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FTB proposes significant changes to market-based sourcing rules

Changes are designed to simplify rules and provide greater clarity for asset managers and professional service providers among others.

After seven years and six interested parties meetings, the FTB has formally issued proposed changes to California's apportionment sales factor market-based sourcing regulation (18 Cal. Code Regs. §25136-2). Taxpayers will have until 5:00 p.m. on October 31, 2024, to submit their comments. These proposals will significantly impact most multistate taxpayers whether located inside California or outside California if they have California customers.

Highlights of the most significant changes include:

- Revamping the sourcing rules for services to provide one set of cascading rules for sourcing sales to both individuals and businesses, rather than separate rules, and providing clarity as to how these rules are applied;
- A new rule for sourcing sales of professional services, which would include, among other services, asset management services (as defined in the new regulation) and tax, payroll, and accounting services. If adopted, taxpayers who provide services to more than 250 customers in any single professional service can source the revenue from those services to their customer's billing address. Specific rules are also proposed to address sourcing revenues from asset management services;
- A new rule as to how to source revenues from a sale when the sale involves both sales of services and property or sales of both tangible and intangible property; and
- Clarifying rules for sales of intangible property, including marketable securities.

In addition, the proposed regulations include additional examples to illustrate how both the existing and proposed provisions apply.

Unless modified, the proposed regulation, if adopted, would be effective beginning with the 2024 taxable year.

Comments can be e-mailed to Hanna Cho at: hanna.cho@ftb.ca.gov, faxed to (916) 885-5786, or mailed to:

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The draft language and the FTB's statement of reasons are available at:

www.ftb.ca.gov/tax-pros/law/regulatory-activity/25136-2%20draft%20text.pdf

www.ftb.ca.gov/tax-pros/law/regulatory-activity/25136-2-ISOR.pdf

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Filing requirements for corporations moving out of state

Leaving the state doesn't mean the corporation no longer must file a California return.

We recently received a Message Board post asking if a corporation, an investment firm that had moved outside California years ago and no longer has property or employees in California, must still file a California return if their gross receipts fall below the economic nexus thresholds (for 2024, $735,109 in California sales or 25% of the taxpayer's total sales).

The corporation still has California customers; however, the revenues from these customers have declined below the thresholds.

First, it’s important to remember that a corporation may be subject to either the California corporation franchise tax or the California corporation income tax. The franchise tax is imposed against corporations:

- Incorporated or organized in California;
- Qualified or registered to do business, whether they are actually “doing business” in California or not; or
- Doing business in California, whether or not incorporated, organized, qualified, or registered under California law.
  (R&TC §23151)

In contrast, the corporation income tax applies to out-of-state corporations that are not doing business in California but that have California-source income. (R&TC §23501)

Even though the corporation may not be incorporated, qualified, or registered to do business in California and is no longer “doing business” in California, it still must file a Form 100 with California to report its California-source income. Under California’s sourcing rules, if the investment firm provides services to California customers, it has California-source income. However, if the corporation is not incorporated or registered in California and is not “doing business” in California, it is not required to pay the $800 minimum franchise tax. (R&TC §23153)

Doing business

The next question is whether this corporation is considered to be “doing business” in California if its sales fell below the $735,109 threshold. Unfortunately, this is not a question that can be answered with a simple yes or no response.

California has two different “doing business” tests for purposes of determining whether a taxpayer has nexus with the state. A taxpayer is considered “doing business” if it:

1. Actively engages in any transaction for the purpose of financial or pecuniary gain or profit (R&TC §23101(a)); or
2. Meets the factor-threshold economic nexus test under R&TC §23101(b) by:
    - Being organized or commercially domiciled in California;
    - Having California sales exceeding $735,109 (2024);
    - Having California real or tangible personal property (valued at original cost) exceeding $73,502;
    - Having California compensation exceeding $73,502; or
    - Having California sales, property, or compensation that exceeds 25% of the business’s total sales, property, or payroll.

Many out-of-state businesses think that they are home free and don’t have to file or pay California taxes if they are below the economic nexus factor thresholds. But they are often mistaken. Even if their California sales, property, or payroll is relatively small, they can still be considered to be actively engaged in a transaction for the purpose of financial or pecuniary gain or profit and therefore required to file a return and pay at least the $800 annual/minimum tax.

Nowhere is “actively engaged” actually defined, but the courts, the State Board of Equalization (when it heard income/franchise tax appeals), and the Office of Tax Appeals (OTA) have consistently applied a very low threshold.

For example, the OTA found that a foreign LLC was still “doing business” in California even though its only connection with California was a California employee to whom it paid $12,427 in wages from October 2, 2014, through December 31, 2015, which was below the payroll threshold for the taxable year outlined above. (***Appeal of ProPharma Sales, LLC***, 2020-OTA-296) The employee established the California physical presence for the LLC. Therefore, the OTA upheld the $800 annual tax assessed by the FTB as well as over $700 in penalties plus interest.

