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07.05.16 Chief Counsel Ruling 2016-03

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Subject: Chief Counsel Ruling Request for ******* ******* ***********

Dear M* xxxxxxx:

This is in response to your Chief Counsel Ruling Request of July 30, 201x, wherein you seek guidance with respect to whether the proceeds from sales of tangible personal property (TPP) must be aggregated with royalties received to determine whether a taxpayer meets California's "doing business" standard under California Revenue and Taxation Code section 23101(b)(2),[1] and whether a third-party licensee's use of taxpayer's trademarks that gives rise to royalties exceeds the protections afforded under Public Law 86-272.[2]

The taxpayer represents that the issues in this ruling request are not the subject of an existing California audit, protest, appeal or litigation involving the taxpayer or a group member.

FACTS:

******* ******* *********** (Taxpayer), a ******** designer and distributor based in **********, designs, markets, and distributes innovative ********. It markets products under famous brand names, and sells its products through department store retailers, specialty store retailers, and online retailers. Taxpayer outsources manufacturing to independent third parties, and warehouses its goods in California, before shipping them to other destinations.

Taxpayer's corporate strategy is to leverage its brands across multiple consumer segments. Taxpayer licenses the use of its trademarks to an unrelated third-party,

[1] Unless otherwise specified, "Section" references are to the California Revenue and Taxation Code currently in effect and "Regulation Section" references are to the applicable California regulations promulgated thereunder.

[2] 15 U.S.C. §§ 381-384 (P.L. 86-272).

********** (Licensee), which is based in *******. Taxpayer utilizes trademarks on virtually all of its products, as these distinctive trademarks are a key factor in creating a market for Taxpayer's products. Taxpayer and Licensee entered into an agreement whereby Taxpayer granted a license to Licensee to use its various trademarks (Licensed Marks) in connection with the manufacture, advertising, marketing, distribution, and sale of its products in the United States and its territories (States). For the use of Taxpayer's Licensed Marks, Licensee paid Taxpayer a royalty based on the net sales of the licensed products throughout each State.

Taxpayer retains control over the use of its Licensed Marks and has the right to control the nature and quality of goods sold under the Licensed Marks by Licensee. Taxpayer grants to Licensee an exclusive, non-transferable, non-assignable license, right and privilege to use the Licensed Marks (License);[3] the License may not be sublicensed without Taxpayer's consent;[4] Taxpayer and Licensee jointly develop a marketing plan for each contract year relating to various geographical areas within the States to be targeted for focused sales efforts during such contract year;[5] Taxpayer controls the quality of products to which the Licensed Marks are attached, and has sole discretion to determine in good faith whether such products meet its quality standards;[6] Taxpayer determines the standards of quality assurance and quality control;[7] Taxpayer makes reasonable changes in the technical specification of the licensed products;[8] Taxpayer approves the stores to which Licensee may sell goods bearing Licensed Marks;[9] and Taxpayer must approve advertising of the licensed products by Licensee.[10]

Taxpayer received royalties from licensing its Licensed Marks to Licensee and proceeds from its own sales of TPP to the different States for the taxable year ending **********, as follows:

[3] License Agreement section (A)
[4] License Agreement section (B)
[5] License Agreement section (C)
[6] License Agreement section (D)
[7] License Agreement section (E)
[8] License Agreement section (F)
[9] License Agreement section (G)
[10] License Agreement section (H)

	Receipts from Licensed Marks	Receipts from the sales of TPP
(State 1)	$*****	$********
(State 2)	$****	$*******
(State 3)	$*****	$*******
(State 4)	$******	$********
(State 5)	$*****	$********
(State 6)	$****	$*******
(State 7)	$*****	$********
(State 8)	$****	$*******
(State 9)	$******	$********
(State 10)	$****	$*******
(State 11)	$****	$*******

ISSUES:

a) Must the proceeds from sales of TPP be aggregated with the royalties received to determine whether Taxpayer met California's "doing business" standard under Section 23101(b)(2)?

b) Is Taxpayer required to throw back sales of TPP from the States where it has met the doing business standard under Section 23101(b)(2) and include them in its California sales factor numerator?

HOLDINGS:

a) Taxpayer must aggregate the proceeds from sales of TPP with royalties received to determine whether it met California's "doing business" standard under Section 23101(b)(2).

b) Taxpayer should not throw back to its California sales factor numerator the sales of TPP from the States where it has met the "doing business" standard under Section 23101(b)(2) and Taxpayer's activities exceed the protections under P.L 86-272. Taxpayer is taxable in those States under Section 25122.

