

Request for Final Approval on Adopting the Multistate Tax Commission's Amendment  
to its Model Regulation IV.17 Relating to Independent Contractors  
(California Regulation Section 25136)

California Revenue and Taxation Code (RTC) section 25136 provides the sales factor numerator assignment rules for all sales other than sales of tangible personal property. This section provides that such sales are assigned to California if the income-producing activity related to the sale occurs in California. If the income-producing activity occurs in more than one state, the sale is assigned to the state where the greater proportion of the income-producing activity occurred. This determination is made based on a comparison of the costs of performance in the various states where the income-producing activity took place.

In applying these rules, the current regulations under RTC section 25136 exclude activities "performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor." (Regulation § 25136(b).) Whether any other actors, such as agents or members of the same combined report, performing income-producing activity on behalf of a taxpayer were included or excluded from income-producing activity was unclear.

In 2006, the Franchise Tax Board issued Legal Ruling 2006-2, which declared that income-producing activities performed by members of the taxpayer's combined reporting group on behalf of the taxpayer were includable as income-producing activities used to assign the sales of the taxpayer. Later in 2006, the Multistate Tax Commission (MTC) adopted an amendment to its Regulation IV.17 that went further than California's Legal Ruling 2006-2 and removed the "on behalf of" exclusion from the regulation.<sup>1</sup> As a result, the MTC amendment removes any dispute as to which actors performing income-producing activity on behalf of a taxpayer will result in inclusion the sales factor because it includes the income-producing activity of all actors performing activities on behalf of a taxpayer.

In January of 2008, an interested parties meeting was held. The meeting was successful but industry was evenly divided about adopting the MTC amendment into Regulation section 25136. Some participants found the amendments to be a necessary change to fully reflect the activities which lead to the production of income, while others find the inclusion to be hard to comply with and burdensome.

On January 10, 2010, a formal hearing was held. Both oral and written comments were received. Staff's Summary of Comments, Responses and Recommendations in conjunction with the hearing follow this Request for Final Approval.

Staff believes that California should adopt the Multistate Tax Commission's (MTC) amendment into MTC Regulation IV.17 to Regulation section 25136 for the following reasons: First, because this is a uniform regulation of the MTC, California's adoption of this

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<sup>1</sup> The removal of the "on behalf of" limitation is also consistent with a 2004 Virginia Supreme Court decision that held a regulation that excluded costs incurred for activities performed "on behalf of" the taxpayer was inconsistent with a statutory provision that assigned income based on "cost of performance". See *General Motors Corporation v. Commonwealth of Virginia*, 602 SE2d 123 (2004).

approach will promote uniformity among the states; Second, the adoption of the amendment will bring clarity to this area and resolve any disagreement as to which "on behalf of" actors' income-producing activities are includable in the determination of the proper sales factor numerator assignment of the taxpayer's sales; Finally, staff believes the inclusion of all activities in the analysis will provide a clearer reflection of activity in each state and more closely reflect the market, which is the purpose of the sales factor.

The amendments to this regulation are proposed to be effective for taxable years beginning on or after January 1, 2008.

Staff requests permission for final approval adopting the Multistate Tax Commission's Amendment to its Model Regulation IV.17 Relating to Independent Contractors (California Regulation Section 25136.)

**STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS  
IN CONJUNCTION WITH HEARING ON CALIFORNIA CODE OF REGULATIONS,  
TITLE 18, SECTION 25136, ON JANUARY 13, 2010**

**Comments from Sutherland dated January 13, 2010**

1. Define "Agent or Independent Contractor"

The proposed amendments to the regulation modify California's current interpretation of "income producing activity" to include "transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." Furthermore, subsection (b)(1) adds language which states that "The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer..." However, the regulation does not provide a definition of an "agent or independent contractor."

**Response:**

The term "agent or independent contractor" is already defined by common law. In any event, creating a new definition for the term "agent or independent contractor" is outside the scope of this regulation project.

**Recommendation:**

No change to the regulation is necessary.

2. Problems with Hierarchy Approach to Sourcing

The proposed amendment to the regulation sets forth a hierarchy approach to sourcing income producing activities performed on behalf of taxpayers. The hierarchy approach is problematic because it considers the relationship between the taxpayer and its customer in determining the taxpayer's sourcing of its income producing activity. This approach is inconsistent with the policy of costs-of-performance – which looks to the location of a taxpayer's costs, and not a taxpayer's customer – to situs a sale. Specific comments are:

- a. Subsection (d)(3)(C) sources the income producing activity based on the location where the activity will be performed pursuant to the contract between the taxpayer and its customer if the activity could not be sourced under subsections (d)(3)(A) and (B). This provision sources revenue generated from the activity of the independent contractor or agent by looking to the taxpayer's relationship with its customer. The income producing activity should be sourced based on the location where the activity will be performed per the contract between the taxpayer and the agent or independent

contractor, not based on a market-sourcing method (i.e., based on the location of the customer.)

