CHAPTER CONTENTS:

1000 RELEVANT LAW

Subsequent sections of this manual cover the aspects of the apportionment and allocation procedures applicable to multistate businesses. To place those rules into the proper perspective, this section provides an overall understanding of the framework of the California Bank and Corporation tax system as it relates to multistate businesses. This section of the manual begins with a discussion of nexus, followed by coverage of the additional jurisdictional limitations imposed by Public Law 86-272 (73 Stat. 555; 15 USC §381, approved September 14, 1959).

1100 NEXUS AND A STATE'S RIGHT TO TAX

When determining whether a state has a right to tax a business entity, the following steps should be taken:

- Determine whether an entity is doing business within the state or deriving income from sources within the state, such that statutory nexus has been established. For taxable years beginning on or after January 1, 2011, a taxpayer must aggregate the proceeds from sales of TPP and OTTPP to determine whether it meets California's "doing business" standard under R&TC § 23101(b)(2). (FTB CCR 2016-3)
- If statutory nexus has been established, determine whether the tests imposed by the Due Process Clause and the Commerce Clause of the U.S. Constitution have been satisfied, such that constitutional nexus has been established.
- If statutory and constitutional nexus have been established, determine whether Public Law 86-272 (15 USC § 381) prevents the state from asserting its right to impose a tax based on net income. If this section does apply, then the state may not impose the franchise or corporate tax, however, the minimum franchise tax may still apply. See MATM 1200 for further information.

Upon determining that statutory nexus and constitutional nexus have been satisfied and that Public Law 86-272 does not apply, then it may be concluded that the state does have the right to impose the corporate or franchise tax.

Doing Business or Deriving Income from Sources within the State

Doing Business:

A business entity is considered doing business within this State if it is actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. (R&TC §23101(a))

R&TC § 23101(b) provides that for taxable years beginning on or after January 1, 2011, a business entity will be considered doing business in this State if the business entity:

- Is organized or commercially domiciled in this State; or
- Satisfies any of the following metrics, which are annually revised for inflation:

    - Sales, as defined in subdivision (e) or (f) of R&TC §25120, of the business entity in this State, including sales by the business entity's agents and independent contractors, exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales
    - Real and tangible personal property of the business entity in this State exceed the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property
    - The amount paid in this State by the business entity for compensation, as defined in subdivision (c) of R&TC 25120, exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the business entity.

Upon finding that a business entity is considered to be doing business within this State, the constitutional nexus standard has been met, and Public Law 86-272 does not apply, then a business entity will be taxed under Chapter 2 of the Corporation Tax Law.

Income from Sources within this State:

A business entity that is not doing business in this State, but derives income from sources within this State or from activities carried on in this State, may also be subject to tax so long as constitutional nexus has been satisfied and Public Law 86-272 does not apply. A business entity that falls under this provision will be taxed under Chapter 3 of the Corporation Tax Law.

Constitutional Nexus

A state has jurisdiction to tax a business entity, so long as it does not violate the requirements imposed by the Due Process Clause and Commerce Clause of the U.S. Constitution. The Due Process and the Commerce Clauses require that there be sufficient "nexus" between the interstate activities of the business entity and the taxing state, in order for the tax to be upheld. The term "nexus" refers to the level of activity or contacts that a taxpayer has established within a taxing jurisdiction.

The Due Process Clause

The Due Process Clause is found both in the Fifth Amendment and the Fourteenth

Amendment to the U.S. Constitution. The Fifth Amendment to the U.S. Constitution reads, in part:

> *No person shall be . . . deprived of life, liberty, or property, without due process of law…*

The Fourteenth Amendment reads, in part:

> *. . . nor shall any State deprive any person of life, liberty, or property, without due process of law. . .*

In the context of taxation, the Due Process Clause requires that a party be provided notice or fair warning that a state may tax that party thereby depriving the party of its property. The courts have held that a party has been provided with fair warning or notice, when its connections with a state are substantial enough to legitimize the state's exercise of power over the corporation. (See *Quill Corp. v. North Dakota* (1992) 504 US 298). In *Quill Corp. v North Dakota*, the U.S. Supreme held that nexus will be established under the Due Process Clause if the following are met:

There must be some definite link, some minimum connection, between the state and the person, property or transaction it seeks to tax; and

- The income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.

The point at which nexus is deemed to be sufficient to provide a state with jurisdiction to tax has not been precisely defined; however, a number of court cases have addressed the issue and have provided some guidance. For many years, physical presence was viewed as necessary for establishing nexus for the purpose of the Due Process Clause. This standard was supported by the U.S. Supreme Court's decision in *National Bellas Hess Inc. v. Department of Revenue of Illinois* ((1967) 386 US 753), a case involving a sales and use tax. In *National Bellas Hess*, the state of Illinois attempted to impose a use tax on the Illinois sales of an out-of-state mail order house whose only contacts with the state were via the U.S. mail or common carrier. Catalogues and advertising flyers were mailed to customers in Illinois. The customers mailed merchandise orders to the taxpayer's Missouri headquarters, and the goods were then sent to the customers either by mail or common carrier.

The U.S. Supreme Court stated that allowing states and other jurisdictions to impose use tax burdens based upon such minimal connections could entangle interstate businesses in a "virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose 'a fair share of the cost of the local government.'" The Court concluded that the mail order house did not have sufficient tax nexus in Illinois, and the requirement that it collect and pay the Illinois use tax therefore violated the due process and commerce clauses.

Subsequently, in *Quill Corporation v. North Dakota* ((1992) 504 US 298), the U.S. Supreme Court revisited the matter and issued a decision that suggests that physical presence may be necessary for nexus, particularly when income and franchise taxes are at issue. This issue in *Quill*, like the issue in *National Bellas Hess*, was whether a mail order house had sufficient nexus within North Dakota for that state to impose a use tax. *Quill* sold office equipment and supplies, and it solicited its sales through catalogs and flyers, advertisements in national periodicals, and telephone calls. All of its merchandise was delivered to its North Dakota customers by mail or common carrier from out-of-state locations. *Quill*'s only property within the state consisted of diskettes containing computer software programs that were licensed to some of its North Dakota customers that enabled them to check on *Quill*'s current inventories and prices and to place orders directly (the trial court found this physical connection to be insignificant for nexus purposes).

