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California Franchise Tax Board Releases Guidance on New "Economic Nexus" Rules

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For taxable years beginning on or after January 1, 2011, new "economic nexus" rules came into effect in California. By way of background, "nexus" rules are put into place by states to establish the minimum contacts, or conduct, necessary to establish a sufficient connection (i.e., "nexus") between the business and the state to give the state the legal power to tax the business.

The new rules primarily affect out-of-state corporations and pass-through entities and their equity holders that have property, payroll or sales in California. Under the prior rules, a company was considered to have nexus with California if it actively engaged in any transaction for the purpose of financial or pecuniary gain or profit. The new rules expand upon the old standard and are intended to "ensnare" businesses that the old standard did not.

The "economic nexus" rules state that a company will have nexus with California if one of the following tests is met:

- it is organized or commercially domiciled in California;
- its sales in California exceed the lesser of $500,000 or 25% of the taxpayer's total sales;

- its real property and tangible personal property in California exceed the lesser of $50,000 or 25% of the taxpayer's total real property and tangible personal property; or
- its California payroll exceeds the lesser of $50,000 or 25% of the total compensation paid by the taxpayer.

The sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities (i.e., a partnership, an LLC treated as a partnership, or an S corporation).

Earlier this month, the FTB issued guidance regarding the "economic nexus" rules. The guidance discusses, among other items, whom the rules affect and filing obligations. In addition, the guidance provides the FTB's position, at least to some extent, on the interaction of Public Law ("PL") 86-272 with the rules. PL 86-272 is a federal law that protects certain out-of-state sellers from the imposition of certain types of state taxes. The FTB states in the guidance that if PL 86-272 applies, it cannot impose a tax that is computed based on net income (i.e., the California franchise and income tax). They do however make it clear that if the company has nexus with California and PL 86-272 applies, the company will still be required to pay a minimum tax and satisfy all filing requirements.

Additionally, the guidance provides specific questions and answers to common scenarios facing businesses. Some of the examples, with the FTB's corresponding answers, are listed below:

Q: Corporation B, an out-of-state corporation, has $100,000 in total property, $200,000 in total payroll, $1,000,000 in total sales, of which $400,000 was sales to California customers. Corporation B has no property or payroll in California. Is Corporation B doing business in California?

A: Yes. Although Corporation B’s California sales are less than the $500,000 threshold, Corporation B’s California sales are 40 percent of its total sales which exceeds 25 percent of the corporation’s total sales ($400,000 ÷ 1,000,000 = 40%).

Q: Partnership A, an out-of-state partnership, has employees who work out of their homes in California. The employees sell and provide warranty work to California customers. Partnership A’s property, payroll and sales in California fall below the threshold amounts. Is Partnership A considered to be doing business in California?

A: Yes. Partnership A is considered doing business in California even if the property, payroll and sales in California fall below the threshold amounts. Partnership A is considered doing business in California through its employees because those employees are “actively engaging” in transactions for profit on behalf of Partnership A.

Q: Corporation C, an out-of-state corporation, is a seller of tangible goods over the Internet and qualifies for protection under PL 86-272. For taxable year 2011, Corporation C has $1,000,000 of sales but no property or payroll in California. Is Corporation C considered doing business in California?

A: Yes. Corporation C is considered doing business in California because it has sales of $1,000,000 in California. Therefore, Corporation C must file a California return to pay the minimum tax. However, since Corporation C is protected under PL 86-272, it will not be subject to California franchise tax.

It is possible that the constitutionality of the “economic nexus” rules will be challenged at some point. In fact, Ohio has a similar set of rules, which are currently the subject of litigation. This newsletter is a general summary of the “economic nexus” rules and newly issued guidance, the specific application of which is beyond the scope of this newsletter. The rules contain many defined terms, exceptions and sourcing rules that are critical to the analysis, which are not addressed herein. Manatt, Phelps & Phillips, LLP's tax attorneys stand ready to assist you with any questions you may have.