**Response:**

The purpose of the cascading rules of this regulation is to utilize objective evidence and information known to the taxpayer to assign third parties' activity to a location. The rules allow for the taxpayer and the third party contractor to specify where the activities to be performed on the taxpayer's behalf will occur and what part of the contract cost is assignable to each state where the activity occurred. If the taxpayer and its third party contractor do not do this, then the rules assume that the third party will perform its services at the location specified in the taxpayer's contract with its customer. Because the third party is performing in place of the taxpayer, it is reasonable to believe that it will be performing its activities in the location where the taxpayer's customer requested the services to be performed by the taxpayer. Lastly, these rules do not assign the actual sales themselves but only the taxpayer's income producing activity (performed by a third party contractor) that produced the sales. The ultimate assignment of the sale will continue to be based on the greater costs of performance, and the state to which the sale is assigned may or may not be the state in which the customer is located, taking all costs into account. This regulation's amendments do not directly provide for market based rules for assignment of sales.

**Recommendation:**

No change to this regulation is necessary.

- b. Subsection (d)(3)(D) sources the income producing activity to the commercial domicile of the taxpayer's customer. This bases the assignment of the income producing activity on a market sourcing method, i.e., the location of the customer. Instead the income producing activity should be sourced based on the commercial domicile of the taxpayer's agent or independent contractor instead.

**Response:**

This provision of the cascading rules only applies in the event that there is no reliable evidence of the location of the income-producing activity and/or costs of performance in either the contract between the taxpayer and the independent contractor or in the contract between the taxpayer and the customer. This rule is based on the reasonable assumption that the income-producing activity will be close to where the customer is located. Again, it is the income-producing activity, and not the sale itself, that is assigned to the customer's commercial domicile. Assignment of the income-producing

activity to the commercial domicile of the taxpayer's customer is not a market based method for assignment of the sale.

**Recommendation:**

No change to this regulation is necessary.

- c. Subsection (d)(3)(E) includes a "throw out" rule that would apply if the other sourcing provisions are not applicable or the income producing activity is in a state in which the taxpayer is not taxable. The effect of this provision is to exclude receipts associated with an income producing activity of the agent or independent contractor if that location cannot be determined or occurs in a state that does not impose tax on the taxpayer. This then results in excluding the activities performed by agents or independent contractors from a taxpayer's costs-of-performance analysis which is in direct contravention with the goal of including these costs. Also, a taxpayer is penalized for using an agent or independent contractor that is performing the income producing activity in a state where the taxpayer is not taxable. Throw out rule was repealed in New Jersey. Finally, this subsection does not address what would happen if the income producing activity was performed in a foreign country where the taxpayer is not taxable. Sutherland suggests a commercial domicile of the taxpayer rule.

**Response:**

The throwout rule provides that if (1) there is no evidence of the actual location of the income-producing activity within a single state, or (2) in the event there is income-producing activity in multiple states, there is no evidence of the location of the income-producing activity in either the contract between the taxpayer and independent contractor or agent or in the contract between the taxpayer and the customer, or (3) the customer's commercial domicile cannot be determined, then the income-producing activity is disregarded. It is reasonable to exclude activity whose location or cost cannot be determined. The sale itself is not thrown out. For example, if the taxpayer has income-producing activity in State A and has income-producing activity through a contractor working on its behalf in another state but it cannot be determined which state, then the independent contractor's activity will be disregarded. The taxpayer's income-producing activity will be assigned to State A and thus the sale to State A since the greater costs of performance are in State A. The receipt is assigned pursuant to California Code of Regulations, title 18, section 25136, as it was written prior to these amendments.

In connection with the throwout rule where the taxpayer is not taxable in the state where the taxpayer's independent contractor is performing the income-

producing activity, the taxpayer is not being penalized. Again, it is the activity, not the sale, which is disregarded. This is a reasonable method to minimize nowhere income, i.e., assigning the underlying sale to states where the taxpayer is not taxable.

Foreign countries are "states" under Revenue and Taxation Code section 25120 (formerly subdivision (f) and now subdivision (g)), and as a result the rules regarding taxability in another state that are contained in Section 25122 apply with equal force to foreign country activities.

**Recommendation:**

No change to this regulation is necessary.

### 3. Expansion of Hierarchy Examples

Amendments to the regulation set out examples. These are limited and address only scenarios where the independent contractor or agent is performing a service directly to the customer involving tangible personal property and where the taxpayer is paid by the customer for the service or activity. The examples do not include whether similar sourcing provisions would apply if the taxpayer was not being paid by the customer for the service (e.g. complimentary), the service does not involve tangible personal property, or the service involves intangible property. Three suggested examples were:

- a. Taxpayer pays an agent or independent contractor to provide a service that does not produce revenue for the taxpayer (e.g., customer service that is provided as part of a revenue producing activity);
- b. Taxpayer pays an agent or independent contractor to provide a service that does not involve the use of tangible personal property (e.g. the agent prepares an advertising campaign);
- c. Taxpayer pays an agent or independent contractor to provide a service that does not involve the use of intangible personal property (e.g., the agent prepares an advertising campaign.)

