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California - Throwback not required when taxpayer, or a member of its unitary group, is subject to tax in the destination jurisdiction using California's "economic nexus" rule

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In brief

In a recently released Chief Counsel Ruling, the Franchise Tax Board (FTB) applied principles of California's new economic nexus standard, the new *Finnigan* rule, and market based sourcing to determine when throwback of sales of tangible personal property is required. The FTB found that a taxpayer does not have to throw back tangible personal property sales where it has more than $500,000 of sales in a foreign jurisdiction. Additionally, a taxpayer does not have to throw back domestic tangible personal property sales when a member of its California unitary group has more than $500,000 of sales, including sales of other than tangible personal property, in the destination state. [Chief Counsel Ruling 2012-03 (8/28/12)]

In detail

California's "economic nexus" standard, Finnigan rule, and market sourcing

Effective for tax years beginning on or after January 1, 2011, California adopts an "economic nexus" standard, the *Finnigan* rule, and market based sourcing, as summarized below.

- **Economic nexus.** California Revenue and Taxation Code (CRTC) section 23101 generally provides, among other qualifications, that a taxpayer is doing business in California if its California sales exceed the lesser of $500,000 or 25% of its total sales.
- ***Finnigan.*** CRTC section 25135(b) adopts a *Finnigan* approach to determining unitary group sales. Under this approach, the California sales factor numerator includes: (1) all sales of the combined reporting group properly assigned to the state; and (2) sales of tangible personal property made to states where no member of the group is subject to tax (the "throwback" rule). However, sales are excluded from the sales factor numerator if any member of the combined reporting group is taxable in the state of the purchaser (i.e., treating the combined reporting group as the "taxpayer" for purposes of throwback).
- **Market sourcing.** CRTC section 25136(b) provides that sales of services are in the state to the extent that the purchaser received the benefit of the service in the state. This rule applies where a taxpayer makes a single sales factor election.

Click here for our summary regarding California's economic nexus, *Finnigan*, and market sourcing rules.

Taxpayer should not throw back sales to a foreign jurisdiction where it has more than $500,000 of sales

For taxable years beginning on or after January 1, 2011, the Ruling found that the taxpayer had more than $500,000 of receipts from sales to certain foreign jurisdictions. The FTB recognized that "[j]ust as an entity would be taxable in California . . . by virtue of having sales of over $500,000 in this state, [the taxpayer] is considered to be taxable in foreign jurisdictions" when the taxpayer's sales exceed $500,000. Accordingly, because the taxpayer was considered to be subject to tax in the foreign jurisdiction by virtue of its sales that exceed $500,000 in that foreign jurisdiction, the taxpayer was not required to throw back those sales to California.

The FTB also acknowledged that Public Law (P.L.) 86-272 would not protect the taxpayer from being taxable in a foreign jurisdiction because the law applies to interstate, not foreign, commerce.

Taxpayer should not throw back domestic sales to a state where a member of its combined group has more than $500,000 of sales

For taxable years beginning on or after January 1, 2011, a member of the taxpayer's California combined group had more than $500,000 in sales allocated to certain states and its activities in those states were not protected under P.L. 86-272. For sales other than sales of tangible personal property, the taxpayer applied the market approach contained in CRTC section 25136(b) to measure its sales attributable to the

foreign jurisdiction. Accordingly, the member was considered taxable in those states where it has greater than $500,000 of sales.

The FTB found that the taxpayer was not required to throw back interstate sales to its California sales factor numerator in states where a member of its California combined group was subject to tax and where the member's activities were not protected under P.L. 86-272.

Actions to think about

The ruling did not address a situation where a taxpayer makes sales of tangible personal property to a foreign jurisdiction where a unitary member is subject to tax. Left unanswered is whether the ruling could also apply to conclude that such a taxpayer would not have to throw back such sales following the "subject to tax" requirements provided in the ruling.

The application of three concepts in California law for years beginning on and after January 1, 2011 - (1) economic nexus; (2) the *Finnigan* rule; and (3) market based sourcing - provide opportunities for taxpayers to take a fresh look at their treatment of throwback sales to determine whether they may be "subject to tax" in domestic and foreign jurisdictions where they may not have been before, and accordingly reduce the amount of sales that are thrown back to California.

Let's talk

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