

Executive Summary

California Regulation section 25136 generally provides that sales of other than tangible property are assigned to the numerator of the sales factor based upon where the income-producing activity is performed. Under subsection (b) of the current regulation, income-producing activity only includes "activity directly engaged in by the taxpayer in the regular course of its trade or business" and "does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." Legal Ruling 2006-2 provides that income-producing activity engaged in by a member in a combined report on behalf of a taxpayer are includable in the numerator of the sales factor.

The amendments adopted by the Multistate Tax Commission reverse the rule that activity of an independent contractor is excluded and make assignments based upon activities of both the taxpayer and those performed on behalf of the taxpayer. This change is accomplished through a series of amendments. Two of the amendments strike the word "directly" and the words "does not" from the language (underlined words) quoted above. Another of the amendments adds additional language, subsection (4)(C), to the model regulation setting forth rules for determining the state where activities performed on behalf of a taxpayer are to be assigned.

Proposed amendments to Regulation section 25136 follow the amendments to the Multistate Tax Commission's model regulation and will include examples to show how the rules work for determining the state where activities performed on behalf of a taxpayer are to be assigned.

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

Staff requests permission to enter into the formal regulatory process to adopt these regulatory amendments.

**Request for Permission to Proceed with Formal Regulation Process 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.¹ 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. An Explanation of the Amended MTC Uniform Regulation Language to California Regulation section 25136 follows this Request for Permission and the Executive Summary.

Because staff wished to have industry input regarding the adoption of the MTC's amendment to its equivalent regulation, an interested parties meeting was held earlier this year. 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.

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 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

¹ 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).

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 to enter into the formal regulatory process to adopt these regulatory amendments.

Explanation of Amended MTC Uniform Regulation Language Proposed for Adoption Into California Regulation Section 25136

The proposed language of the amended MTC uniform regulation which staff recommends that California adopt into Regulation section 25136 addresses several issues: the cost of the activity performed by an agent or independent contractor on behalf of the taxpayer, the potential lack of information regarding the location of such activity, the preclusion of having to "look through" to the subcontractor's cost of performance, the potential for lack of nexus between the taxpayer and the state where the activity is performed, and the potential for lack of reliable and objective evidence as to the cost and/or location of the income-producing activity.

The proposed amendments specifically address the issues above as follows.

1. Definitional sections.

Income-producing Activity. The proposed language includes all the taxpayer's income-producing activity, regardless of whether it is performed by the taxpayer itself or another entity acting on the taxpayer's behalf. It specifically includes the income-producing activity of agents and independent contractors performed on behalf of a taxpayer. The MTC report states that the rationale for the original rule of excluding agents and independent contractors was unclear. Possible rationales for the original rule include the theory that acts of an independent contractor were remote from the acts of the taxpayer and the possibility that subcontractors may have discretion where its portion of services are performed. The proposed cascading rules below under "Application" addresses both these rationales.

Costs of Performance. The proposed language includes as part of the taxpayer's costs of performance only the taxpayer's payments to an agent or independent contractor. The costs of performance incurred by the agent or independent contractor in performing the activities for the taxpayer are not relevant because they are not costs related to the taxpayer and its customer that are the subject of the sale being assigned. The only relevant cost to determination of the costs of performance by a third party is the taxpayer's direct costs of performance associated with that performance.

2. Application.

The proposed language provides cascading rules for determining the location and cost of the agent's or independent contractor's income-producing activity performed on behalf of a taxpayer.

Subsection (d)(3)(A)(i) provides that if the income-producing activity is all in California, then it is assigned to California.

Subsection (d)(3)(A)(ii) provides that if income-producing activity is performed in more than one state, the regulation looks to the contract between the taxpayer and the agent or independent contractor to determine the location and cost of the income-producing activity.

Subsection (d)(3)(A)(iii) provides that if the contract between the taxpayer and the agent or independent contractor is insufficient to be able to reasonably determine the location and cost of the income-producing activity, the regulation looks to the contract between the taxpayer and the taxpayer's customer to determine the location and cost of the income-producing activity.

Subsection (d)(3)(A)(iv) provides that if the contract between the taxpayer and the taxpayer's customer is insufficient to be able to reasonably determine the location and cost of the income-producing activity, then the regulation looks to the domicile of the taxpayer's customer (if it is a business, then the commercial domicile).