The Court held that, for Due Process Clause purposes only, the minimum connection would exist so long as an out-of-state corporation purposefully directed itself of the benefits of an economic market in the taxing state, even if it had no physical presence in the state. Since *Quill* had purposefully directed a substantial amount of its activities at North Dakota residents, it was clearly receiving benefits from its access to the state, and clearly had fair warning that its activity may be subject to North Dakota's jurisdiction. The Court therefore found that North Dakota's use tax did not violate the Due Process Clause. The Court, however, reached a different conclusion with respect to the nexus requirement of the Commerce Clause, as discussed below.

Commerce Clause

Article I, Section 8, Clause 3 of the U.S. Constitution provides:

> *The Congress shall have power . . . To regulate commerce with foreign nations, and among the several States, and with the Indian tribes.*

This clause provides Congress with the affirmative power to regulate interstate commerce. Additionally, the Commerce Clause is more than an affirmative grant of power. It also prohibits certain state actions that interfere with interstate commerce. (*Quill Corporation v. North Dakota* (1992) 504 U.S. 298.) This judicially created negative prohibition against state laws that unduly burden or discriminate against interstate commerce is often referred to as the "dormant Commerce Clause" or the "negative Commerce Clause." In 1977, the U.S. Supreme Court ruled in *Complete Auto Transit, Inc. v. Brady* ((1977) 430 U.S. 274) that a state tax will not be found to violate the Commerce Clause if it meets the following four-part test:

- It must be applied to an activity with a "substantial nexus" with the taxing state,
- It must be fairly apportioned,
- It does not discriminate against interstate commerce, and
- It must be fairly related to the services provided by the state.

The U.S. Supreme Court provided additional guidance regarding the Commerce Clause in the case of *Quill Corporation v. North Dakota* (1992) 504 U.S. 298. In *Quill*, the court found that the Commerce Clause limitations on the taxing powers of the state are similar to the limitations imposed by the Due Process Clause. However, these two Clauses do pose distinct limitations. Accordingly, while a State may have the authority to tax a particular taxpayer under the Due Process Clause, imposition of the tax may nonetheless violate the Commerce Clause.

The Court found that the Due Process Clause only requires a "minimum connection" between a business entity and a state for a state to have authority to impose a tax, whereas the Commerce Clause requires the state to have a "substantial nexus" with the business entity it seeks to tax, which constitutes a higher degree of contact.

The Court explained that the "substantial nexus" requirement under the Commerce Clause is a means for limiting state burdens on interstate commerce, and not just a requirement for fair warning and notice (as is the requirement of Due Process). For this reason, the Court formulated the nexus requirement of the Commerce Clause different from the nexus requirement of the Due Process Clause.

In *Quill*, the U.S. Supreme Court went on to explain that to establish "substantial nexus" under the Commerce Clause, a state must show that the out-of-state retailer, or a representative of the out-of-state retailer, has a sufficient substantial physical presence in the state to justify the imposition of a use tax collection obligation. Based on this, the Court concluded that the facts in *Quill* did not constitute substantial nexus. However, the Court strictly limited its conclusion to sales and use taxes, and implied that it might not require physical presence when other types of taxes were involved.

Subsequent to *Quill*, several courts have delved into whether, and to what extent, physical presence is required to establish nexus under the Commerce Clause. The New York Court of Appeals ruled in *Orvis Co. v. Tax Appeals Tribunal* (1995) 86 N.Y.2d 165 [654 N.E.2d 954; 630 N.Y.S.2d 680], that "substantial nexus" could be found under the Commerce Clause without having "substantial physical presence." In that case, Vermont corporations marketed products to New York customers through mail order and had a substantial customer base in New York. Visits by employees of the corporations involved to New York were described by the taxpayers as sporadic and occasional. The NY Court of Appeals stated:

> *We do not read Quill Corp. v North Dakota to make a substantial physical presence of an out-of-State vendor in New York a prerequisite to imposing the duty upon the vendor to collect the use tax from its New York clientele.*

Therefore, because there was also a substantial economic presence in New York, in addition to the level of physical presence, which was only "more than a slightest presence," the Court found this enough to establish nexus. A California Court of Appeal followed Orvis in deciding *Borders Online v. State Bd. Of Equalization* (2005) 129 Cal.App.4th 1179, thus indicating that this rationale may be of use for California purposes. Public Law 86-272 did not apply to these cases because they involve sales and use tax rather than income tax.

The implication of the *Quill* decision, requiring some physical presence for sales and use taxes, on state income and franchise taxes is unclear. Since there is no Supreme Court precedent on this issue for franchise tax purposes, states have argued – with some success – that the physical presence requirement of *Quill* should not be extended to franchise and income taxes.

The South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Commission* (1993) 313 S.C. 15 [437 S.E.2d 13, cert denied, (1993) 510 U.S. 992] has taken the position that physical presence is not necessary to establish substantial nexus in regards to the imposition of the South Carolina income tax. *Geoffrey* was a Delaware company with no offices, employees or tangible property in South Carolina. *Geoffrey* executed a license agreement, which gave its parent, Toys R Us, Inc., the right to use the "Toys R Us" trade name (as well as other trade names, trademarks, merchandising skills, techniques and know-how) in all but five states. In consideration for the licenses, *Geoffrey* received a royalty of one percent of the net sales of Toys R Us, Inc., or any of its affiliated, associated, or subsidiary companies, on licensed products sold or licensed services rendered under a licensed mark. Subsequent to the agreement, Toys R Us began doing business in South Carolina, and made royalty payments to *Geoffrey* based upon its sales in that state. The State of South Carolina assessed income tax on *Geoffrey*'s royalty income. *Geoffrey* filed a claim for refund, arguing that it did not have sufficient nexus in South Carolina for its royalty income to be taxable there. The South Carolina Supreme Court disagreed, holding that *Geoffrey*'s presence in South Carolina satisfied both the Due Process and Commerce Clause tests.

Geoffrey had asserted that Due Process Clause had not been satisfied since it had not purposefully directed its activity at South Carolina, pointing out that Toys R Us had no South Carolina stores when the license agreement was executed and that the subsequent expansion was the unilateral activity of Toys R Us, which cannot create the minimum connection between South Carolina and *Geoffrey* as required by the Due Process Clause. The South Carolina Supreme Court responded that by electing to license its trademarks for use by Toys R Us in many states, *Geoffrey* contemplated and purposefully sought the benefit of economic contact with those states. Thus, by licensing intangibles for use in South Carolina and receiving income in exchange for their use, *Geoffrey* was found to have the minimum connection required by the Due Process Clause.