**Response:**

The commentator raises the issue of whether certain activities are considered income producing activities, rather than how the income producing activities of independent contractors and agents should be assigned. The same issue would arise if the taxpayer itself performed the activities suggested by the commentator. The examples are meant only to clarify how the cascading rules work. If, in fact, the above activities are income producing activities, then the cascading rules would apply. The examples are illustrative of the rules and are not meant to address all possible contracts. Furthermore, sales of personal services are assigned under Regulation section 25136 (d)(2)(C). Examples are contained in that subsection.

**Recommendation:**

No change to his regulation is necessary.

4. Sourcing Provisions for Costs-of-Performance

The proposed amendments to the regulation are limited to addressing services on behalf of a taxpayer. However, taxpayers incur costs to agents or independent contractors for the use of intangible property.

**Response:**

If a taxpayer incurs costs to agents or independent contractors for the use of intangible property, such costs would already be counted as the taxpayer's costs of performance under the current regulation. Accordingly, this comment does not directly affect the scope of the amendments and is outside the scope of this regulation's amendments.

**Recommendation:**

No change to this regulation is necessary.

## Oral Comments Received at the Regulatory Hearing

Hearing Transcript – Page 5. Comments from Ernie Dronenburg representing Deloitte & Touche

1. This is a good change and it reflects more clearly the business activities in the state, and we wholeheartedly support it.

**Response:** None necessary.

**Recommendation:** No change to this regulation is necessary.

Hearing Transcript – Page 6. Comments from Brian Tillinghast, representing Deloitte Tax, and Lorin Engquist, representing Health Net.

1. There has been no underlying change to the statute itself. What is the authority for limiting the retroactivity to years beginning on or after January 1, 2008?

**Response:** The original notice for this regulation project was given in the latter part of 2007. It was felt that out of fairness to all taxpayers the appropriate date for the

application of the amendments of this regulation should be prospective, and thus the regulation specifically applies to tax years beginning on or after January 1, 2008.

**Recommendation:** No change to this regulation is necessary.

Hearing Transcript – Pages 7-8. Comment from Lorin Engquist, representing Health Net.

1. Example C(3)(a) is confusing.

**Response:** See 15-day notice and accompanying text changes.

**Recommendation:** See 15-day notice text changes. No change to this regulation is necessary.

Hearing Transcript – Page 8. Comment from Michael Cataldo, representing Pillsbury Winthrop.

1. Does the Franchise Tax Board consider the regulatory changes to be a change in the law for purposes of the substantial understatement penalty?

**Response:** Under RTC section 19138, taxpayers are subject to a Large Corporate Income Tax Underpayment Penalty (LCUP) for understatements of tax in excess of \$1 million. However, no penalty can be imposed where the understatement is attributable to a change in the law (including amendments to regulations like the proposed amendments to Regulation section 25136) that is promulgated after the date the taxpayer files the return for the taxable year for which the change is operative.

**Recommendation:** No change to this regulation necessary.

Hearing Transcript – Page 8-9. Comment from Steve Danowitz, representing Ernst & Young.

1. Regarding 25136(b) where the change is made from "obtaining gains or profit" to "producing that item of income" does staff consider that to be a substantive change?

**Response:** Staff believes that this is not a substantive change but rather a clarification of existing law as it is applied within Regulation section 25136.

**Recommendation:** No change to this regulation is necessary.

1. In reference to 25136(d)(2)(C) where it says "independent contractor for the performance of personal services," does "personal" there have a meaningful context and was it intentionally put there and for what purpose?

**Response:** The section to which the commentator refers does not directly affect the scope of the amendments. The Franchise Tax Board previously issued Legal Ruling 2005-1 dealing with the issue of the definition of personal services.

**Recommendation:** No change to this regulation is necessary.

2. Do the regulations handle situations where you subcontract to Contractor A for 50% of the services to be provided and that subcontractor will then turn around and subcontract with some else to handle the majority of that, say 30% and then 15% would then go to a third contractor. Would the taxpayer be picking up that 15% cost of performance with the first contractor or would that just escape?

**Response:** The taxpayer's sale would be assigned by looking to its own income producing activities as well as those of Contractor A. If Contractor A were to utilize subcontractors to perform its activities for the taxpayer, the location of these activities would be relevant to the assignment of the cost charged by Contractor A to the taxpayer, but the cost itself would remain the cost of the contract between Contractor A and the taxpayer. The cost paid by Contractor A to the independent contractors is not relevant to the assignment of the taxpayer's sale. However, it would be relevant to the assignment of Contractor A's receipt.

