

California FTB Ruling: Application of “doing business” standard for throwback rule

Overview

The California Franchise Tax Board (FTB) recently released Chief Counsel Ruling 2016-03¹ (Ruling 2016-03) which provides guidance for multistate corporations with sales of both tangible personal property and sales of other than tangible personal property in determining whether they are taxable in another state for purposes of the throwback rule under the California corporate franchise tax and how California’s “doing business” standard under California Revenue and Taxation Code (CRTC) section 23101(b)(2) applies in this context.² The FTB concluded that:

1. The taxpayer must aggregate its sales of tangible personal property with the royalties that it received in determining whether it met California’s “doing business” standard under CRTC section 23101(b)(2).
2. In determining whether the taxpayer is “taxable in another state” under CRTC section 25122, if the taxpayer meets the “doing business” standard under CRTC section 23101(b)(2) and its activities exceed the protections under P.L. 86-272, then the taxpayer would not throw back its sales of tangible personal property in those states to the California sales factor numerator.

This Tax Alert summarizes Chief Counsel Ruling 2016-03 and provides taxpayer considerations.

Factual background

The taxpayer that sought the Chief Counsel Ruling designed, marketed, and distributed tangible personal property through various retailers. It outsourced manufacturing to independent third parties and warehoused its goods in California before it shipped them to other destinations. The taxpayer also licensed the use of its trademarks to an unaffiliated third party in exchange for royalty payments based on that third party’s sales in various U.S. states. Therefore, the taxpayer had two revenue streams – sales of its products and receipt of royalties.

The taxpayer maintained control over the use of its trademarks, such as the right to control the nature and quality of the products, the right to make changes to the technical specifications of the products, and the right to approve the advertising and stores where the products could be sold.

Aggregating sales of tangible personal property and royalties to determine “doing business” standard

A corporation is/will be considered to be “doing business” in California if, among other things, its sales within the state exceed certain economic thresholds.³ “Sales” is generally defined as all gross receipts not allocated, and “gross receipts” is defined to include the sales of tangible property or the use of property or capital, including royalties, in a transaction that produces business income if the income, gain, or loss is recognized under the Internal Revenue Code.⁴ The FTB found that, because taxpayer’s business activities included both the sale of tangible personal property and royalties derived from the licensing of its trademarks to a third party, both categories of gross receipts should be aggregated for purposes of determining whether the taxpayer was “doing business” in the various states at issue.⁵ Specifically, the FTB concluded that “sales from TPP [(tangible personal property)] and OTTPP [(other than tangible personal property)] must be aggregated to determine whether [the t]axpayer is doing business in a state under the economic nexus standard of [CRTC] Section 23101(b)(2).”⁶

¹ Ruling 2016-03 is available [here](#).

² Chief Counsel Rulings are taxpayer-specific rulings issued by the FTB and as such, Ruling 2016-03, p. 8, provides that “[t]he tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts [the taxpayer] ha[s] submitted.”

³ Cal. Rev. & Tax. Code § 23101(b)(2); for taxable years beginning on or after January 1, 2015, the sales threshold is \$536,446.

⁴ Cal. Rev. & Tax. Code § 25120(f)(1)-(2).

⁵ Ruling 2016-03, p.4.

⁶ *Id.*

Throwback of sales to California and Public Law 86-272

In California, sales of tangible personal property are assigned to the California sales factor numerator (or “thrown back”) for apportionment purposes if the property is shipped from California and the taxpayer is “not taxable in the state of the purchaser.”⁷ Under the second prong of CRTS section 25122,⁸ a taxpayer is taxable in the state of the purchaser (or “taxable in another state”) if its business activity in the state is sufficient to give the state jurisdiction to subject the taxpayer to a net income tax by reason of such business activity under the United States Constitution and statutes, regardless of whether the state does or does not, in fact, subject the taxpayer to such tax.⁹

A taxpayer otherwise taxable in a state may nevertheless be protected from the state’s authority to tax under Public Law 86-272 (P.L. 86-272), which prohibits a state from taxing income derived within its borders from interstate commerce if a taxpayer’s only business activity within the state generally consists of the “solicitation of orders”¹⁰ for sales of tangible personal property. However, P.L. 86-272 does not apply to activities within a state unrelated to the solicitation of sales of tangible personal property unless they are *de minimis* (i.e., trivial) in nature, or to solicitation activities associated with sales of other than tangible personal property.¹¹ In Franchise Tax Board Publication 1050¹² (FTB 1050), the FTB identified twenty unprotected activities for which the protection of P.L. 86-272 did not apply including the licensing of trademarks.

