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LEGAL RULING 2006 - 02

May 3, 2006

SUBJECT: Application of the "On Behalf Of" Exclusionary Rule of Regulation 25136(b) in the Assignment of Receipts from Sales Other Than Sales of Tangible Personal Property

ISSUE

When a taxpayer member of a combined reporting group has a sale of other than tangible personal property, how are amounts paid by that taxpayer member to another member of the combined reporting group to perform activities related to that sale considered in assigning receipts derived from that sale?

FACTS

Situation 1:

Corporation P contracts to provide services to ZCorp at locations in State A (California) and Country (B), for \$100. In performing its contract with ZCorp, Corporation P incurs costs of \$10 in State A. In addition, Corporation P subcontracts with Corporation S, a member of Corporation P's combined reporting group, to have Corporation S perform part of the work in Country B for a fee of \$60. P and S are U.S. domestic corporations that are not exempted from the tax (as defined in section 23036¹) by part 11 of the Revenue and Taxation Code or the California Constitution.

Situation 2:

Same facts as above, except "California" is substituted for "Country B" and "State A" is any jurisdiction other than California.

LAW AND ANALYSIS

Receipts from a sale "other than a sale of tangible personal property" are included in the sales factor under the rules set forth in section 25136 and the regulations promulgated thereunder. Section 25136 assigns receipts from sales of other than tangible personal property to the state where a taxpayer's income-producing activity relating to such sales

¹ All section references are to the Revenue and Taxation Code, and all references to regulations are to the California Code of Regulations, title 18, unless otherwise noted.

occurs. If the income-producing activity takes place in more than one state, the receipt is assigned to the state where the greater proportion of the income-producing activity takes place, based upon costs of performance.

Regulation section 25136, subsection (b)² generally defines income-producing activity as "the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business" It continues by excluding from income-producing activities "transactions and activities performed on behalf of a taxpayer" (hereafter referred to as the "on behalf of" rule or exclusion). Next, subsection (b) lists four specific items as examples of what are income-producing activities of the taxpayer and then specifically excludes the "mere holding of intangible personal property" as an income-producing activity.

The "on behalf of" rule cannot exclude all possible actors who perform services on behalf of a taxpayer. A corporation is an artificial legal entity that can only act through its members [shareholders], officers, or agents. (*Dearborn v. Grand Lodge, A.O.U.W.* (1903) 138 Cal. 658, 663; *Acco Contractors, Inc. v. McNamara & Peepe Lumber Co.* (1976) 63 Cal.App.3d 292, 295; 15 Cal.Jur.3d, Corporations § 9, p.71.)³ Because a corporation is an artificial legal entity, it can never literally perform an act itself; someone must perform acts on its behalf. Therefore, the "on behalf of" rule contained in the general statement of subsection (b) cannot be applied literally. The fact that it cannot be applied literally is recognized in the first example of an income-producing activity contained in the regulation, "the rendering of personal services by employees." Additionally, if the "on behalf of" rule were to be literally applied, there would be no need for the example provided with respect to that rule: "such as those conducted on its behalf by an independent contractor."

However, use of the phrase "such as" to describe the scope of the "on behalf of" rule in regulation section 25136, subsection (b), indicates that the class of actors whose acts are not included in a taxpayer's income-producing activity includes not only independent contractors, but also others that perform transactions and activities on a taxpayer's behalf. Therefore, it is apparent that some acts are clearly included as income-producing activity of a taxpayer, such as those of employees, officers, and directors, and other acts are clearly excluded, such as those of independent contractors. The question then is whether there are any acts performed on behalf of a taxpayer by other

² This ruling construes the general rule contained in regulation 25136, subsection (b). It is not applicable to the special rules set forth in subsection (d)(2) and, therefore, is not applicable to personal services as described in subsection (d)(2)(C).

³ In *Dearborn* the "corporation" involved was a benevolent association whose "shareholders" were its members. Therefore, the term members, in context, should be understood as meaning shareholders. In many instances, the agents who perform services for the corporation are the employees of the corporation. (See *Acco Contractors v. McNamara & Peepe Lumber Co.*, *supra*, 63 Cal.App.3d at p. 296.)

than the taxpayer's employees, officers, or directors that should be included in its income-producing activity for sales factor purposes.

