## *7530 THROWBACK SALES*

**NOTE: On April 22, 1999 the SBE issued its decision in *Appeal of Huffy Corporation*. In this case the SBE reviewed their *Finnigan/Nutrasweet* interpretation of §25135 and concluded that its "pre-*Finnigan* decision in *Appeal of Joyce, Inc.* is the better law." The decisions deal with the term "taxpayer" for throwback sales purposes. The general rule for determining which state a sale of tangible personal property should be apportioned (the numerator assignment) is the state of destination. An exception to this rule is where the taxpayer shipping the goods is not taxable in the state of destination perhaps due to PL 86-272. The Joyce rule provides that you look to each separate entity to determine if that entity is taxable in the destination state. Therefore, under the Joyce rule, sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state. The *Finnigan/Nutrasweet* decisions held that the unitary group is the taxpayer. Accordingly, under the Finnigan rule sales are not thrown back to the state of origination if any member of the unitary group is taxable in the destination state.**

**In *Huffy*, the SBE noted that both FTB and taxpayers have relied on the *Finnigan* decision for the past eight years and ruled that their holding for a renewed implementation for the Joyce rule should be applied prospectively from the date of their decision. Therefore, for taxable years beginning on or after April 22, 1999, the FTB and taxpayers will again use the Joyce rule. For taxable years beginning before April 22, 1999, Finnigan is the rule.**

When the taxpayer ships goods from this state to a state where the taxpayer is not taxable, the sales are assigned to the California numerator under the provisions of §25135(b). This is termed the "throwback" rule. As discussed in MATM 1200 – MATM 1240, Public Law 86-272 precludes states from taxing businesses whose activities within the state do not exceed solicitation of sales. Under the destination rule that is normally used to assign sales, this restriction on a state's ability to tax would frequently result in sales being assigned to a destination state in which the taxpayer would be immune from taxation. To prevent this result, the throwback rule requires such sales to be "thrown back" to the numerator of the state from which the goods were shipped.

There are three aspects of this issue that the auditor must consider:

If a corporation is selling goods destined for California, and that corporation's activities within California exceed the P.L. 86-272 threshold (i.e., the corporation is a California taxpayer), then the auditor should verify that the corporation is not throwing-back California destination sales to the states from which they were shipped. The auditor should also verify that the selling corporation has an assigned California corporation number.

If a seller's activities within California do not exceed the P.L. 86-272 threshold, but any member of the combined report is a taxpayer in this state, then the California destination sales are not thrown back to the state from which they were shipped.

If a taxpayer is shipping goods from California, the auditor should verify that the taxpayer is taxable in the destination states.

**Note regarding foreign commerce:** For sales between the U.S. and a foreign country, the standard for determining whether a corporation is taxable is constitutional nexus, *not* P.L. 86-272. See MATM 1240 for more discussion.

**Identification of throwback issues:**

When examining the by-state records for property and payroll, the auditor should be on the lookout for states in which the taxpayer does not have significant amounts of property or payroll. A throwback issue may exist if the by-state sales records reveal that the taxpayer makes sales to these states. To aid in identifying throwback issues, it may be helpful to construct a workpaper schedule for each year similar to the following nexus chart:

| Destination states for products with a CA shipping origin | Nexus Indicators: | | | | |
|---|---|---|---|---|---|
| | Return filed | Inventory | Assets | Rented Property | Payroll |
| 1. | | | | | |
| 2. | | | | | |
| 3. | | | | | |
| 4. | | | | | |
| 5. | | | | | |

Positive nexus items for each listed state should be listed across the chart. Filed returns should only be listed if they indicate bona fide activity within the state (as opposed to mere qualifying returns reporting a minimum tax). If the chart indicates that nexus has been established by way of a filed return or by property or rented facilities within a state, that state may be eliminated as a throwback candidate. Sales to remaining states with no returns or property have throwback potential and should be examined further.

NOTE: The above chart must be prepared for the combined reporting group as a whole for tax years beginning before April 22, 1999 to reflect the Finnigan rule. Sales to a destination state will not be thrown back to the shipping state if *any member* of the combined group is taxable in the destination state in accordance with the SBE decisions in *Finnigan/Nutrasweet*.. After April 22, 1999, the chart must be prepared on a separate entity basis to reflect the Joyce rule. Sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state in accordance with the SBE decision in Huffy.

In the *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., August 25, 1988 ("Finnigan I"), the SBE ruled that in the context of §25135(b)(2), the word "taxpayer" means all members of the combined reporting group. Therefore, the SBE held that when a member of a group conducting a unitary business in California shipped sales from California to another state, the throwback rule does not apply if *any* member of that combined reporting group is taxable in the destination state.

**Example:** CF Company is an interstate trucking company that operates and delivers in all states west of the Mississippi. It files a combined return with TM Company, a trailer manufacturer, whose operations are solely in California. TM sells trailers to CF and to other customers, and the two companies are unitary. TM ships trailers to a customer in Arizona.

Holding (1): For tax years beginning before April 22, 1999, even though TM does not have any operations outside of California, its sales to Arizona would not be thrown back to California because CF is taxable in Arizona. This is the Finnigan rule.

Holding (2): For tax years beginning on or after April 22, 1999, TM sales are thrown back to California because TM is not taxable in Arizona. This is the Joyce rule.

