


myStateTaxOffice

A Washington National Tax Services (WNTS)
Publication

December 3, 2012

California Proposition 39: Single sales factor for most taxpayers and market-based sourcing for all taxpayers

 Follow @twitter

Authored by: Ligia Machado, Elaine Warneke, and Michael Santoro

In brief

On November 6, 2012, California voters passed Proposition 39, which requires most taxpayers to apportion their California income using a single sales factor and requires all taxpayers to use market-based sourcing for receipts from the sale of intangibles for tax years beginning on or after January 1, 2013. The scope of Proposition 39 has been subject to some confusion, particularly with regard to whether banks and financial corporations are required to use market-based sourcing for intangibles. We have confirmed with the Franchise Tax Board ("FTB") that banks and financial corporations are required to use market-based sourcing for intangibles unless sourcing for the specific intangible is addressed in the existing special apportionment regulations.

Proposition 39 in detail

Mandatory Single Sales Factor

Effective January 1, 2013, Proposition 39 changes the apportionment formula for taxpayers previously subject to the four-factor formula (property, payroll, and double-weighted sales) to a single sales factor formula.

The change applies to all taxpayers except for those that derive more than 50% of their gross business receipts from conducting one or more "qualified business



activity," including banking and financial, savings and loan, extractive and agricultural activities as defined by California Revenue and Taxation Code ("R&TC") section 25128. Prior to Proposition 39, such taxpayers were required to use an equally weighted three-factor formula. Following Proposition 39, these taxpayers will continue to use the equally weighted, three-factor formula. Proposition 39 also created R&TC section 25136.1, which provides special apportionment rules for cable companies apportioning business income in California.

Market-Based Sourcing

Effective January 1, 2013, all taxpayers will be required to source their receipts from sales of other than tangible personal property using the market-based sourcing rules, such that:

- Services will be sourced based on where the customer received the benefit of that service.
- The sale of intangible property will be sourced based on where the intangible is used.
- The sale of marketable securities will be sourced based on the location of the customer.
- The sale, lease, rental or licensing of real property and the lease, rental or licensing of tangible personal property will be sourced based on the location of the property.

Presumably, the guidance under California Code of Regulations section 25136-2 for applying the market-based sourcing rules under the single sales factor election available for 2011 and 2012 will continue to apply to all taxpayers effective January 1, 2013.

As we confirmed with the FTB, while Proposition 39 does not require qualified businesses, such as banks and financials, to apportion income based on the single sales factor, it does require qualified businesses to use market-based sourcing for revenues that are not otherwise addressed under California's special industry apportionment regulations. Proposition 39 thereby changes the rules and rejects the cost of performance method of sourcing sales of other than tangible personal property for these qualified businesses as well. Contrary to the current rules, Proposition 39 mandates market-based sourcing for banks and financials including the non-financial members of their unitary reporting groups.

California Filing Options Before and After Proposition 39

This summary does not address a possible election to apportion income pursuant to the terms of the Multistate Tax Compact ("MTC"), currently being litigated in *The Gillette Company et. al. v. FTB and the subject of certain R&TC changes*. Please be advised that such an election will be challenged by the FTB and raises numerous complexities beyond the scope of this alert. If you are considering an MTC election please consult with a State and Local Tax subject matter specialist at PwC.

For 2011 and 2012 Tax Years:

For tax years beginning on or after January 1, 2011, California taxpayers not required to use the equally weighted, three-factor formula above, have two filing options:

- 1) *Double-Weighted Sales Factor Method (former default)*: Four-factor, double-weighted sales factor, formula with cost of performance sourcing for receipts from the sale of other than tangible personal property.
- 2) *Single Sales Factor Method*: Sales factor only, with market-based sourcing for receipts from the sale of other than tangible personal property.

Beginning in 2013:

For tax years beginning on or after January 1, 2013, California taxpayers not required to use the equally weighted, three-factor formula above, must use the single sales factor method apportioning based on the sales factor only with market-based sourcing for receipts from sales of other than tangible personal property.

Actions to think about

Proposition 39 may significantly impact California taxpayers that are required to change from cost of performance to market-based sourcing for sales of other than tangible personal property. Banking and financial corporations (along with other taxpayers engaged in "qualified business activities") traditionally sourcing revenue streams not covered by a special industry apportionment regulation under the cost of performance method will have to apply market-based sourcing rules.

Let's talk

If you have questions about Proposition 39, please contact one of the following individuals:

Ligia Machado
Partner, Sacramento
(916) 930-8260
ligia.l.machado@us.pwc.com

Elaine Warneke
Director, Sacramento
(916) 930-8321
elaine.s.warneke@us.pwc.com

This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

SOLICITATION

© 2012 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.