

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 94-1

March 3, 1994

APPLICATION OF THE TERM "TAXPAYER" IN SECTION 25128, AS AMENDED BY SB 1176

ISSUES

1. If a combined unitary group of corporations consists of members engaged in the extractive industry, and other members not so engaged, and more than 50% of the gross business receipts of the combined unitary group is from extractive activities, do the nonextractive members apportion their income using a single weighted sales factor?
2. If a corporation is a member of a combined unitary group, some of whose members are taxable in California, and that corporation has no activity in California other than selling tangible personal property to California customers exclusively by salesmen soliciting orders in the state (approved outside of the state), does the term "taxpayer," appearing in Revenue and Taxation Code (RTC) §25128(c)(4), require that gross receipts from such sales be assigned to California for purposes of the sales factor?

FACTS

Corporations A and B are members of a combined unitary group. Corporation A owns and operates an oil drilling operation in California, and sells crude oil exclusively to various unrelated refineries in the state. Corporation B owns and operates a manufacturing company in Arizona, which manufactures and sells various products used by its customers as a raw material for manufacture of finished goods. Corporation B, considered alone, is not engaged in an extractive business activity. Corporation A's total gross receipts from the sale of crude oil is \$50,000X. Corporation B's total gross receipts from the sale of its raw materials is \$25,000X. Some of Corporation B's products are sold to unrelated customers in California. To aid its promotion of sales to the California customers, employees of Corporation B enter the state to describe and demonstrate the characteristics of its products offered for sale, for the purpose of soliciting orders from those customers, which are approved in Arizona. Corporation B's gross receipts from the sale of such products to California customers is \$5,000X. Corporation B conducts no other activity in California.

LAW AND ANALYSIS

SB 1176 (Ch. 946, Stat. 1993) substantially amended RTC §25128. For income years beginning on or after January 1, 1993, §25128, as amended, provides that the business income of a taxpayer which derives income from sources within and without the state must be apportioned by multiplying such income by a fraction, the numerator of which is the sum of the payroll factor, the property, and twice the sales factor, and the denominator of which

is four (i.e., a "double weighted sales factor").

However, under §25128(b), certain "taxpayers" engaged in agricultural or extractive business activity must apportion their business income using the standard three-factor formula, the fraction of which is the sum of the payroll, property and sales factors, and the denominator of which is three (i.e., a "single weighted sales factor"). A "taxpayer" is considered to be conducting an agricultural or extractive business activity if more than 50% of its gross business receipts is derived from such activities, as defined in §25128(c).

In addition to providing definitions for "extractive" and "agricultural" business activities, RTC §25128(c), as amended, provides, in pertinent part:

(c) For purposes of this section:

(4) In any case where the income and apportionment factors of two or more affiliated banks or corporations are required to be included in a combined report under Section 25101, the term "taxpayer" shall refer to all of those corporations (emphasis added).

In the absence of §25128(c)(4), if affiliated corporations were members of a combined unitary group, it would be uncertain whether the application of a single or double weighted sales factor is to be made for each member of a combined unitary group, or for the entire combined unitary group as a whole. If double or single weighting of the sales factor were to be determined on an entity basis, there would be substantial uncertainty in determining the California source income of the combined unitary group, and each entity's respective tax liability under Legal Ruling 234, October 27, 1959, CCH 1201-418, PH 113,617, modified by FTB Notice 90-3, June 8, 1990.

Revenue and Taxation Code §25128(c)(4) avoids these difficulties by requiring the applicable apportionment method to be determined with respect to the group as a whole. Read together, Sections 25128(b) and 25128(c)(4) require that if a taxpayer (for this purpose, a combined unitary group) has more than 50% of its gross business receipts from agricultural or extractive activity, all of the business income of the taxpayer (the combined business income of the group) is apportioned using a single weighted sales factor. Thus, if a member of a combined unitary group, considered alone, does not have more than 50% of its gross business receipts in an agricultural or extractive business, but the combined unitary group as a whole does, the entire unitary business income of the group is apportioned using a single weighted sales factor. Under the facts described, the total business receipts attributable to the A-B unitary group is \$75,000X, of which \$50,000X is attributable to an extractive business. Because more than 50% of such gross receipts is from an extractive business, the combined unitary business income of Corporation A and Corporation B is apportioned using a single weighted sales factor.

