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7500 SALES FACTOR

The purpose of the sales factor is to reflect market sales to the state where those sales are made.

The sales factor is a fraction, the numerator of which is the total sales in this state during the taxable year and the denominator of which is the total sales everywhere during the taxable year (R&TC §25134).

For purposes of the sales factor of the apportionment formula, the term "sales" has been defined as all gross receipts derived by the taxpayer from transactions and activity in the regular course of the taxpayer's trade or business. Business income is generally included in the apportionment formula; non-business income is not.

CCR §25134 provides guidelines for what is included in sales for purposes of the sales factor. The following areas are covered in this manual. Please see the corresponding code sections for more detail.

7505 RECONCILIATION OF SALES FACTOR

If the entities included in the combined group are the same as those in the annual report or SEC 10-K, those reports may be an excellent resource for testing the sales factor denominator. If the reporting group is different, then the by-company detail in the workpapers to the financial statements can be used to piece together the sales for the combined group, although adjustments may have to be made to take into account consolidating adjustments for intercompany sales. You will need to request the consolidating working papers from the taxpayer.

Although the Federal consolidated Form 1120 may be used to test the sales of domestic entities, it will not contain sales of foreign entities or of unitary affiliates that are owned less than 80 percent. When sales are compiled from separate Forms 1120 or from Forms 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations), be aware of the fact that intercompany eliminations will not have been made. Although the Form 5471 contains a section for listing intercompany sales, it may not always be reliable.

By comparing the gross receipts from the financial statements to the denominator of the sales factor per Schedule R, you should be able to identify whether intercompany eliminations have been made, and whether the sales factor includes any types of sales other than trade receipts. Any significant differences between the financial statement sales and those reported in the sales factor should be flagged for examination.

For small privately held corporations that do not have audited financial statements, you can make the reconciliation directly to the taxpayer's trial balance and/or sales records.

If there are any unitary partnerships, remember that a share of the partnership receipts should be reflected in the reconciliation. The partnership receipts may be reconciled against the partnership financial statements or tax return. See MATM 7516.5 for further information regarding partnership sales.

While reconciling the sales factor, be alert for any unitary implications that may affect other areas of your examination. For example, substantial intercompany sales that are being eliminated for book purposes between the taxpayer and an affiliate designated as nonunitary may be noticed during a reconciliation of sales from the consolidating workpapers. This should alert you to the possibility that a unitary relationship may exist between those companies.

7510 DEFINITION OF SALES

Depending on the years in your audit cycle, you need to consider the definition of "sales" in computing the sales factor.

- **TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 2011**

R&TC section 25120(e):

> For taxable years beginning before January 1, 2011, "sales" means all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive.

R&TC sections 25123 through 25127 provide rules for the allocation of various items of nonbusiness income, which is defined as all income other than business income (R&TC §25120(d)).

The term "sales" includes all gross receipts giving rise to business income. This definition expands the meaning of sales beyond merely trade revenues, and includes receipts from the sale of business assets, rental income, commissions, interest, and other types of receipts generated by the business. Receipts from non-recognition transactions, such as like-kind exchanges, IRC section 351 transfers, and reorganizations generally should not be considered in the sales factor.

Per CCR section 25134(a)(1), for purposes of the sales factor of the apportionment factor, "sales" means all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business**.** See CCR section 25134 for the rules for determining "sales" in various situations.

The numerator of the sales factor includes gross receipts attributable to California and derived by the taxpayer from transactions and activities in the regular course of its trade or business. Interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts are included (CCR §25134(c)).

The treatment of various types of receipts in the factor is discussed in detail in the following sections.

CCR §25134(a)(2) places some parameters on the broad inclusion of all gross receipts in the factor by providing that receipts may be disregarded in some cases in order for the apportionment formula to operate fairly. Special rules for these exceptions are contained in CCR §25137(c), see MATM 7511

- **TAXABLE YEARS BEGINNING ON OR AFTER JANUARY 1, 2011**

R&TC §25120(f):

For taxable years beginning on or after January 1, 2011:

(1) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive.

(2) “Gross receipts” means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code, as applicable for purposes of this part. Amounts realized on the sale or exchange of

property shall not be reduced by the costs of goods sold or the basis of property sold.

R&TC §25120(f)(2) lists items that must not be included in gross receipts, even though they may generate business income. Those items are:

- Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument (R&TC §25120(f)(2)(A)).

- The principal amount received under a repurchase agreement or other transaction properly characterized as a loan (R&TC §25120(f)(2)(B)).

- Proceeds from the issuance of the taxpayer's own stock or from sale of treasury stock (R&TC §25120(f)(2)(C)).

- Damages and other amounts received as the result of litigation (R&TC §25120(f)(2)(D)).

- Property acquired by an agent on behalf of another (R&TC §25120(f)(2)(E)).

- Tax refunds and other tax benefit recoveries (R&TC §25120(f)(2)(F)).

- Pension reversions (R&TC §25120(f)(2)(G)).

- Contributions to capital (except for sale of securities by securities dealers) (R&TC §25120(f)(2)(H)).

- Income from discharge of indebtedness (R&TC §25120(f)(2)(I)).

- Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code (R&TC §25120(f)(2)(J)).

- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of those intangible assets (R&TC §25120(f)(2)(K)).

- Amounts received from hedging transactions involving intangible assets (R&TC §25120(f)(2)(L)).

7511 DISREGARDED SALES

R&TC §25137 provides that different allocation and apportionment methods may be used in some cases where the standard apportionment provisions will not fairly represent the taxpayer's business activities within the state.

CCR §25134(a)(2), provides that in some cases certain gross receipts should be disregarded in order that the apportionment formula will operate fairly to this state and those receipts should be excluded under CCR §25137(c).

Special rules for the sales factor provide that gross receipts can be disregarded in certain situations, including the following:

- Substantial Receipts from an Occasional Sale (See MATM 7511.1).

- Insubstantial Receipts from an Incidental or Occasional Activity (See MATM 7511.2).

- Unassignable Income From Intangible Property (See MATM 7511.3).

- Effective for tax years beginning on or after January 1, 2007, interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business as well as the gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of such intangible assets (CCR § 25137(c)(1)(D)).Also see MATM 7514.1 (Dividend Income) and 7514.2 (Interest Income).

- Intercompany Receipts between members of a combined reporting group are eliminated from the sales factor (See MATM 7511.4 and MATM 5260).

For taxable years beginning on or after January 1, 2011, R&TC §25120(f)(2) provides that "gross receipts," even if business income, shall not include certain items such as:

- Income from discharge of indebtedness
- Amounts received from hedging transactions
- Treasury function transactions (including overall net gains)`

See R&TC section 25120(f)(2) or MATM 7510 for a complete list of excluded items.

7511.1 Substantial Receipts from Occasional Sale

CCR section 25137 allows for an exclusion of gross receipts from the sales factor of the apportionment formula, without a further showing of distortion, in the case “where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer’s trade or business” (CCR §25137(c)(1)(A)). The regulation provides the following example:

> "[G]ross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial."

- A sale is “substantial” if its exclusion results in a 5 percent or greater decrease in the taxpayer's or combined reporting group's sales factor denominator [CCR §25137(c)(1)(A)1]; and

- A sale is “occasional” if the transaction is outside of the taxpayer's normal course of business and occurs infrequently (CCR §25137(c)(1)(A)2).

In the *Appeal of Fluor Corporation,* 95-SBE-016, December 12, 1995, the SBE held that if a relevant special formula is provided for in the 25137 regulations and the conditions and circumstances delineated are satisfied, then the regulation applies and no further showing of distortion is required in order to exclude the receipts from the sales factor. On the other hand, if either the taxpayer or the FTB objects to the exclusion of the receipts from the factor, then that party bears the burden of proof for establishing that application of the regulation does not fairly represent the extent of the taxpayer's activities in the state. The *Fluor* decision overrules the earlier decision in *Appeal of Triangle Publications*, *Inc*., 84-SBE-086, June 27, 1984, wherein the SBE had held that distortion must be proven before the regulation could be applied. For further discussion of CCR §25137 and deviations from the standard apportionment formula, see MATM 7701.

The presence of substantial gross receipts can usually be identified rather easily. The gain and loss schedule (Schedule D) will reveal large sales of business assets. Large dispositions of business assets are also usually disclosed in the annual reports, SEC 10-Ks and the notes to the financial statements. The reconciliation of the denominator of the sales factor (MATM 7505) will identify whether the taxpayer has included receipts other than trade revenues in the sales factor, and the taxpayer's apportionment work papers will provide detail as to what items have been included in the factor.

Once substantial receipts have been identified, the nature of the taxpayer's business may give you an indication of whether the receipts are from an incidental or occasional sale as contemplated by the regulation. For example, if a large retail grocery chain owns its own fleet of wholesale delivery trucks and replaces them pursuant to a regular replacement program, then the dispositions are a regular and routine part of the business activity and are not eligible for exclusion under CCR §25137(c)(1)(A) even if the amounts are substantial. On the other hand, suppose that the grocery chain decided to sharply cut back its trucking activities by making a large one-time reduction in its fleet. Since this would be an incidental or occasional transaction, it is the type of sale contemplated by the CCR section so long as it is "substantial" relative to the taxpayer's other activities.

It is important to remember that in order for CCR §25137(c)(1)(A) to apply, the receipt in question must not only be substantial, it must also be from an occasional sale**.** Not all receipts meet both criteria. For example, a disposition of business assets may qualify as an occasional transaction. However, the receipt may not be substantial. Alternatively, the taxpayer may have substantial receipts from a transaction, which do not meet the occasional transaction test. The receipt must meet both criteria before it can be excluded from the computation of the sales factor.

7511.2 Insubstantial Receipts from Incidental or Occasional Activities

CCR §25137(c)(1)(B) states that insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor so long as such exclusion does not materially affect the amount of income apportioned to California. By way of example, the regulation states that gross receipts from the sale of office furniture, business automobiles, etc., may be included or excluded from the sales factor at the taxpayer's option if the receipts are insubstantial and are the result of incidental or occasional transactions. The purpose for this provision is to ease the compliance burden on taxpayers by not requiring them to keep track of minor miscellaneous receipts for sales factor purposes.

The taxpayer should be consistent in its treatment of such receipts from year to year. However, the exclusion of insubstantial receipts from the sales factor is at the taxpayer's option. You may not use CCR §25137(c)(1)(B) to remove receipts which the taxpayer has included in the sales factor.

