California's Adoption of Economic Nexus Principles Negates the Throwback Rule for Certain Taxpayers

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In this article, Bart Baer and Matthew Johnson, of Deloitte Tax LLP, discuss a recent California Chief Counsel Ruling that applies the principles of the state's new economic nexus standards, as well as its *Finnigan* principles and market-based sourcing, to determine when the throwback of sales of tangible personal property is required. Although these new economic nexus standards are effective for tax years beginning on or after Jan. 1, 2011, the authors argue that it is inconsistent to apply different constitutionally permissible criteria in years prior to 2011 for throwback purposes. As a result, the authors reason that the analysis in the Chief Counsel Ruling potentially provides the foundation for certain California taxpayers to seek relief from throwback sales on a refund basis while also serving as further information to be considered by certain taxpayers in other states that have similar rules for throwback sales.

California's Adoption of Economic Nexus Principles Negates the Throwback Rule for Certain Taxpayers

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Introduction

Recent California guidance illustrates the significant impact that a state's adoption of economic nexus principles has on the continuing viability of the throwback rule.[1] The Franchise Tax Board (''FTB'')

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recently released Chief Counsel Ruling 2012-03,[2] holding, in two different fact patterns, that a taxpayer should not throw back to California certain sales of tangible personal property shipped from California to other states where California's economic nexus thresholds were met in the destination states. The result in this Chief Counsel Ruling (''CCR'') is based on the interplay of California's recent adoption of economic nexus principles, the definition of when a taxpayer is ''taxable'' in a non-California jurisdiction for throwback purposes, and California's re-adoption of *Finnigan*[3] principles. This article analyzes CCR 2012-03 and discusses its potential implications for similarly situated taxpayers.

California's Throwback Rule

California apportions income to the state using a three-factor apportionment formula consisting of single weighted property and payroll factors, and a double weighted sales factor.[4] For taxable years beginning on or after Jan. 1, 2011, taxpayers generally may elect to apportion income using a single sales factor.[5] Section 25135 provides rules for determining the portion of the sales included in the numerator of the California sales factor, and generally provides that sales of tangible personal property (''TPP'') are so included if the TPP is delivered or shipped to a purchaser within California. In addition, sales of TPP are included in the numerator of the California sales factor if the TPP is shipped from an office, store, warehouse, factory, or other place of storage in California to another state if the selling taxpayer ''is not taxable in the state of the purchaser.''[6] This inclusion of TPP sales shipped from California to a state where the taxpayer is not taxable is commonly referred to as the ''Throwback Rule.''

For purposes of the Throwback Rule, Cal. Rev. & Tax. Code §25122 defines when a taxpayer is taxable in another state and provides:

For purposes of allocation and apportionment of income under this act, *a taxpayer is taxable in another state if*: (a) in that state it is subject to 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, or (b) *that state has jurisdiction to subject the taxpayer to a net income tax* regardless of whether, in fact, the state does or does not. (Emphasis added.)

California Code of Regulations, tit. 18, (''Regulation'') §25122 provides that the standards of the United States Constitution and the statutes of the United States, namely Public Law (''Pub. Law'') No. 86-272,[7] apply for the purpose of determining when another state has jurisdiction to subject the taxpayer to a net income tax. Importantly, the California State Board of Equalization (''SBE'') has concluded that the ''interstate commerce'' protections found in Pub. Law No. 86-272 apply only to sales amongst the states and districts of the United States and not to sales destined for foreign jurisdictions.[8]

California's Adoption Of Bright-Line Nexus Standards

The California Corporation Franchise Tax (''CFT'') is measured by net income and is imposed on corporations ''doing business'' in California.[9] The term ''doing business'' is defined by Cal. Rev. & Tax. Code §23101(a) as ''actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.''[10] Recently, the California Legislature enacted Cal. Rev. & Tax. Code §23101(b) to adopt objective criteria for determining if a taxpayer's activity in the state is sufficient to subject the taxpayer to the CFT.[11] These new, bright-line standards are effective for tax years beginning on or after Jan. 1, 2011.[12] In particular, §23101(b)(2) provides that a corporation ''is doing business in this state for a taxable year'' if the taxpayer's sales in California exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales.[13] ''Sales'' are defined by §§25130(e) or (f), and are aggregated to include sales by the taxpayer's agent or independent contractor.[14] The new guideline further provides that sales are sourced to California using the assignment rules under §25135 for sales of TPP and using the market-based sourcing rules under §25136(b), as modified by the special industry allocation and apportionment regulations under §25137,

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other consequences arising from the reader's particular situation.

