization. Please see response 8 for information on a California-only election.

Recommendation: Staff recommends no change.

Comment:

17.1 And so I don't think trying to re-source it to California, which will even further confuse all the issues of AB 1115, is really the answer. (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 17:

This regulation clarifies source is determined at realization. There is no re-sourcing.

Recommendation: Staff recommends no change.

Comment:

18.1 And just as you may lose some tax on intangible income that is not going to be received prior to a person becoming a nonresident, you also receive tax by those who move into this state and receive some intangible income from something sold in another state. So it all just comes out in the wash, doesn't it? (Vicki L. Mulak, California Society of Enrolled Agents, Public Hearing held July 17, 2006.)

Response 18:

The proposed amendment to this regulation seeks to clarify when sourcing rules apply so taxpayers and their representatives may comply with the state tax law.

Recommendation: Staff recommends no change.

Comment:

19.1 Lastly, Lynn and I do respectfully request that this regulation be returned to the Board for review and that you answer the questions that we posed here today. (Gina Rodriguez, Spidell Publishing, Public Hearing held July 17, 2006.)

Response 19:

This item is expected to be considered by the Board at its meeting on December 4, 2006.

Recommendation: Staff recommends no change except the addition in the first example of the parenthetical phrase: (absent a business situs exception).



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18 CA ADC § 17952

§ 17952.* Income from Intangible Personal Property.

Term **D**

18 CCR § 17952

Cal. Admin. Code tit. 18, § 17952

Barclays Official California Code of Regulations Currentness

Title 18. Public Revenues

Division 3. Franchise Tax Board

Chapter 2.5. Personal Income Tax (Taxable Years Beginning After 12-31-54)

* **Subchapter 11. Gross Income of Nonresidents (Refs & Annos)**

→§ 17952.* Income from Intangible Personal Property.

(a) Income of nonresidents from rentals or royalties for the use of, or for the privilege of using in this State, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property is taxable, if such intangible property has a business situs in this State within the meaning of (c) below.

(b) Income of nonresidents from intangible personal property such as shares of stock in corporations, bonds, notes, bank deposits and other indebtedness is taxable as income from sources within this State only if the property has a situs for taxation in this State, except that if a nonresident buys or sells stock, bonds, and other such property in California, or places orders with brokers in California to buy or sell such property, so regularly, systematically and continuously as to constitute doing business in this State, the profit or gain derived from such activity is taxable as income from a business carried on here, irrespective of the situs of the property for taxation.

(c) Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds or other intangible personal property in California as security for the payment of indebtedness, taxes, etc., incurred in connection with a business in this State, the property has a business situs here. Again, if a nonresident maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State, the bank account has a business situs here.

If intangible personal property of a nonresident has acquired a business situs here, the entire income from the property including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within this State, taxable to the nonresident.

(d) The source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property. For example, if a California resident sells intangible personal property under the installment method, and subsequently becomes a nonresident, any later recognized gain attributable to any installment payment receipts relating to that sale will be sourced to California (absent a business situs exception). Further, a California nonresident who sells intangible personal property would be taxed by California on gain as it is recognized upon receipt of future installment payments if the intangible personal property had a business situs in California

at the time of the sale.

* This regulation is substantially the same as Title 18, Cal. Adm. Code, Chapter 3, Subchapter 2, Section 17211-14(f).

Note: Authority cited: Section 19503, Revenue and Taxation Code. Reference: Sections 17041 and 17952, Revenue and Taxation Code.

HISTORY

1. Renumbering and amendment of Sections 17951-17954(f) to Section 17952 filed 1-15-82; effective thirtieth day thereafter (Register 82, No. 3).
2. Change without regulatory effect amending subsection (a) and Notefiled 12-10-2002 pursuant to section 100, title 1, California Code of Regulations (Register 2002, No. 50).
3. New subsection (d) filed 7-2-2007; operative 8-1-2007 (Register 2007, No. 27).

