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HOW US BUSINESS MANAGES ITS TAX LIABILITY

April 2011
Volume 11, Number 4

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California's New Apportionment Rules for Multistate Taxpayers

By Jeffrey A. Mannisto and Matthew A. Portnoff (Manatt, Phelps & Phillips, LLP)

Over the past two years, the California legislature has enacted significant changes in California tax law, including a substantial modification to California's apportionment rules (New Apportionment Rules) used to determine California-source business income, for franchise and income tax purposes, of multistate taxpayers doing business in California (Taxpayers). The New Apportionment Rules are effective for tax years beginning on or after January 1, 2011. Under the New Apportionment Rules Taxpayers are now able to elect between two different apportionment regimes for determining California-source business income: (1) a new single-sales factor apportionment formula based on market sourcing; or (2) the continued use of a double-weighted sales factor apportionment formula based on costs of performance sourcing. The foregoing apportionment rules apply to Taxpayers other than those engaged in specialized industries and/or businesses; the latter-referenced taxpayers are subject to industry and/or business-specific apportionment rules.

This article provides an overview of the New Apportionment Rules and identifies certain considerations of which Taxpayers should be aware before making an annual election.

Background

For more than 40 years, California has employed a unitary method to determine the portion of a Taxpayer's business income reasonably attributable to the State based on the rules promulgated under the Uniform Division of Income Tax for Purposes Act and the Multistate Tax Compact. Under this method, Taxpayers are required to apportion business income for California tax purposes using a three-factor sales apportionment formula (Three Factor Apportionment Formula) which includes a payroll factor, a property factor and a double-weighted sales factor. Each of these factors is a fraction, the numerator of

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which is the sum of the Taxpayer's payroll, property and two times sales within California and the denominator of which is the sum of the Taxpayer's payroll, property and two times sales everywhere. The product of this fraction and the Taxpayer's total business income is used to determine the Taxpayer's business income subject to California tax.

In applying the Three Factor Apportionment Formula, Taxpayers are required to use the "costs of performance" method to source gross receipts from sales "other than the

The proposed regulations provide guidance for determining the source of sales of intangibles and ongoing licenses of intangibles.

sale of tangible personal property." Under this method, sales are included in the California sales factor if a "greater portion of the income-producing activity" generating the gross receipts is performed in California based on the costs of performance. This is an all-or-nothing approach whereby gross receipts associated with a particular income-producing activity are sourced entirely to California if the greater portion of the costs of performance occurs in California. Conversely, gross receipts are excluded entirely from the California sales factor if the greater portion of the costs of performance occurs outside of California.

New Apportionment Rules

Under the New Apportionment Rules, Taxpayers are permitted to make an annual irrevocable election on an original timely filed return to apportion business income by using a single-sales factor apportionment formula (Single-Sales Factor Apportionment Formula). The Franchise Tax Board (FTB) recently released revised proposed regulations, subject to public comment, which provide initial guidance for Taxpayers making an annual election, including specific and detailed guidance pertinent to the various legal forms in which a Taxpayer may conduct business (e.g., corporation, corporate division, corporate member of combined reporting group, partnership, corporate-owned partnership or sole proprietorship). Regardless of the legal form by which a Taxpayer conducts business, the Single-Sales Factor

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Apportionment Formula requires all Taxpayers to use a market-based sourcing method for sales other than sales of tangible personal property, as discussed below. Taxpayers not making the annual election are required to continue to use the Three Factor Apportionment Formula.

The market-based apportionment sourcing method is codified in Revenue and Taxation Code Section 25136, as revised, which provides as follows:

- Sales from services are sourced to California to the extent the purchaser of the service received the benefit of the service in California.
- Sales from intangible property are sourced to California to the extent the property is used in California.
- Sales from the sale, lease, rental or licensing of real property are sourced to California if the real property is located in California.
- Sales from the rental, lease or licensing of tangible

The proposed regulations attempt to better approximate the extent to which the benefit of a service was received or intangible property was used in California.

personal property are sourced to California if the property is located in California.

The FTB has recently released proposed regulations pertaining to the market-based sourcing method. Under the proposed regulations, the FTB differentiates between the sale of services to businesses and the sale of services to individuals to determine the benefit of where the service is received. For businesses, services are sourced in the following order: (1) the contract between the Taxpayer and its customer or the Taxpayer's books and records; (2) a reasonable approximation of the customer's activities; (3) the location from which the customer placed the order for service; or (4) the customer's billing address. In comparison, services are sourced to individuals as follows: (1) the billing address of the customer; (2) the contract between the Taxpayer and its customer or the Taxpayer's books and records; or (3) a reasonable approximation of the customer's activities.

The proposed regulations also provide guidance for determining the source of sales of intangibles and ongoing licenses of intangibles. Under the proposed regulations, sales of intangibles and ongoing licenses of intangibles are to be sourced according to where the

intangible property was used by the Taxpayer prior to the purchase, determined in the following order: (1) the contract between the Taxpayer and its customer or the Taxpayer's books and records; (2) a reasonable approximation of the activities of the customer; or (3) the customer's billing address.

The proposed regulations further distinguish between licenses of marketing intangibles and nonmarketing or manufacturing intangibles. Marketing intangibles are sourced to California in the same manner as the location of where the intangible property was first used (or created) by the Taxpayer, as provided above, but sales made at wholesale are sourced based on the final location of the consumer. For nonmarketing and manufacturing intangibles, the proposed regulations provide that the Taxpayer's gross receipts are sourced according to the extent the use takes place in California, determined in the following order: (1) the contract between the Taxpayer and its customer or the Taxpayer's books and records; (2) a reasonable approximation of the activities of the customer; or (3) the state of the licensee's (customer's) billing address.

The proposed regulations attempt to make the market-based sourcing method easier for Taxpayers to implement and are intended to better approximate the extent to which the benefit of a service was received or intangible property was used in California. However, because the FTB has not yet adopted temporary or final regulations, including appropriate safe harbors, it is anticipated that Taxpayers looking to adopt the market-based sourcing method may be subject to increased scrutiny by the FTB during the transition. Furthermore, given the absence of firm guidance, especially for determinations of where the benefit of a service was received or where an intangible was used, disputes with the FTB may arise from time to time until firm guidance is released.

Conclusion

California's move to elective, market-based sourcing for sales other than sales of tangible personal property provides Taxpayers a potentially attractive alternative for determining California-source business income. As such, the New Apportionment Rules are expected to make California a more competitive place to do business, especially for Taxpayers with significant out-of-state sales and substantial in-state payroll and property. However, given the lack of firm guidance and the Governor's repeated overtures to repeal the elective nature of the Single-Sales Factor Apportionment Formula, Taxpayers are strongly urged to consult their individual tax advisors prior to making an annual election.

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