ANALYSIS:

a) Taxpayer must aggregate proceeds from sales of TPP with royalties received to determine whether it met California's "doing business" standard under Section

23101(b)(2), because amounts realized from both sales of TPP and royalties received are sales for purposes of Section 23101(b)(2).

"Doing business" is defined under Section 23101(a) as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." For taxable years beginning on or after January 1, 2011, a corporation is also doing business in California if any of the conditions under Section 23101(b) are met.[11]

Pursuant to Section 23101(b)(2), for taxable years beginning on or after January 1, 2014, a corporation is "doing business" in California when its sales exceed the lesser of $529,562 or 25 percent of the taxpayer's total sales. Section 23101(b)(2) provides that sales are defined under Sections 25120(e) or (f). The location of those sales must be determined using the assignment rules under Sections 25135 and 25136, and the regulations thereunder, as modified by regulations under Section 25137.

For taxable years beginning on or after January 1, 2011, Section 25120(f) provides, in pertinent part, that:

(1) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive.
(2) "Gross receipts" means the gross amounts realized . . . on the sale or exchange of property . . . or the use of property or capital (including . . . royalties . . .) in a transaction that produces business income, in which the income, gain, or loss is recognized . . . under the Internal Revenue Code . . . .

Here, the gross amounts Taxpayer realized from its sales of TPP and from royalties (sale of other than tangible personal property, "OTTPP") are Taxpayer's gross receipts. Therefore, sales from TPP and OTTPP must be aggregated to determine whether Taxpayer is doing business in a state under the economic nexus standard of Section 23101(b)(2). Based on the facts provided, Taxpayer's aggregate sales from TPP and OTTPP for the taxable year ending on ********** exceeded $529,562 in each of the aforementioned States. Therefore, Taxpayer was doing business in States 1 through 11.

b) For the taxable year ending on**********, Taxpayer should not throw back to its California sales factor numerator TPP sales because Licensee's use of Licensed Marks, which produced royalty income for Taxpayer, was neither a protected activity under P.L. 86-272 nor a *de minimis* activity for purposes of P.L. 86-272.

[11] A taxpayer may still be "doing business" in California under Section 23101(a) even if none of the conditions of Section 23101(b) are met.

Section 25134 and the regulations thereunder define what sales are for purposes of calculating California's sales factor numerator and denominator. Sections 25135 and 25136 are utilized in order to determine the location to which such sales are assigned for purposes of the sales factor numerator.

Section 25135 provides rules for assigning sales of TPP. In particular, Section 25135(a)(2) provides that sales of TPP are attributed to California if TPP is shipped from California and the taxpayer is not taxable in the state of the purchaser.

Section 25136 provides rules for assigning sales from OTTPP in California. For taxable years beginning on or after January 1, 2011, California assigns such sales based on market sourcing rules.

Section 25122 provides rules for determining whether a taxpayer is taxable in the state of the purchaser for purposes of allocation and apportionment. Regulation section 25122(c) provides that the determination of whether a taxpayer is taxable in another state is made by determining whether the taxpayer's activity in that state would be sufficient to give the state jurisdiction to impose a net income tax, by reason of such business activity, under the Constitution and statutes of the United States.

Although Taxpayer is doing business due to its substantial economic presence in States 1 through 11, Taxpayer may nevertheless still be immune from income taxation in those States pursuant to P.L. 86-272,[12] and would then be required to throw back its sales of TPP to California.[13]

i) Taxpayer's royalty income derived from Licensee's use of Licensed Marks is an activity outside P.L. 86-272 protections, where Taxpayer availed itself of the market in States 1 through 11 and retained control over the use of its Licensed Marks.

For purposes of the California sales factor, Taxpayer's Licensed Marks are intangible property[14] used by Licensee in States 1 through 11.[15] As a result of being so employed, Taxpayer's Licensed Marks generated royalties in States 1 through 11.

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[12] Regulation § 25122(c).

[13] Regulation § 25135(a)(2)(B) provides that sales of TPP are assigned to California if the taxpayer is not taxable in the state of the purchaser.

[14] For taxable years beginning on or after January 1, 2011, Regulation § 25136-2(b)(4)(A) provides:

> (4) "Intangible property" includes, but is not limited to, patents, copyrights, trademarks, service marks, trade names, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, trade secrets, stock, contract rights including broadcasting rights, and other similar intangible assets.
>
> (A) A "marketing intangible" includes, but is not limited to, the license of a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services or other items.