The Business Enterprise And Combined Reporting

One class of possible actors that could perform services on behalf of a taxpayer is other members of the taxpayer's unitary group. A unitary relationship is one in which "several elements of a business are treated as one unit for taxation purposes." (*Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Bd.* (1991) 229 Cal.App.3d 784, 787.) If a unitary relationship exists, the "separate parts cannot be fairly considered by themselves. . . ." (*Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 673, affd. (1942) 315 U.S. 501; see also, *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, 480 ("[i]f the crux of the matter is to ascertain that portion of the business which is done within the state, then the same considerations justify the use of the formula allocation method in the one case [single entity] as in the other [multiple entities within a unitary business]")).

Justice Ginsburg of the United States Supreme Court, in *Barclays Bank PLC v. Franchise Tax Bd.* (1994) 512 U.S. 298, 312, commenting on a position argued by an *amicus*, stated in footnote 10, that "the theory underlying unitary taxation is that 'certain intangible 'flows of value' within the unitary group serve to link the various members together as if they were essentially a single entity.'"

The business income of a unitary group is apportioned to the states in which the group conducts business by application of the apportionment formula utilizing a combined report. (Peters, *State Income Tax Problems of Interstate Business* (1975) 33rd Annual 1975 N.Y.U. Inst. on Fed. Tax., pp. 899, 922; Cal. Code Regs., tit. 18, § 25106.5.) "Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations." (Keesling, *A Current Look at the Combined Report and Uniformity in Allocation Practice*, (1975) 42 J.Tax. 106.)

Section 25136 provides for the assignment of receipts, from transactions other than sales of tangible personal property, to the state where the income-producing activity is performed, or if the activity is performed in more than one state, to the location where the greater proportion of income-producing activity occurs, based on costs of performance. If an independent subcontractor performs activities for the contracting taxpayer, its activities are excluded from the income-producing activities analysis by virtue of the "on behalf of" rule.⁴

⁴ Assuming the independent subcontractor is an apportioning taxpayer, it would itself, of course, have gross receipts with respect to its subcontract, and it would assign those gross receipts under section 25136 to wherever its activities were performed by it under the subcontract.

When a contractor and subcontractor are members of the same combined reporting group, it is inconsistent to disregard the activity of the subcontractor in determining the income-producing activity of the contractor because such activities are directly proximate to the generation of business income by the group. When members of a combined reporting group transact business with one another, the transactions have no economic effect on the group as an integrated trade or business. In other words, the transactions do not generate economic income or losses to the enterprise as a whole. As a result, intercompany sales between members of a combined reporting group are generally not taken into account immediately in determining the net income subject to apportionment, and the effects of those sales are disregarded in the sales factor. (*Chase Brass & Copper Co. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457, 473; *Appeal of Texaco, Inc.*, 78-SBE-004, Jan. 11, 1978 (elimination of intercompany sales in the sales factor ruled appropriate).) Under regulation section 25106.5-1, subsection (a), "The general rule is one of deferring gains or losses from intercompany transactions in order to produce the effect of transactions between divisions of a single corporation." Consequently, the effects of intercompany transactions are properly disregarded in computing income in a combined report in the same manner that they would be disregarded within a single corporate enterprise. (Keesling, *supra*, at p. 109.)

Within a combined reporting group, considering only the acts of the contractor and ignoring the activities performed by other members of the group relating to the same contract does not reasonably reflect the income-producing activity of the economic enterprise in performing services for third parties. When the subcontractor is a member of the same combined reporting group as the contractor, it is unlikely, if not impossible, for it to be an independent contractor. (Cf. *Reader's Digest Ass'n, Inc. v. Franchise Tax Board* (2001) 94 Cal.App.4th 1240, in which the court held that a corporation, based upon typical unitary relationships, was not an independent contractor within the meaning of Public Law 86-272 (15 U.S.C. §381).) Treating a member of the combined reporting group as an independent contractor could tend to concentrate receipts into states where third party contracting decisions are made, regardless of where costs were incurred in performing the service.⁵ Moreover, such an approach may not reflect any of the benefits and protections accorded to the activities by the state or states where the activities are performed and does not reasonably reflect the business activities of the enterprise in this state.⁶

⁵ The contracting member of the group could simply enter into the third party contract and then assign the work to another member of the group, thereby eliminating all income-producing activities except for the negotiation of the contract itself. This could be subject to manipulation and might be abusive.

⁶ While this ruling interprets the "on behalf of" language in regulation section 25136, it is also based on the authority of section 25137 in order to clearly reflect the business activities of the taxpayer in this state.