The quoted portion of RTC §25128(c)(4) also bears some similarity to the broad language of the opinions of Appeal of Finnigan Corp., August 25, 1988, 88-SBE022, modif. by Opin. on Pet. Rehg., January 24, 1990, 88-SBE-022-A, and Appeal of The NutraSweet Company, October 29, 1992, 92-SBE-024. These cases held that the term 'taxpayer,'

appearing in RTC §25122 refers to the entire combined unitary group. A question is thus raised whether the SB 1176 amendment of §25128 was a legislative codification of these opinions.

Revenue and Taxation Code §25122 provides that a taxpayer is "taxable" in a state if it is subject to an income, franchise, or corporate stock tax, or if the state has jurisdiction to impose a net income tax. RTC §25135 generally provides that, for purposes of the numerator of the sales factor of a taxpayer subject to apportionment, gross receipts from the sale of tangible property are assigned to the state where the property is delivered or shipped (i.e., state of destination). That section also provides that if the taxpayer is not "taxable" in the state of destination, such gross receipts are assigned to the state from where the property is shipped (i.e., "thrown back").

In Appeal of Finnigan, *supra*, a case involving potential "throwback" of sales to California, the Board of Equalization held that if any member of a combined unitary group is taxable in a state, then all sales by any member of a such group would be assigned to that state, even if the selling member itself had no tax nexus in the state of destination. The Board reached its conclusion on the basis that the word "taxpayer," appearing in Revenue and Taxation §25122, referred to the entire combined unitary group, and that the group was "taxable" in a state if any member of the group was taxable in that state. The Board of Equalization affirmed its Finnigan holding in the Appeal of The NutraSweet Company, *supra*, where it held that, for purposes of §§25122 and 25135, the sales to a California destination must be assigned to the California sales factor numerator of the group, if any member of the combined unitary group was subject to California taxation.

Despite the superficial similarity of the terms of RTC §25128(c)(4), to the Finnigan and NutraSweet holdings, that section does not purport to define the term "taxpayer" for purposes of all, or even the apportionment factor provisions, of the Uniform Division of income for Tax Purposes Act (UDITPA) (RTC §§25120 and 25139). The lead sentence of §25128(c) limits the scope of §25128(c)(4) by providing "For purposes of this section..." Thus, by the terms of §25128(c), §25128(c)(4) applies only to the use of the term "taxpayer" which appears in §25128(b) (the only other subdivision in which the term "taxpayer" appears). Had the legislature intended an adoption of the holding of these cases, amendment of either or both of RTC §§25122 or 25135 would have been expected.

The holdings of Finnigan and NutraSweet, interpreting RTC §§25122 and 25135, require that Corporation B's \$5,000X of California receipts be assigned to California. See FTB Notice 90-3, *supra*. The holding in Finnigan (and by implication the holding in NutraSweet) is currently under challenge in Brown Group Retail, Successor by Merger to Wetherby Kayser Shoe Company v. Franchise Tax Board (No. C714010, Superior Court, Los Angeles). If the Finnigan (and NutraSweet) holdings are reversed by a court of law, RTC §25128(c)(4), because of its limited application, will have no bearing on the issue whether "taxable in another state," as used in RTC §§25122 and 25135, refers to each member of the unitary group or the entire group.

HOLDING

1. When a combined unitary group of corporations consists of members engaged in both extractive and nonextractive business activity, and more than 50% of the gross business receipts of the combined unitary group is from extractive activities, all of such members must apportion their income using a single weighted sales factor.

2. The scope of RTC §25128(c)(4) is limited to the determination of whether single or double weighted sales factor applies to a taxpayer or combined unitary group. It has no application to the other provisions of UDITPA, including RTC §25122, which defines taxability in another state, or §25135, which assigns sales of tangible personal property for purposes of the sales factor numerator.

DRAFTING INFORMATION

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