The South Carolina Supreme Court also found the "minimum connection" requirement of the Commerce Clause to have been satisfied by the presence within the state of *Geoffrey*'s intangible property (the lower court found the agreement resulted in Toys R Us having a franchise in South Carolina; and when Toys R Us made sales, accounts receivable, located in South Carolina, were generated for *Geoffrey*). With respect to the Due Process requirement that the tax be rationally related to benefits that have been conferred, the Court stated that by providing an orderly society, South Carolina had made it possible for *Geoffrey* to earn income from Toys R Us customers in that state. Thus, the court found that the Due Process Clause had been satisfied, because there was a minimum connection between *Geoffrey* and the state and the income to be taxed was rationally related to the values connected to the state.

In analyzing the Commerce Clause aspects of the case, the South Carolina Supreme Court reiterated that the physical presence requirement set forth in *Quill* was decided in the context of a use tax. Additionally, the court noted that *Quill* did not consider whether physical presence was also required for purposes of a franchise or income tax. The South Carolina Court concluded that physical presence was not required in regards to South Carolina income tax, and concluded that the exploitation of the economic market by licensing intangibles for use in the state and by deriving income from their use there, *Geoffrey* had substantial nexus with South Carolina.

Additionally, in Tax Commissioner of the *State of West Virginia v. MBNA America Bank, N.A.* (2006) 220 W. Va.163 [640 S.E.2d 226, cert. denied, (2007) 127 S.Ct. 2997], the West Virginia Supreme Court stated:

> *The major question left open by the Supreme Court's opinion in Quill is the one that now confronts us: Does the physical presence requirement applicable to determining the constitutionality of requiring out-of-state mail-order houses to collect use taxes on in-state sales under the Commerce Clause extend to other types of state taxes? MBNA's position is that Quill extends to the business franchise and corporation net income taxes at issue. The Tax Commissioner posits, on the other hand, that physical presence is not a requirement of the substantial nexus standard in regards to the taxes at issue.*
>
> *After careful consideration of the parties' arguments, the relevant legal authority, and the Court's reasoning in Quill, we conclude that Quill's physical-presence requirement for showing a substantial Commerce Clause nexus applies only to use and sales taxes and not to business franchise and corporation net income taxes.*

Although both Geoffrey and MBNA were decided by courts outside of California and would not be binding upon a California court, they provide strong support for the proposition that physical presence is not a constitutional prerequisite to imposing a franchise or income tax.

In sum, when determining whether nexus has been established, it is clear that significant physical presence within a state will be enough under both the Due Process and Commerce Clauses. However, substantial nexus may also be established with less than a significant physical presence and perhaps even with a purely economic (nonphysical) presence. As a result, when asserting nexus with, arguably minor physical connections, it is important that the audit narrative identify all elements of the taxpayer's physical presence in this state and highlight the importance of those connections to the taxpayer's business activity.

Public Law 86-272

For a detailed discussion of the requirements of Public Law 86-272, see MATM 1200. In general, if Public Law 86-272 applies, a business entity will not be subject to a net income tax, such as the corporate tax or the franchise tax. However, the minimum franchise tax may still be required, since it is a flat tax not measured by income, and thus not within the scope of Public Law 86-272.

Also, it is important to note that for taxable years beginning on or after January 1, 2011, Appeal of *Finnigan Corp*., 88-SBE-022, Aug. 25, 1988, is applicable, such that the determination whether an entity is taxable in another jurisdiction is made on the combined unitary group basis. (See R&TC §25135(b).) In determining whether Public Law 86-272 applies to exempt taxation upon income in a specific jurisdiction, consider whether any member within the combined unitary group has activities beyond those protected activities under Public Law 86-272. If so, then Public Law 86-272 will not provide relief.

Audit Considerations - Throwback

When a California taxpayer makes sales to other states or foreign country destinations, it is important to determine whether the California taxpayer is taxable in those other states or foreign countries in which the sales are being made. The reason being, any sales made in states or foreign destinations in which the California taxpayer does not have nexus, will be thrown back to California. (See *Appeal of Dresser Industries, Inc*., 83-SBE-118, October 26,1983.) When the taxpayer's sales are to another state, the nexus determination will take into account whether the taxpayer is entitled to the protections of Public Law 86-272. However, when taxpayer's sales are to another country, one applies the nexus standards of the U.S. Constitution (without taking into account Public Law 86-272) in determining whether the taxpayer was subject to that country's tax jurisdiction.

Taxable years beginning or on after January 1, 2011

For tax years beginning on or after January 1, 2011, the determination of whether a taxpayer is taxable in other jurisdictions will be made on a combined unitary group basis. (R&TC § 25135(b).) Thus, it is important to assess whether any members within the combined unitary group are taxable in other jurisdictions, and if not, sales may then be thrown back. Moreover, when determining whether a California taxpayer is taxable in other jurisdictions, one should consider *Orvis Co. v. Tax Appeals Tribunal* (1995) 86 N.Y.2d 165 [654 N.E.2d 954; 630 N.Y.S.2d 680] in determining the strength of the taxpayer's connections in the state jurisdiction. Remember, that the case law is still developing in this area so there is no bright-line threshold. In determining whether substantial nexus has been established in the other state, you should fully develop all of the facts and clearly explain the rational supporting the nexus determination. See TAM 2012-1 and Chief Counsel Rulings 2012-3 and 2016-03 for guidance on how the 2011 law changes affect the sales factor.

In some cases, nexus may be established by activities of an agent rather than by activities of the taxpayer. This issue is discussed in MATM 1110.

Audit Considerations – Nexus

When a taxpayer first enters a taxing jurisdiction or when the taxpayer's activities within a jurisdiction are increasing, it may be necessary to establish the date upon which nexus was established. Although a taxpayer establishes nexus during the taxable year, the state will not have authority to tax income earned prior to the date upon which nexus was achieved. See MATM 1210 for an example of this concept.

When considering the materiality of a nexus issue, take into account the effects of Public Law 86-272 limitations and other carve-out provisions of the Revenue and Taxation Code (e.g., R&TC §§ 23102 and 23104, and the partial exemption from tax afforded to insurance companies under Article 13, section 28 of the California Constitution discussed in MATM 3085). Public Law 86-272 does not apply in situations when the tax is something other than a net income tax and when the sales do not involve tangible personal property. However, if Public Law 86-272 does apply, such that a corporation is immune from a state tax based on net income, then nexus is relevant in determining whether the minimum franchise tax may still be imposed.

