

FTB Proposes Amendments to Sales Factor Cost of Performance Regs

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Starting in 2011, California will use a market-based method to determine the source of receipts from sales other than sales of tangible personal property. Until then, California will continue to use the “cost of performance” method for those sales, as required by Revenue and Taxation Code section 25136 and as described in section 25136 of the California Code of Regulations (Regulation 25136). Although Regulation 25136 has been in place since 1973 and will soon be replaced by new market-based sourcing rules that will be effective in 2011, the California Franchise Tax Board has determined that this regulation is in need of correction because it can result in the assignment of sales to other states that the FTB believes should properly be assigned to California.

Under California’s cost of performance method, a sale is assigned to the jurisdiction where the preponderance of the taxpayer’s income-producing activity is performed, measured by the costs of performing that activity. Regulation 25136 excludes from the definition of income-producing activity those activities that are performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. However, under FTB Legal Ruling 2006-2, for the analysis of income-producing activity, the income-producing activity of a member of a combined group performed on behalf of a taxpayer may be treated as an activity directly engaged in by the taxpayer. The proposed amendments to Regulation 25136 are intended to conform to the Multistate Tax Commission’s regulations by expanding the definition of income-producing activity to include those activities that are performed on behalf of the taxpayer by an agent or independent contractor.

Recognizing that taxpayers may have difficulty determining where an agent or independent contractor incurred costs on behalf of the taxpayer, the proposed regulations provide a cascading set of rules for determining the location of an income-producing activity performed by an agent or independent contractor.

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Reasonably determinable location of the income-producing activity. Generally, an income-producing activity of an agent and independent contractor would be included in a state if the taxpayer can reasonably determine at the time of filing its return that all of the income-producing activity is actually performed in that state.

Contract between taxpayer and agent or independent contractor. If, however, the income-producing activity is performed in more than one state, it may be difficult for the taxpayer to ascertain exactly where the activity was performed and where the costs for that activity were incurred. Accordingly, the proposed regulation provides that the activity is in a state to the extent that the contract between the taxpayer and the agent or independent contractor or the taxpayer’s records indicate that the activity is to be performed in the state and the portion of the taxpayer’s payment for the performance of that activity in the state is determinable under the contract. For example, if a taxpayer can determine, based on its records, the number of times a service is performed in each state and can determine, based on its contract, the cost of the service with an independent contractor, the taxpayer can reasonably determine the cost of performance associated with each state and, therefore, this rule would apply.

Contract between taxpayer and customer. Recognizing that the contract between the taxpayer and the agent or independent contractor may not provide that information, the regulation alternatively looks to the contract between the taxpayer and the taxpayer's customer. Under this rule, the activity is in a state to the extent that the contract between the taxpayer and the taxpayer's customer or the taxpayer's records indicates that the activity is to be performed in the state and the portion of the taxpayer's payment for the performance of that activity in the state is determinable under the contract. For example, if a taxpayer can determine the number of times a service is performed in each state based on its records and can determine the cost of the service based on its contract with the customer, but not the contract with the independent contractor, the taxpayer can reasonably determine the cost of performance associated with each state and, therefore, this rule would apply.

Customer's domicile. For situations in which the contracts do not provide guidance as to where the activities are performed, the proposed regulation looks to the domicile (or commercial domicile) of the taxpayer's customers. Regulation 25136 is an interpretation of Revenue and Taxation Code section 25136, which sources sales other than sales of tangible personal property, based on cost of performance. By sourcing those sales by reference to the location of the customer's domicile, the proposed regulation implements a market-based approach. In that regard, the proposed regulation is probably invalid because it is contrary to the statute it purports to interpret.

Disregard the income-producing activity. The proposed regulation provides that if the contracts do not provide the necessary information and the domicile of the customers cannot be determined, the income-producing activity of the agent or independent contractor is simply disregarded for purposes of determining the taxpayer's income-producing activity.

Activity throwout rule. Regardless of which method of determining the location of the income-producing activity applies, the income-producing activity would be disregarded when it is performed in a state in which the taxpayer is not taxable. That rule would appear to disregard activities conducted not only by independent contractors but also by combined group members in states where the taxpayer is not subject to tax (similar to the *Joyce* method).

Although these proposed amendments seek to provide a more comprehensive and equitable method of apportioning taxpayers' receipts from sales other than sales of tangible personal property, they impose on taxpayers the additional administrative burdens of determining where unrelated parties' activities were performed. In apparent recogni-

tion of that fact, the proposed regulations look to common sources of information to which taxpayers have access.