The main issue with respect to insubstantial receipts is one of materiality. In order for the taxpayer to exclude receipts from the sales factor under this test, the inclusion of the receipts must not materially affect net income apportioned to this state. There are no bright line tests for determining materiality. Exclusion of incidental receipts of $50,000 to a taxpayer with trade revenues of $500,000 may be substantial and will probably require further analysis. That same $50,000 in incidental receipts to a taxpayer with trade revenues of $50,000,000 is certainly immaterial and should be left to the option of the taxpayer whether to include or exclude. Situations that are not as readily determinable as those described above will require your good judgment. By calculating apportioned net income with and without the incidental receipts, the potential tax change can be determined. If the taxpayer has been consistent in its treatment of these gross receipts and the potential tax change is not material, the taxpayer's method should not be adjusted.

If the test check turns out to be material and the receipts are not excludable under any other provisions of the law and regulations, then they should be included in the computation of the sales factor.

7511.3 Unassignable Income from Intangible Property

Receipts from transactions involving intangible property are assigned to the numerator of the sales factor if the income producing activity is in this state. Receipts from transactions involving intangible property are also assigned to the numerator of the sales factor if the income producing activity is both in and outside the state and the greater proportion of the income producing activity is performed in this state, based on costs of performance (see MATM 7514). Where business income from intangible property cannot be attributed to any particular income producing activity of the taxpayer, the receipts cannot be assigned to the numerator of any state and shall also be excluded from the denominator of the sales factor (CCR §25137(c)(1)(C)).

CCR §25136(b) defines the term "income producing activity" to mean the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income.

For Taxable years beginning before December 31, 2007, such activity does not include transactions and activities performed on behalf of a taxpayer, such as activities conducted by an independent contractor**.**

For Taxable years beginning on or after January 1, 2008, such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor**.** As explained in FTB Legal Ruling 2006-02, income-producing activities include activities performed by other members of the combined report as long as the activities are directly related to the generation of the income. Acts of agents also are attributed to the principal in determining the location of the income producing activity. The regulation specifically states that the mere holding of intangible personal property is not, of itself, an income producing activity.

As set forth in CCR §25137(c)(1)(C), if the income results from the mere holding of the intangible asset, such as stock, patents or bonds, and there is no readily identifiable income producing activity, then the receipts are excluded from the factor.

If the taxpayer's receipts from intangible property are material to the factor, you should determine whether an income producing activity exists for each item of income. This determination cannot usually be made based solely upon the type of income. For example, if the taxpayer earns interest and dividend income from investments of excess cash that are managed by an unrelated investment firm, no income producing activity is engaged in by the taxpayer with respect to that income. On the other hand, if the taxpayer maintains an investment department staffed by employees whose function is to manage the investments, then those employees are performing an income-producing activity traceable to their work location.

Material sales of stock should be excluded from the sales factor if the location of the income producing activity cannot be determined, or if it is a substantial, occasional sale as discussed in MATM 7512.

For apportioning trades or business that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or business for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign receipts from sales of intangibles using the market assignment and not income producing activity/cost of performance. Therefore, income from intangible property cannot be excluded under CCR § 25137(c)(1)(C).

7511.4 Intercompany Receipts

Intercompany revenues between members of a combined reporting group are eliminated from the sales factor. This avoids duplication and prevents manipulation of the factor. For example, if Corporation A sells goods to Corporation B at $90 and Corporation B resells the same goods to outsiders at $100, only the $100 is included in the sales factor; the $90 is eliminated as an intercompany sale. See MATM 5260 for additional discussion of intercompany transactions.

The statute does not specifically provide for the elimination of intercompany revenues. However, in *Chase Brass & Copper Co., Inc. v. Franchise Tax Board* (1977) 70 Cal.App.3d 457 [138 Cal.Rptr. 901], the California Court of Appeal affirmed FTB's exclusion of sales between members of the unitary group. The court reasoned that while gross income is used to compute the sales factor, only net income is subject to the franchise tax. Since no net income is produced by the intercompany sales, there is no reason to represent those sales in the sales factor.

R&TC 25106.5 subsequently authorized the FTB to adopt regulations necessary to ensure that the tax liability or net income of any taxpayer whose income is derived from or attributable to sources within this state which is required to be determined by a combined report is properly reported, determined, computed, assessed, collected or adjusted. CCR §25106.5-1 addresses intercompany transactions and generally adopted the 1995 federal regulations reflected in Treasury Regulation §1.1502-13 (as modified through March 17, 1997) and is effective for intercompany transactions occurring on or after January 1, 2001.

Only intercompany revenues within the combined unitary business are eliminated. Sales from a unitary business activity to a nonbusiness activity are not eliminated. Similarly, sales between two nonunitary divisions of a corporation are not eliminated. In a water's-edge group, sales to an excluded foreign corporation are not eliminated even though the entities might be unitary. See CCR §25106.5-1(j) for the rules for partially included water's-edge corporations.

The following are some common types of intercompany revenues that are eliminated:

- Sales
- Dividends
- Services fees
- Rents
- Management fees
- Royalties
- Interest
- Administrative fees

The eliminating adjustments in the workpapers to the consolidated financial statements should identify intercompany items. The chart of accounts may also reveal accounts that are reserved for intercompany revenues.

Although some intercompany elimination may be made on the federal return, intercompany revenue from "period expenses" may not be identified for federal tax purposes. Period expenses are items for which the seller/service provider recognizes income in the same period as the buyer/service recipient deducts a corresponding expense. An example of a period expense would be intercompany rents, which are generally reported as income by the lessor in the same period as the related lessee deducts the rent expense. Since the income and expense are awash in the consolidated return, they are not eliminated for federal tax purposes. See CCR §25106.5-1 for guidance on intercompany transactions.

While reviewing the consolidating workpapers for evidence of intercompany sales, you should be alert for significant intercompany activity with affiliates that have not been included in the combined report. Such activity can be an indication of a unitary relationship.

7512 NUMERATOR ASSIGNMENT – TANGIBLE PERSONAL PROPERTY

The first step in assigning sales of tangible personal property to the numerator of the sales factor is to identify the state to which the property was delivered or shipped. Once this has been identified, the next question is to determine the taxpayer's taxability in that state. To answer this question, you must determine whether the taxpayer has sufficient nexus with the destination state that would support having that state tax the seller. For a discussion of what is necessary to establish nexus or loss of immunity under P.L. 86-272, see MATM 1100 – MATM 1240.

The Department's position of what constitutes a California sale has changed over the years. This is the direct result of amendments to the Code and several court decisions involving the definition of "taxpayer."

Only sales of tangible personal property are covered in this section. These rules do not apply to sales of real property, services, or intangibles. See MATM 7513, 7514, 7515 for the rules for these types of sales.

Background

For many years, the *Appeal of Joyce, Inc*., 66-SBE-070, November 23, 1966, provided guidance for the allocation and apportionment of franchise taxes in California. Under *Joyce*, we look to each corporation separately to determine if it is taxable for franchise or income tax purposes and apportionment purposes. We do not make this determination for the combined group as a whole. Under *Joyce*, "taxpayer" as used in R&TC §25135(a)(2)(B), refers to the individual corporation selling the product.

In the *Appeal of Finnigan Corporation*, 88-SBE-022A, August 25, 1988, the State Board of Equalization(SBE) ruled the word "taxpayer," as used in R&TC §25135(a)(2)(b), means "all of the corporations within the unitary group." The SBE held that when sales are shipped from California to another state by a member of a unitary group, the throwback rule does not apply if any of the corporations within the unitary group is taxable in the other state. If no member of the combined reporting group is taxable in the state to which goods are delivered or shipped, then the sales are assigned to the state *from* which the goods were shipped (MATM 7512.4). On Petition for Rehearing, 88-SBE-022A, January 24, 1990, the SBE expressly overruled the apportionment rule announced in the *Appeal of Joyce.*

In the *Appeal of Huffy Corporation*, 99-SBE-005, April 22, 1999, the SBE reversed itself again, and ruled that the apportionment method announced in *Joyce* should be applied prospectively to taxable years beginning on or after April 22, 1999.

The *Finnigan* rules are again in effect for taxable years beginning on or after January 1, 2011. Legislation has resulted in changes to how corporations are taxed in California. One of the changes revises R&TC §25135 by adopting the *Finnigan* rule in assigning sales of personal property. (R&TC §25135(b).)

In summary, the two rules for determining the California destination and throwback sales are as follows:

The *Joyce* Rule	The *Finnigan* Rule

"Taxpayer" means only the entity making the sale, so the throwback rule applies only when the seller is not taxable in the destination state.	"Taxpayer" means the entire unitary group, so the throwback rule applies only when no member of the unitary group is taxable in the destination state.

Example

Corporation A and Corporation B are engaged in a unitary business. Corporation A is a Washington corporation and has no nexus in California, but it sells products into California. Corporation B is a California corporation.

Under *Joyce*, Corporation A's sales into California will not go into the California numerator, and will be thrown back to the shipping state. Under *Finningan*, Corporation A's sales into California will be included in the California numerator.

The applicability of the above rules by taxable year is provided in the table below:

Taxable Year	Rule applicable	MATM Section
1966- 1990	*Joyce*	7512.3
1990- 04/21/1999	*Finnigan*	7512.4
04/22/1999- 12/31/2010	*Joyce*	7512.3
01/01/2011 forward	*Finnigan*	7512.4

Depending on the taxable year, the meaning of "taxpayer" may change from *Joyce* to *Finnigan* and vise versa. In general, sales of tangible personal property are assigned to California and included in the numerator if:

- The product is delivered or shipped to a purchaser in this state (except sales to the U.S. Government (MATM 7516.2)) regardless of f.o.b. point or other conditions of sale; and the **taxpayer is taxable** in this state (destination); or

- The product is shipped from an office, store, warehouse, factory, or other place of storage in this state, and either one of the following applies:

    - The purchaser is the U.S. Government
    - The **taxpayer is not taxable** in the state where the goods are delivered or shipped (throwback).

The determination of whether a corporation is immune from taxation in a state is made on an entity-by-entity basis. Under *Finnigan*, sales are assigned to this state if any member of the combined reporting group is taxable in this state. This can result in situations where the sales factor numerator will contain sales attributable to a member that is not taxable in this state (such sales are often termed "reverse *Finnigan* sales"). In such cases, a special formula is required to apportion the California income among the taxable members of the combined reporting group. For more information on this issue, see MATM 7512.4 (Throwback sales) and Refer to Regulation 25106.5 for examples of the Finnigan computation.

