

February 24, 2009

## California Restructures Its Corporate Income Tax

As state legislators were falling asleep after several days of marathon sessions, a budget bill was finally passed on February 19 that drastically alters several aspects of California's corporate income tax. With the state nearly broke and facing a \$42 billion budget deficit, the state was on the verge of laying off thousands of state workers, cancelling infrastructure projects and halting issuance of income tax refunds unless a budget bill was passed. SBX3 15 and ABX3 15, as signed by Governor Schwarzenegger on February 20, create winners and losers among California taxpayers.<sup>1</sup>

### New Nexus Standard – Factor Presence

Prior to passage of SBX3 15, Cal. Rev. and Tax. Code Sec. 23101 provided that a corporation is "doing business" in California if it is "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." Based on this provision, the California Franchise Tax Board (FTB) had not formally described its taxing jurisdiction as being based on a physical presence or an economic presence.

SBX3 15 revises Cal. Rev. and Tax. Code Sec. 23101 for tax years beginning on or after January 1, 2011, to provide that a taxpayer is "doing business" in the state if it is organized or commercially domiciled in the state or it has:

- Sales in the state that exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales (including sales by an agent or independent contractor);
- Real property and tangible personal property in the state that exceed the lesser of \$50,000 or 25 percent of the taxpayer's total real property and tangible personal property; or
- Payroll in the state that exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer.

**Sutherland Observation:** California's new "doing business" standard is modeled after the Multistate Tax Commission's (MTC) Factor Presence Nexus Standard for Business Activity Taxes but is applied for the first time to a true corporate income tax. The MTC's Standard provides the same quantitative sales, property and payroll thresholds to establish substantial nexus. Ohio enacted the same factor presence nexus standard a few years ago when it overhauled its corporate income tax structure and enacted the Commercial Activity Tax (CAT). The constitutionality of the factor presence nexus standard is currently being challenged in Ohio as applied to the CAT, which is arguably a transaction tax for which physical presence is required. See *Overstock.com, Inc. v. Levin et al.*, Case No. 08CVH-11-16412 (Court of Common Pleas, Franklin County, Ohio, Nov. 14, 2008).

California has adopted a provision that is not contained in the MTC Standard that specifically requires the inclusion of a taxpayer's pro rata share of a pass-through entity's factors in calculating the thresholds. Further, California did not adopt one of the more onerous provisions of the MTC Standard, which requires the thresholds be applied to the unitary group rather than on an entity basis. Under the MTC Standard, if the unitary group met any of the thresholds, every entity in the unitary group is deemed to have nexus.

<sup>1</sup> SBX3 15 and ABX3 15 contain identical provisions and, for ease of reference, will hereinafter be referred to as SBX3 15.

## Single Sales Factor Election

For many years, California law provided that most multistate corporate taxpayers determine their taxable income attributable to California using a three-factor, double-weighted sales apportionment formula. The three-factor formula consists of payroll, property and sales with each factor representing in-state activity over the taxpayer's activity everywhere. For tax years beginning on or after January 1, 2011, SBX3 15 provides corporate taxpayers with the ability to make an annual irrevocable election on an original timely filed return to apportion business income by a single sales factor apportionment formula. Taxpayers not making this election would continue to use California's three-factor, double-weighted sales formula.

**Sutherland Observation:** California now joins a growing number of states that have either a mandatory or an elective single sales factor apportionment formula (approximately 16 states). Several other states (e.g., Virginia) have also proposed legislation to enact a single sales factor apportionment formula available to a limited set of taxpayers. A single sales factor apportionment formula serves as an incentive to companies that have significant in-state payroll and property. Presumably, many in-state California corporations will choose to make the single sales factor election and benefit from a decrease in California income tax. However, out-of-state corporations will likely choose to continue utilizing the three-factor, double-weighted sales formula.

## Elimination of Sourcing Based On Costs-of-Performance

For multistate corporate taxpayers that earn revenue from services or intangibles, California, like many states, has historically sourced sales based on the location of the taxpayer's "costs-of-performance." In applying this method, a taxpayer evaluates its income-producing activities and if an activity was performed solely in California, then all receipts from that activity would be included in the California sales factor numerator. If the income producing activity was performed in and outside of California, then the receipts were included in the sales factor numerator only if a greater proportion of the costs were in California than in any other state (commonly referred to as the preponderance costs-of-performance rule).