P.L. 86-272 prohibits a state from imposing an income tax on income derived within its borders from interstate commerce if the only business activity in that state consists of the solicitation of orders for sales of tangible personal property. P.L. 86-272 protection is not afforded to transactions other than sales of tangible personal property.[16]

In *Wisconsin Department of Revenue v. William Wrigley Jr. Co.* (1992) 505 U.S. 214 (*Wrigley*), the United States Supreme Court defined the term "solicitation of orders" to mean activities that are essential or entirely "ancillary" to making requests for orders. In accordance with *Wrigley*, the Franchise Tax Board's publication FTB 1050, entitled "Application and Interpretation of Public Law 86-272", defines protected activities under P.L. 86-272 to be activities limited solely to "(1) speech or conduct that explicitly or implicitly invites an order; and (2) activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order."

FTB 1050 identifies twenty unprotected activities, including the licensing of trademarks:

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[15] For taxable years beginning on or after January 1, 2011, Regulation § 25136-2(b)(7) provides that "The use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee...."

[16] P.L. 86-272 establishes a "minimum standard" for imposition of a state net income tax based on solicitation of interstate sales:

> (a) No state, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the *only business activities* within such State by or on behalf of such person during such taxable year are either, or both, the following:
>
> > (1) The solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which are sent outside the State for approval or rejection, and,
> > if approved, are filled by shipment or delivery from a point outside the State; and
> >
> > (2) The solicitation of orders of such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).
>
> ....
>
> (c) For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

15 U.S.C. § 381. [Emphasis added]

19. Entering into franchising or licensing agreements; selling or otherwise disposing of franchises or licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license by the franchisor or licensor to its franchisee or licensee within the state.

Deriving royalty income from unrelated third party Licensee's use of Taxpayer's Licensed Marks is not a protected business activity under P.L. 86-272 where Taxpayer purposefully avails itself of the market in States 1 through 11. Taxpayer represents it controlled the use of its Licensed Marks where it developed with Licensee a joint marketing plan in the aforementioned states; Licensee needed Taxpayer's approval to sublicense the Licensed Marks, to advertise goods with Taxpayer's Licensed Marks, and to determine stores where goods bearing Taxpayer's Licensed Marks could be sold; and Taxpayer controlled the nature and quality of goods sold with Taxpayer's Licensed Marks.

Based on the above facts, deriving royalty income from unrelated third party Licensee's use of Taxpayer's Licensed Marks is an activity outside P.L. 86-272's protections in the aforementioned states.

ii) Deriving royalty income from Licensee's use of Taxpayer's Licensed Marks is not *de minimis* for purposes of P.L. 86-272.

The Supreme Court in *Wrigley* indicated that even when an activity is not entirely ancillary to requests for purchase, P.L. 86-272 may still protect a taxpayer from taxation if the in-state activity is *de minimis*. Whether an activity is *de minimis* depends upon whether that activity establishes a "nontrivial additional connection with the taxing State."[17]

In *Wrigley*, a nontrivial (i.e., not *de minimis*) connection to the state was established, and the protections of P.L. 86-272 were exceeded, when the taxpayer's representative exchanged stale gum with fresh gum and such sales amounted to only 0.00007 percent of taxpayer's annual sales in Wisconsin. Exchanging stale gum was a matter of regular company policy on a continuing basis and resulted in maintaining a stock of gum worth several thousand dollars in the State. The Supreme Court had "little difficulty concluding that the [combined activities] constituted a nontrivial additional connection with the State" sufficient to exceed the protections of the statute.[18]

Based on the facts represented in the ruling request, Taxpayer's active involvement in Licensee's use of Licensed Marks was not *de minimis*, much like the exchange of stale gum in *Wrigley.* The purposeful targeting in States 1 through 11 and the licensing of Taxpayer's Licensed Marks and their use by the Licensee was a nontrivial additional connection for purposes of P.L. 86-272. Therefore, Taxpayer is taxable in States 1 through 11 and should not throw back to its California sales factor numerator any sales of TPP from States 1 through 11.

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[17] *Wrigley,* 505 U.S. at 232.

[18] *Id.* at 235.

Please be advised that the tax consequences expressed in this Chief Counsel Ruling are applicable only to the named taxpayer and are based upon and limited to the facts you have submitted. In the event of a change in relevant legislation, or judicial or administrative case law, a change in federal interpretation of federal law in cases where our opinion is based upon such an interpretation, or a change in the material facts or circumstances relating to your request upon which this opinion is based, this opinion may no longer be applicable. It is your responsibility to be aware of these changes, should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of paragraph (1) of subdivision (a) of section 21012 of the Revenue and Taxation Code. Please attach a copy of this letter and your request to the appropriate return(s) (if any) when filed or in response to any notices or inquiries which might be issued.

Sincerely,

Ted Tourian
Tax Counsel III