Most taxpayers selling tangible personal property maintain sales records by destination since assignment on that basis is standard under UDITPA. Taxpayers also usually maintain sales by origin or from point of shipment. To ensure that these by-state records include all of the taxpayer's sales, the total for all states should be compared to the sales included in the denominator of the factor and any differences should be reconciled. In addition you should review the by-state sales records to verify that all sales on the list are assigned to a particular state. Sometimes, the by-state schedules contain amounts designated as "unassigned sales" or "sales to nontaxable states." If material amounts of sales are not specifically assigned, you should determine whether any portion of those sales are attributable to California. Specific steps for auditing the various numerator issues are discussed in detail in the following sections.

7512.1 Tangible Personal Property Defined

There is no statutory or regulatory definition of tangible personal property. Black's Law Dictionary (9th edition, 2009) defines the term to encompass "personal property that can be seen, weighed, measured, felt or touched or is in any other way perceptible to the senses."For assets such as computer software, the distinction between tangible and intangible property can become blurred. See MATM 7152 for a discussion of this issue.

Occasionally, taxpayers will argue that a transaction is something other than a sale of tangible personal property in order to avoid the rules found in R&TC §25135. The following cases illustrate the importance of gaining an understanding of the taxpayer's activities and how its sales are structured and reported.

In *Appeal of Babcock and Wilcox Co*., 78-SBE-001, January 11, 1978, the taxpayer fabricated subunits for large steam generating systems in another state, and assembled the systems at the purchaser's location in California. Completed systems might cover an area as large as a city block. In addition to the fabrication, performance of the contracts for completed systems required many service functions such as planning, drafting, engineering, installation and testing. The taxpayer's position was that since performance of the contract involved so many elements, the transaction must be something other than the sale of tangible personal property. Therefore, the taxpayer argued that the sale should be assigned to the other state where the greater proportion of the income-producing activities was performed. The SBE did not agree with the taxpayer, stating:
"It is hard to imagine any manufactured product which, to a greater or lesser degree, does not involve many elements such as planning, design and engineering in its production. Nevertheless, the existence of such fact does not prevent the finished product from being classified as tangible personal property."

By looking to statutes including the California Civil Code and the Revenue and Taxation Code and cases, the SBE confirmed that the property was correctly classified as tangible personal property assignable to California as the state to which it was delivered or shipped.

On the other hand, in *Appeal of Mark IV Metal Products, Inc*., 82-SBE-181, August 17, 1982, the California-based taxpayer attempted to use the destination rule to assign revenue outside of California. The taxpayer manufactured tables and chairs from metal. A principal customer was a Texas company, which shipped unfinished steel to the taxpayer in California for fabrication into seat parts. The finished parts were then shipped by common carrier back to the Texas company. The taxpayer never held title to the metal or the metal products. By taking the position that the transactions were sales of tangible personal property, the taxpayer sought to have the sales assigned to Texas, the state to which the property was delivered or shipped. The SBE disagreed, holding that the sales were sales of services, not sales of tangible personal property. Since sales of services are assigned to the state where the income producing activity was performed, the SBE concluded that the sales were includable in the numerator of the sales factor.

In *Appeal of Dart Container Corporation of California*, 92-SBE-021, July 30, 1992, the taxpayer attempted to treat a portion of the sales price of its products as royalties assignable to the state where the income producing activity was performed. Sales orders were submitted to the parent, who then purchased the products from its manufacturing subsidiary nearest the customer, and resold them to the customer. The selling subsidiary drop-shipped the product to the customer. The parent paid the subsidiary a percentage of the selling price (76.5% - 88%) and was liable for all expenses associated with the sale. The taxpayer characterized the amount of the sales price retained by the parent as reimbursement for the costs connected with the sale, and the remainder as a royalty payment from the subsidiary for the use of the parent's technology. The taxpayer attempted to assign the portion of the selling price, which represented the royalties to the state in which the technology was developed.

The SBE did not allow the taxpayer's treatment, finding that there was no separate sale of an intangible item. Since tangible personal property was sold for a single price, the entire amount of the sales price constituted gross receipts from the sale of tangible personal property subject to the destination rule.

7512.2 Delivered or Shipped Defined

As discussed in MATM 7520, R&TC §25135 provides that sales of tangible personal property are assigned to California if:

- The *property is delivered or shipped* to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or
- The property *is shipped* from an office, store, warehouse, factory or other place of storage within this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

To properly assign sales under R&TC §25135, the determination of where goods are considered to have been delivered or shipped is often a key issue.

In *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal.App.4th 1789, the taxpayer manufactured aircraft at a facility in California. The taxpayer's customers took physical possession of the aircraft in California, and then flew the aircraft to the state or country where the aircraft was to be used. The taxpayer took the position that R&TC §25135(a) (renumbered to section 25135(a)(1), effective February 20, 2009) would assign sales to California only if there was a "purchaser . . . within this state." Since the aircraft was destined for use outside California, the taxpayer argued that the purchaser was not "within this state."

FTB argued that the statute should be read to include the sales if the property was "delivered . . . to a purchaser within this state," regardless of the ultimate destination of the goods.

Pointing out that the objective of the sales factor is to recognize the contribution of the consumer states to the production of income, the court held that the statute requires that there be a purchaser within this state, and that the purchaser is not "within this state" if the goods are destined for use outside this state.

Following the issuance of this decision, FTB withdrew its Legal Ruling 348 and issued Legal Ruling 95-3, providing examples of how the *McDonnell Douglas* decision would be applied.

Appeal of Mazda Motors of America (Central), Inc., 94-SBE-009, November 29, 1994 was decided by the SBE shortly after the *McDonnell Douglas* decision. In *Mazda Motors*, the taxpayer imported vehicles and parts from Japan for sale in the United States. The vehicles and parts entered the U.S. through two ports of entry in California, and some vehicles were placed in storage facilities maintained by the taxpayer while awaiting further shipment to their ultimate destination. According to an agreement between the taxpayer and its Gulf coast distributor, vehicles were deemed delivered to the distributor at the port of entry at 5:00 p.m. of the first day on which customs clearance was obtained. Title and risk of loss passed to the distributor upon such delivery, and the distributor was responsible for all taxes arising after that time. Pursuant to the distributor's directions, the taxpayer stored, assembled, installed accessories, repaired and serviced vehicles at the port of entry. The distributor would then direct the taxpayer where and to whom to ship the vehicles and the taxpayer would arrange for the transportation at the distributor's cost. The taxpayer charged the distributor for all of these services.

The taxpayer argued that since the distributor did not take possession and control of the vehicles in California, delivery did not occur in this state. The SBE disagreed, stating that the taxpayer's own contracts clearly specified that delivery to the distributor occurred in California. Although the distributor did not take physical control over the vehicles, it exercised sufficient control to manifest an ownership interest. The activities of the distributor in directing the taxpayer as to the type of accessories to install "are indicative of something much more substantive than mere temporary storage in California for purposes of further shipment elsewhere in the stream of interstate commerce." The SBE found that those activities distinguished this case from a *McDonnell Douglas*-type situation where the out-of-state purchaser merely picked up the goods in this state.

To reflect the holdings in these decisions, the department takes the position that a purchaser's receipt of goods within California for the mere purpose of immediate transportation to another state is not adequate to meet the R&TC §25135 requirement of a purchaser "within" the state.

On the other hand, if goods are shipped to a physical location of a purchaser in California, or if a purchaser takes possession or constructive possession through an agent or bailee in this state for purposes such as warehousing, repackaging, or adding accessories, the property is "delivered . . . to a purchaser within the state" and the sale is a California sale. Any subsequent transportation of the goods to another state will not affect the California assignment of the sale.

Once the goods are delivered to the purchaser, the purchaser will have records to support the ultimate destination of the goods, but the seller will generally not have access to such records. It will be difficult for both you and the taxpayer to know whether a receipt by the purchaser is the ultimate destination or merely the first step in an interstate transportation of the goods. Therefore, it should be presumed that any goods taken into possession by the purchaser in California have been delivered or shipped to a purchaser within this state. This presumption may be rebutted if the taxpayer can demonstrate that the purchaser immediately transported the property to another state. You should be careful to consider the relevance and reliability of any evidence the taxpayer provides you to determine whether the taxpayer has met its burden of proof.

Conversely, sales delivered to a purchaser outside this state but immediately transported to a destination within this state with no warehousing, repackaging, addition of accessories, etc., in the other state are California sales so long as the seller is taxable in this state. Since the information needed to establish the ultimate destination of goods will generally be in the control of third parties, it will usually be difficult to identify and examine this issue. You should weigh the materiality of the issue against the resources that you will need to secure the necessary documentation.

Where goods are shipped from California, but the "taxpayer" or "seller" is not taxable in the state of the purchaser, the sales will be "thrown back" to California under the provisions of R&TC §25135 (a)(2)(B).

See MATM 7512, MATM 7526, and MATM 7512.3 or 7512.4 for a detailed discussion of the definition of taxpayer by income year.

CCR §25135 contains examples of when a sale is delivered or shipped to a purchaser within this state. The following examples illustrate the application of these rules in some additional situations:

Example 1

Corporation X is a part of a unitary group consisting of Corporation X, Corporation Y and Corporation Z. Corporation X manufactures machinery in California and sells it to a purchaser who has places of business in State A and State B. The purchaser picks up the machinery in California using its own trucks and transports the machinery to its own place of business in State A.

The machinery is considered to be shipped to the purchaser in State A.

Joyce Rule:
If the seller, Corporation X, has nexus in State A and is therefore taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California.

Finnigan Rule:

- If the seller, Corporation X, has nexus and is therefore taxable in State A, the sale is a State A sale.
- If the seller Corporation X has no nexus and is not taxable in State A, but another member of the unitary group, Corporation Y or Corporation Z, has nexus in State A and is therefore taxable in State A, then it is still considered a State A sale.

- If none of the unitary members have nexus and are therefore not taxable in State A, the sale is thrown back to California.

Example 2

Assume the same facts as in Example 1, but a few days after the machinery arrives at the purchaser's place of business in State A, the purchaser transports it to its place of business in State B.

Sales will generally be assigned to the first physical location of the purchaser. In this situation, the machinery is considered shipped to a purchaser in State A. The sale is considered terminated at that point, and the subsequent transportation to State B has no effect on the assignment of the sale.

Joyce Rule:
If the seller, Corporation X, has nexus and is taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California.

Finnigan Rule:
- If the seller, Corporation X, has nexus and is taxable in State A, the sale is a State A sale.
- If the seller Corporation X is not taxable in State A, but another member of the unitary group, Corporation Y or Corporation Z, has nexus and is taxable in State A, then it is still considered a State A sale.
- If none of the unitary members have nexus and are therefore not taxable in State A, the sale is thrown back to California.