Due to the effects of combined reporting when the contractor and the subcontractor are in a unitary relationship and are members of the same combined reporting group, the activities of the subcontractor in performance of the contract will be considered income-producing activities *directly* engaged in by the contractor⁷ for purposes of the sales factor in order to more accurately assign the receipt to the place where the services were performed. Payments made by the contractor to the subcontractor are for costs incurred in the performance of the service and are assigned to the location where the subcontractor performed the service as provided for in regulation section 25136. If the contractor paid the subcontractor an amount reflecting an "arm's-length price" for the performance of the services, that payment will be considered a payment by the contractor of a cost item and be used to measure the contractor's costs of performance, even if the intercompany income and expense for that item is not reported in the combined report during the taxable year for purposes of combined reporting. If the contractor does not pay the subcontractor for the performance of the service, or if the amount of the payment does not reflect an arm's-length price for the service performed, then the actual costs incurred by the subcontractor may be imputed to the contractor to measure the cost of performance.⁸

The rule set forth herein assumes agency nexus and, for purposes of geographically determining where the greater costs of performance occur, assigns the receipt to the state where the subcontractor actually performs the service on behalf of the contractor.⁹

⁷ Regulation section 25136, subsection (b), states that only activities *directly* engaged in by the taxpayer are to be used to assign sales other than sales of tangible personal property.

⁸ The principles of attribution of expenses, constructive dividends, constructive contributions to capital, etc., are well established in the tax law. For example, in Revenue Ruling 84-68, 1984-1 C.B. 31, the Internal Revenue Service (IRS) determined that a parent's payment of cash bonuses to its subsidiary's employees should be treated as a constructive contribution to the subsidiary's capital accompanied by a constructive payment by the subsidiary of the cash bonuses to its employees. The expenses were held to be those of the subsidiary, not the parent. Similarly, in Revenue Ruling 78-83, 1978-1 C.B. 79, the IRS found that amounts paid to a corporation's sister foreign subsidiary in excess of reasonable compensation for services and expenses on its behalf were treated as constructive dividends to the common domestic parent. (See also, Rev. Rul. 69-630, 1969-2 C.B. 112; Rev. Rul. 73-605, 1973-2 C.B. 109.) In addition, either section 25102 or Internal Revenue Code section 482 may also be used to clearly reflect income and expenses.

⁹ See, e.g., *Tyler Pipe Industries v. Washington State Department of Revenue* (1987) 483 U.S. 232, 250, where the Supreme Court restated the principle it set forth in *Scripto, Inc. v. Carson* (1960) 362 U.S. 207, that acts performed on behalf of a taxpayer were sufficient to establish nexus, and the type of representative was "a fine distinction ... without constitutional significance."

If the greater costs of performance took place in California, the gross receipts from the sale is assigned to California, and the contractor has an apportioned tax liability to this state.

Water's-Edge Combined Reports

As a consequence of a water's-edge election under section 25110, et seq., certain members of a unitary group may be excluded, in whole or in part, from a combined report. To the extent that entities are excluded from a combined report by this election, they are treated as third parties for combined reporting purposes. Consequently, transactions with excluded entities to the extent they are not included in the combined report are neither deferred nor eliminated, and the income and factors related to such excluded activities are not taken into account in the allocation and apportionment of the income of the combined reporting group.¹⁰ In such cases, the "on behalf of" rule operates to exclude activities performed by entities that are not included in (and thus not impacted by the effects of) the combined report from the geographic determination of where the greater costs of performance occur for purposes of assigning gross receipts from sales other than sales of tangible personal property.

HOLDING

Situation 1:

Because Corporation S is a member of the same unitary enterprise as Corporation P, and is included in the same combined reporting group, Corporation S's activities with regard to Corporation P's obligation to ZCorp are not in the nature of those performed by an independent contractor, and therefore are considered in determining the income-producing activity of Corporation P for sales factor purposes. Corporation P's cost of \$10 and its \$60 payment to Corporation S are considered in determining the location of the greater costs of performance in order to assign Corporation P's \$100 receipt from ZCorp. For purposes of determining the location of Corporation P's income-producing activity, it is irrelevant that the \$60 payment by Corporation P to Corporation S is eliminated as an intercompany transaction because Corporation P's costs of performance are incurred where the activities for which the payments were made are performed. Therefore, because the \$60 paid to Corporation S for activities performed in Country B is greater than the \$10 incurred in California, Corporation P's receipt from the ZCorp contract is assigned to Country B, where the greater costs of performance were incurred.

¹⁰ Entities that are excluded from the water's-edge combined reporting group to any extent, while still factually unitary with the other entities in the water's edge group, are treated as unaffiliated third parties to the extent they are excluded for accounting purposes.

Situation 2:

Same as Situation 1, but Corporation P's receipt from the ZCorp contract is assigned to California, where the greater costs of performance were incurred.

CONTACT INFORMATION

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