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California's Current Sales Factor Landscape

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INTRODUCTION

On November 2, 2010, by a margin of nearly 1.5 million votes, California voters rejected Proposition 24.¹ In doing so, the voters decided to maintain three business tax provisions scheduled to take effect in 2011: (1) the single sales factor apportionment election; (2) net operating loss carrybacks; and (3) shared tax credits for "unitary" businesses. This Proposition, also known as the Repeal Corporate Tax Loopholes Act, sought to eliminate these provisions enacted in the fiscal year 2008 and fiscal year 2009 budgets to prevent the loss of general fund revenue. Indeed, the California Franchise Tax Board ("FTB") had projected the single sales factor apportionment election would cost California nearly \$2 billion cumulatively by 2013.² Accordingly, after back-to-back budget measures³ and now the failed Proposition, the dust has settled – for now – for corporate taxpayers who make sales of other than tangible personal property (i.e., intangibles and services) in terms of how California intends to treat those taxpayers who make the single sales factor apportionment election and those who do not.

THE ELECTION: REVENUE AND TAXATION CODE SECTION 25128.5

For tax years beginning on or after January 1, 2011, Revenue and Taxation Code⁴ section 25128.5 provides an irrevocable annual election for corporate taxpayers on a timely filed return to apportion business income to California by using a single sales factor. This election is available to any business except businesses for which more than 50 percent of the gross business receipts come from the following business activities: agriculture, extractive, savings and loan, and banking or other financial activities (i.e., businesses described in section 25128(c)), which are required instead to use an equally-weighted three-factor apportionment formula.⁵

With the defeat of Proposition 24 and the recent amendments to section 25136, corporate taxpayers who make sales of other than tangible personal property have one additional and significant factor to consider in deciding whether or not to make the section 25128.5 irrevocable annual election; namely, the decision to make the election will determine the landscape in which a taxpayer's sales of other than tangible personal property will be sourced for California apportionment purposes.

MAKING THE ELECTION: WHERE THE BENEFIT IS "RECEIVED" OR WHERE THE PROPERTY IS "USED"

For more than forty years, California generally used the Uniform Division of Income for Tax Purposes Act ("UDITPA") method for sourcing sales of other than tangible personal property for California sales factor apportionment purposes.⁶

¹ California State Ballot Measures – Statewide Results, available at <http://vote.sos.ca.gov/returns/ballot-measures/>; see also Proposition 24, Initiative Statute 1412, (09-0058, #1NS).

² FTB Final Bill Analysis of Assembly Bill ("AB") X3 15, dated Feb. 18, 2009, p. 2.

³ See ABX3 15, § 11 (2009); Senate Bill ("SB") 858, § 27 (2010).

⁴ All statutory references are to the California Revenue and Taxation Code unless otherwise indicated.

⁵ Cal. Rev. & Tax. Code § 25128(b) (2010).

⁶ Cal. Rev. & Tax. Code § 25136 (2008) (added Stats. 1966 ch. 2 § 7).

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The UDITPA sales factor for sales of other than tangible personal property was designed to capture a taxpayer's "income producing activity," which is defined by California regulation as "transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit"⁷ and the location of which is based on where the "costs of performance"⁸ are incurred.

In 2009, the California Legislature discarded the "costs of performance" design of the UDITPA sales factor regarding sales of other than tangible personal property and moved instead to a so-called "market" state approach.⁹ However, in the 2010 Budget Act, the California Legislature amended section 25136 once again to provide that for taxpayers who do not elect or are not eligible to elect to use a single sales factor corporate apportionment formula, sales, other than sales of tangible personal property, will be sourced based on "cost of performance" instead of a market approach.¹⁰

Accordingly, for corporate taxpayers who make the section 25128.5 single sales factor election for tax years beginning on or after January 1, 2011, sales, other than sales of tangible personal property, are sourced to California as follows: (1) sales from services are in California to the extent the purchaser of the service received the benefit of the service in California; (2) sales from intangible property are in California to the extent the property is used in California, except for sales of marketable securities, which are in California if the customer is in California; and (3) sales from the sale, lease, rental, or licensing of real or tangible personal property are in California if the real or tangible personal property is located in California.¹¹