Example 3

Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a common carrier in State A and arranges shipment to its place of business in State B.

The purchaser did not have possession in California or in State A for purposes other than in the process of shipment. The ultimate destination is therefore considered to be State B.

Joyce Rule:
If the seller Corporation X has nexus in State B and is therefore taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

Finnigan Rule:
- If the seller, Corporation X, has a nexus and is taxable in State B, the sale is a State B sale.
- If the seller Corporation X is not taxable in State B, but another member of the unitary group, Corporation Y or Corporation Z, has nexus and is taxable in State B, then it is still considered a State B sale.
- If none of the unitary members have nexus and are therefore not taxable in State B, the sale is thrown back to California.

Example 4

Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery directly to its own customer in State C.

The purchaser did not have possession in California for purposes other than in the process of shipment. The purchaser's customer will be considered the "purchaser" for purposes of R&TC §25135(a)(1).

Joyce Rule:
If the seller, Corporation X, has nexus and is taxable in State C, the sale is a State C sale. If not, the sale is thrown back to California.

Finnigan Rule:
If any of the members of the unitary group, Corporations X, Y and Z, has nexus and is taxable in State C, the sale is a State C sale. If not, the sale is thrown back to California

Example 5

A seller manufactures machinery in California. While the machinery is still stored at a location maintained by the seller, the seller transfers title to the machinery to the purchaser. The seller adds accessories to the machinery at the direction of the purchaser, and then places the machinery with a common carrier for transportation to State C.

Because title to the machinery passed to the purchaser in this state, and the purchaser took constructive possession of the property in this state for purposes other than in the process of shipment (as evidenced by the fact that the purchaser directed the seller to install accessories), the purchaser is considered to be "within this state" at the time possession was constructively delivered to the purchaser. In this case under both the *Joyce* and *Finnigan* Rules, this is a California sale.

Example 6

Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a location owned by a third party in State B. Under a separate contract, the third party adds accessories and repackages the machinery at the direction of the purchaser's customer. The goods are then transported to the purchaser's customer in State C.

Because the purchaser's customer has constructive possession of the machinery in State B under the *Mazda* holding, and because the machinery was not delivered or shipped to the purchaser in any state, the purchaser's customer is considered the purchaser for purposes of R&TC §25135(a)(1).

Joyce Rule:
If the seller Corporation X has nexus and is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

Finnigan Rule:
If any of the members of the unitary group, Corporations X, Y and Z, has nexus and is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California

Example 7

Corporation X is a part of a unitary group consisting of Corporation X, Corporation Y and Corporation Z. Corporation X manufactures machinery in State A. Corporation X ships an order from its State A warehouse to purchaser corporation's warehouse in California. Corporation X is protected under P.L. 86-272 in California. Corporation Z, a part of the unitary group, however, has a manufacturing plant in California.

Joyce Rule:
As seller Corporation X has no nexus and is not taxable in California, the sales will be thrown back to State A.

Finnigan Rule:

- Though the actual seller Corporation X does not have nexus in California, one of the members of its combined group, Corporation Z, has nexus here and is taxable in this state.
- The sales made by Corporation X are treated as California Sales and will be assigned to California.

Example 8 (Double throwback rule, MATM 7512.5).

Corporation X, which sells machinery, is unitary with Corporation Y and Corporation Z. Corporation X operates a sales department in California. A purchaser corporation contacts the California sales office of Corporation X and places an order. Corporation X directs an unaffiliated manufacturer in State A to ship the order to the purchaser corporation's warehouse in State B.

Joyce Rule:

- If Corporation X has nexus in both State A and State B, the sale would be assigned to State B, where the purchaser is located.
- If Corporation X only has nexus in State A and not in State B, then the sale will be assigned to State A.
- If Corporation X has no nexus in either State A or State B, then the sale will be assigned to California where Corporation X has its sales office.

Finnigan Rule:

- If Corporation X has nexus in both State A and State B, the sale would be assigned to State B, where the purchaser is located.
- If Corporation X only has nexus in State A (not in State B), but Corporation Z, a member of the unitary group has a nexus in State B, the purchaser's state, the sale will still be assigned to State B.
- Assume no member of the unitary group has nexus in State B and Corporation X does not have nexus in State A. However, Corporation Y, a member of the unitary group, has nexus in State A. The sale will be assigned to State A.
- If none of the members of the unitary group have nexus in State A or State B; the sale would be assigned to California where Corporation X has its sales office.

7512.3 Throwback Sales under the *Joyce Rule*

Effective for taxable Years from 11/23/1966-08/24/1988 and 04/22/1999-12/31/2010

Pursuant to R&TC §25135, under the *Joyce* Rule, sales of tangible personal property are assigned to California and included in the numerator if:

- The product is delivered or shipped to a purchaser in this state (except sales to the U.S. Government (MATM 7512.6) regardless of f.o.b. point or other conditions of sale; and the taxpayer is taxable in this state (the destination rule); or

- The product is shipped from an office, store, warehouse, factory, or other place of storage in this state and
    - The purchaser is the U.S. Government
    - The taxpayer is not taxable in the state where the goods are delivered or shipped (the throwback rule).

Under the destination rule goods that were shipped to a California destination from any point of origin were California sales if the taxpayer was taxable in this state. Under the throwback rule, goods shipped from California to another state were also considered California sales, if the taxpayer was not taxable in the other state.

In determining the above, the term "taxpayer" applies to each corporation separately, not the combined group as a whole. Also, as a result, if a member of the combined group was not taxable in California its destination sales to California would not be included in the apportionment factor as California sales. This is commonly known as the "*Joyce* Rule".

Verifying Destination Sales

Most taxpayers selling tangible personal property maintain sales records by destination since assignment on that basis is standard under UDITPA. Taxpayers also usually maintain sales by origin or from point of shipment. To ensure that these by-state records include all of the taxpayer's sales, the total for all states should be compared to the sales included in the denominator of the factor and any differences should be reconciled. When preparing this analysis for the *Joyce* rule, you will only include all California destination sales of the companies that are subject to tax in California and are California taxpayers.

In addition, you should review the by-state sales records to verify that all sales on the list are assigned to a particular state. Sometimes, the by-state schedules contain amounts designated as "unassigned sales" or "sales to nontaxable states." If material amounts of sales are not specifically assigned, determine whether any portion of the sales are attributable to California.

Verifying Throwback Sales

When examining the by-state records for property and payroll, you should be on the lookout for states in which the taxpayer does not have significant amounts of property or payroll. A throwback issue may exist if the by-state sales records reveal that the taxpayer makes sales to these states. To aid in identifying throwback issues, it may be helpful to construct a work paper schedule for each year similar to the following nexus chart:

Destination states for products with a CA shipping origin	Nexus Indicators:				
	Return filed	Inventory	Assets	Rented Property	Payroll
1.					
2.					
3.					
4.					
5.					

Positive nexus items for each listed state should be listed across the chart. Filed returns should only be listed if they indicate bona fide activity within the state (as opposed to mere qualifying returns reporting a minimum tax). If the chart indicates that nexus has been established by way of a filed return or by property or rented facilities within a state, that state may be eliminated as a throwback candidate. Sales to remaining states with no returns or property have throwback potential and should be examined further.

Keep in mind the existence of payroll may only indicate the existence of sales personnel and the taxpayer will need to prove their activities go beyond the solicitation of sales.

Once potential throwback sales are identified, you can question the taxpayer as to their proper classification and possibly the issue can be resolved without additional work. If the taxpayer maintains taxability in the destination state, the following steps should be taken:

If the taxpayer has filed a return and/or paid taxes to another state because of an audit adjustment in that state, and that state has an income or franchise tax, it is usually presumptive evidence that they are taxable in that state. If so, you should ask the taxpayer to produce copies of the other state return or other state audit adjustment. If a taxpayer voluntarily files and pays a tax, or pays a minimal fee for qualification, organization or for the privilege or doing business in the state, but does not actually engage in business activity within the state sufficient to establish nexus, then the taxpayer is not taxable in the state (CCR §25122(b)(1)).

The taxpayer may take the position that sales into the destination state are immune from taxation as provided by P.L. 86-272, but still file a franchise tax return and pay the minimum tax for various business reasons such as contract enforcement and ability to use that state's courts. In such circumstances, the department will not treat the taxpayer as taxable in the destination state as the minimum tax was paid for regulatory purposes and has no relation to the business activity in the state.

You should therefore scan the other state returns to gain additional assurance that taxability exists. Unless there is a material tax effect however, you should not spend a great deal of time on the issue if tax returns have been filed or tax has been paid pursuant to the other state's audit adjustment.

However, if the potential tax effect of a throwback sale is material, the fact that the taxpayer has filed a return in the destination state may not resolve the issue. A taxpayer may self-assess or agree with the other state's audit determination if the result in assigning the sale to the destination state results in a net reduction in tax. The definition of materiality for the purposes of throwback sales is a large difference in tax between the additional tax paid to the destination state and the California tax savings by not throwing the sale back to California. You should discuss this issue with your supervisor.

You may pursue factual development of the potential throwback sale issue, assuming the tax effect is material, even though a tax return has been filed in the destination state or agreed with the other state's audit adjustment. Audit adjustments may be proposed if the taxpayer does not have nexus in the destination state or is exempt under P.L. 86-272.

If a taxpayer has not filed returns or paid taxes in the destination state for the year at issue or the state does not impose any income or franchise tax, taxability in the destination state for the year in issue must be established by incontrovertible evidence that the taxpayer's activities within the state cause nexus under the U.S. Constitution and exceed the activities protected by P.L. 86-272. A complete discussion of nexus requirements and P.L. 86-272 may be found in MATM 1100 – MATM 1240.

If the taxpayer is able to provide evidence of business activity that establishes that the destination state has jurisdiction to subject the taxpayer to a net income tax irrespective of whether it decides to levy a tax or not, it is considered to be taxable within another state (CCR §25122 (a)). Under these circumstances the taxpayer does not have to throw back its sales to the state where the sales originate. However, as can be seen in the *Appeal of The Olga Company* below, the burden of proof rests on the taxpayer.

The *Appeal of The Olga Company*, 84-SBE-092, dated June 27, 1984, stated in part:

"Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86.272. We believe that this weighs heavily against appellant and that, in order to prevail, appellant must clearly establish that its activities within the foreign states go beyond mere solicitation."

An example of the application of the above rules:

CF Company is an interstate trucking company that operates and delivers in all states west of the Mississippi. It files a combined return with TM Company, a trailer manufacturer, whose operations are solely in California. TM sells trailers to CF and to other customers, and the two companies are unitary. TM ships trailers to a customer in Arizona.