[2] Chief Counsel Ruling 2012-03, Franchise Tax Board (Aug. 28, 2012), available at: https://www.ftb.ca.gov/law/ccr/2012_3.pdf.

[3] *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal. (Aug. 25, 1988); *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal. (Jan. 24, 1990).

[4] California Revenue & Taxation Code (''Cal. Rev. & Tax. Code'') §25128.

[5] Cal. Rev. & Tax. Code §25128.5. Taxpayers predominately engaged in agricultural, extractive, savings and loan, or banking or financial business activities, however, may not elect to use a single sales factor formula. *Id. See also*, §25128. All undesignated statutory references are to the California Revenue and Taxation Code (Cal. Rev. & Tax. Code).

[6] Cal. Rev. & Tax. Code §25135(a)(2).

[7] 15 U.S.C. §§381 through 384. Pub. Law No. 86-272 is a federal law implementing Congressional authority under the Commerce Clause to restrict when a state may impose an income tax on a corporation selling TPP in a state. In general, Pub. Law No. 86-272 prohibits states from taxing out-of-state businesses whose only activity within the state is the ''solicitation of orders'' for TPP by employees of the taxpayer or a ''representative'' of the taxpayer, provided the orders are approved out of state and the TPP is shipped from out of state. The U.S. Supreme Court has also held that those activities that are entirely ancillary to requesting purchases are also protected. These would include activities where the only reason to perform them is to facilitate requests for purchases. Also protected are other ''de minimis'' activities that constitute a trivial connection to the state. *See Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992).

[8] *Appeal of Dresser Industries Inc.*, Cal. St. Bd. of Equal. (June 29, 1982); *Appeal of Dresser Industries Inc.*, Cal. St. Bd. of Equal. (Oct. 26, 1983).

[9] Cal. Rev. & Tax. Code §23151(a).

[10] Cal. Rev. & Tax. Code §23101(a).

[11] Cal. Rev. & Tax. Code §23101(b). Also of note is §23101(d), which requires a taxpayer to include in the determination of sales, property, and payroll the taxpayer's pro rata or distributive share of these items from pass-through entities.

[12] Cal. Rev. & Tax. Code §23101(b).

[13] Cal. Rev. & Tax. Code §23101(b)(2). Sections 23101(b)(3) and (4) similarly provide that a taxpayer is doing business in the state if the taxpayer's tangible property or payroll in the state exceeds $50,000 or 25 percent of the taxpayer's total property or payroll.

[14] Cal. Rev. & Tax. Code §23101(b).

for sales of non-TPP.[15] In sum, California will deem a corporation to be doing business in the state based on its economic presence, and regardless of whether the taxpayer has physical presence in the state, simply based on its level of sales in the state, *i.e.*, if California-sourced sales exceed $500,000 or 25 percent of the taxpayer's total sales.

California's Re-Adoption Of *Finnigan* Principles

California has had a long and inconsistent history in defining when unitary group principles override the protections of Public Law No. 86-272 in applying the Throwback Rule. In the unitary group context, the state has vacillated between determining taxable nexus on a single-entity basis (the *Joyce* rule) versus a unitary group basis (the *Finnigan* rule), both for in-bound and outbound sales. In 1966, the SBE decided, in *Appeal of Joyce*, that one looks only to the activity of the individual entity making the TPP sale in determining whether the entity exceeds the protections of Pub. Law No. 86-272 on TPP sales into a state.[16] In 1988, the SBE reversed course in *Appeal of Finnigan Corporation* and decided that one looks to the activities of the entire unitary group in determining whether an entity is Pub. Law No. 86-272-protected on sales of TPP into a state.[17] In 1999, the SBE again returned to *Joyce* principles.[18] Finally, in 2009,[19] the California Legislature acted affirmatively to re-adopt *Finnigan* principles for taxable years beginning on or after Jan. 1, 2011.[20] As a result, California taxpayers now have clarity that taxable nexus will be determined on a unitary group basis and therefore the Throwback Rule will not apply to TPP sales shipped from California to another jurisdiction where any member of the taxpayer's unitary group is considered taxable in that jurisdiction.