1110 ATTRIBUTIONAL NEXUS

An entity is generally subject to state and local taxation in the state in which it owns property or employs people, so long as the activity conducted by those employees exceeds the nexus thresholds set by state and the federal law. Sometimes, a state will assert nexus upon an out-of-state entity based on that entity's relationship with another entity that is present in the taxing state. This is referred to as "attributional nexus," "agency nexus," and, less frequently, "affiliation nexus". Attributional nexus and agency nexus refers to the market state's assertion that there is an agency relationship between an in-state-entity, who clearly has a physical presence in the market state, with the out-of-state entity, which causes the out-of-state-entity to have nexus through its use of an agent to conduct its business in the market state.

The fact that an agent – or even an independent contractor – performs activities on behalf of the taxpayer in the market state does not diminish the fact that the taxpayer is realizing benefits from within the state and is potentially subject to its tax jurisdiction. Also, from a constitutional perspective, the fact that the agent might also work for other principals is unimportant (although only the activities performed on behalf of the taxpayer may be considered in determining whether the threshold for nexus has been met). The relevant test for determining nexus focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent or independent contractor on the taxpayer's behalf. (*Scripto Inc. v. Carson* (1960) 362 U.S. 207; *Illinois Commercial Men's Association v. State Board of Equalization* (1983) 34 Cal.3d 839.) Typically, agency nexus has been found to exist in situations where the agent's (or independent contractor's) activities were found to be associated with the out-of-state taxpayer's ability to establish or maintain a market for its products in the taxing state. (See *Tyler Pipe Industries v. Washington Department of Revenue* (1987) 483 U.S. 232; *Borders Online v. State Bd. of Equal*. (2005) 129 Cal.App.4th 1179.) It is not clear, however, whether agency nexus is limited to such situations. For example, in *Illinois Commercial Men's Association v. State Board of Equalization*, (1983) 34 Cal.3d 839, the California Supreme Court found agency nexus to exist because the in-state agent's activities were an "integral and crucial aspect of the business" even though those activities neither established nor maintained the taxpayer's in-state business. Nevertheless, if agency nexus is to be asserted, it is helpful if you can establish that the in-state agent's activities on behalf of the out-of-state taxpayer were significant in establishing or maintaining the out-of-state taxpayer's market within this state.

Corporations often act as agents for unitary affiliates. For example, assume that Corporations A and B are unitary. Corporation A manufactures power tools in Wisconsin, and has no employees and engages in no direct activities in California. Corporation B is a building supply distributor operating in California. When B's employees solicit sales from building supply retailers in California, they also solicit sales of power tools on behalf of Corporation A. When power tool orders are taken, the orders are forwarded to Corporation A, and B's employees receive a commission. Corporation B's activities in California on A's behalf cause A to have nexus within this state.

You should also consider court filings. When a corporation elects to avail itself of California courts and administrative quasi-judicial bodies in order to advance its economic self-interests, this may be viewed as a factor in determining whether the taxpayer is physically present in this state. Search the Internet to see if the taxpayer's name appears in any of the various courts.

The courts have been fairly liberal in finding an agency relationship to exist, as illustrated in the following cases:

> In *Illinois Commercial Men's Association. v. State Board of Equalization* (1983) 34 Cal. 3d 839, the taxpayers were foreign insurers who solicited business in California. They did not own or lease property in California; however, they each employed independent contractors, which operated in California, who investigated and settled insurance claims on the taxpayers' behalf. The Court found that the independent contractors were actually agents, because the investigation and settlement of claims by these parties was an integral and crucial aspect of the business of insurance. Additionally, the court noted the fact that they were labeled as independent contractors was of little significance for purposes of determining whether the Due Process Clause had been satisfied. Moreover, the Court found that insurers' activities in the state, through these agents, were sufficient to form the definite link and minimum connection required to justify imposition of the tax despite the fact that these activities neither established nor maintained the taxpayer's in-state business.

> In *Scholastic Book Clubs, Inc. v. State Board of Equalization* (1989) 207 Cal.App.3d 734, the taxpayer had no property or employees in California. It conducted business by mailing catalogs to teachers and librarians in schools throughout the United States. Each catalog included "offer sheets" for the teachers to distribute to their students, but the teachers were under no obligation to do so. The teachers would consolidate the orders and payments made by their students, and submit them to the taxpayer. Orders were filled and shipped from a Missouri warehouse to the teacher, who then distributed the materials to the students. To encourage teachers to place orders, the taxpayer gave them "bonus points" based upon the size of their orders. The bonus points could be used to obtain merchandise from a gift catalog.

> The taxpayer argued that it had no real agency relationship with the teachers and, therefore, the activities of the teachers should not cause the taxpayer to have nexus within California. The Court disagreed, finding the relevant fact to be that the teachers served the function of obtaining sales within California from

local customers. The Court noted that the taxpayer depended on the teachers to act as its conduit to the students. Moreover, the Court found an implied contract existed between the taxpayer and the teachers as evidenced by the fact that the taxpayer rewarded the teachers with bonus points if they obtained and processed orders. The taxpayer attempted to minimize the payment of bonus points by claiming that the teachers could not earn their living through bonus points. The Court responded by stating that "neither the form of the remuneration, the amount thereof, nor the fact that the teachers and librarians were not formally employed by, or dependent upon appellant for their primary income has any legal significance in determining whether they acted as appellant's representatives in soliciting orders for appellant's products in California." The Court held that the taxpayer was exploiting or enjoying the benefit of California's schools and employees to obtain sales, and thus had nexus within the state.

California Civil Code §1793.2 provides that every manufacturer of consumer goods sold within California with express warranties must maintain repair facilities reasonably close to the sales location. To comply with this provision, the warranty work can be subcontracted to an independent third party. Since performing warranty work through a subcontractor may be enough to establish taxability within the state, request copies of the manufacturer's warranty provisions. In addition, determine how the warranties are honored and if the repairs are subcontracted or not. Request copies of contracts for subcontracting of warranty services. The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller's business, creates nexus. (*Scripto Inc. v. Carson* (1960) 362 U.S. 207; *General Trading Corp. vs. Iowa* (1966) 322 U.S. 327; *Tyler Pipe Industries, Inc. vs. Washington Department of Revenue* (1987) 483 U.S. 232). Depending on the facts of an audit, the out-of-state manufacturer may have nexus in California by providing for repair facilities.

1120 FREE TRADE ZONES

Corporations that operate in a Free Trade Zone (also called Foreign Trade Zones) within California are not exempt from Franchise or Income tax. Corporations can warehouse, assemble, and manufacture goods within a Free Trade Zone. Such goods are exempt from U.S. customs duties and federal excise taxes until sent from the zone.