FTB filed a petition for rehearing from the decision in *Finnigan I*, and the SBE then issued its *Opinion on Petition for Rehearing* ("Finnigan II") on 1/24/90. In Finnigan II, the SBE agreed that its opinion in Finnigan I was "analytically and philosophically incompatible" with *Joyce*, and expressly overruled *Joyce.* The opinion also clarified that this was strictly an apportionment rule. Although sales made by an entity that is immune from taxation can be included in the sales factor of the combined reporting group, the entity itself cannot be taxed. When it is necessary to identify the tax liabilities of each taxpayer in the unitary group, the presence of "Finnigan sales" will require a modification to the normal intrastate apportionment rules. These calculations are described in MATM 7905.

The *Finnigan I and II* opinions had dealt with a situation where sales were shipped from California and were deemed to be assignable to the numerator of the destination state. A question remained as to whether the same result would apply to sales shipped from another state to a California destination ("reverse Finnigan sales"). The SBE confirmed that its decision in Finnigan I and II applied equally to reverse Finnigan sales in *Appeal of The Nutrasweet Company*, Cal. St. Bd. of Equal., October 29, 1992.

Note that the Finnigan rationale only applies to combined reporting group members. Therefore, the fact that a unitary foreign affiliate has nexus in a particular location is not considered in determining the throwback sales for a water's-edge taxpayer if the affiliate is excluded from the combined report because of the water's-edge election.

**Audit steps for examining throwback issues:**

Once potential throwback sales are identified, the auditor can question the taxpayer as to their proper classification and possibly the issue can be resolved without additional work. If the taxpayer maintains that they are taxable in the destination state-, the following steps -should be taken:

If a taxpayer has filed a return and/or paid taxes to another state because of an audit adjustment in that state, and that state has an income or franchise tax, it is usually presumptive evidence that the taxpayer is taxable in that state. If so, the auditor should ask the taxpayer to produce copies of the other state return or other state audit adjustment. If a taxpayer voluntarily files and pays a tax, or pays a minimal fee for qualification, organization or for the privilege or doing business in the state, but does not actually engage in business activity within the state sufficient to establish nexus, then the taxpayer is not taxable in the state (Regulation 25122(b)(1)). The taxpayer may take the position that sales into the destination state are immune from taxation as provided by PL 86-272 but still file a franchise tax return and pay the minimum tax for various business reasons such as contract enforcement and ability to use that state's courts. In such circumstances, the department will not treat the taxpayer as taxable in the destination state as the minimum tax was paid for regulatory purposes and has no relation to the business activity in the state.

The auditor should therefore scan the other state returns to gain additional assurance that taxability exists. Unless there is a material tax effect however, the auditor should not spend a great deal of time on the issue if tax returns have been filed or tax has been paid pursuant to the other state's audit adjustment.

However, if the potential tax effect of a throwback sale is material, the fact that the taxpayer has filed a return in the destination state may not resolve the issue. A taxpayer, may self-assess or agree with the other state's audit determination if the result in assigning the sale to the destination state results in a net reduction in tax. The definition of materiality for the purposes of throwback sales is a large difference in tax between the additional tax paid to the destination state and the California tax savings by not throwing the sale back to California. The auditor should discuss this issue with his/her supervisor.

The auditor may pursue factual development of the potential throwback sale issue, assuming the tax effect is material, even though the taxpayer has filed a return in the destination state or agreed with the other state's audit adjustment. Audit adjustments may be proposed if the taxpayer does not have nexus in the destination state or is exempt under PL 86-272.

If a taxpayer has not filed returns or paid taxes in the destination state for the year at issue, taxability in the destination state for the year in issue must be established by incontrovertible evidence that the taxpayer's activities within the state cause nexus under the U.S. Constitution and exceed the activities protected by P.L. 86-272. (A complete discussion of nexus requirements and P.L. 86-272 may be found in MATM 1100 – MATM 1240.)

The *Appeal of The Olga Company*, Cal. St. Bd. of Equal., June 27, 1984, stated in part:

"Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86.272. We believe that this weighs heavily against appellant and that, in order to prevail, appellant must clearly establish that its activities within the foreign states go beyond mere solicitation."

When the situation exists of a taxpayer not filing returns or paying taxes in the destination state for the year at issue, the taxpayer should be asked to complete Form FTB 4505 "*Declaration to Support Claim of Taxability in Other States of the United States."* A copy of the form is included at Exhibit G.

Since the Form FTB 4505 contains the taxpayer's declaration, it should be completed by the taxpayer, not the auditor. The declaration itself will not suffice for relief from throwback. Activity claimed in the declaration is still subject to audit verification. The completed declaration should be submitted as part of the completed audit report, and Corporation Audit will furnish a copy to the destination state. The purpose for this form is to provide accountability by ensuring that sales that may not be thrown back to California are brought to the attention of the destination state where the taxpayer is claiming taxability.

Once the Form FTB 4505 Declaration has been completed, the claimed activities should be reviewed to determine whether they are sufficient to establish taxability. If the materiality of the issue warrants it, the auditor should verify the existence of the claimed property or activities in the state. For example, if the taxpayer claims that inventory is stored in a public warehouse within the destination state, the auditor may want to request the inventory confirmation letters that would have been sent by the taxpayer's outside accountants during the annual audit.

If the taxpayer will not sign the Declaration, then the auditor should continue the factual development. Consistent with the SBE decision in *The Olga Company* and CCR §25122 the taxpayer has the burden to clearly show that they are taxable in the destination state. Sales will be thrown back to California if the taxpayer cannot meet this burden.

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