Based on these authorities and FTB 1050, the FTB concluded that the taxpayer’s activities associated with the generation of royalty income derived from an unrelated third party’s use of the taxpayer’s trademarks was outside of the protections of P.L. 86-272 and that the taxpayer’s active involvement in the licensee’s use of the trademarks was not *de minimis*. Therefore, the taxpayer was “doing business” in the various states at issue and thus, was taxable in those states. Accordingly, the taxpayer would not throw back any of the sales of the tangible personal property to customers in those states to its California sales factor numerator.¹³

Considerations

The FTB’s first holding regarding the aggregation of sales of TPP and royalties in determining whether a taxpayer is “doing business” in a state is consistent with the express language of the statute defining “sales” and “gross receipts” to include both TPP and royalties. Although Ruling 2016-03 deals specifically with royalties, it could apply more generally to gross receipts from “other than tangible personal property” such as services, interest, and dividends.¹⁴

Ruling 2016-03 also confirms the FTB’s position on how California’s “doing business” standard applies to determine if the other state had “jurisdiction to subject the taxpayer to a net income tax” under CRTS section 25122(b) for purposes of California’s throwback rule. Specifically, the FTB explained that, if a taxpayer aggregates its sales of TPP and OTTPP to a particular state and the total of those sales exceeds the applicable threshold under CRTS section 23101(b)(2), the taxpayer is considered to be “doing business” in that state and thus, taxable in that state, unless the taxpayer’s activities are protected under P.L. 86-272 or otherwise *de minimis*. Relative to the P.L. 86-272 analysis, the focus is on the nature of the taxpayer’s activity in the state (and not the dollar amount of the taxpayer’s sales of TPP or OTTPP to that state). If such activity exceeds the protections of P.L. 86-272 and is not *de minimis* (as was determined in the Ruling 2016-03 scenario involving taxpayer’s active involvement in the licensee’s use of the trademarks), the taxpayer is considered taxable in that other state for purposes of the throwback rule and the taxpayer would not throw back sales to customers in those states to California.

Although P.L. 86-272 only applies to sales of TPP (and not OTTPP), the existence of sales of OTTPP may indicate that the taxpayer is engaging in activities beyond the protections of P.L. 86-272 which may require further evaluation. Moreover, because California’s “doing business” standard is fairly broad, the FTB’s position in Ruling 2016-03 suggests

⁷ Cal. Rev. & Tax. Code § 25135(a)(2).

⁸ Under the first prong of CRTS section 25122, if the state actually imposes on the taxpayer a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, such taxpayer would be considered taxable in that other state for purposes of the throwback rule. Cal. Rev. & Tax Code § 25122(a); Cal. Code. Regs. tit. 18, § 25122(b).

⁹ Cal. Rev. & Tax. Code § 25122(b); Cal. Code. Regs. tit. 18, § 25122(c).

¹⁰ “Solicitation of orders” is defined to mean activities that are essential or entirely ancillary to making requests for orders. *Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214, 228-29 (1992) (“*Wrigley*”); Ruling 2016-03, p.6.

¹¹ *Wrigley*, 505 U.S. 214, 231-32; Ruling 2016-03, p.4-7.

¹² FTB 1050 is available [here](#).

¹³ Ruling 2016-03, p.7.

¹⁴ See Cal. Rev. & Tax Code § 25120(f)(2). When the FTB applied the California rules to the taxpayer’s facts, the FTB appeared to use language that broadened the application to not just royalties, but also to “other than tangible personal property” in general.

External Multistate Tax Alert

that more taxpayers could be found "taxable in another state" for purposes of the throwback rule and thus, less sales would be thrown back to California.

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