As a general rule, storing property within this state will be sufficient to establish taxable nexus. The value of such property is then included in the numerator of the property factor of the taxpayer's apportionment formula for this state. However, if inventory is simply warehoused in this state for a brief period of time awaiting further transportation of the goods to the ultimate destination (e.g., the goods pass through the state as part of a "stream of commerce"), neither the inventory nor the sale would be assignable to this state. Alternatively, if the purchaser takes possession (or constructive possession through an agent or bailee) so that the goods leave the stream of commerce within this state, such as for inspection or minor assembly work, the inventory and the sale are assignable to this state. For further discussion of this issue, see *Appeal of Mazda Motors, Inc.*, 94-SBE-009, November 29, 1994. Also see FTB Legal Ruling 95-3, July 20, 1995, and *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal. App. 4th 1789.

1200 PUBLIC LAW 86-272

Congress enacted Public Law 86-272 on September 14, 1959 to prohibit states from imposing an income tax upon a taxpayer whose only activity within a state is solicitation of orders for the sale of tangible personal property (15 USC §381 et seq.) Since such activity is generally sufficient to establish nexus (MATM 1100), the business community was concerned that interstate commerce would be burdened because businesses would be subject to tax in many states in which they had minimal activities. Congress enacted Public Law 86-272 in response to this concern. Public Law 86-272 exempts an entity from income-based taxes when that entity's activities within a taxing state are limited to the solicitation of orders by company representatives for sales of tangible personal property, which orders are sent outside the state for approval and filled by shipment from outside the state.

Public Law 86-272 established the following provision in the U.S. Code:

TITLE 15: COMMERCE AND TRADE

CHAPTER 10B: STATE TAXATION OF INCOME FROM

INTERSTATE COMMERCE – NET INCOME TAXES

SECTION 381

(a) Minimum standards

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, 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 orders 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 by 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).

(b) Domestic corporations; persons domiciled in or residents of a State

The provisions of subsection (a) of this section shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to:

1. Any corporation which is incorporated under the laws of such state, or
2. Any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) Sales or solicitation of orders for sales by independent contractors

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.

(d) Definitions

1. The term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and
2. The term "representative" does not include an independent contractor.

1210 KEY PROVISIONS OF PUBLIC LAW 86-272 (15 USC § 381)

- Immunity in a state does not apply to any corporation incorporated within the state. (Note that a corporation will be eligible for immunity if it is qualified to do business in the state, so long as it is not incorporated there. Since immunity only applies to taxes based on net income, a taxpayer qualified to do business in California would still be liable for at least the minimum franchise tax.)
- Immunity only applies to sellers of tangible personal property. Activities related to sales of real estate or intangibles, to the leasing, renting, or licensing of property, to the provision of services, or to any other transactions not specifically protected under P.L. 86-272 will cause a loss of immunity.
- To maintain immunity, activity within the state must not go beyond solicitation of orders for sales of tangible personal property. (An exception is made for de minimis activities.) Activities that are considered to fall within the meaning of "solicitation" are discussed in MATM 1220.
- Approval of the orders must be made outside the state to maintain immunity.
- Deliveries to customers must be made from a point outside the state to maintain immunity.
- Certain in-state activities conducted on behalf of the taxpayer by an independent contractor may not cause loss of immunity even though such activities would not be allowed if performed by the taxpayer directly. This topic is covered in more detail in MATM 1230.
- A single event during the taxable year can cause the loss of immunity for the entire year so long as the taxpayer had nexus within the state. If nexus is

established mid-year, then the taxpayer would not be taxable prior to the date of nexus. The following example will illustrate this concept:

ABC Corporation, a calendar year corporation, is a manufacturer of recycling equipment headquartered in Arizona. ABC made sales to California customers throughout 2007, but from January to June the sales were ordered over the telephone by the California customers, and were shipped by common carrier from the Arizona headquarters. ABC had no other connections with California during this time period. On July 1, 2007, ABC assigned an employee to live in California and solicit sales from California customers (this act established nexus). On December 1, ABC's employee exceeded the activities allowed under Public Law. 86-272 by assembling a large recycling system at a customer's California location.

Although the employee's activity on December 1 caused loss of immunity under Public Law 86-272 for the entire year, ABC did not have nexus in California until July 1. California would have the right to tax ABC on its income attributable to California sources from July 1 to the end of the year.

The loss of immunity in one year does not carry over to a subsequent year. Therefore, if the employee's activities did not exceed allowable solicitation during 2008, ABC would again be immune from California tax in that year.

- Public Law 86-272 only applies to interstate commerce and not to foreign commerce. See MATM 1240 for further discussion of this issue.
- The availability of the Public Law 86-272 exemption must be determined separately for each corporation in the combined group. Thus, the activities of one member of the combined group may not cause loss of immunity for another member. (An exception may arise when one member of the combined report acts as an agent, representative or independent contractor for another member. See MATM 1230.

For sales factor purposes, sales to a state in which the taxpayer is immune from taxability under Public Law 86-272 will be "thrown-back" to the state from which the goods were shipped. See MATM 7530.

1220 "SOLICITATION OF SALES" DEFINED

In *Wisconsin Department of Revenue v. William Wrigley Jr., Co*. ((1992) 505 U.S. 214), the U.S. Supreme Court established a standard for interpreting the term "solicitation." Under that standard, "solicitation of orders" means activities that are essential or entirely "ancillary" to making requests for orders.

The Court explained that ancillary activities are those that serve no independent business function apart from their connection to the solicitation of orders. If a company would engage in certain activities for reasons other than solicitation, the fact that they have assigned those activities to salespersons does not make the activities ancillary to solicitation of orders. The Court presented the following example:

> *"Providing a car and a stock of free samples to salesmen is part of the 'solicitation of orders' because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the 'solicitation of orders,' since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into 'solicitation' by merely being assigned to salesmen."*

The following is another example of how the courts have limited the interpretation of "solicitation of orders" to mean activities directly related to making requests for orders:

In *Brown Group Retail v. Franchise Tax Board* (1996) 44 Cal.App.4th 823, the taxpayer sold shoes to independent retailers. In addition to sales personnel who solicited sales within California, the taxpayer also employed two individuals within the state whose function was to help shoe retailers establish and enhance their stores. This involved providing assistance and advice regarding everything from site selection and store lease negotiations to improving inventory turnover, trimming windows and setting up bookkeeping systems. These services were provided free of charge, and the employees who provided the services were not allowed to take orders for sales. The purpose for providing these services was to increase the retailers' sales, which would in turn benefit the taxpayer. The Court held that while this activity was ultimately intended to increase the taxpayer's sales, it did not facilitate requests for sales. Therefore, it was not a protected activity under Public Law 86-272.

