Understanding California's New Apportionment Regime

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California's recent tax changes allow taxpayers to elect between significantly different income tax apportionment regimes, and revert back to the *Finnigan* method to calculate a combined return. The apportionment election requires taxpayers to choose between a single-sales factor and market sourcing for sales of services and intangibles, or a three-factor formula (double-weighting sales) and a costs-of-performance sourcing method. In this Pinch of SALT, we will explain California's new apportionment regime and related nuances taxpayers should consider in evaluating options and requirements.

Costs-of-Performance Is Given a Second Life

On February 19, 2009, California abandoned its long-standing costs-of-performance apportionment method used to source receipts earned from services and intangibles. This repeal turned out to be short-lived as California's Legislature restored costs-of-performance for some taxpayers.

California was an early adopter of the Uniform Division of Income for Tax Purposes Act and the Multistate Tax Compact. As a result California has mandated taxpayers use the costs-of-performance sourcing method for over 40 years to source income from services and intangibles.[1] The repeal of the costs-of-performance method, enacted February 19, 2009, was set to become effective January 1, 2011.

On October 8, 2010, SB 858 not only restored California's costs-of-performance sourcing method, but also made a taxpayer's sales-factor sourcing method dependent on the taxpayer's apportionment formula election. SB 858 provides that effective January 1, 2011:

- taxpayers that do not elect to apportion income via a single-sales-factor apportionment formula will be required to use California's three-factor apportionment formula (consisting of a payroll factor, a property factor, and a double-weighted sales factor), and they must source receipts from sales "other than sales of tangible personal property" using California's long-standing preponderance costs-of-performance method; and
- taxpayers that elect to apportion income via a single-sales-factor apportionment formula will be required to source receipts from "sales other than sales of tangible personal property" using California's new market sourcing provisions.[2]

Notably, California's annual single-sales-factor election survived an effort to repeal it during California's November elections.[3] The California Teachers' Association became the primary advocate and sponsor of its repeal through Proposition 24, which ultimately failed in the November 2 elections.

California's Proposed Market Sourcing Rules

Because taxpayers electing single-sales factor must apply a market-based apportionment method,

[1]UDITPA became operative in California in 1967.

[2]Under Calif. Revenue and Taxation Code section 25137, California has developed specific apportionment regulations for specific industries (including, for example, contractors, franchisors, commercial fishermen, motion picture and television film producers, and railroads). Calif. Admin. Code, Title 18, sections 25137-1 through 25137-14. Those special industry rules will remain in place and will not be affected by the single-sales-factor apportionment formula election. Thus, taxpayers who qualify to use the special industry rules will continue to source their receipts according to their industry rules.

[3]*See, e.g.,* Yes on 24 Tax Fairness Act, *available at* http://yesprop24.org/.

the application of the market sourcing regime will be a primary consideration. By statute, California's market sourcing rules provide that "sales, other than sales of tangible property," are to be sourced as follows:

> (1) Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.
>
> (2) Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
>
> (3) Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
>
> (4) Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.[4]

The California Franchise Tax Board has held three interested parties meetings to develop proposed regulations to implement those rules.[5] Notably, the FTB has departed from the approach now being considered by the Multistate Tax Commission and instead has decided to adopt a series of cascading rules.[6]

Sales of Services

Under the current proposed regulation, California differentiates between sales of services to individuals and sales of services to businesses when determining where the benefit of a service is received. For individuals, services are sourced in the following order:

- the billing address of the taxpayer's customer;
- the contract between the taxpayer and its customer or the taxpayer's books and records;
- or a reasonable approximation of the activities of the customer.[7]

For businesses, services are sourced in the following order:

- the contract between the taxpayer and its customer or the taxpayer's books and records;
- a reasonable approximation of the activities of the customer;
- the location from which the customer placed the order for the service;
- or the customer's billing address.[8]

That approach recognizes the likelihood that individuals will receive the benefit of a service at their billing address as well as the inherent difficulty in determining where the benefit of a service is received when the service is sold to a business that is located in multiple states.