Based on the *Joyce* rules in effect for these years, TM sales would be thrown back to California since TM is not taxable in Arizona

7512.4 Throwback Sales under the *Finnigan* Rule

Effective Taxable Years from 08/25/88 to 4/21/99 and 01/01/2011 Forward

Pursuant to R&TC §25135, under the *Finnigan* Rule, sales of tangible personal property are assigned to California and included in the numerator if:

- Any product that is delivered or shipped to a purchaser in this state by any member of the combined group (except sales to the U.S. Government (MATM 7512.6) regardless of f.o.b. point or other conditions of sale as long as one member of the group is taxable in this state (the destination rule); or
- The product is shipped from an office, store, warehouse, factory, or other place of storage in this state, and either one of the following applies:
    - The purchaser is the U.S. Government
    - No member of the unitary group is taxable in the other state where the goods are delivered or shipped (the throwback rule).

Under the destination rule goods that were shipped to a California destination from any point of origin are California sales if any member of the unitary group is taxable in this state. Under the throwback rule, goods shipped from California to another state are also considered California sales, if no member of the unitary group is taxable in the other state. The rules for whether a taxpayer is taxable in a state are set forth at R&TC and CCR § 25122.

In determining the above, the term "taxpayer" applies to the combined group as a whole. We do not look at each taxpayer separately. Also as a result, even if a member of the combined group is not taxable in California, its destination sales to California would be included in the apportionment factor as California sales.

Verifying Destination Sales

Most taxpayers selling tangible personal property maintain sales records by destination since assignment on that basis is standard under UDITPA. Taxpayers also usually maintain sales by origin or from point of shipment. To ensure that these by-state records include all of the taxpayer's sales, the total for all states should be compared to the sales included in the denominator of the factor and any differences should be reconciled. When preparing this analysis for the the Finnigan years, you will include all California destination sales of the unitary group, regardless of whether the selling entity is taxable in this state or not, so long as one member of the combined reporting group is taxable in this state

For example, Corp A, an out-of-state seller of tangible personal property whose activities in California are protected under P.L. 86-272, has $2,000,000 of sales from California customers. Corp B, a member of the same combined reporting group, provides warranty service to customers nationwide including in California. Corp B has $1,000,000 of California sales as this is where the benefit of its warranty service is received. Even if Corp A remains protected by P.L. 86-272, Corp A's $2,000,000 sales receipts are assigned to California for sales factor purposes and not thrown back to the state of origin for 2011 forward due to the operation of the Finnigan rule at RT&C § 25135(b). If protected by P.L. 86-272, Corp A would not be subject to income or franchise tax in this state, however its sales receipts would be included in the apportionment formula.

In addition, you should review the by-state sales records to verify that all sales on the list are assigned to a particular state. Sometimes, the by-state schedules contain amounts designated as "unassigned sales" or "sales to nontaxable states." If material amounts of sales are not specifically assigned, determine whether any portion of the sales are attributable to California.

Verifying Throwback Sales

Taxpayer may be taxable in the other state if any member of the unitary group is a seller of other than tangible personal property and it is considered doing business in the other state (i.e. economic nexus), see MATM 1100.

For example, Corp A, a seller of TPP ships goods from California to State A. Corp B, a member of the same combined reporting group, provides warranty service to customers nationwide including in State A. Corp B has $1,000,000 of warranty service in State A because that is where the benefit of service is received, therefore Corp B is taxable in

State A. Because Corp B, a member of the combined reporting group is taxable in State A, sales made by Corp A to State A is not subject to throwback in CA.

Taxpayer may be taxable in another state under CCR § 25122 if: 1) by reason of business activity in another state the taxpayer is subject to one of the types of taxes specified in Section 25122(a); namely: a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or 2) by reason of such business activity another state has jurisdiction to subject the taxpayer to a net income tax (exceed P.L. 86-272), regardless of whether the state imposes such a tax on the taxpayer. If no member of the unitary group is taxable in the other state, the sales receipts are considered California sales under the throwback rule.

When examining the by-state records for property and payroll, you should be on the lookout for states in which the unitary group does not have significant amounts of property or payroll. A throwback issue may exist if the by-state sales records reveal that the unitary group makes sales to these states. To aid in identifying throwback issues, it may be helpful to construct a work paper schedule for each year similar to the following nexus chart:

Destination states for products with a CA shipping origin	Nexus Indicators:				
	Return filed	Inventory	Assets	Rented Property	Payroll
1.					
2.					
3.					
4.					
5.					

Positive nexus items for each listed state should be listed across the chart. Filed returns should only be listed if they indicate bona fide activity within the state (as opposed to mere qualifying returns reporting a minimum tax). If the chart indicates that tax return has been filed or there is property/location or rented facilities within a state, that state may be eliminated as a throwback candidate as the taxpayer may be taxable in that state by losing protection under P.L. 86-272. If the taxpayer is claiming taxability in the other state because they are subject to tax in the other state, verify that the taxpayer actually filed a return and paid a tax in that state. If a taxpayer voluntarily files and pays a tax, or pays a minimal fee for qualification, organization or for the privilege or doing business in the state, but does not actually engage in business activity within the state sufficient to establish nexus, then the corporation is not taxable in the state (CCR §25122(b)(1)). If any of the corporations in the combined report has filed a return and/or paid taxes to another state because of an audit adjustment in that state, and that state has an income or franchise tax, it is usually presumptive evidence that the corporation is taxable in that state. If so, you should ask the taxpayer to produce copies of the other state return or other state audit adjustment

Sales to remaining states with no returns filed or property have throwback potential and should be examined further. Keep in mind the existence of payroll may only indicate the existence of sales personnel and the taxpayer will need to prove their activities go beyond the solicitation of sales.

Once potential throwback sales are identified, you can question the taxpayer as to their proper classification and possibly the issue can be resolved without additional work. If the taxpayer maintains that the unitary group is taxable in the destination state, the following steps should be taken:

The taxpayer may take the position that sales into the destination state are immune from taxation as provided by P.L. 86-272, but still file a franchise tax return and pay the minimum tax for various business reasons such as contract enforcement and ability to use that state's courts. In such circumstances, the department will not treat the unitary group as taxable in the destination state as the minimum tax was paid for regulatory purposes and has no relation to the business activity in the state.

You should therefore scan the other state returns to gain additional assurance that taxability exists. Unless there is a material tax effect however, you should not spend a great deal of time on the issue if tax returns have been filed or tax has been paid pursuant to the other state's audit adjustment.

However, if the potential tax effect of a throwback sale is material, the fact that at least one member of the combined group has filed a return in the destination state may not resolve the issue. A taxpayer, may self-assess or agree with the other state's audit determination if the result in assigning the sale to the destination state results in a net reduction in tax. The definition of materiality for the purposes of throwback sales is a large difference in tax between the additional tax paid to the destination state and the California tax savings by not throwing the sale back to California. You should discuss this issue with your supervisor.

You may pursue factual development of the potential throwback sale issue, assuming the tax effect is material, even though a tax return has been filed in the destination state or agreed with the other state's audit adjustment. Audit adjustments may be proposed if the taxpayer does not have nexus in the destination state or is exempt under P.L. 86-272.

If a taxpayer has not filed a return or paid taxes in the destination state for the year at issue or the state does not impose any income or franchise tax, taxability in the destination state for the year in issue must be established by incontrovertible evidence that the taxpayer's activities within the state cause nexus under the U.S. Constitution and exceed the activities protected by P.L. 86-272. (A complete discussion of nexus requirements and P.L. 86-272 may be found in MATM 1100 – MATM 1240.).

If the taxpayer is able to provide evidence of business activity that establishes that the destination state has jurisdiction to subject a member of the combined group to a net income tax irrespective of whether it decides to levy a tax or not, it is considered to be taxable within another state (CCR §25122 (a)). Under these circumstances the combined group does not have to throw back its sales to the state where the sales originate. However, as can be seen in the *Appeal of The Olga Company* below, the burden of proof rests on the taxpayer.

The *Appeal of The Olga Company*, 84-SBE-092, dated June 27,1984 , stated in part: "Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86.272. We believe that this weighs heavily against appellant and that, in order to prevail, appellant must clearly establish that its activities within the foreign states go beyond mere solicitation."

Consistent with the SBE decision in the *Appeal of The Olga Company* and provisions of CCR §25122, the taxpayer has the burden to clearly show that it is taxable in the destination state. Sales will be thrown back to California if the taxpayer cannot meet this burden.

7512.5 Double Throwback Rule

CCR §25135(a)(7) provides a rule for situations where the taxpayer is not taxable in *either* the state of destination or the state of origin. This situation might occur if a taxpayer's salesperson located in California directs an unaffiliated manufacturer in one state to ship merchandise directly to the taxpayer's customer in another state.

For example, assume a California sales office of the taxpayer directs a manufacturer in Colorado to ship merchandise directly to taxpayer's customer in Arizona:

- If the taxpayer is taxable in Arizona, then the sale is assigned to that state under the destination rule.
- If the taxpayer is taxable in Colorado, but not Arizona, then the sale is assigned to Colorado as a throwback sale.
- If the taxpayer is not taxable in either Colorado or Arizona, then the regulation provides that the sale would be assigned to California. This is known as the "double throwback" rule.

See MATM 7512.3 7512.4 & 7512 for a detailed discussion of the definition of taxpayer by taxable year.

7512.6 Sales of Tangible Personal Property to U.S. Government

Sales to the U.S. Government are an exception to the normal destination rule for assigning sales of tangible personal property. These sales are assigned to the state *from* which the goods are shipped regardless of whether the taxpayer is taxable in the destination state. (R&TC § 25135(b).) One of the reasons for using origin rather than destination is because the government often gives coded destination instructions to vendors for security reasons so the destination of goods is not always known. This treatment applies only to sales of *tangible personal property* to the United States Government. Sales to state, local, or foreign governments are subject to the normal rules for assigning sales.

CCR §25135(b) provides that the payments must be made directly by the government to the seller pursuant to the terms of a contract to qualify as sales to the U.S. Government. If the taxpayer is a subcontractor that make sales to the prime contractor, then these sales are not considered U.S. Government sales even though the government is the ultimate recipient and the work is subject to governmental approval. A sale of tangible personal property to the U.S. Government is assigned to California when shipment takes place from an office, store, warehouse, factory, or other place of storage in this state. Some sales to the U.S. Government involve work done on a product in stages in several states. For example, work on a missile may be started in Florida. The missile may then be moved to Arizona where more components are added. Finally, the missile is moved to California where it is completed. Sale and shipment of the finished missile to the government takes place in California. If the taxpayer performed the entire project, the sale is assigned to California in its entirety. On the other hand, if the government pays different contractors for the work completed in various states, only the incremental work done by the taxpayer is included in the factor. You should examine the government contracts, annual reports, or SEC Forms 10-K or directly question the taxpayer to determine if this issue exists. If so, you should verify that the sales have been treated correctly in the sales factor.