The language of Public Law 86-272 (15 USC §381(c)) implies that maintenance of an office within the state goes beyond solicitation, even if that office is maintained exclusively to facilitate requests for purchases. In the *Wrigley* case, the Court distinguished between offices that are formally attributed to the company, and in-home offices used by sales personnel to complete paperwork or hold occasional meetings. The in-home offices maintained by *Wrigley*'s salespeople were found to serve no purpose apart from their role in facilitating solicitation, and so did not cause loss of immunity.

The U.S. Supreme Court in *Wrigley* also concluded that a de minimis exception should be applied. Even if a taxpayer performs activities within a state that are not "ancillary to solicitation," those activities should not cause the taxpayer to lose immunity if they are de minimis or trivial. In determining whether such activities are trivial enough to be considered de minimis, look at the nonprotected activities as a whole and not individually. The facts in *Wrigley* serve as an illustration of how the de minimis exception should be applied:

In Wrigley, the Court found the following activities of the taxpayer to go beyond the solicitation of orders:

- Replacement of stale gum in customers' displays
- "Agency stock checks." (This consisted of directly selling gum to fill customers' display racks)
- Storage of gum within the state for the primary purpose of stale gum replacement and agency stock checks.

The taxpayer argued that these activities were minimal, and emphasized that the gum sold in agency stocks accounted for only .00007% of Wrigley's annual sales within that state, and amounted to only several hundred dollars a year. The Court did not agree that the activities were de minimis, stating:

"We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through 'agency stock checks'. Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State."

The Multistate Tax Commission has adopted guidelines for applying Public Law 86-272 that reflect the standards established by the Wrigley decision. Contained in those guidelines are examples of activities that are generally considered to exceed solicitation, as well as examples of protected activities. Keep in mind that these rules are not intended to cover all possible situations. Judge each case on its own facts. More importantly, consider those facts in the context of the taxpayer's activities within the state as a whole.

De Minimis Activities:

De minimis activities are those that, when taken together, establish only a trivial connection with the taxing state. An activity conducted within a taxing state on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) will normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the state is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing state, then such activity exceeds the protection of Public Law 86-272.

Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing state is not determinative of whether a de minimis level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing state is inconsistent with the limited protection afforded by Public Law 86-272.

For examples of protected activities and unprotected activities see FTB Publication 1050.

1230 ACTIVITIES OF INDEPENDENT CONTRACTORS

Public Law 86-272 extends protection to certain in-state activities if an independent contractor conducts them, even though immunity would be lost if those same activities were conducted directly by the taxpayer. Independent contractors may engage in the following limited activities within the state without causing the taxpayer to lose immunity:

- Soliciting sales
- Making sales
- Maintaining an office.

Except for purposes of display, the taxpayer may not maintain any inventory or stock of goods within the state under consignment with the independent contractor. Maintenance of such inventory will cause loss of immunity.

Sales representatives who represent a single principal are not considered to be independent contractors, and are subject to the same limitations as an employee.

In Appeal of *Nardis of Dallas, Inc.*, 75-SBE-024, April 22, 1975, a salesman solicited orders in California for a Texas-based company, and maintained a showroom within California for that purpose. The taxpayer argued that the salesman was an independent contractor; therefore, the maintenance of the showroom should be a protected activity under Public Law 86-272. The State Board of Equalization disagreed, stating that the salesman was not an independent contractor under the tests developed at common law. Factors that the SBE found to be significant in determining that an employer/employee relationship existed included the taxpayer's right to discharge the salesman upon notice, and the fact that the parties themselves believed that they had created an employment relationship, as evidenced by the payment of unemployment taxes. As an employee of the taxpayer, maintenance of the showroom went beyond the minimum activities allowed under Public Law 86-272.

In *The Reader's Digest Ass'n Inc. v. Franchise Tax Bd*. (2001) 94 Cal.App.4th 1240, it was held that a taxpayer's in-state subsidiary that leased offices in California and claimed to be the taxpayer's "independent contractor" for the solicitation of sales in California was not a true "independent contractor" within the meaning of Public Law 86-272, because it was not an independent business but an integral part of the taxpayer's business, and its only customer was the taxpayer. Accordingly, the taxpayer was not entitled to the protections of Public Law 86-272.

1240 FOREIGN COMMERCE

The immunity provided by Public Law 86-272 is expressly limited to interstate commerce. Further, although CCR §25122(c) states that U.S. jurisdictional standards must be applied to determine whether a foreign country has jurisdiction to subject a taxpayer to tax, the SBE has held that this refers to U.S. Constitutional nexus, and that the jurisdictional limitations of Public Law 86-272 are not considered. (*Appeal of Dresser Industries, Inc.*, 82-SBE-307, June 29, 1982.) Thus, if sales are made from California to a foreign country destination, the relevant question in determining whether those sales are thrown back to California is whether the taxpayer has constitutional nexus in the foreign country using the standards discussed in MATM 1100 and MATM 1110. If nexus is present, the sales may not be thrown back to the California sales factor numerator (MATM 7530) even if the taxpayer's activities within that country do not go beyond solicitation of orders for sales.

If sales are made from a foreign country to a California destination and are not viewed as interstate commerce, the sales will be included in the sales factor numerator as long as the taxpayer has constitutional nexus within California. P.L. 86-272 will not apply (because it only applies to interstate commerce), and the taxpayer will be taxable on its California income regardless of whether its California activities exceed solicitation of orders. This issue may arise when foreign country entities with constitutional nexus within the state make sales directly to customers within the U.S. (as opposed to indirect sales through a domestic sales affiliate). Information from the foreign country entities will usually have to be requested if you suspect that this issue exists.

For taxable years beginning on or after January 1, 2011 see TAM 2012-1 and Chief Counsel Rulings 2012-3 and 2016-03 for guidance on how the 2011 law changes affect the sales factor.

1300 CORPORATION FRANCHISE TAX

The corporation franchise tax is found in Chapter 2 of the Bank and Corporation Tax Law. This tax is paid for the privilege of doing business within California, and the amount of the tax is the greater of (1) the franchise tax under R&TC § 23151 or (2) the minimum franchise tax under R&TC § 23153.

A minimum franchise tax is imposed on all corporations, which are incorporated or qualified to do business in this state, which are not expressly exempted under the Bank and Corporation Tax Law (such as credit unions or charitable organizations) or the Constitution of California (such as insurance companies). The minimum tax is a flat amount that is imposed regardless of whether the corporation is active, inactive, operates at a loss, or files a short period return.