For tax years beginning on or after January 1, 2011, SBX3 15 repeals these established sourcing principles and implements "market-based" sourcing concepts. As revised, Cal. Rev. and Tax. Code Sec. 25136 provides for the following sourcing rules for sales, other than sales of tangible personal property:

- Receipts from services are in the state to the extent the purchaser of the service received the benefit of the service in the state;
- Receipts from intangible property are in the state if the property is used in the state. For marketable securities, if the taxpayer's customer is in the state, the receipts are in the state; and
- Receipts from the sale, lease, rental or licensing of real and tangible property are in the state if the property is located in the state.

**Sutherland Observation:** The elimination of costs-of-performance sourcing along with the enactment of an elective single sales factor apportionment formula benefits California-based service companies that have a significant out-of-state customer base. However, many service companies with significant operations outside of California will likely see a substantial California tax hike resulting from the switch from costs-of-performance to market-based sourcing.

While the shift to market-based sourcing of service and intangible receipts is viewed by some states as a way to increase corporate income taxes on out-of-state businesses, California has been a long-time adopter of the Uniform Division for Income Tax Purposes Act (UDITPA) and the MTC Compact—both of

which contain costs-of-performance sourcing. While UDITPA is under a “review” process, it is surprising that California moved to abolish costs-of-performance given its wide adoption.

Further, as is the case with other recent state adoptions of a “market-based” approach, the new statutory language is ambiguous. For example, California has now adopted a “benefits received” rule for sourcing services but does not provide how to determine where the benefit of a service is received. Last year Illinois adopted a similar sourcing method and then quickly repealed that method and adopted more specific definitions of “market.” Ohio, which has a similar rule for its CAT, adopted extensive regulations to define “benefit received” and in many circumstances left the definition up to the taxpayer’s books and records.

### Switch From *Joyce* to *Finnigan*

All states that mandate combined reporting have generally adopted either the *Joyce* or the *Finnigan* approach to calculating the combined sales factor numerator. The *Joyce* approach provides that the sales factor numerator of the combined group consists of sales by only those corporations that have nexus in California and are required to file a California corporate income tax return. However, the *Finnigan* approach provides that the sales factor numerator of the combined group includes all corporations in the unitary group that have California sales (regardless of whether the corporation has nexus or is P.L. 86-272 protected). California has had a tumultuous history surrounding its adoption of *Joyce* and/or *Finnigan* through a series of decisions where California first adopted *Joyce*, then *Finnigan*, and then went back to *Joyce* in the late 1990s. SBX3 15 changes the California rule once again and requires taxpayers to use the *Finnigan* rule when reporting sales of tangible personal property for combined reporting purposes.

**Sutherland Observation:** While *Finnigan* has historically been the minority rule in combined reporting states, an increasing number of states have recently adopted combined reporting that have incorporated the *Finnigan* rule into their statutes or via court decisions. For example, Massachusetts, Michigan and New York have adopted *Finnigan*. Because *Finnigan* includes sales of unitary corporations with no independent nexus in the state in the sales factor numerator, it has been questioned as being constitutionally suspect. However, the constitutionality of *Finnigan* has been upheld—see *Disney Enterprises, Inc. v. Tax Appeals Tribunal of the State of New York*, 888 N.E.2d 1029 (N.Y. Court of Appeals, March 25, 2008)—where the New York Court of Appeals held that it was permissible to include the New York destination sales of certain nontaxpayer subsidiaries in the numerator of the group’s receipts factor. According to the court, inclusion of the sales did not amount to a tax on the subsidiaries without nexus, but instead was a method of calculating the tax imposed on the combined unitary group, which was subject to New York taxation. However, New York, unlike California, defines the taxpayer as the entire unitary group and this could make a difference for similar challenges.

For many companies, the impact of the transition back to *Finnigan* may be minimal because of the bright-line nexus standard, which will likely subject most companies to California tax. However, for taxpayers that sell tangible personal property to California customers and are protected by P.L. 86-272, the transition to *Finnigan* will have a significant impact because sales of tangible personal property would be included in the numerator of the sales factor even though the seller is protected from California tax. Finally, the transition to *Finnigan* is likely beneficial for sellers of tangible personal property from California to other states because sales from California locations will no longer be required to be “thrown back” if any member of the taxpayer’s unitary combined group is taxable in the destination state.