Sales or Licenses of Intangibles

For sales of intangibles, the FTB distinguished between sales of intangibles and ongoing licenses of intangibles to determine the extent to which property is used in the state. Under the proposed regulation, sales of intangibles are to be sourced according to where the property was used by the taxpayer before the purchase, determined in the following order:

- the contract between the taxpayer and its customer or the taxpayer's books and records;
- a reasonable approximation of the activities of the purchaser (subject to jurisdictional limitations on the purchaser's use of the intangible); or
- the customer's billing address.[9]

The rationale provided for this rule is that the purchaser is likely to use the intangible in the same manner before and after the sale.

Further, the FTB added another twist in the sourcing of intangibles (similar to the Massachusetts market sourcing rule[10]) in the proposed regulation. The proposed regulation now distinguishes between licenses of marketing intangibles and licenses of non-marketing and manufacturing intangibles.[11] Marketing intangibles are sourced to the

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[4]Calif. Revenue and Taxation Code section 25136(b).

[5]During the first interested parties meeting held February 10, 2010, the FTB discussed market sourcing rules enacted in other states and received comments from taxpayers regarding the administrative and practical difficulties created by these rules. The FTB took those considerations under advisement and promulgated a proposed regulation that was discussed at the second meeting on July 19 and later revised for the most recent November 8 meeting. The FTB again revised the regulation following the meeting. A copy of the most recent version of the proposed regulation is *available at* http://www.ftb.ca.gov/law/meetings/attachements/120210/3b.pdf. .

[6]The Multistate Tax Commission has opted to source based on "the extent the service is delivered to a location in the state" or the "extent the intangible property is used by the payor in the state." If the location cannot be determined under this general rule, the MTC permits the taxpayer to use a reasonable approximation. Draft Amended Compact Art. IV.17(a), Attachment C(1), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Minutes/Compact%20Amendment%20UC%20teleconf%20memo%2010-8-10.pdf.

[7]Proposed Regulation 25136(c)(1).

[8]Proposed Regulation 25136(c)(2).

[9]Proposed Regulation 25136(d)(1).

[10]Mass. Regs. Code section 63.38.1(9)(d)(3)(c)(ii)(A), (B).

[11]"Marketing intangibles" include licenses of "a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services or other items." Proposed Regulation 25136(b)(5)(A). "Non-marketing and manufacturing intangibles" include "the license of a patent, copyright, or trade secrets to be used in a manufacturing process, where the value of the intangible lies predominantly in its use in such process." Proposed Regulation 25136(b)(5)(B).

state in the same manner as the sale of the associated goods, determined in the following order:

- the contract between the taxpayer and its customer; or
- the taxpayer's books and records and a reasonable approximation of the activities of the taxpayer's customer.[12]

If a sale is made at wholesale, the proposed regulation provides that receipts are sourced based on the location of the final consumer, rather than the taxpayer's actual customer. Those receipts may be attributed to California based on the California population compared with the population in all areas where the goods are marketed, if the taxpayer lack information regarding the actual location.

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For nonmarketing intangibles and manufacturing intangibles, the proposed regulation provides that receipts are sourced according to "the extent that the use for which the fees are paid takes place in this state."[13] That determination is to be made in the following order:

- the contract between the taxpayer and its customer or the taxpayer's books and records;
- a reasonable approximation of the activities of the taxpayer's customer; or
- the state of the licensee's billing address.[14]

The FTB confirmed at the November interested parties meeting that the intent of those provisions is to look through to the final consumer of the product — rather than the taxpayer's customer — when determining where an intangible is used. Because taxpayers may not contract with or receive receipts from the final consumer, that "look through" approach is likely to be difficult to implement and may be subject to challenge.

Issues for Future Consideration

As noted in our September column, "The Implementation of "Market" Sourcing Rules: Practical Concerns,"[15] the FTB must balance its objective to determine the extent to which the benefit of a service was received or intangible property was used in California against the need for a simple, easily administrable rule. The FTB has acknowledged that by amending the rules for sourcing receipts from services provided to individuals. Originally, the regulation proposed sourcing those receipts according to the terms of the contract between the taxpayer and its customer, the billing address of the taxpayer's customer, or a reasonable approximation of the activities of the customer. By changing the order of those rules to first consider the customer's billing address, the FTB has attempted to make the market sourcing rules more feasible for taxpayers to implement.