The amount of the minimum tax is generally $800 for taxable years beginning on or after January 1, 1990 (R&TC § 23153).

The franchise tax is imposed upon all banks and corporations "doing business" in California. See MATM 1310 for a definition of "doing business." The rate of tax for general corporations is prescribed by R&TC § 23151. The rate for banks and financial corporations is prescribed by R&TC § 23186. For addition information see FTB Publication 1063.

1310 DOING BUSINESS

Any corporation that is actively engaging in any transaction in California for the purpose of financial gain or pecuniary profit is "doing business" in this state. (R&TC § 23101(a))

Commencing in 2011, R&TC contains a test for doing business based upon the absolute and relative amounts of the taxpayer's property, payroll and sales that are in California. See MATM 1100.

The term "doing business" is given a broad interpretation. The R&TC § 23101 defines it to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." A very limited exception to this standard is provided by R&TC § 23101.5 if a corporation's only activities within the state are either:

- The purchase of personal property or services solely for its own use (or for use by its affiliate) outside the state, provided that certain restrictions regarding the presence of employees within the state are met; or
- The presence of employees in the state solely for the purpose of attending a public or private school, college or university.

In addition, R&TC §23102 provides that a holding company organized to hold stock or bonds will not be considered to be "doing business" if its only activities are the receipt of dividends or interest, and the disbursement of those receipts to shareholders. To qualify under this exception, the holding company may not engage in trading the stock, bonds or other securities that it holds.

Also consider the provisions of CCR § 23101(a) which reads, in part: ". . . if the only activities of employees of foreign corporations within this State engaging exclusively in interstate commerce are the solicitation of orders for goods to be shipped to customers in this State from points outside this State, the corporations are probably within the purview of Public Law 86-272 (15 U.S.C. §§ 381, et seq. Accordingly, such corporations would not be subject to either a tax measured by income imposed under Chapter 2 or the income tax imposed under Chapter 3. However, the corporation may be subject to the minimum tax imposed by § 23153, Revenue and Taxation Code."

In general, the California apportionment rules for partnerships treat a partner as being engaged in the trade or business of the partnership, as if conducted directly by the partner. This is true whether the partnership is a general partnership, a limited partnership, a "check-the-box" entity treated as a partnership, or an S corporation. (CCR §§ 25137-1 and 17951-4.) Thus, if the partnership has California source income, so will the partner.

If a partnership is doing business within the state, then all of the general partners of that partnership are also considered to be doing business within the state. However, in the *Appeal of Amman & Schmid Finanz AG, et. al.,* 96-SBE-008, April 11, 1996, the SBE held that a limited partner would not be considered to be doing business merely because it owned a limited partnership interest in a partnership that was doing business within the state.

Outside of these limited exceptions, the definition of "doing business" is very broad. Also, since the language of R&TC § 23101 refers to "any" transaction, it is not necessary that the corporation conducts business or engages in transactions within the state on a regular basis. An isolated transaction during the year may be enough to cause the corporation to be doing business (see *Carson Estate Co. v. McColgan*, 21 Cal.2d. 516). Even negotiations that are an integral part of entering into a transaction may be considered to be doing business (*Appeal of Ebee Corp., Taxpayer, and Bacciocco, Assumer and/or Transferee*, 74-SBE-002, February 19, 1974).

There have been several Court and SBE decisions dealing with activities that will constitute doing business, and when a commencing or liquidating corporation will be considered to be doing business. Many of these cases are listed in the annotations under R&TC § 23101. If you come across these issues, consult those cases as well as the regulations under R&TC § 23101.

For more information on doing business, refer to the FTBNet webpage.
((*********************************))

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

1400 CORPORATION INCOME TAX

Under Chapter 3 of the Bank and Corporation Tax Law, an income tax is imposed on all corporations which, while not "doing business" in California, do "derive income from sources within this state." (R&TC § 23501.) "Income derived from or attributable to sources within this State" is defined in R&TC § 23040 to include income from tangible or intangible property located or having a situs in California, and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate, or foreign country commerce.

For taxable years beginning on or after January 1, 1993, R&TC § 23040.1 provides an exception to the general definition of "income derived from or attributable to sources within this state" for a partner's distributive share from an investment partnership of interest, dividends, and gains from the sale or exchange of investment securities. This exception will not apply if the partner or any of its unitary affiliates or partnerships has any income derived from or attributable sources within the state other than qualified investment partnership income. Furthermore, the exception will not apply if the partner or any of its unitary affiliates or partnerships participates in the management of the investment activities of the investment partnership. Additional requirements and definitions regarding this exception are contained in R&TC § 23040.1. For additional information see FTB Publication 1063.

In most cases, a corporation with sufficient activities to have nexus within the state will also be considered to be "doing business" within the state, so the franchise tax will be applied. Some examples of when the income tax under Chapter 3 would be applicable are:

- When the income from sources within California is derived entirely from passive investments. Even then, the taxpayer will probably be considered to be "doing business" in the years in which they negotiate or enter into transactions to acquire or dispose of the investments.
- CCR § 23040(b) provides that a foreign (non-California) corporation will be subject to the income tax rather than the franchise tax if its activities within the state are exclusively in interstate or foreign country commerce. For example, a foreign (non-California) corporation will be subject to the income tax if it ships goods from outside the state to fill orders taken by its employees in California (assuming that the corporation is not immune under Public Law 86-272). See MATM 1210. Foreign (non-California) corporations will also be subject to the income tax if they maintain inventories of goods within the state for the exclusive purpose of filling orders taken by independent dealers or brokers. On the other hand, if a foreign (non-California) corporation maintains an inventory in California for purposes of filling orders taken by employees, then the corporation is considered to be engaged in intrastate business within California, and is therefore subject to the franchise tax.
- If a corporation's only connections with this state are as a limited partner in a partnership that is doing business within the state, then that corporation will be subject to the income tax rather than the franchise tax (MATM 1310).

Both the franchise and income taxes are subject to the allocation and apportionment provisions of California law. The primary differences between the two taxes are that:

- Corporations subject to the income tax do not have a minimum tax if they are not incorporated or qualified within the state. (If a taxpayer is incorporated or qualified within California however, it will be subject to the minimum franchise tax as well as the income tax. In such cases, R&TC §23503 allows the minimum franchise tax to be offset against the income tax.)
- U.S. government income is exempt from income tax. Since the franchise tax is not a tax on net income, but is only measured by income, U.S. government income may be included in the tax base for the franchise tax. See MATM 6065.

