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Technical Advice Memorandum 2012-01

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Subject: Request for Technical Advice Memorandum on whether a taxpayer may properly assert the existence of substantial sales in a destination state without physical presence to establish that it is subject to taxation in that state, thereby avoiding the throwback rule under Revenue and Taxation Code section 25135.

Memorandum

Question Presented:

For taxable years beginning before January 1, 2011, is a taxpayer subject to taxation in another state¹ for purposes of Revenue and Taxation Code section 25122,² where the taxpayer's only contact with that state was more than \$500,000 in sales of tangible personal property?

Background:

For sales factor purposes, goods shipped from this state are generally assigned to this state if the taxpayer is not taxable in the destination state.³ Taxability in the destination state is

¹ For purposes of this memorandum, "state" is intended to be given the same meaning found in Revenue and Taxation Code section 25120, subdivision (g), which provides that: "'State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof."

² 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.

³ Rev. & Tax. Code, § 25135(b).

determined under section 25122,⁴ and the regulations thereunder. For sales destined for foreign countries, the issue of whether a taxpayer is subject to taxation in that country is determined under U.S. Constitutional standards.⁵ Some taxpayers have asserted that for taxable years beginning before January 1, 2011, substantial economic presence in a state is sufficient to make them subject to taxation there under U.S. Constitutional standards; and thus, they are not required to throw back their foreign country destination sales to the numerator of their California sales factor.⁶

Short Conclusion:

For taxable years beginning before January 1, 2011, a taxpayer whose only contact with another state was the sale of tangible personal property into that state is not taxable in that state under U.S. Constitutional standards for purposes of section 25122. A taxpayer must demonstrate physical presence in that state in order to avoid the application of the throwback rules under section 25122.

Analysis and Discussion:

For purposes of allocation and apportionment, section 25122 provides that a taxpayer's sales will not be thrown back to California if: (a) the appellant is subject to an income tax in the foreign country,⁷ or (b) if the foreign country could impose an income tax under U.S. Constitutional standards.⁸

In order for a state to impose a net income tax on a taxpayer under U.S. Constitutional standards, nexus under both the 14th Amendment due process clause and the commerce clause must exist between a taxpayer and the taxing state.⁹ Nexus exists under the due process clause when an out-of-state company purposefully avails itself of the benefits of an economic market in the forum state, even though it may not be physically present there.¹⁰

⁴ Limitations under Public Law 86-272 do not apply to sales to and from foreign jurisdictions or sales of other than tangible personal property.

⁵ Reg. § 25122(c).

⁶ The origin of this contention is the Legislature's enactment of subdivision (b) of section 23101, effective for taxable years beginning on or after January 1, 2011. The meaning and effect of this enactment is discussed later in this analysis.

⁷ According to section 25122(a) and Reg. § 25122(a), if a taxpayer is in fact subject to taxation by reason of only selling tangible personal property in another state, California will not require that taxpayer to throwback such sales into the California numerator.

⁸ See also Reg. § 25122(c) ("In the case of any 'state' as defined in Section 25120(f), other than a state of the United States or political subdivision of such state, the determination of whether such 'state' has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that 'state.' If jurisdiction is otherwise present, such 'state' is not considered as without jurisdiction by reason of the provisions of a treaty between that state and the United States."); *Appeal of Dresser Industries, Inc.* 82-SBE-307, June 29, 1982, rehearing 83-SBE-118, Oct. 26, 1983.

⁹ *Quill Corp. v. North Dakota* (1992) 504 U.S. 298.

¹⁰ *Id.*, at 308.

Nexus under the commerce clause exists if the activities the state seeks to tax have a "substantial nexus" with the taxing state.¹¹

The rules regarding whether physical presence is necessary in order to establish substantial nexus under the commerce clause have evolved over time. In *National Bellas Hess, Inc. v. Department of Revenue* (1967) 386 U.S. 753, the U.S. Supreme Court determined that physical presence was necessary to meet the commerce clause's substantial nexus requirement, with respect to a sales and use tax collection case. In *Quill Corporation v. North Dakota* (1992) 504 U.S. 298, the U.S. Supreme Court held that the nexus requirements under the due process clause are met where a taxpayer has sufficient economic activity in the state, even absent physical presence. With respect to the commerce clause, however, the Court affirmed the formalistic "bright-line" physical presence approach established in *Bellas Hess*.

Since *Quill*, there have been varying state interpretations as to whether physical presence is required to find substantial nexus under the commerce clause. Some state courts have applied *Quill's* bright line "physical presence" test for purposes of franchise and income tax,¹² while others have limited *Quill's* bright-line physical presence test to sales and use tax, and found that substantial economic nexus in a forum state satisfies the requirement of substantial nexus under the commerce clause.¹³

Notwithstanding the varying authorities on this issue, California authorities have consistently provided that physical presence is required in order for a taxpayer to have sufficient nexus to be subject to tax. In *Appeal of John H. Grace Co.*, 80-SBE-115, Oct. 28, 1980, the State Board of Equalization determined that a taxpayer was not subject to California income tax where the taxpayer leased railroad cars to unrelated industrial companies who in turn arranged for other railroad companies to use the cars to transport property in interstate commerce. The Board ruled that the taxpayer did not have substantial nexus in California, and determined that economic presence did not constitute sufficient statutory nexus to support the corporate income tax:

"[W]e decline to follow the lead of the Oregon Supreme Court by accepting mere economic presence as constituting sufficient statutory nexus to support the corporate income tax."