18 CCR § 17952, ← 18 CA ADC § 17952 →

This database is current through 5/28/10 Register 2010, No. 22

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REVENUE AND TAXATION CODE

SECTION 19503

19503. (a) The Franchise Tax Board shall prescribe all rules and regulations necessary for the enforcement of Part 10 (commencing with Section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), and this part and may prescribe the extent to which any ruling (including any judicial decision or any administrative determination other than by regulation) shall be applied without retroactive effect.

(b) (1) Except as otherwise provided in this subdivision, no regulation relating to Part 10 (commencing with Section 17001), Part 10.7 (commencing with Section 21001), Part 11 (commencing with Section 23001), or this part shall apply to any taxable year ending before the date on which any notice substantially describing the expected contents of any regulation is issued to the public.

(2) Paragraph (1) shall not apply to either of the following:

(A) Regulations issued within 24 months of the date of the enactment of the statutory provision to which the regulation relates.

(B) Regulations issued within 24 months of the date that temporary or final federal regulations with respect to statutory provisions to which California conforms are filed with the Federal Register.

(3) The Franchise Tax Board may provide that any regulation may take effect or apply retroactively to prevent abuse.

(4) The Franchise Tax Board may provide that any regulation may apply retroactively to correct a procedural defect in the issuance of any prior regulation.

(5) The limitation of paragraph (1) shall not apply to any regulation relating to the Franchise Tax Board's policies, practices, or procedures.

(6) The limitation of paragraph (1) may be superseded by a legislative grant of authority to the Franchise Tax Board to prescribe the effective date with respect to any regulation.

(7) The Franchise Tax Board may provide for any taxpayer to elect to apply any regulation before the dates specified in paragraph (1).

(c) The amendments made by the act adding this subdivision are operative with respect to regulations which relate to California statutory provisions enacted on or after January 1, 1998.

GOVERNMENT CODE

SECTION 11343.4

11343.4. A regulation or an order of repeal required to be filed with the Secretary of State shall become effective on the 30th day after the date of filing unless:

(a) Otherwise specifically provided by the statute pursuant to which the regulation or order of repeal was adopted, in which event it becomes effective on the day prescribed by the statute.

(b) A later date is prescribed by the state agency in a written instrument filed with, or as part of, the regulation or order of repeal.

(c) The agency makes a written request to the office demonstrating good cause for an earlier effective date, in which case the office may prescribe an earlier date.



Saturday, March 01, 2003

Change to Taxation of New Residents and New Nonresidents

ThumbTax

By: Taxletter Staff

Below is a chart to help you calculate income for a taxpayer who changed residence for taxable years beginning on or after January 1, 2002.

	New Resident	New Nonresident
Wages	Taxed on all wages received as a resident.	Taxed on wages earned while a California resident only if services were performed in California.
Installment sale All installment sale gains on California property are taxable to residents and nonresidents.	A new resident is taxed on the installment portion of all gains received while a resident whether the property was located in California or in another state.	A nonresident is not taxed by California on the installment payments received while a nonresident if the property does not have a California situs, even if the original sale occurred while the taxpayer was a resident.
1031 exchanges California conforms to IRC §1031.	New residents are treated as if they had always been residents and are taxed on all the gain on the sale of property, including	When a taxpayer who deferred gain on California property under IRC §1031 to property located in another state sells the out-of-state property,



Spidell Publishing Inc.

Monday, January 01, 2007

Taxing Former Residents on Installment Sales of Intangibles

Franchise Tax Board approves proposed regulation

By: Renée Rodda

The three-member Franchise Tax Board on December 4, 2006, approved a proposed regulation that formalizes its current practice of taxing former residents on installment gains received on intangibles sold while they were residents of California (Prop. 18 Cal. Code Regs. §17952). Spidell Publishing testified in opposition to the regulation because we believe it is in violation of AB 1115 (Ch. 01-920), which provides that carryover items, such as deferred income, suspended losses, or suspended deductions should be determined as if a former resident had always been a nonresident (and a new resident had always been a resident).