Subsection (d)(3)(B) provides that if none of the above is sufficient to reasonably determine the location and cost of the income-producing activity of the agent or independent contractor on behalf of the taxpayer, or although it is determinable, the taxpayer is not taxable in that state, such income-producing activity is disregarded.

Staff is currently developing examples for the cascading rules.

The purpose of these rules is to utilize objective evidence and information known to the taxpayer to assign the 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 done by the taxpayer. If neither contract provides any specificity, the default rule is to assign the activity to the commercial domicile of the taxpayer's customer. This is essentially a market reflection rule, consistent with the purposes of the sales factor, and is meant as a catch-all to assign the activity to the location of the customer. Of course, if the taxpayer does not have the facts to even apply this rule, the activity is disregarded, as there is no objective evidence upon which to assign the activity to a location.

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

§ 25136. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

(a) In General. Section 25136 provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section, gross receipts are attributed to this state if the income-producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income-producing activity is performed within and without this state but the greater proportion of the income-producing activity is performed in this state, based on costs of performance.

(b) Income-Producing Activity: Defined. The term "income-producing activity" applies to each separate item of income and means the transactions and activity ~~directly~~ engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of ~~obtaining gains or profit~~ producing that item of income. Such activity ~~does not include~~ includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income-producing activity includes but is not limited to the following:

(1) The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.

(2) The sale, rental, leasing, licensing or other use of real property.

(3) The rental, leasing, licensing or other use of tangible personal property.

(4) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, of itself, an income-producing activity.

(c) Costs of Performance: Defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income-producing activity which gives rise to the particular item of income. Included in the taxpayer's costs of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.

(d) Application.

(1) In General. Receipts (other than from sales of tangible personal property) in respect to a particular income-producing activity are in this state if:

(A) the income-producing activity is performed wholly within this state; or

(B) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

(2) Special Rules. The following are special rules for determining when receipts from the income-producing activities described below are in this state:

(A) Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

(B) Gross receipts from the rental, lease or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income-producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.

EXAMPLE:

Taxpayer is the owner of 10 railroad cars. During the year, the total of the days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\begin{array}{r} (10 \times 50) = \\ \underline{500} \\ 3650 \end{array} \quad \times \text{ Total Receipts} = \text{Receipts Attributable to this State}$$

(C) Gross receipts for the performance of personal services are attributable to this

state to the extent such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts for the performance of such services shall be attributable to this state only if a greater portion of the services were performed in this state, based on costs of performance. Usually where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income-producing activity; in such cases, the gross receipts ~~for~~ from the performance of services attributable to this state shall be measured by the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal services not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.

EXAMPLE (i):

Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

EXAMPLE (ii):

The taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in this state for a sum of \$9,000. The project required 600 person hours to obtain the basic data and prepare the survey report. Two hundred of the 600 person hours were expended in this state. The receipts attributable to this state are \$3,000.

$$\frac{(200 \text{ person hours} \times \$9,000)}{600 \text{ person hours}}$$

(3) Services on Behalf of Taxpayer. An income-producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to this state if such income-producing activity is in this state.

(A) Such income-producing activity is in this state:

(i) when the taxpayer can reasonably determine at the time of filing that the income-producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the

location where the income-producing activity is actually performed shall be deemed to be not reasonably determinable at the time of filing;

(ii) if the taxpayer cannot reasonably determine at the time of filing where the income-producing activity is actually performed, when the contract between the taxpayer and the agent or independent contractor indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or independent contractor associated with such performance is determinable under the contract;

(iii) if it cannot be determined where the income-producing activity is actually performed and the agent or independent contractor's contract with the taxpayer does not indicate where it is to be performed, when the contract between the taxpayer and the taxpayer's customer indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or independent contractor associated with such performance is determinable under the contract; or

(iv) if it cannot be determined where the income-producing activity is actually performed and neither contract indicates where it is to be performed or the portion of the payment associated with such performance, when the domicile of the taxpayer's customer is in this state. If the taxpayer's customer is not an individual, "domicile" means commercial domicile.

(B) If the location of the income-producing activity by an agent or independent contractor, or the portion of the payment associated with such performance, cannot be determined under subsection (d)(3)(A)(i) through (iii), or the taxpayer customer's domicile cannot be determined under (d)(3)(A)(iv), or, although determinable, such income-producing activity is in a state in which the taxpayer is not taxable, such income-producing activity shall be disregarded.

NOTE: Authority cited: Section 19503, Revenue and Taxation Code
Reference: Section 25136, Revenue and Taxation Code