We believe the FTB would apply a similar analysis to the question posed regarding the investment firm that had California sales below the sales threshold, especially if the sales revenues were still significant or were from a significant number of customers. However, if the investment firm only had minimal revenues from a few customers, they may not be considered to be “doing business.” Unfortunately, there is no bright line when it comes to the “financial gain or pecuniary gain or profit” analysis. Taxpayers and tax professionals must use their best judgment.

Apportioning flowthrough income received from partnership

A recent OTA decision demonstrates how complex these issues can be.

A nonresident taxpayer failed to show that the FTB improperly apportioned to California flowthrough income from lower-tier partnerships that he received from his single member LLC (SMLLC). (***Appeal of Blau***, 2024-OTA-282; pet. for rehg. denied 2024-OTA-283) The case provides an excellent example of how California’s apportionment rules apply in transactions involving multitier partnerships.

The taxpayer was the sole member of Yukon Holdings, a SMLLC. Yukon owned a little over 11% in The Related Companies (TRC), a limited partnership. TRC generated passthrough income directly and indirectly from other partnerships, including RG IV LP (RG), in which TRC was a 99.99% limited partner.

The income at issue

During the 2011 tax year, the taxpayer received $85 million in passthrough IRC §1231 net gain that originated from RG. The taxpayer did not report any of the $85 million as California-source income.

On audit, the FTB determined that $80 million of the $85 million §1231 net gain was business income subject to apportionment. After applying Yukon’s 10.0640% apportionment percentage, the FTB determined that the taxpayer had an additional $8 million in taxable income for the year, resulting in an additional tax of over $650,000.

Which apportionment percentage to use?

The taxpayer contended, without proof, that the §1231 net income was not included in Yukon’s apportionment formula. Because he did not have any information related to the gross receipts of the lower-tier passthrough entities, he argued that the FTB should use the reported apportionment factors from TRC and add the §1231 net gains to TRC’s reported sales factor to source the §1231 net gain business income. This would result in a California apportionment percentage of 9.251% rather than the 10.0640% applied by the FTB.

The OTA rejected the taxpayer's argument, finding that:

- California law requires the inclusion of gross receipts, not net gain, in the calculation of California's sales factor. (R&TC §25120(f)(1)) There is no exception for §1231 net gains;
- The taxpayer didn't provide any proof that TRC had excluded the gross receipts from the §1231 net gain transaction. Even if TRC had excluded the gross receipts, the exclusion may have been required. California law requires the exclusion of gross receipts derived from a "substantial and occasional" sale (18 Cal. Code Regs. §25137(c)(1)(A)); and
- The FTB's determination is presumed correct, and the taxpayer failed to show why the FTB should not use Yukon's 10.0640% apportionment percentage.

Partnership income apportionment

How business income is treated at the partner/member level depends on whether the partner/member's trade or business is unitary with the partnership/LLC's trade or business (disregarding the ownership interest). (18 Cal. Code Regs. §25137-1) For purposes of determining whether a partnership is unitary with its partner(s), the FTB and tax practitioners usually rely on the:

- Contribution or dependency test; or
- Three unities test (ownership, operations, and use, modified to eliminate the ownership requirement).

General partners are much more likely to be treated as unitary with the partnership than limited partners. (***Appeal of PBS Building Systems, Inc.***, 94-SBE-008)

If an apportioning trade or business conducted by a partner is unitary with the apportioning trade or business of the partnership, the partner's distributable share of business income of the partnership is generally treated as business income of the partner.

Conversely, if a partner is not unitary with the partnership, it apportions its business income separately from the partnership income and then adds that to its share of the partnership's income apportioned to California to determine its total income subject to California tax.

Unitary issues are discussed in more detail in "Unity issues of passthrough entities" in the October 2021 issue of *Spidell's Strategic Tax Advisor®*.

In this case, the taxpayer failed to show whether TRC and RG were unitary and therefore failed to rebut the presumption that the FTB's determination was correct.

Challenges faced in passthrough entity apportionment audits and appeals

This case is a classic example of what taxpayers must provide on audit and/or appeal to prevail in these partnership apportionment audits. Unfortunately, for many taxpayers it's not always possible to get this information from the lower-tier entities, which as this case demonstrates, will result in the FTB's determination being sustained. In this case, for the taxpayer to have prevailed, much more documentation was required such as:

- Evidence of the gross receipts received by RG and how those flowed through to TRC;

- How TRC and RG determined their apportionment percentages; and
- Evidence of the unitary relationship between both RG/TRC and TRC/Yukon.

About the Author

Sandy Weiner, J.D., has over two decades of experience as a California tax analyst with an expertise in business tax issues. She is Spidell's California Editor, and lectures on complex tax issues such as apportionment, combined reporting, and state credits and incentives. She is also an expert at conformity issues. She is a graduate of Colorado College with her J.D. from Hastings College of the Law.

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