The regulation now goes to the Office of Administrative Law, where it will likely be approved and published.

~~Approval of the regulation means that the FTB will have it both ways:~~

- Taxing the gain to an individual who moves into California and receives payments on a prior installment sale of an intangible (because residents are taxed on worldwide income); and
- Taxing a former resident on the deferred gain on the sale of intangibles.

Note

Intangible property includes items such as stocks, bonds, notes, bank deposits, accounts receivable, patents, trademarks, copyrights, and goodwill (R&TC §17952 and 18 Cal. Code Regs.

§1138.22).

Why the regulation violates AB 1115

Here is the scenario under the new regulation: A California resident sells an intangible, such as stock from a closely held corporation on the installment method (publicly traded stock is not eligible for installment sale treatment under IRC §453(k)(2)(A), to which California conforms). Half of the payment is to be made in 2005 and half in 2007. The resident reports half of the gain and interest income in 2005 and becomes a nonresident in 2006. In 2007, the remaining gain is taxable in California under the propose regulation.

The FTB believes that the gain is taxable to California because the taxpayer was a resident at the time of sale. Generally, however, the income from intangibles is sourced to the owner's state of residence. Under AB 1115 and ~~R&TC §17041(1)(3)~~ deferred income is includable in California taxable income of a nonresident only to the extent that it was derived from California sources and must be "calculated as if the nonresident had been a nonresident for all prior years."

Example of New Regulation's Effect

In 2002 when he was a resident of New Jersey, Ron sold stock from a closely held corporation in an installment sale. Ron became a resident of California in 2005 and received the final installment payment in 2006. The gain recognized in 2006 of \$10,000 is taxable to California because residents are taxed on income from all sources (R&TC §17041).

Karen was a resident of California in 2002 when she sold stock from a closely held corporation in an installment sale. Karen became a resident

of Nevada in 2005. She received the final installment in 2006. The gain recognized in 2006 of \$10,000 is taxable to California, according to the new regulation because the gain on the intangible asset was realized at the time she was a resident.

If Karen had waited until 2005 to sell her stock, none of the gain would be taxable to California.

Who does the regulation affect?

This regulation will cause a client who is a shareholder in a closely held corporation to pay tax on the installment payments if that client was a resident at the time of sale but a nonresident when the payment is received. Thus, you should advise your client who is selling the stock in a corporation to move out of California before the sale to avoid tax on the sale.

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Tax and Accounting Center

Internal Revenue Code

Subtitle A — INCOME TAXES (Sections 1 to 1564)

Chapter 1 — Normal taxes and surtaxes (Sections 1 to 1400U-3)

Subchapter N — Tax Based on Income From Sources Within or Without the United States (Sections 861 to 999)

Part I — Source Rules and Other General Rules Relating to Foreign Income (Sections 861 to 865)

Sec. 864. Definitions And Special Rules

864(c) Effectively Connected Income, Etc.

864(c)(6) Treatment Of Certain Deferred Payments, Etc.

For purposes of this title, in the case of any income or gain of a nonresident alien individual or a foreign corporation which—

864(c)(6)(A)

is taken into account for any taxable year, but

864(c)(6)(B)

is attributable to a sale or exchange of property or the performance of services (or any other transaction) in any other taxable year,

the determination of whether such income or gain is taxable under section 871(b) or 882 (as the case may be) shall be made as if such income or gain were taken into account in such other taxable year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the taxable year referred to in subparagraph (A).

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[JOINT COMMITTEE PRINT]

**GENERAL EXPLANATION
OF THE
TAX REFORM ACT OF 1986**

(H.R. 3838, 99TH CONGRESS;
PUBLIC LAW 99-514)

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION



MAY 4, 1987

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1987

the number of changes
resulted in significant

the legislative back-
ground, explanations of
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changes to prior tax
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ARRING HOUSE, INC.