You should get a breakdown between the types of revenue when the sales to the U.S. Government are a mixture of tangible personal property and other types of receipts. For instance, assume that the contract price for a sale of computers to the U.S. Government includes a service contract, and the amounts of the service fees are specified in the contract. The portion of the sales price attributable to the computer sale is subject to the special rules for sales of tangible personal property to the government while the portion attributable to the service contract is assigned under normal rules for service revenue.

Audit verification

Schedule R-1 has a line item to report sales shipped from California to the U.S. Government. Also one of the questions on Schedule R-2, asks if the California sales figure on Schedule R-1 include all sales shipped from this state where the purchaser is the U.S. Government. Even if no government sales are included on the Schedule R-1 line and the taxpayer answers no to the question on the Schedule R-2 line, you may want to look deeper for government sales, particularly if the taxpayer is in an industry which commonly deals with the government such as aerospace contractors. When examining these types of taxpayers, it would a good idea for you to inquire about the existence of government sales during the initial interviews. Additional sources for this information are annual reports and SEC Forms 10-K, which may disclose business segments involved in government contracts.

Determine the type of revenues involved if you know the taxpayer generates government revenues. Sales of tangible personal property must be segregated from other types of sales so that the appropriate assignment rules may be applied. The taxpayer can generally provide this information. You may want to verify revenue by examining government contracts, sales reports or runs, and general ledger summaries.

You must determine the amount of sales shipped from California once you are aware that the taxpayer is selling tangible personal property to the U.S. Government. The taxpayer's sales runs or similar records will generally identify the origin of the sales. You need to be careful, however, to consider whether the sales records properly treat sales where no shipment was made and sales where components were added on in various states.

7512.7 Trade Receipts

CCR §25134(a)(1)(A) provides rules for inclusion of gross receipts from sales of goods or products held primarily for sale to customers in the ordinary course of the trade or business. The amount of such receipts includable in the sales factor is computed as follows:

Gross Sales
- Returns and allowances
+ All interest income, service charges, carrying charges, or time-price differential charges incidental to such sales.
+ Federal & State excise taxes (including sales taxes) if such taxes are passed on to the buyer or included as part of the selling price of the product.
= AMOUNT INCLUDABLE IN SALES FACTOR

Returns and Allowances:

"Returns" are goods that have been returned for credit, and "allowances" include shortages in shipping, breakage, spoilage, inferior quality, and similar situations. The sales reported on Line 1 of both the Federal Form 1120 and the California Form 100 are "gross sales less returns and allowances," and should correspond to the amounts reported in the sales factor.

Excise Taxes:

CCR §25134(a)(1)(A) states in part "In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, 'sales' includes all gross receipts from the sale of such goods or products" or other property characterized as inventory that is "held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business." This subsection also states, "Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product."

The value added tax (VAT) charged by many foreign countries is a tax assessed on the increase in the value of goods and services brought about by what a business does to them between the time of purchase and the time of sale. The VAT is not an income tax and qualifies as a state excise tax to the extent that it is a tax on the sale of tangible property. The VAT therefore meets the criteria of CCR §25134(a)(1)(A) for inclusion in the sales factor for VAT paid on sales of tangible property. VAT paid for services or use of intangibles is excluded from the sales factor.

Sale of Tangibles: A value-added tax is a tax assessed on goods and services on the value added by each producing unit. The value-added tax is essentially a consumption tax. VAT paid by the taxpayer to other states or foreign governments on sales of tangibles is included in the taxpayer's sales factor denominator so long as the taxpayer can verify that the VAT on sales of tangibles was remitted to that government.

Sale of Services: For services, there are fees and commissions and other similar items that are included in the sales factor. Since the VAT on services is not a tax on the sale of goods or products, VAT paid by a taxpayer to other states or foreign governments on services is not included in the taxpayer's sales factor denominator.

The gross amount of the VAT should be included in the sales factor as opposed to the net amount paid. The distinction between gross and net and the mechanism behind the VAT is important to understand in order to include the correct amount.

For example, assume Corporation Ltd. manufactures umbrellas in the UK. During the month of April, Corporation Ltd. purchased £10,000 of materials to make umbrellas and sold £25,000 worth of umbrellas. Also assume the VAT rate is 20 percent. Corporation Ltd. would have withheld £5000 worth of VAT on the sale of umbrellas. In addition, the seller of the materials would have withheld VAT of £2000 on Corporation Ltd. purchases. The VAT return of Corporation Ltd. would disclose VAT of £5000 on sales, VAT of £2000 on purchases, and a net VAT payable of £3000 to the British government.

The accounting entries are:

	Dr.	Cr.
Purchases	10,000	
VAT Recoverable	2,000	
Accounts Payable		12,000
To record inventory purchase.		
Accounts Receivable	30,000	
Sales		25,000
VAT Payable		5,000
To record sales.		
VAT Payable	5,000	
VAT Recoverable		2,000
Cash		3,000
To record payment of VAT liability.		

The department will treat the amount of VAT paid by the purchaser to the seller as the amount of excise tax passed on to the buyer and included in the sales factor. In the Corporation Ltd. example, VAT of £5000 would be included in the sales factor.

In some instances the VAT return may show a net refund due to the corporation because the VAT paid on purchases exceeds the VAT on sales as not all of the sales were subject to tax. In such situations, the net refund due will not be included in the sales factor. Of course, the actual VAT on sales will be included in the sales factor.

Examples

The taxpayer is in the business of selling tangible personal products. The taxpayer also offers a warranty contract for extended product servicing. The warranty contract is most likely incidental to the sale of the product. The VAT on the service component of the sale should not be pursued.

The taxpayer is an international firm providing a service such as management consultant. VAT should not be included in the sales factor based on the taxpayer’s business description.

The taxpayer’s subsidiary in the foreign country is in the business of selling a product and licensing others to manufacture other products. The foreign country assesses the VAT on the products and royalty income. The royalty income is material based on a review of the federal Form 5471. You should determine or, if necessary, estimate the amount of VAT on the royalties and exclude that portion of the VAT.

Possible Audit Steps for the VAT

An understanding of information is basic to resolving this issue. Possible items to consider include:

- How is the VAT accounted for in the books of original entry?

- Are separate accounts for receivables and payables kept in the books of original entry?

- What are the debits and credits concerning the VAT?

Obtain copies of the VAT return and the annual report.

- Do the footnotes in the annual report provide the amount of VAT paid? If so, additional audit steps might not be necessary.

- Does the management discussion of the year's activities in the annual report provide the amount of VAT paid?

You also need to have an understanding of the taxpayer's operations in the foreign country. If the taxpayer only exports to a foreign country and does not have a presence in that country, the law of the foreign country may provide that the purchaser pays the VAT directly to the government. If so, there will be no VAT for the seller to take into account. Additionally, the type of business the taxpayer engages in is important to ensure that the correct VAT rate is used since some countries have different VAT rates for different products.

Similar to all issues, use your judgment. For example, the taxpayer filed a claim for six years to include the VAT in the sales factor. The taxpayer only has source information for the two most current years. If you are comfortable that the taxpayer's methodology is reasonable given the facts and circumstances, then accept the first four years amounts based on the audit of the last two years.

You know from interviewing employees of the taxpayer that their foreign country operations are limited to the resale of inventory purchased from its parent. Export sales are not an issue. The taxpayer has a copy of the VAT return for the most current period and no export sales are listed on the return. The foreign country operations are limited to the sale of tangible property so that the VAT on personal services or use of intangibles is not an issue. The taxpayer through the Federal Form 5471 identified the amount of gross sales and intercompany sales. Since intercompany sales are eliminated from the sales factor the VAT on intercompany sales should likewise not be included in the sales factor. In such facts and circumstances it would be reasonable to estimate the VAT based on gross sales less intercompany sales times the VAT rate.

The taxpayer wants to estimate the amount of the VAT based on gross receipts in the federal Form 5471 times the VAT rate. This would not be reasonable without a showing of how the taxpayer takes into account the VAT on purchases, export sales, intercompany sales, etc.

CCR §25106.5-10 (formally CCR §25106.5-3) section requires the FTB to consider the effort and expense required to obtain the necessary information. CCR §25106.5-10(e)(1) provides "In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board shall accept reasonable approximations."

In many instances the information needed to compute the amount of VAT to include in the sales factor is under the control of foreign entities. You will have to address CCR §25106.5-10 and the "reasonable approximation" standard, which was discussed in the US Supreme Court decision in *Barclay Bank Plc. v. Franchise Tax Board*, (1994) 512 US 298.

It is important to remember in the Barclays' litigation that the California Supreme Court remanded the case back to the Court of Appeal to address the issue of whether the administrative burden for a foreign parent complying with worldwide combined report violates either the nondiscrimination component of the dormant commerce clause or the due process clause. The US Supreme Court extensively quoted the Court of Appeal decision. The Court of Appeal decision (10 Cal.App.4th 1742 (1992)) is helpful to fully understand the issue of reasonable approximations. The Court of Appeal looked at current CCR §25106.5-10(e)(1), formally CCR §25137-6, and stated at page 1762: "It is this mandatory consideration of the effort and expense against the backdrop of data developed from the regularly maintained documents that circumscribes the Board's discretion under CCR §25137-6 and provides a framework for meaningful judicial review if the Board arbitrarily exercises that discretion."

The Court of Appeal went on to say "…the board must consider the cost and effort of producing WWCR [worldwide combined report] information in deciding whether to accept reasonable approximations, and that consideration is to use regularly maintained or other readily accessible corporate documents as the cost guideline."

The US Supreme Court reviewed the Court of Appeal's application of the regulation. The Court concluded that the state's application of the regulation did not violate the taxpayer's constitutional rights.

As with any audit issue, your judgment as to materiality of the issue versus the burden on both you and the taxpayer to resolve must be used to determine the technical correctness and the extent of documentation needed to allow the VAT in the sales factor.

Individual country VAT information can be obtained from the BNA-Foreign Income Series Portfolio.

In addition to the value-added tax, other foreign taxes may qualify as excise taxes. For certain types of products such as alcoholic beverages, tobacco products or tires, the excise taxes may be quite material.