¹¹ *Id.*, at 313.

¹² For cases holding that *Quill's* physical presence test also applies to income and franchise taxes, see *J.C. Penney Nat'l Bank v. Johnson*, *supra*, (Tenn. Ct. App. 1999) 19 S.W. 3d 831, *cert. den.* (2000) ___ U.S. ___, 121 S. Ct. 305; *Rylander v. Bandag Licensing Corp.* (Tex. Ct. App. 3d Dist., 2000) 18 S.W.3d 296.

¹³ For cases holding that *Quill* is limited to only sales and use tax, see *Geoffrey, Inc. v. South Carolina Tax Comm'n* (1993) 313 S.C. 15, *cert. den.* 510 U.S. 992; *A&F Trademark, Inc v North Carolina* (N.C. Ct. App, 2004) 605 S.E.2d 187, *cert. den.* (2005) 546 U.S. 821; *Lanco, Inc. v. Division of Taxation* (2006) 188 N.J. 380 *cert. den.* (2007) 551 U.S. 1131; *Tax Comm'r v. MBNA Am. Bank, N.A.* (2006) 220 W. Va. 163 *cert. den.* (2007) ___ U.S. ___, 127 S. Ct. 2997; *KFC Corp. v. Iowa Dep't of Revenue* (Iowa 2010) 792 N.W.2d 308 *cert. den.* (2011) ___ U.S. ___, 132 S. Ct. 97.

In *Appeal of Dresser Industries, Inc.*, 82-SBE-307, June 29, 1982, rehearing 83-SBE-118, Oct. 26, 1983, the State Board of Equalization determined a foreign country has jurisdiction to subject a taxpayer to a net income tax under Regulation section 25122(c) where the appellant demonstrated “a regular and systematic pattern of local sales solicitation on [appellant’s] behalf in the foreign countries in question.” On the basis of this evidence, the Board applied the physical presence standard of *Bellas Hess* and determined that appellant had substantial nexus with the foreign countries in question; and thus, the appellant was not required to throw back its sales to California.

Although not a published decision, and thus, one that cannot be cited for precedent, in *Appeal of Galvantech Inc.*, SBE Case No. 288289 (Feb. 1, 2006), the State Board of Equalization determined a foreign country did not have jurisdiction to subject a taxpayer to a net income tax under Regulation section 25122 subdivision (c) simply because a taxpayer ships goods from California to a foreign jurisdiction. The Board ruled that, pursuant to section 25135 subdivision (b), a taxpayer must include the resulting thrown back sales in the California numerator in cases when the sales were shipped from California to a foreign jurisdiction.

In yet another unpublished decision, the State Board of Equalization stated in *Appeal of Kenneth Klee and Robyn Klee*, SBE Case No. 356944 (May 13, 2008), that the physical presence standard articulated in *Quill* applied only to multistate corporations. Thus, under California law, physical presence was required to establish substantial nexus under the commerce clause for U.S. Constitutional standards.

For taxable years beginning on or after January 1, 2011, the Legislature amended section 23101 by adding subdivision (b), which provides in part:¹⁴

For taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state for a taxable year if any of the following conditions has been satisfied:

...

(2) Sales, as defined in subdivision (e) or (f) of Section 25120 as applicable for the taxable year, of the taxpayer in this state exceed the lesser of five hundred thousand dollars (\$500,000) or 25 percent of the taxpayer's total sales. ...

By enacting legislation providing that a taxpayer is doing business in California where a taxpayer's only contact with this state are sales exceeding \$500,000, California's Legislature determined for the first time that substantial economic presence meets U.S. Constitutional standards under California law. In enacting this statutory provision, California's Legislature determined that under California law, physical presence is no longer required in order for the state to subject a business to tax. However, the amendment to

¹⁴ Added by Stats. 1949, c. 557, p. 963, § 1, operative July 1, 1951. Amended by Stats. 2009-2010, 3rd Ex. Sess., c. 10 (A.B.15), § 7, eff. Feb. 20, 2009; Stats.2009-2010, 3rd Ex. Sess., c. 17 (S.B.15), § 7, eff. Feb. 20, 2009; Stats.2010, c. 721 (S.B.858), § 19, eff. Oct. 19, 2010.

section 23101 specifically provides that the newly enacted circumstances applied only to taxable years beginning on or after January 1, 2011.

Accordingly, for taxable years beginning before January 1, 2011, California law required physical presence (either directly or through agents or independent contractors) to establish substantial nexus under the commerce clause. Thus, for throw back purposes in taxable years beginning before January 1, 2011, a taxpayer must demonstrate physical presence (either directly or through agents or independent contractors) in the destination state to establish that it is subject to taxation in that state and avoid the application of the throwback rule under section 25122 and Regulation 25122(c).