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its continued viability, and, if necessary, propose legislation to obvi-
ate any abuses. Congress did not extend the treaty shopping prohibi-
tion to dividend and interest payments made by U.S. corporations
because the appropriate extension of the theory embodied in Re-
venue Rulings 84-152, 1984-2 C.B. 381, and 84-153, 1984-2 C.B. 383,
may provide appropriate federal income tax treatment for these
and similar transactions.

Effective Date

The provisions are effective for taxable years beginning after De-
cember 31, 1986.

For U.S. branches of foreign corporations that have undistrib-
uted accumulated earnings and profits as of their first taxable
years beginning on or after January 1, 1987, the Act's provisions
apply only to earnings and profits generated in taxable years be-
ginning after December 31, 1986, that are considered distributed
from the branch to the home office (limited by post-effective date
earnings and profits). Prior law's withholding tax on dividends ap-
plies to the pre-effective date accumulated earnings and profits
that are distributed after the effective date. Thus, if a branch's
income did not constitute at least 50 percent of the corporation's
income for the base period prescribed under prior law, there is no
withholding tax imposed on dividends paid after 1986 that repre-
sent pre-effective date earnings. Similarly, pre-effective date defi-
cits in earnings and profits are not eligible to reduce post-effective
date earnings in applying the branch profits tax. Post-effective date
deficits in earnings and profits do not reduce pre-effective date
earnings in applying prior law's withholding tax to distributions
after 1986 where the distributions are attributable to pre-effective
date earnings.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts
by \$13 million in 1987, \$20 million in 1988, \$23 million in 1989, \$26
million in 1990, and \$28 million in 1991.

2. Treatment of deferred payments and appreciation arising out of
business conducted within the United States (retain character
of effectively connected income) (sec. 1242 of the Act and sec.
864(c) of the Code)⁷

Prior Law

The United States taxes the worldwide income of U.S. citizens,
residents, and corporations on a net basis at graduated rates. Non-
resident aliens and foreign corporations are generally taxed only
on their U.S. source income. The United States taxes foreign tax-
payers' income that is "effectively connected" with a U.S. trade or
business on a net basis at graduated rates, in much the same way

⁷ For legislative background of the provision, see: H.R. 3838, as reported by the House Com-
mittee on Ways and Means on December 7, 1985, sec. 652; H.Rep. 99-426, pp. 435-436; H.R. 3838,
as reported by the Senate Committee on Finance on May 29, 1986, sec. 953; S.Rep. 99-313, pp.
407-409; Senate floor amendment, 132 Cong. Rec. S 8227 and 8370 (June 24 and June 25, 1986);
and H.Rep. 99-841, Vol. II (September 18, 1986), p. 651 (Conference Report).

that it taxes the income of U.S. persons. U.S. income of a foreign taxpayer that is not effectively connected with a U.S. trade or business is generally subject to a 30-percent withholding tax on the gross amount of the income, although certain types of this income earned by foreign investors, such as portfolio interest income, are exempt from U.S. tax. U.S. income tax treaties reduce or eliminate the 30-percent withholding tax in many cases. The United States does not generally tax foreign taxpayers on capital gains that are not connected with a U.S. trade or business (real property gains have been the major exception to this rule).

Although gains from the sale of assets used by a foreign corporation in a U.S. trade or business ordinarily would constitute effectively connected income fully subject to U.S. tax, under prior law foreign persons may have been able to avoid U.S. tax on income attributable to a U.S. trade or business if they received the income in a year after the trade or business had ceased to exist (e.g., by selling property and recognizing the gain on the installment basis). Foreign persons may also have been able to avoid U.S. tax by removing property of a trade or business from the United States before its disposition.