Chief Counsel Ruling 2012-03

CCR 2012-03 addresses a request by a unitary group of taxpayers seeking certainty regarding the application of the Throwback Rule in two different situations. The first situation addresses the interplay between California's new economic nexus standard and California's Throwback Rule in the case of foreign TPP sales. The second situation layers in a more complex application of the new economic nexus rules, including the application of market-sourcing rules to determine the amount of sales in a state, as well as incorporating the re-adopted *Finnigan* principles.

In the ruling's background facts, a taxpayer member of a unitary group (''TPP Seller'') develops and markets only TPP, which it sells and ships from California to other domestic and foreign jurisdictions. TPP Seller's sales to customers in certain domestic and foreign jurisdictions exceed $500,000 per year based on the ship-to address of the customers. On a stand-alone basis, TPP Seller is protected from taxation in certain domestic jurisdictions under Pub. Law No. 86-272.

Another taxpayer in the unitary group (''Affiliate'') develops and markets only non-TPP. Affiliate's customers are located in several domestic jurisdictions and foreign jurisdictions. On a stand-alone basis, Affiliate's activities are not protected from taxation under Pub. Law No. 86-272. However, Affiliate generally does not have any contacts with jurisdictions outside California other than making non-TPP sales to customers in those jurisdictions, and it does not file in those jurisdictions. Applying California's new market sourcing regulations for the purposes of determining whether the bright-line nexus standards are met in those other jurisdictions, Affiliate has sales in several of the domestic and foreign jurisdictions exceeding $500,000 per year based on the billing address of the customer.

The FTB ruled on two throwback issues for this unitary group of taxpayers. In the first ruling, the FTB held that, for the 2011 and future taxable years, TPP Seller-should not throw back to the California sales factor numerator any TPP sales made to a foreign jurisdiction where TPP Seller made sales in excess of $500,000. The FTB reasoned that, just as an entity is taxable in California under §23101(b)for years beginning after Jan. 1, 2011 by virtue of having sales of over $500,000 per year assigned to this state, a taxpayer is similarly considered taxable under §25122 in foreign jurisdictions where sales exceed $500,000 per year. Furthermore, because TPP Seller's sales are to a foreign jurisdiction, Pub. Law No. 86-272 would not preclude TPP Seller from being taxable in a foreign jurisdiction.[21] Thus, because TPP Seller is considered taxable in the foreign jurisdiction under §25122, the Throwback Rule is inapplicable to those sales.

In the second ruling, the FTB held that TPP Seller should not throw back to the California sales factor numerator any domestic TPP sales where Affiliate made non-TPP sales in excess of $500,000. Here, the CCR explained the full ramifications of the interplay between California's new economic nexus standard, California's Throwback Rule, and the re-adoption of *Finnigan*. First, the FTB analyzed whether Affiliate was taxable in the non-California jurisdictions based on its level of sales. As in the first ruling, the FTB reasoned that just as an entity is taxable in California by virtue of having sales of over $500,000 per year assigned to this state, a taxpayer is similarly considered taxable under §25122 in non-California jurisdictions where sales exceed $500,000 per year. The key difference in this second ruling is that Affiliate made non-TPP sales that were assigned under California's market sourcing rules and taken into consideration to reach the $500,000 threshold, whereas the first ruling considered only TPP Seller's TPP sales to the foreign jurisdictions.

[15] Cal. Rev. & Tax. Code §23101(b).

[16] *Appeal of Joyce*, Cal. St. Bd. of Equal. (Nov. 23, 1966).

[17] *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal. (Aug. 25, 1988); *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal. (Jan. 24, 1990).

[18] *Appeal of Huffy Corporation*, Cal. St. Bd. of Equal. (April 22, 1999); *Appeal of Huffy Corporation*, Cal. St. Bd. of Equal. (Sept. 1, 1999).

[19] Cal. Rev. & Tax. Code §25135(b).

[20] In FTB Notice 90-3, (June 8, 1990) *available at*: https://www.ftb.ca.gov/law/notices/1990/ftbn90_3.pdf, the Franchise Tax Board provided that the *Finnigan* standard applied to all of the apportionment factors (*i.e.*, property, payroll and sales). However, the California legislature in the amendments to §25135(b) has affirmatively re-adopted the *Finnigan* standard for only the sales factor.