Inquiries of the taxpayer will usually reveal whether excise taxes have been included in the sales factor. Taxpayers are merely collectors of sales and excise taxes, and are responsible for remitting those taxes to the federal or state taxing authorities. Therefore, they will maintain sales records indicating the amounts of taxes. Depending upon how the records are compiled, reconstructing the excise taxes includable in the factor may be time consuming and should only be pursued when material.

Audit verification

The audit steps for reconciling trade revenues in the denominator of the factor to the audited financial statements and/or the Federal 1120s are described in MATM 7505. Initial procedures for using the taxpayer's by-state sales records to verify numerator amounts are covered in MATM 7520. You should verify that the trade receipts included in the denominator of the sales factor tie to the trade receipts reflected in the by-state sales records. Any material differences revealed by these reconciliations should be investigated further.

A problem that is commonly encountered with respect to the sales factor is that the by-state sales runs used to prepare the numerator may not be reported on the same basis as the sources used for the denominator figures. For example, the by-state sales runs of some taxpayers are shown at gross rather than net of returns and allowances. Since the information necessary to correct the numerator is not always available in a by-state format, taxpayers (or you) faced with this problem may attempt to use estimates to convert numerator sales to the proper amount. This is usually accomplished by applying percentages of the variances ratably to each state. For example:

Total Gross Sales	1,100,000
Total Returns & Allowances	-100,000
Total Net Sales	**1,000,000**

Sales from By-State Records :				
California				500,000
Arizona				400,000
Oregon				200,000
Total				**1,100,000**
Total net sales / Total gross sales	=	1,000,000 / 1,100,000	=	91%

By-State Sales at Net:	
California ($500,000 x 91%)	455,000

Arizona ($400,000 x 91%)	363,000
Oregon ($200,000 x 91%)	182,000
Total	**1,000,000**

You should review the taxpayer's calculation to ensure that the method of estimation is reasonable.

7512.8 Vendor Allowance

VENDOR ALLOWANCES – VENDOR PERSPECTIVE

Vendors who are selling their products or services to retailers/customers sometimes pay allowances or incentives to retailers. These vendor allowances can be in the form of various types of credits and rebates associated with selling and/or promoting a vendor's products. These vendors may have arrangements with more than one retailer and could have more than one arrangement with the same retailer. The vendor and retailer negotiate the terms and conditions of these vendor allowances. The issue is whether the vendor allowance reduces the sales price of the products/services being sold to the retailers and reduces the vendor's revenue/gross receipts received from the retailers on the underlying sale for California sales factor purposes.

Example:

Vendor W agrees to pay Retailer R $10 per product that R sells to its customers for products that remain unsold after 60 days so that R can reduce the sales price by $10 per item sold.

Another fact pattern is where a vendor is a service provider. Sometimes the service that the vendor is providing requires equipment that is purchased from a third party. The vendor may provide an allowance to the equipment manufacturer to reduce the price of the equipment and create more of a market for the vendor's services that are sold to customers. Hence, in this situation the vendor allowance is not directly going to the purchaser of the vendor's services but to the third party equipment manufacturer. This may be an arrangement where a customer is required to purchase the equipment from a third party manufacturer or reseller before the customer may purchase vendor's services. The equipment is often manufactured and distributed by third parties and sold to end-customers through resellers without direct involvement of the service provider. The issue in this fact pattern is whether the vendor allowance paid to the third party equipment manufacturer or reseller has any effect on the sale price of the services the vendor is selling to the customer and whether the revenue the vendor is receiving for payment of those services by the customer is reduced by the amount of the allowance.

Example:

Vendor V provides the service of installing and setting up phone answering systems for small and medium businesses. To receive this service, customers are required to purchase telephones and software from Manufacturer M.

CCR §25134(a)(1)(A) provides the rules for when a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products has "sales" that are considered to be gross receipts. "Sales" in those situations includes all gross receipts from the sales of the goods or products to customers in the ordinary course of its trade or business.

CCR §25134(a)(1)(C) provides the rules for when a taxpayer engaged in providing services has sales that are considered to be gross receipts. "Sales" in those situations include the gross receipts from the performance of those services including fees, commissions, and similar items.

For taxable years beginning before 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(e), emphasis added.)

For taxable years beginning on or after 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(f)(1) In addition, " 'Gross receipts' means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital ... in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code, as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold." (R&TC §25120(f)(2), emphasis added)

a. Federal Treatment:

1. Treasury Regulation §1.471-3(b) that provides the rules for trade discounts stating that trade discounts reduce the invoice price
2. Treasury Regulation §1.471-3(e) that provides the rules for sales-based vendor allowances stating that these decrease the cost of goods sold (COGS), but only in very specific chargeback fact patterns.

b. California Treatment:

1. Fact Patterns and Options: There are generally two fact patterns from the vendor perspective, one where the vendor is paying an allowance directly to its customer/retailer, and the other where there are three parties involved because the vendor pays the allowance to a manufacturer/retailer which in turn passes a benefit to the customer. Since the facts are different in these situations, the options for treatment are slightly different and will be addressed separately below.

A. When a vendor is paying consideration to a customer, there are two options for treatment of the allowance for the vendor:

1) **Reduce the Vendor's Revenue and Gross Receipts:** When the vendor allowance is paid to the purchaser of the underlying product a vendor is selling, it is presumed that the vendor allowance paid reduces the sales price of the product that the vendor is selling to the retailer. Generally, the vendor allowance cannot be separated from the underlying sale of a product by the vendor to the retailer. Typically, there is no separate sale of a product or service by the retailer back to the vendor under CCR §25134(a)(1)(A) or (C). Therefore, this is not treated as a separate line of revenue to the retailer nor an expense for the vendor. Instead, the amount of the allowance reduces the vendor's revenue and gross receipts for California sales factor purposes.

Example:

If a vendor sells item X to a retailer for $50, when the retailer pays the vendor the $50, the vendor normally has gross receipts of $50 for California sales factor purposes. If the vendor pays an allowance of $10 per item sold and that allowance is not separable from the underlying product sold to the retailer, then there is no separate sale of a product or service back to the vendor and the $10 allowance reduces the revenue and gross receipts that the vendor receives per product from $50 to $40.

2) **Expense and Do Not Reduce Vendor's Revenue and Gross Receipts:** To not have the vendor allowance reduce revenue for the vendor, the vendor must show that the retailer sold a product or a service back to the vendor and that the identifiable benefit to the vendor is (1) separable from the product the vendor is selling to the retailer and (2) measurable (can reasonably estimate the fair value), so that there is a separate sale of a product or service by the retailer back to the vendor under CCR §25134(a)(1)(A) or (C). Any excess value of the identifiable benefit to the vendor above the amount of the allowance reduces revenue/gross receipts for the vendor on amounts received from the retailer for the underlying product.

Example:

If a vendor sells item X to a retailer for $50, when the retailer pays the vendor the $50, the vendor normally has gross receipts of $50 for California sales factor purposes. If the vendor pays an allowance for $10 per item sold and that allowance is paid for a separate sale of a product/service by the retailer back to the vendor and the identifiable benefit to the vendor is measurable, then the $10 that the vendor pays to the retailer is an expense item that does not reduce the sales price of the product nor the revenue and gross receipts received upon sale of that product to the retailer. The vendor would still have $50 in gross receipts for California sales factor purposes, and also a $10 expense item for the purchase of a product/service from the retailer. The $50 in gross receipts is not reduced by the $10 allowance as the vendor is paying the $10 to purchase a product/service (under CCR §25134(a)(1)(A) or (C)) from the retailer rather than merely discounting the price of the product that the vendor sold to the retailer. If the allowance is $14 instead of $10 and the value of the product/service provided by the retailer to the vendor is $10, then the excess amount of $4 over the value of what was provided reduces revenue/gross receipts for California sales factor purposes for the vendor.

B. When a vendor is paying consideration to a manufacturer or reseller that is not the customer for the vendor's services there are two options:

1) **Reduce Vendor Revenue–Linked by Contract**: If the consideration paid by the vendor/service provider to the manufacturer/reseller (that is not a customer of the vendor) can be linked contractually to a benefit received by the vendor's customer, then the vendor's sales price for the service sold to the customer is adjusted down by the amount of the allowance as is the revenue and gross receipts received by the vendor from the customer. This is because there is no sale of a product/service back to the vendor under CCR §25134(a)(1)(A) or (C) that is separate from the underlying sale of a product/service by the vendor to the customer.

Example:

Vendor X is a service provider providing cellular phone service to customers. Vendor X agrees to pay $100 per cell phone to distributor Y for phones that Y sells to X's customers. By contract, Y is required to reduce the selling price for the phones sold to X's customers so the customers are required to receive cash consideration. X's revenue and gross receipts earned from customers is reduced by the $100 allowance and the reduction is amortized over the life of the contract. That is, for a 2-year contract X's revenue would be reduced $50 for each of the 2 years.

2) **Does Not Reduce Vendor Revenue - Separate Expense Item**: The vendor allowance paid to the manufacturer will only be treated as a separate expense item (and not reduce revenue and gross receipts received from the customer) if the vendor received an identifiable benefit (product/services) in exchange for the allowance paid that is (1) sufficiently separable from the service the vendor is selling to the customer and (2) the vendor can reasonably estimate the fair value of this identified benefit (measurable). If the identifiable benefit to the vendor is separable and measurable, then there is a sale of a product/service back to the vendor under CCR §25134(a)(1)(A) or (C) that gives rise to revenue and gross receipts for the vendor, meaning

the gross receipts from the sale of the underlying product are not reduced by the value of the allowance paid to the manufacturer and the vendor has an expense item. Any excess in fair value of the allowance paid over the fair value of the identifiable benefit received by the vendor will reduce the sales price of the services and revenue/gross receipts for California sales factor purposes and not be an expense item to the extent of that excess.