Reasons for Change

Under prior law, foreign taxpayers could avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business had ceased to exist. For example, the business could sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer could defer the income to a later taxable year. If the taxpayer had no U.S. trade or business in that year, then the income recognized in that year was not treated as effectively connected with a U.S. trade or business. Congress believed that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similarly, Congress believed that foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the United States where payment of the income is deferred until a subsequent year in which the individual is not present in the United States. Finally, Congress believed that gains accrued by a foreign person's U.S. trade or business should be subject to U.S. tax, and that such tax should not be avoidable through the simple expedient of removing property from the country prior to its disposition. Congress recognized that U.S. persons that transfer assets out of U.S. tax jurisdiction may be subject to tax on unrealized appreciation (sec. 367). Congress believed a similar rule is appropriate for foreign persons as well.

Explanation of Provisions

The Act amends section 864(c) to provide that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other

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oid U.S. tax by re- or business in a rist. For example, installment obliga- installment basis, xable year. If the it year, then the as effectively con- elieved that income s should be taxed at income is de- gress believed that U.S. tax on their he United States a subsequent year ed States. Finally, eign person's U.S. and that such tax dient of removing on. Congress recog- of U.S. tax jurisdic- ciation (sec. 367). or foreign persons

ny income or gain as attributable to a eated as effectively usiness if it would unt in that other

taxable year. Thus, deferring the recognition of income until a later taxable year will no longer change the manner in which the U.S. tax system treats the income.

In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business.

A foreign corporation that is treated as deriving effectively connected income under these rules is also to be treated as engaged in trade or business in the United States during the taxable year in which the income arises. Moreover, any income treated as effectively connected by these provisions is to be considered attributable to a U.S. office of the U.S. trade or business.

For example, assume a foreign individual owns all the stock of a foreign corporation, which uses the calendar year as its fiscal year. The foreign corporation owns business property physically located in the United States. The foreign corporation ceases U.S. business activity in the United States at the end of 1987. If the foreign corporation had sold its property at a gain in 1987, the gain would have been attributable to its U.S. office and, thereby, U.S. source and effectively connected with a U.S. trade or business. Disregarding any effect of the rule provided by this provision of the Act, if the foreign corporation, however, had sold the property in 1989, the gain would not have been so connected, due to the cessation of U.S. business activities by it prior to the beginning of 1988. Under this provision of the Act, if the foreign corporation sells the property in 1989, any gain will be characterized as effectively connected. Similarly, if the foreign corporation, having ceased U.S. business at the end of 1987, completely liquidates in 1989 and either sells its property in liquidation or transfers its property to its shareholder, this provision characterizes any gain recognized as effectively connected with a U.S. trade or business.

Effective Date

These provisions apply to taxable years beginning after 1986. The provision treating deferred payments as generating effectively connected income (new sec. 864(c)(6)) applies only to income that arises from sales, exchanges, the performance of services, or other transactions occurring in taxable years beginning after 1986. Similarly, the provision determining effectively connected status as of the time of cessation of business (new sec. 864(c)(7)) applies only to property ceasing to be used in connection with a U.S. trade or business in a taxable year beginning after 1986. Thus, for example, the provision does not apply to a sale or exchange of property after 1986 if the cessation of business occurred prior to 1987.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than \$5 million per year.

Calendar No. 665

99TH CONGRESS
2d Session

SENATE

REPORT
99-313

TAX REFORM ACT OF 1986

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

TO ACCOMPANY

H.R. 3838

together with

ADDITIONAL VIEWS

[Including cost estimate of the Congressional Budget Office]



MAY 29, 1986.—Ordered to be printed

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WASHINGTON : 1986

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HOUSE, INC.

corporation are not treaty shopping. If the owners are treaty shopping, then the United States will impose its 30 percent withholding tax on U.S. source interest payments made by the corporation, unless a treaty between the United States and the recipients' country of residence otherwise reduces or eliminates the tax and no treaty shopping with respect to the latter treaty takes place..

Effective Date

The provision is effective for taxable years beginning after December 31, 1986.