## Other Changes

In addition to the aforementioned changes, the Governor also signed SBX2 15 and ABX3 3 which, in conjunction with SBX3 15, provide a number of other important changes, including:

- Complete exclusion from the sales factor of receipts generated in connection with a taxpayer's treasury function (also substantially adopted from an MTC model) and from certain hedging transactions for tax years beginning on or after January 1, 2011;
- A 1 percent increase in the state sales tax rate, from 5 to 6 percent, effective April 1, 2009, with a sunset in 2011 or 2012;
- An increase in marginal personal income tax rates by 0.125 to 0.25 percent for tax years 2009 to 2012; and
- Several new corporate and personal income tax credits, including a small business jobs tax credit, motion picture production credit and a homebuyers' credit.

## Financial Statement Impact

Although many of these changes do not take effect until tax years beginning on or after January 1, 2011, the changes may impact many taxpayers' state tax provisions. Because the Governor signed the legislation into law during the first quarter of 2009 for calendar year taxpayers, changes to taxpayers' deferred tax rate may need to be reviewed in the first quarter of 2009. For many taxpayers primarily based within California, the elective single sales factor, market sourcing and adoption of the *Finnigan* method may also result in the reduction of the taxpayers' state effective tax rate. On the other hand, for taxpayers who are primarily based outside of California and who make sales into California, the repeal of cost-of-performance, and the impact of the *Finnigan* rule combined with a bright-line economic presence standard may result in the increase of the taxpayers' state effective rate.



*If you have any questions regarding this Legal Alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

|                     |              |  |
|---------------------|--------------|--|
| Jeffrey A. Friedman | 202.383.0718 | <a href="mailto:jeff.friedman@sutherland.com">jeff.friedman@sutherland.com</a>       |
| Kendall L. Houghton | 202.383.0402 | <a href="mailto:kendall.houghton@sutherland.com">kendall.houghton@sutherland.com</a> |
| W. Scott Wright     | 404.853.8374 | <a href="mailto:scott.wright@sutherland.com">scott.wright@sutherland.com</a>         |
| Eric S. Tresh       | 404.853.8579 | <a href="mailto:eric.tresh@sutherland.com">eric.tresh@sutherland.com</a>             |
| Diann L. Smith      | 212.389.5016 | <a href="mailto:diann.smith@sutherland.com">diann.smith@sutherland.com</a>           |
| Stephen P. Kranz    | 202.383.0267 | <a href="mailto:steve.kranz@sutherland.com">steve.kranz@sutherland.com</a>           |
| Michele Borens      | 202.383.0936 | <a href="mailto:michele.borens@sutherland.com">michele.borens@sutherland.com</a>     |
| Marc A. Simonetti   | 212.389.5015 | <a href="mailto:marc.simonetti@sutherland.com">marc.simonetti@sutherland.com</a>     |
| Pilar Mata          | 202.383.8815 | <a href="mailto:pilar.mata@sutherland.com">pilar.mata@sutherland.com</a>             |
| Jessica L. Kerner   | 212.389.5009 | <a href="mailto:jessica.kerner@sutherland.com">jessica.kerner@sutherland.com</a>     |
| Maryann H. Luongo   | 202.383.0175 | <a href="mailto:maryann.luongo@sutherland.com">maryann.luongo@sutherland.com</a>     |
| Charles C. Kearns   | 404.853.8005 | <a href="mailto:charlie.kearns@sutherland.com">charlie.kearns@sutherland.com</a>     |
| Jonathan A. Feldman | 404.853.8189 | <a href="mailto:jonathan.feldman@sutherland.com">jonathan.feldman@sutherland.com</a> |
| Jolie A. Sims       | 404.853.8057 | <a href="mailto:jolie.sims@sutherland.com">jolie.sims@sutherland.com</a>             |
| Richard C. Call     | 212.389.5031 | <a href="mailto:richard.call@sutherland.com">richard.call@sutherland.com</a>         |
| Maria M. Todorova   | 404.853.8214 | <a href="mailto:maria.todorova@sutherland.com">maria.todorova@sutherland.com</a>     |
| Miranda K. Davis    | 404.853.8242 | <a href="mailto:miranda.davis@sutherland.com">miranda.davis@sutherland.com</a>       |
| Matthew P. Hedstrom | 212.389.5033 | <a href="mailto:matthew.hedstrom@sutherland.com">matthew.hedstrom@sutherland.com</a> |