Having been authorized in 2009 to "prescribe regulations as necessary or appropriate to carry out the purposes" of the market-state-based approach established by the Legislature,¹² the FTB has been diligently working through the process of amending its regulations to reflect the statutory changes. On November 8, 2010, the FTB held its third Interested Parties Meeting ("IPM")¹³ to elicit public input on revised draft language for amendments to the current regulation: Title 18, California Code of Regulations section 25136. The latest revised discussion draft regulation defines "Benefit of a service is received" to mean "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service"¹⁴ and "Intangible personal property is used" to mean "the location where the intangible property is employed by the taxpayer's customer or licensee."¹⁵

⁷ 18 Cal. Code Regs. § 25136(b) (2009) (recent amendments to FTB Regulation 25136 are discussed below); see also Cal. Rev. & Tax. Code §§ 25134-25136; *General Mills v. Franchise Tax Bd.* (2009) 172 Cal. App. 4th 1535, 1547.

⁸ Cal. Rev. & Tax. Code § 25136 (2008). California regulations likewise define "costs of performance" as "direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer." 18 Cal. Code Regs. § 25136(c) (2009).

⁹ SBX3 15, ABX3 15, Laws 2009.

¹⁰ SB 858, § 27, Cal. Rev. & Tax. Code § 25136(a) (2010). For a general discussion of the key tax provisions of the 2010 Budget Act, see E. Coffill and T. Gustafson, "Key Tax Provisions of California's 2010-2011 Budget Act," Oct. 22, 2010, available at <http://www.mofo.com/files/Uploads/Images/101022-Budget-Act.pdf>.

¹¹ Cal. Rev. & Tax. Code § 25136(b) (2010).

¹² Cal. Rev. & Tax. Code § 25136(b) (2009); see also Cal. Rev. & Tax. Code § 25136(c) (2010).

¹³ FTB Interested Parties Meeting Notice, Nov. 8, 2010, available at http://www.ftb.ca.gov/law/intParty/3rd_ipmtg_110810.pdf. The FTB's first two IPMs were held on February 10 and July 19 of this year, respectively. See FTB Interested Parties Meeting Notice, Feb. 10, 2010, available at http://www.ftb.ca.gov/law/intParty/ipmtg_021010.pdf; FTB Interested Parties Meeting Notice, July 19, 2010, available at http://www.ftb.ca.gov/law/intParty/2nd_ipmtg_071910.pdf.

¹⁴ Revised Discussion Draft for Proposed Regulation Section 25136, subsection (b)(1), Nov. 8, 2010, available at http://www.ftb.ca.gov/law/intParty/3rd_revised_discussion_draft_110810.pdf.

¹⁵ Proposed Regulation Section 25136(b)(6).

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The draft regulation also provides specific cascading rules for a number of varying scenarios for taxpayers to use in determining whether sales of services or intangibles are to be assigned to California for apportionment purposes. For example, sales of services to a corporation or another business entity will be assigned by looking to:

- The contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records (exclusive of the billing address of the taxpayer's customer) kept in the normal course of business;¹⁶
- A reasonable approximation by reference to the activities of the taxpayer's customer to the extent such information is available to the taxpayer;¹⁷
- The location from which the taxpayer's customer placed the order for the service;¹⁸ and finally
- The taxpayer's customer's billing address.¹⁹

Further, the draft regulation is replete with over twenty examples to guide taxpayers through varying scenarios and application of the relevant cascading rules. The FTB must continue to move quickly on this project in order to have new regulatory provisions in place for taxable years beginning on January 1, 2011. FTB Staff has requested the three-member Board grant permission for FTB Staff to enter into the formal regulatory process; the Board should rule on the request at its upcoming meeting on December 2, 2010.²⁰

NOT MAKING THE ELECTION: "COST OF PERFORMANCE" CONTINUED

As discussed above, as part of California's 2010 Budget Act, the California Legislature amended section 25136 to provide that for taxpayers who do not make or are not eligible to make the section 25128.5 election to use a single sales factor corporate apportionment formula, sales, other than sales of tangible personal property, will be sourced based on "cost of performance" instead of a market approach.²¹ An uncodified section of the underlying legislation provides that no inference should be drawn from the amendments made by the legislation with respect to the extent to which the rules for the assignment of sales of intangibles and services, before and after the amendments, are intended to properly reflect the market for the activities of the taxpayer giving rise to the business income.²²