Similarly, taxpayers providing services to multistate customers should be permitted to source receipts to the state where the benefit is primarily received, with the option to source receipts to multiple locations if the taxpayer has more accurate information from the contract with its customer or the taxpayer's books and records. If the current version of the rules is retained, consideration should be given to the amount of time and volume of information that must be consulted to source receipts using a higher-tier rule if the taxpayer opts to source under a lower-tier rule.

Finally, the FTB has considered whether to provide taxpayers with a safe haven for using the sourcing method provided under the first tier of a particular cascading rule and has implemented such a safe harbor for sales of services to individuals. However, other sections of the regulation permit the taxpayer *or* the FTB to overcome the presumption that the first-tier rule satisfactorily identifies where the benefit of the service is received or where the intangible property is used for other transactions. Unless taxpayers are provided with a safe harbor, they are likely to be subject to time-consuming requests for information from auditors to establish whether another source of information better reflects where the benefit of the service was received or the intangible was used. Those disputes should be avoided if a taxpayer has acted in good faith and is willing to follow the FTB's preferred sourcing method.

On December 2 the FTB requested that the State Board of Equalization initiate a formal rulemaking process for the market sourcing rules. It is likely that this process will be fast-tracked in order to have a final regulation in place by the close of 2011.

California Readopts *Finnigan* to Compute the Unitary Group's Sales Factor

Finally, California will revert to the *Finnigan* method for purposes of calculating taxpayers' sales factor numerator. Although California has an elaborate history surrounding its adoption of *Joyce*

[12]Proposed Regulation 25136(d)(2)(A).
[13]Proposed Regulation 25136 (d)(2)(B).
[14]*Id.*
[15]Pilar Mata and Melissa J. Smith, "A Pinch of SALT: The Implementation of 'Market' Sourcing Rules: Practical Concerns," *State Tax Notes*, Sept. 6, 2010, p. 649, Doc *2010-18847*, or *2010 STT 172-1*.

and *Finnigan,*[16] its switch back to the *Finnigan* method is not that surprising given the method's growing popularity among other combined reporting states.[17]

Combined reporting states that have adopted the *Joyce* method include in the sales factor numerator only the amount of sales by members of the unitary combined group that independently have nexus with the state. In contrast, under the *Finnigan* method, sales from *all* members of the unitary combined group are included in the sales factor numerator, regardless of whether the individual group member has nexus with the state. The *Finnigan*/*Joyce* distinction also affects whether sales to various states are "thrown back" to the state of origin if the seller/group member does not have nexus with the destination state but another member of the unitary group does.

Because the *Finnigan* method is perceived by states to result in a larger apportionment factor for out-of-state companies, it is not surprising that California has readopted the *Finnigan* method for tax periods beginning after January 1, 2011. However, because of California's existing throwback rule, the *Finnigan* analysis will result in complicated analysis for California taxpayers.

Conclusion

By reinstating the costs-of-performance method and retaining the single-sales-factor election, California has taken its first step toward making the state a more competitive place to do business, particularly for industries that provide services and intangibles. Taxpayers evaluating the new apportionment regime should make sure their voices are heard as the BOE develops its new market sourcing regulation to ensure that the full benefits of the new apportionment regime can be realized. ☆

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Sutherland's SALT Practice is composed of more than 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, and property tax matters as well as unclaimed property matters. Sutherland's SALT Practice also monitors and comments on state legislative and political efforts.

[16]In 1966 the Board of Equalization ruled *In the Appeal of Joyce*, that sales of a seller that did not have nexus with California as a result of Public Law 86-272 could not be included in the sales factor numerator of the unitary combined group. 66-SBE-070 (Nov. 23, 1966). The BOE overruled that decision in 1988 in *Appeal of Finnigan*, in the context of California's throwback rule, when it held that if any member of the unitary combined group were taxable in another state, the sales could not be thrown back to California. 88-SBE-022-A (Jan. 24, 1990). The BOE once again reversed itself in *Appeal of Huffy Corp.* and returned to the *Joyce* method for prospective tax years. 99-SBE-005 (May 22, 1999). The BOE rationalized its decision to return to the *Joyce* method on the grounds that "our *Finnigan*/*NutraSweet* interpretation of Revenue and Taxation Code section 25135 remains inconsistent with that of nearly all other states that have comparable legislation and should not be adhered to." *Id.*

[17]Since 1999 approximately six states have adopted the *Finnigan* method either by legislation or an administrative decision.