For U.S. branches of foreign corporations that have undistributed accumulated earnings and profits as of their first taxable years beginning on or after January 1, 1987, the bill's provisions are to apply to income generated in taxable years after December 31, 1986, that are considered distributed from the branch to the home office, limited by post-effective date earnings and profits. Meanwhile, present law's second-level withholding tax on dividends is to apply to the pre-effective date accumulated earnings and profits that are distributed after the effective date. Thus, if a branch's income had not constituted at least 50 percent of the corporation's income for the base period prescribed under present law, there would be no withholding tax imposed.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by \$13 million in 1987, \$20 million in 1988, \$23 million in 1989, \$26 million in 1990, and \$28 million in 1991.

2. Retain Character of Effectively Connected Income (sec. 953 of the bill and sec. 864 of the Code)

Present Law

The United States taxes the worldwide income of U.S. citizens, residents, and corporations on a net basis at graduated rates. Non-resident aliens and foreign corporations are generally taxed only on their U.S. source income. The United States taxes foreign taxpayers' income that is "effectively connected" with a U.S. trade or business on a net basis at graduated rates, in much the same way that it taxes the income of U.S. persons. U.S. income of a foreign taxpayer that is not connected with a U.S. trade or business is generally subject to a 30-percent withholding tax on the gross amount of such income, although certain types of such income earned by foreign investors, such as portfolio interest income, are exempt from U.S. tax. U.S. income tax treaties reduce or eliminate the 30-percent withholding tax in many cases. The United States does not generally tax foreign taxpayers on capital gains that are not connected with a U.S. trade or business (real property gains have been the major exception to this rule).

Although gains from the sale of assets used by a foreign corporation in a U.S. trade or business ordinarily would constitute effectively connected income fully subject to U.S. tax, under present law foreign persons may be able to avoid U.S. tax on income attributable to a U.S. trade or business if they receive the income in a year

after the trade or business has ceased to exist (e.g., by selling property and recognizing the gain on the installment basis). Foreign persons may also be able to avoid U.S. tax by removing property of a trade or business from the United States before selling it.

Reasons for Change

Under present law foreign taxpayers can avoid U.S. tax by receiving income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist. For example, the business can sell property and accept an installment obligation as payment. By recognizing the gain on the installment basis, the taxpayer can defer the income to a later taxable year. If the taxpayer had no U.S. trade or business in that year, then the income recognized in that year is not treated as effectively connected with a U.S. trade or business. The committee believes that income earned by a foreign person's U.S. trade or business should be taxed as such, regardless of whether recognition of that income is deferred until a later taxable year. Similarly, the committee believes that foreign persons should not be able to avoid U.S. tax on their income from the performance of services in the United States where payment of the income is deferred until a subsequent year in which the individual is not present in the United States. Finally, the committee likewise believes that gains accrued by a foreign person's U.S. trade or business should be subject to U.S. tax, and that such tax should not be avoidable through the simple expedient of removing property from the country prior to its sale. The committee recognizes that U.S. persons that transfer assets out of U.S. tax jurisdiction may be subject to tax on unrealized appreciation (sec. 367). The committee believes a similar rule is appropriate for foreign persons as well.

Explanation of Provision

The bill amends section 864(c) to provide that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated if it had been taken into account in that other taxable year. Thus, deferring the recognition of income until a later taxable year will no longer change the manner in which the U.S. tax system treats the income.

In addition, the bill provides that the removal from U.S. tax jurisdiction of the assets of a foreign person's U.S. trade or business will be treated for U.S. tax purposes as a taxable disposition of those assets. Removal of business assets occurs by physical departure from the United States. Removal also occurs by disposition within the United States after the trade or business has ended.