**Recommendation:** No change to this regulation is necessary.

FINAL STATEMENT OF REASONS  
FOR PROPOSED AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS,  
TITLE 18, SECTION 25136

The proposed regulations do not impose any mandate on local agencies or school districts.

Update of Initial Statement of Reasons

The public notice required by section 11346.4 of the Government Code was mailed and published in the California Notice Register on October 23, 2009. The hearing was held, as noticed, on January 13, 2010, to consider the adoption of proposed amendments to Regulation section 25136, which addresses the sales factor for sales of other than tangible personal property. There were sixteen attendees at the hearing and oral testimony was received from seven individuals representing various interests. Four written comments were received during the comment period, which ended at 5:00 p.m. on January 13, 2010.

As a result of comments received, changes were made to the initial proposed regulation. The changes were noticed in a 15-day change notice, mailed on February 23, 2010. No comments were received regarding the 15-day changes.

Minor editing changes were made to the proposed regulation for clarity as part of the 15-day changes. The proposed modifications constitute nonsubstantial changes (within the meaning of Govt. Code section 11346.8). These modifications are described below:

1. The first sentence in the examples under Regulation sections 25136(d)(3)(A), (B), (C), (D) and (E) is amended so that it is clear that the taxpayer in the example is not a provider of personal services which would instead be governed by the provisions of Regulation 25136(d)(2)(C). The examples in each subsection referred to above are amended to read:

The taxpayer, a satellite TV provider, contracts with its customer, an owner of apartment buildings, to provide and install satellite dishes for \$1,000,000 in this state.

2. The last sentence in the examples under Regulation sections 25136(d)(3)(B), (C), (D), and (E) was determined to be unnecessary and as a result caused confusion. It is deleted in order to simplify the examples:

~~(See subsection (d)(2), Special Rules, for examples of exceptions to this method of assignment of a receipt to the sales factor numerator.)~~

3. The entire example in Regulation section 25136(d)(3)(C) is amended because several commentators felt it was disjointed and confusing. In addition some facts were unnecessarily repeated. The example is amended to read:

The taxpayer, a satellite TV provider, contracts with its customer, an owner of apartment buildings, to provide and install satellite dishes for \$1,000,000 in this state and States A and B on an as needed basis. The taxpayer then subcontracts with and pays agent or independent contractor X to install the satellite dishes in

this state and States A and B for \$200 per installation. The taxpayer's records show that X installed 1,000 satellite dishes each in this state and State A and 1,750 satellite dishes in State B. The contract between the taxpayer and X does not indicate the taxpayer's costs associated with X's installation of the satellite dishes in each state. However, the taxpayer's contract with its customer indicates that the activity will take place in this state and States A and B, and the taxpayer's records indicate the number of installations in each state. the taxpayer's contract with its customer indicates that the cost of X's performance is \$200 per installation. Accordingly, the taxpayer can reasonably determine at the time of filing its return the costs of performing installation services in each state because the taxpayer's records the number of installations in each state and the contract between the taxpayer and its customers indicate the costs of each installation. The taxpayer's cost of performance is \$200,000 in both this State and State A and is \$350,000 in State B. The taxpayer's greater cost of performance of \$350,000 will be assigned to State B pursuant to subsection (d)(3)(C) for purposes of assigning the \$1,000,000 receipt to the numerator of the sales factor. (See subsection (d)(2), Special Rules, for examples of exceptions to this method of assignment of a receipt to the sales factor numerator.)

4. Subsection (e) is added to set forth that the amendments to the regulation are applicable to taxable years beginning on or after January 1, 2008. Interested parties requested that the proposed regulation include an effective date within the regulation and the January 1, 2008 date is reasonable as the date had been publicly disclosed and discussed in two Franchise Tax Board public meetings: the first in September, 2007 and the second in June 2008. In the June 2008 Franchise Tax Board public meeting, staff requested and the Board approved that the applicable date for the amendments to the regulation would be for taxable years beginning on or after January 1, 2008. The new language reads:

(e) The amendments to this regulation are applicable to taxable years beginning on or after January 1, 2008.

The final version of the regulation was presented to the Franchise Tax Board for its approval at its April 6, 2010 public meeting. The Board was provided with all of the comments received during the regulatory process as well as responses to the comments. The Board approved the regulation by a vote of ??.

#### Alternatives Determined

The Franchise Tax Board has not received any proposed alternatives that would lessen the adverse economic impact that the proposed regulations would have on small businesses. The Franchise Tax Board has determined that no alternative would be more effective in carrying out the purpose of the proposed regulations or would be as effective and less burdensome to affected private persons than the proposed amendments to the existing regulation.