[21] Citing *Appeal of Dresser Industries Inc.*, Cal. St. Bd. of Equal. (Jun. 29, 1982); *Appeal of Dresser Industries Inc.*, Cal. St. Bd. of Equal. (Oct. 26, 1983).

The FTB further reasoned in the second ruling that, since Affiliate is considered taxable in a state under §25122, Affiliate's unitary affiliates are also considered taxable in that state due to California's re-adoption of *Finnigan* principles. Thus, for purposes of the Throwback Rule, TPP Seller is considered taxable in each state where Affiliate's non-TPP sales exceed $500,000 per year even though TPP Seller would be otherwise protected from taxation by Pub. Law No. 86-272 on a stand-alone basis. Consequently, the FTB held that TPP Seller would not throw back any sales to the California numerator of the sales factor that are made to a state where Affiliate makes in excess of $500,000 of non-TPP sales as determined using the new market-sourcing rules adopted under Regulation §25136-2 as required by §23101.

CCR 2012-03: Taxpayer Implications

Prospective Application of CCR 2012-03. For tax years starting on or after Jan. 1, 2011, California's adoption of economic nexus principles could potentially enable taxpayers with fact patterns similar to those described above to reduce throwback for sales of TPP shipped from California.

Possible Retroactive Application: CCR 2012-03. CCR 2012-03 specifically leaves open the question of whether California's economic nexus standards embodied in §23101(b) should also apply to tax years prior to 2011.[22] However, it appears logical that the objective nexus-creating criteria established in the amendments to §23101(b) apply to all tax years, past and present. As discussed above, application of the Throwback Rule is based on a determination of whether the destination state has jurisdiction to impose tax under U.S. Constitutional standards, as limited by federal statutes such as Pub. Law No. 86-272. CCR 2012-03 concludes that certain objective business activities conducted by a taxpayer, such as selling $500,000 of TPP to a foreign jurisdiction in a particular year, create the requisite jurisdiction to tax, thus rendering the Throwback Rule inapplicable,. Arguably, it is inconsistent to conclude that there are different constitutionally permissible criteria in years prior to 2011 for determining when a state has jurisdiction to tax. As a result, the reasoning in CCR 2012-03 may also potentially provide taxpayers relief from the Throwback Rule on a retroactive basis.

Application to States Other Than California. Although an analysis of the rules in other states is beyond the scope of this article, the reasoning in CCR 2012-03 may potentially suggest a similar outcome in other states that have apportionment rules similar to California's Throwback Rule and that assert economic nexus is constitutionally permissible to determine jurisdiction to tax on an in-bound basis.[23] Taxpayers facing throwback should consider whether the throwback state asserts economic nexus principles on an in-bound basis and whether the state determines ''taxability'' for purposes of throwback on the basis of whether the destination state has the right to subject the taxpayer to tax.

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[22] In a footnote, CCR 2012-02 provides: ''This ruling does not address whether a corporation is taxable in California prior to Jan. 1, 2011 if one of the conditions under §23101(b) were met; it addresses only facts and statutory law applicable for the 2011 taxable year and forward. This ruling does not address the taxable or taxability standards under Regulation §25122 prior to Jan. 1, 2011.''

[23] State courts finding that economic nexus principles are constitutional include: *Geoffrey Inc. v. South Carolina Tax Commission*, 313 S.C. 15 (1993), *cert. denied* 114 S. Ct. 550 (1993); *Lanco Inc. v. Director of Taxation*, 188 N.J. 380 (2006), *cert. denied* 2007 U.S. LEXIS 7736 (2007); *Geoffrey Inc. vs. Commissioner of Revenue*, 453 Mass. 17 (2009), *cert. denied* 129 S.Ct. 2853 (6/22/09); *Tax Commissioner of the State of West Virginia v. MBNA America Bank*, N.A. 220 W. Va. 163 (2006), *cert. denied* 127 S. Ct. 2997 (2007); *Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1, 899 N.E.2d 76 (2009), *cert. denied* 129 S. Ct. 2827 (2009); *KFC Corporation v. Iowa Dep't of Revenue*, 729 N.W.2d 308 (Iowa 2010).

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