The recent amendments require taxpayers to source sales of other than tangible personal property in accordance with the "costs of performance" method if they do *not* elect single sales factor apportionment. However, it is important to note the cost of performance landscape has changed. Earlier this year, the FTB adopted a number of revisions to the cost of performance rules in FTB Regulation 25136 (sales of other than tangible personal property) to conform to changes made in August 2007 by the Multistate Tax Commission to MTC Regulation IV.17 (which was virtually identical to FTB Regulation 25136 prior to the August 2007 amendments).²³ The changes provide that income producing activity includes not only activity directly engaged in by the taxpayer in the regular course of its trade or business, but also includes

¹⁶ Proposed Regulation Section 25136(c)(2)(A).

¹⁷ Proposed Regulation Section 25136(c)(2)(B).

¹⁸ Proposed Regulation Section 25136(c)(2)(C).

¹⁹ Proposed Regulation Section 25136(c)(2)(D).

²⁰ FTB Staff "Request for Permission to Proceed with Formal Regulation Process on Renumbering Regulation Section 25136 as Regulation Section 25136(a) and to Adopt New Regulation Section 25136(b)," p. 1 (Dec. 2, 2010 Board Meeting Agenda Item 3.b).

²¹ SB 858, § 27, Cal. Rev. & Tax. Code § 25136(a) (2010).

²² SB 858, § 41.

²³ 18 Cal. Code Regs. § 25136, eff. July 17, 2010.

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activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.²⁴ Further, payments made by the taxpayer for such third-party activities are included as part of the taxpayer's costs of performance.²⁵ The changes are retroactive to taxable years starting January 1, 2008.²⁶

MAKING THE ELECTION

In light of the developments described above, taxpayers who are considering making the section 25128.5 single sales factor election should consider the impact of the new dichotomy between "market" and "costs of performance" sourcing under recent California law. Such taxpayers with significant or material amounts of sales of other than tangible personal property should now reconsider whether to elect single sales factor apportionment for taxable years beginning on or after January 1, 2011. On the one hand, a taxpayer may decide to make the section 25128.5 election and adhere to the forthcoming, market-based sourcing amendments to FTB Regulation 25136, after taking into account the tax effect of such a sourcing methodology. On the other hand, such a taxpayer may opt not to make the section 25128.5 election and instead use the traditional, three-factor apportionment formula with a double-weighted sales factor, taking into account the tax effects of a costs of performance sourcing methodology. In making that decision, California corporate taxpayers must keep in mind the new factor presence nexus rules which also come into effect for tax years beginning on or after January 1, 2011. Under section 23101, a taxpayer will be considered to be doing business in California – and therefore subject to California franchise tax – if it meets any of the following conditions: (1) the taxpayer is organized or commercially domiciled in California; (2) *the taxpayer's sales in California exceed the lesser of \$500,000 or 25% of the taxpayer's total sales*; (3) the value of the taxpayer's real and tangible personal property in California exceeds the lesser of \$50,000 or 25% of the taxpayer's total real and tangible personal property; or (4) the taxpayer pays compensation in California exceeding the lesser of \$50,000 or 25% of the total compensation paid by the taxpayer.²⁷

How the new nexus rules will affect the amendments to section 25136 (if at all) remains to be seen. Moreover, taxpayers should stay tuned for further developments in FTB's market-based sourcing amendments to FTB Regulation 25136, as well as upcoming FTB regulations regarding the single sales factor election.

If you have any questions or would like further information on these developments, please contact Morrison & Foerster's Sacramento State & Local Tax Group:

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²⁴ 18 Cal. Code Regs. § 25136(b) (2010).

²⁵ 18 Cal. Code Regs. § 25136(c) (2010).

²⁶ 18 Cal. Code Regs. § 25136(e) (2010).

²⁷ Cal. Rev. & Tax. Code § 23101(b) (2009), emphasis added. The threshold amounts used in this test will be adjusted annually for inflation. Cal. Rev. & Tax. Code § 23101(c) (2009).

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