1500 COMMERCIAL DOMICILE

Certain items of nonbusiness income from intangibles, such as interest and dividend income, are allocated to the state in which the corporation's commercial domicile is located. The commercial domicile of a corporation is defined in R&TC § 25120(b) to mean the principal place from which the trade or business of the taxpayer is directed or managed (also see CCR § 23040(a)). The commercial domicile may be distinguished from the legal domicile, which is merely the state of incorporation.

In most cases, a corporation's commercial domicile is the location of the headquarters or principal offices. In some situations, it will not be as easy to identify where the actual control of the corporation took place. Analyze the facts and circumstances. The SBE pointed out some of the relevant factors to consider in the following decision:

In *Appeal of Norton Simon, Inc*., 72-SBE-008, March 28, 1972, the taxpayer had formerly been engaged in the manufacture of plywood in Washington. Although it had sold most of its plywood operations by the appeal years, the taxpayer still held some interests and rights related to those operations and oversaw the management of those rights. The taxpayer's only office was in Washington. The taxpayer also had a large investment portfolio that was managed by an executive committee of the Board of Directors in California. Because of the magnitude of its investment activity in relation to its remaining plywood-related activity, the Securities and Exchange Commission required the taxpayer to register as an investment company. Although the certificates evidencing the taxpayer's investments had originally been kept in a safe-deposit box in California, the executive committee transferred the certificates to Washington in order to avoid becoming subject to California tax.

The taxpayer argued that its commercial domicile was in Washington for the following reasons:

Its officers and employees were Washington residents;

- Its books and records were located in Washington
- Most of its intangible assets were located in Washington
- Its stockholders met in Washington
- It filed its federal returns in Washington
- It owned timber rights and security interests in property in that state

The SBE acknowledged that the facts relied upon by the taxpayer are often mentioned in case law as tending to establish a commercial domicile, but the SBE went on to state that those facts were not decisive in this particular case. During the appeal years, the taxpayer's entire income was from its investment activities, and the executive committee in California managed those activities. Although the executive committee met only once in a two-year period, it was responsible for the day-to-day investment decisions on an informal basis. Stating that the "essence of the concept of commercial domicile is that it is the place where the corporate management functions, the place where real control exists with respect to the business activities," the SBE held that the real control of the business had shifted to California when the plywood operations were sold.

In *Appeal of Vinnell Corporation (VIC),* 78-SBE-030, May 4, 1978, VIC was incorporated in Panama, and was engaged in construction contracting in several foreign countries. None of its contracting activities were performed in California. Management of the business was conducted through regional offices located overseas. The dominant figure in VIC's management was a California resident, but he exercised his duties as president during his constant travels to the regional offices. All of VIC's directors and 11 of its 16 officers were California residents, and they met periodically in California to review and approve (after the fact) the management decisions made by the overseas officers. VIC also maintained a California bank account for receiving the ultimate profit from the foreign construction work, and maintained a general ledger here. The FTB took the position that although VIC did no business in California, it maintained sufficient contacts in California for this state to be considered the commercial domicile.

The SBE disagreed, pointing out that it is the location of actual control that is important, not the location of ultimate control. The evidence in the case indicated that all of VIC's business activities were controlled regionally, and there was no documentation to support a center of active operational control. With respect to the board of directors meetings within the state, the SBE stated that passive acquiescence, after the fact, is not the active management and control required to establish a commercial domicile

1600 RELEVAN LAW SECTIONS

R&TC § 25101 – Basis of Allocation

R&TC § 25101 provides that when the net income of a taxpayer is derived from or attributable to sources both within and without the state, the tax shall be measured by the net income derived from sources within the state. This section authorizes the determination of California income by reference to the combined income of a group of unitary corporations (*Edison California Stores v. McColgan*, 30 Cal.2d 472; this case involved section 10 of the Bank and Corporation Franchise Tax Act, the predecessor to R&TC § 25101). Also, the California Supreme Court has stated that the language in this section requires the use of formula apportionment when the business activities are conducted both within and outside the state (*Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, 386 Pac.2d 33). See MATM 3005.

R&TC § 25105 – Determination of ownership of control

This section provides the ownership requirements for inclusion in a combined report. The ownership requirements changed significantly for taxable years beginning January 1, 1995. See MATM 3050.

R&TC § 25106 – Income from intercompany dividend distribution

This section provides that dividends paid from one corporation to another shall be eliminated to the extent that those dividends are paid out of combined unitary business income. This section was enacted to prevent income from being taxed more than once as it flowed up through the combined group. See MATM 6032.

At the time that this section was enacted, two cases involving intercompany dividends were being litigated (*Safeway Stores*, 3 Cal.3d 745 (1970); *Pacific Telephone Co. v. Franchise Tax Board*, 7 Cal.3d 544). Because of these cases the last paragraph of R&TC §25106 was included to indicate that no inference in any pending litigation cases was intended to be drawn from enactment of that section.

R&TC § 25108 – Net operating loss

This section provides the rules for applying the net operating loss provisions to taxpayers filing a combined report or taxpayers with income derived from sources within and outside the state. See MATM 8000.

R&TC § 25120 – Definitions

R&TC § 25120 contains definitions for terms that are used in the UDITPA §§ 25120 - 25139.

R&TC §§ 25121 -25122 – When allocation and apportionment applies

The general rule in R&TC § 25101 provides that the apportionment and allocation provisions apply to corporations with net income derived from or attributable to sources within this state. R&TC § 25121 restricts this rule somewhat by requiring that income be taxable outside California before the apportionment provisions will apply. R&TC §25122 explains when a taxpayer will be considered to be taxable in another state. See MATM 1200.

R&TC §§ 25123 – 25127 – Allocation of nonbusiness income

These sections provide the rules for allocation of nonbusiness income. See MATM 4000.

R&TC §§ 25128 -25136 – Apportionment formula

R&TC § 25128 sets forth the apportionment formula, and R&TC §§ 25129 - 25136 provide the rules for determining the property, payroll and sales factors. See MATM 7000.

R&TC § 25137 – Equitable adjustment of standard allocation or apportionment

In cases where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state, this section permits the taxpayer to petition the Franchise Tax Board for the use of separate accounting, the exclusion or inclusion of one or more factors, or the use of any other method that will more equitably allocate and apportion the taxpayer's income. This section also provides authority for the FTB to require such a deviation from the standard formula. The Regulations under this section provide special formulas that have been developed to apportion income for certain industries. See MATM 7700.

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