These proposed amendments impose on taxpayers the additional administrative burdens of determining where unrelated parties' activities were performed.

However, the proposed activity throwout rule is troubling. That rule might increase the California sales factor fraction if the taxpayer is not taxable in another state, because (1) it does not have nexus in the other state or (2) it is exempt from income tax in the other state tax based on Public Law 86-272. The law could be interpreted to also disregard activities if the state in which the activity was performed does not have an income tax. For example, if the costs of performance for an income-producing activity are incurred 40 percent in Utah, 35 percent in California, and 25 percent in New York, the receipts associated with that activity are not included in the California sales factor because the costs of performance in Utah exceed the costs of performance in California.¹ However, if instead the taxpayer is not subject to tax in Utah because it does not have nexus in that state, the result is that all gross receipts associated with that income-producing activity would be included in the California sales factor. Similar to the throwout rule that was formerly used by New Jersey and is now used by Rhode Island and West Virginia, this rule violates the fair apportionment prong of the test for constitutionality of a tax under *Complete Auto Transit v. Brady*.² It violates the internal consistency and external consistency tests for evaluating whether a tax violates the U.S. Constitution's commerce clause as set forth in *Container Corp. of America v. Franchise Tax Board*.³

The external consistency test stipulates that the "factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated."⁴ The proposed activity throwout rule violates the external consistency test because it has the potential of increasing the California sales factor of a taxpayer for activities conducted in other states. Further, the proposed rule could be interpreted to effectively treat activities conducted

¹See Regulation 25136.

²430 U.S. 274 (1977).

³463 U.S. 159, 192 (1983).

⁴*Id.*, 463 U.S. at 169.

in states without an income tax as instead conducted in states with an income tax.⁵ For example, if activities are performed in California, Nevada, and New York, the activities conducted in Nevada have the potential to increase the taxpayer's sales factor in California by treating those Nevada activities as California activities.

The internal consistency test establishes that "the [apportionment] formula must be such that if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed."⁶ The conceptual underpinning of this test is that a taxing statute that taxes more than 100 percent of a taxpayer's business activity is unfair. If the proposed activity throwout rule is interpreted to disregard activities conducted in states without an income tax, the rule would violate this principle because it would divide states into two categories: states with an income tax and states with a tax structure that does not have an income tax. The taxpayer would then pay tax on 100 percent of its income to states with an income tax, and also pay tax in the other states that have chosen other forms of taxing the business activity of a taxpayer, resulting in a tax on more than 100 percent of the business activity of the taxpayer. To illustrate the point by taking the application of the activity throwout rule to an extreme, assume that California retains an income tax, but every other state migrates to a gross receipts tax. Also assume that a de minimis amount of the taxpayer's income-producing activity is performed in California. The activity throwout rule would source to California all sales that relate to activities performed in multiple states.

The activity throwout rule also likely violates the due process clause's rational relationship test, which

requires that a rational relationship exist between the income subject to tax and the in-state values of the corporation.⁷ If the activity throwout rule is interpreted to disregard activities in states that do not have an income tax, it would violate that test because it increases a taxpayer's tax burden in a state based not on the activities of the taxpayer in that state, but on another state's policy of not taxing income or the other state's constitutional or federal statutory prohibition on taxing the taxpayer. Using the example above of activities performed in California, New York, and Utah, in which the taxpayer has no nexus with Utah, the taxpayer's California tax burden would increase not as a result of its California activities, but as a result of its choice not to conduct activities in Utah sufficient to create nexus in that state.

The proposed activity throwout rule is troubling. That rule might increase the California sales factor fraction if the taxpayer is not taxable in another state.

These proposed changes would apply for tax years beginning on or after January 1, 2008. Accordingly, all multistate taxpayers doing business in California that use agents or independent contractors would be required to file amended tax returns to redetermine the tax that is owed as a result of changes in their sales factors arising from sales other than sales of tangible personal property.

The FTB has provided for taxpayers to submit comments until January 13, 2010, for consideration before the proposed regulation is adopted. On that date, the FTB will conduct an interested persons hearing in Sacramento, Calif., to consider the adoption of Regulation 25136. Interested persons will be permitted on that date to make oral comments concerning the proposed regulation. ☆

⁵See *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000) (invalidating a statute that allowed interest expense deductions only to the extent the interest expense exceeded interest and dividend income that a nondomiciliary corporation received from nonunitary business or investments). (For the decision, see *Doc 2000-5169* or *2000 STT 36-58*.)

⁶*Container Corp.*, 463 U.S. at 169.

⁷See *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).