For example, assume foreign individual I owns foreign corporation C, which uses the calendar year as its fiscal year. C owns business property physically located in the United States. C ceases U.S. business activity in the United States at the end of 1987. Disregarding any effect of the new rule provided by this provision of the bill, if C had sold its property at a gain in 1987, the gain would have been effectively connected with a U.S. trade or business, but if C

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had sold the property in 1989, the gain would not have been so connected, due to the cessation of U.S. business activities by C prior to the beginning of 1988. Under section 953 of the bill, if C sells the property in 1989, any gain would be characterized as effectively connected. If C completely liquidates in 1989 and transfers its property to I, its sole shareholder, section 953 of the bill would cause the disposition of the property to be treated as a taxable disposition by C notwithstanding the nonrecognition provisions of Code Section 336, and would characterize any gains as effectively connected with a U.S. trade or business. On the other hand, if C completely liquidated and transferred its property to I in 1987, without previously terminating its U.S. trade or business, the nonrecognition provisions of Section 336 would not be overridden because the transfer in liquidation would not be treated as a removal from U.S. tax jurisdiction. Note that in this latter case, the assets would remain within U.S. tax jurisdiction as property producing effectively connected income for I.

Because the provision is intended to tax only gain that accrues while property is within the United States, property brought into the United States will be deemed to have a basis equal to its fair market value on the date that it was brought into the country. This special basis rule applies solely for purposes of determining the amount of gain required to be recognized upon the removal of the asset, and not for any other purpose of the Code (*e.g.*, depreciation).

Effective Date

The provision applies to taxable years beginning after 1986.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by less than \$5 million per year.

3. Tax-Free Exchanges by Expatriates (sec. 954 of the bill and sec. 877 of the Code)

Present Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will, for ten years, continue to be taxed as a citizen on U.S. source income, but not foreign source income, under Code section 877. U.S. income of such tax-avoidance expatriates will thus be subject to tax on a net basis at graduated rates, regardless of how such income would be taxed to a nonresident alien. U.S. income for this purpose includes gains from sales of U.S. property (*i.e.*, property located in the United States, stock of U.S. corporations, and debt obligations issued by any U.S. person, including Federal, state and local governments).

Reasons for Change

Tax-avoidance expatriates may under present law be able to avoid U.S. tax by making a tax-free exchange of U.S. property for foreign property. The sale of the U.S. property would be subject to

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2d Session

HOUSE OF REPRESENTATIVES

REPORT
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TAX REFORM ACT OF 1986

CONFERENCE REPORT

TO ACCOMPANY

H.R. 3838



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LEARNING HOUSE, INC.

2. Retain Character of Effectively Connected Income

Present Law

The United States taxes foreign persons' income that is effectively connected with a U.S. trade or business on a net basis at graduated rates, in the same manner that it taxes the income of U.S. persons. Foreign persons may not be subject to U.S. tax if they receive income that was earned by a U.S. trade or business in a year after the trade or business has ceased to exist (e.g., by selling property and recognizing the gain on the installment basis) or dispose of U.S. business property at a gain in a year after the business has ceased to exist.

House Bill

The House bill provides that income or gain is treated as effectively connected with a U.S. trade or business if it is attributable to another taxable year and would have been so treated if it had been taken into account in that other year. This provision applies to taxable years beginning after 1985.

Senate Amendment

The Senate amendment generally follows the House bill, but amends present law in two additional respects. First, under the Senate amendment, a foreign person's sale of U.S. assets that formerly were used in a U.S. business is taxable. Second, the Senate amendment treats the removal of business assets from U.S. jurisdiction as a disposition, with a basis step-up for this purpose for business assets brought into the United States. The Senate amendment applies to taxable years beginning after 1986.

Conference Agreement

The conference agreement generally follows the Senate amendment except that it does not include the provision treating the removal of business assets as a disposition, and it only treats income as being effectively connected if the assets are sold within 10 years after being used in a U.S. business.

3. Tax-Free Exchanges by Expatriates

Present Law

A U.S. citizen who gives up citizenship for a principal purpose of avoiding U.S. tax will generally continue for a period of ten years to be taxed as a citizen on U.S. source income, but not on foreign source income. U.S. source income for this purpose includes gains from sales of U.S. property. Tax-avoidance expatriates may be able to avoid tax by making a tax-free exchange of U.S. property.

House Bill

The House bill applies the tax-avoidance expatriate rules to gains on the sale of property the basis of which was determined by reference to property located in the United States, stock of a U.S. corporation, or a debt obligation of any U.S. person. This provision

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