Example:

Vendor A is a service provider that processes credit card payments for retailers. The retailers must purchase a scanning machine from Manufacturer B before they can subscribe to A's services. By contract A agrees to pay $100 to B for each machine B sells to A's customers. In return, B agrees to perform advertising for A's services to targeted retailers. A is receiving an identifiable benefit of advertising from B that is separate from the sale of A's services to the retailers and the fair value of the advertising can be reasonably estimated. B is selling a service back to A under CCR §25134(a)(1)(C) and A is paying for the service with the allowance. The payments from retailers to A for services are not reduced by the amount of the allowance that A paid to B, but instead these payments are characterized as a separate expense item. If the advertising is for both B's machines and A's services, then the fair market value of the identifiable benefit to the vendor should be only the value of the advertising of the service.

i) If the consideration paid by the vendor to the manufacturer results in cash consideration or the equivalent (including reduced sales price or instant rebates) being provided to the vendor's customer, then the allowance reduces the vendor's revenue and gross receipts for California sales factor purposes for amounts paid by the customer to the vendor for services.

ii) If the consideration paid by the vendor results in the manufacturer providing to the vendor's customer a free product or service (like a gift certificate from the vendor for a free airline ticket honored by another unrelated party), or anything other than cash, the cost of the consideration is characterized as an expense for the vendor that does not reduce the sales price of the services the vendor is selling to the customer. The free item is considered a deliverable in the exchange transaction and not a refund/rebate of a portion of sales price charged to the customer.

c. RESOURCES:

1. The EITF 01-9 [link] and ASC 605-50 [link]

2. SEC Staff Accounting Bulletin 104 (Dec. 2003): This document summarizes

SEC staff views on how to apply revenue recognition guidance. Revenue is earned and realized when:

A. There is persuasive evidence of an arrangement. This ensures that there is an understanding between the parties regarding the specific nature and terms of the transaction and that this understanding has been finalized. Proper treatment of the transaction depends on the evidence of the final understanding reached by the parties. Whether an item is persuasive evidence of an arrangement is determined by an entity's customer business practices. If an entity's standard practice is to have both sides sign an agreement, then that is the required persuasive evidence of an arrangement. There can be no revenue recognition until there is persuasive evidence of an arrangement.

B. Delivery has occurred or the services have been rendered. This is required because until the products have been delivered or the services provided, the seller has not yet substantially completed its obligations as set forth in the agreement, and the revenue should not yet be recognized. Delivery is deemed to have occurred when customer takes title and assumes the risks and rewards of ownership.

C. The seller's price to the buyer is fixed or determinable. One must look at many factors, such as payment terms, discounts, and rebates, to determine whether a price is fixed or determinable. These factors can vary from one agreement to the next agreement. The amounts to be recognized as revenue should not be subject to refund or adjustment before the price is considered fixed or determinable.

D. Collectability is reasonably assured. Where there is no reasonable assurance that a fee can be collected, the fee is not realizable and there is no revenue recognition.

d. GENERAL GUIDELINES:

The vendor allowance paid by the vendor to the retailer is presumed to reduce the gross receipts received by the vendor for the underlying sale of product or service to the retailer and not treated as a separate expense item for the vendor. This presumption is overcome when the vendor allowance is a payment from a vendor to a retailer for products or services delivered to the vendor, the vendor allowance paid by the vendor is then treated as a separate expense item for the vendor. The allowance will not reduce the sales price of the underlying products sold to the retailer or the vendor’s revenue or gross receipts for California sales factor purposes provided the vendor receives an identifiable benefit (products or services) in exchange for the allowance paid to the retailer. The identifiable benefit must be both:

1. Separable: The benefit to the vendor must be sufficiently separate from the vendor's underlying sale of its products or services to the retailer so that the vendor could have entered into an exchange transaction with a party other than a retailer to provide the benefit.

2. Measurable: The vendor must be able to reasonably estimate the fair value of the benefit provided to the vendor. If the vendor allowance paid by the vendor exceeds the estimated fair value of the benefit received by the vendor, the excess amount reduces the sales price of the underlying products sold to the retailer and the vendor's revenue and gross receipts for California sales factor purposes. Factors that may impair a vendor's ability to determine whether a rebate or refund can be probably or reasonably estimated include:

    A) The rebate or refund relates to purchases that will occur over a relatively long period.

    B) There is no historical experience with similar products or lack of ability to apply experience due to changing circumstances.

    C) In the past, significant adjustments to expected cash rebates or refunds were necessary.

e. TYPES OF ALLOWANCES

1. **Cash Discounts**:

    A. Collectability is reasonably assured. Where there is no reasonable assurance that a fee can be collected, the fee is not realizable and there is no revenue recognition.

    B. Price Adjustments for Certain Classes of Customers: When a vendor allows a price reduction to certain classes of customers, there is no identifiable benefit to the vendor that is separate from the underlying sale of a product/service to the retailer. The retailer is not providing a product/service back to the vendor for which the vendor is paying with the allowance under CCR §25134. Therefore the amount of the allowance reduces the sales price and the amount of revenue/gross receipts for the vendor for California sales factor purposes.

2. **Trade discounts:** When a vendor gives a discount to a retailer for volume purchases, the vendor is not receiving a benefit that is separate from the underlying sale of a product/service to the retailer. The retailer is not providing a product/service back to the vendor for which the vendor is paying with the allowance under CCR §25134. Therefore, the amount of the allowance reduces the sales price and the amount of revenue/gross receipts for the vendor for California sales factor purposes.

3. **Advance Trade Discounts:** If the retailer meets the requirements for the IRS safe harbor Advance Trade Discount so that the vendor treats the allowance as a reduction to COGS, then the vendor paying the allowance will reduce the sales price by the amount of the allowance and reduce revenue/gross receipts for California sales factor purposes.

4. **Defective or Damaged Merchandise Allowance:** Often retailers agree to accept damaged or defective merchandise back from their customers and in return the vendor agrees to pay a percentage of total purchases to cover handling costs. These allowances reduce the sales price and revenue/gross receipts for California sales factor purposes for the vendor as there is no separate sale of a product/service back to the vendor under CCR §25134(a)(1)(A) or (C).

5. Advertising Allowance: When a vendor agrees to share the costs of advertising with a retailer so that ads go out with both the names of the vendor and the retailer, the amount paid by the vendor for the advertising reduces the sales price of the products/services sold by the vendor and the revenue/gross receipts for California sales factor purposes for the vendor unless the vendor can show it received an identifiable benefit that is (1) separate from the products/services vendor sold to the retailer and (2) measurable (can reasonably estimate the fair market value of the benefit to the vendor.) If the vendor can show both of these things, then there is a separate sale of a service by the retailer back to the vendor under CCR §25134(a)(1)(C) so the allowance paid by the vendor does not reduce the sales price of the products/services sold to the retailer and does not reduce the revenue/gross receipts for California sales factor purposes received by the vendor. Any excess value of identifiable benefit received by the vendor from the retailer of any above the amount of the allowance paid by the vendor would reduce the sales price of the product/service sold by the vendor to the retailer.

Examples:

A) **Advertising Allowance with No Evidence of Benefit to Vendor:** Company M is a large denim jean manufacturer that sells its jeans through retailers that sell clothing. Company M pays $10 per pair of jeans sold as an advertising allowance. The retailers are expected to include Company M's jeans in local advertisements, but are not required to provide documentation to Company M showing how the advertising allowance was used to promote Company M's products.

Result:

Company M does not receive an identifiable benefit in return for the allowance because Company M cannot identify the benefit it has received since retailers do not provide documentation of any advertising that has been run. The allowance is characterized as a reduction of revenue for Company M.

B) **Advertising Allowance with Evidence of Benefit to Vendor:** Same facts as #1 except the retailers are required to maintain documentation of the advertising and provide it to Company M upon request.

Result:

Now Company M is receiving an identifiable benefit (advertising) in return for the allowance. The benefit is sufficiently separable from the retailer's purchase of Company M's jeans because Company M could have purchased that advertising from another party that does not purchase Company M's jeans. If the fair value of that benefit can be reasonably estimated and that amount equals or exceeds the amount of the advertising allowance, the advertising allowance would be characterized as a cost incurred for Company M. If the allowance exceeds the value of the benefit, that excess consideration would be characterized as a reduction of revenue for Company M.

C) **Cooperative Advertising:** Company S manufactures toys carried by many retailers. Retailers receive an allowance of up to 2 percent of total purchases from Company S if certain qualitative advertising criteria are met and if specified amounts are spent on advertisements. A retailer must maintain documentation of all advertising performed that include Company S's products, including showing that the cost exceeds the 2 percent advertising allowance and provide documentation upon request.

Result:

Company S is receiving an identifiable benefit from the retailer (advertising) in return for the 2 percent allowance. That benefit is sufficiently separable from the retailer's purchase of Company S's products because Company S could have purchased that advertising from another party that does not purchase Company S's products. The estimated fair value of the advertising benefit is made through an allocation of the cost incurred by a retailer for the advertising on the basis of the portion of an advertisement that includes Company S's products. Therefore, the 2 percent allowance should be characterized as an expense for Company S and Company S does not reduce its revenue/gross receipts for California sales factor purposes by the amount of the allowance paid.

D) **Exclusive Beverage Supply Contract that includes an Advertising Benefit:** Company N produces beverages and has supply contracts with major venues. One contract gives Company N a 3-year right to be the exclusive beverage vendor at an arena with Company N then receiving a percentage of retailer beverage revenues based on a per-cup price set by the arena. Under the contract, Company N also pays an annual fee for a banner ad displayed in the arena at each event that year. This aspect of the contract was not a condition of the exclusive beverage supply arrangement and was added to the contract at the request of

Company N after the terms of the beverage supply arrangement were agreed upon. For the first year of the 3-year contract, the banner ad fee is $40,000, which is a price that anyone wishing to place a comparable banner ad would pay. The prices for the second and third years will be based on the prices for banner ads set prior to those event seasons. The venue sells banner ads at those prices to others that are not vendors to the venue. That is, Company N will pay the same price for banner advertising as any other company would pay.

Result:

Company N is receiving an identifiable benefit (banner advertising) from the arena in return for the $40,000 fee. That benefit is sufficiently separable from the arena's purchase of Company N's beverages because Company N could have purchased similar advertising from a different arena that does not purchase Company N's beverages. There is evidence that $40,000 is the fair value of the banner ad because similar banner ads are sold to other parties, some of whom do not provide products/services to the arena. Therefore, the $40,000 is an expense for Company N and does not reduce the revenue/gross receipts for California sales factor purposes that Company N receives for sale of its beverages at the venue. The payment for the banner ad is a separate sale under CCR §25134(a)(1)(C) with the vendor purchasing a service from the arena.

E) **Modification of Exclusive Beverage Supply Contract to Obtain an Advertising Benefit**: Company Z is a major beverage producer with a contract to supply beverages at a major venue giving Company Z a 3-year right to be the exclusive beverage supplier to the arena. The contract requires Company Z to sell beverages to the arena at a specified fixed price for the entire term of the contract and includes contractual minimums that must be purchased by the venue. That pricing is comparable to what Company Z would charge any high- volume customer. The original contract did not provide for banner advertising within the arena, and the arena does not sell banner ads to parties other than to vendors. One year into the 3-year contract term, Company Z desires to have banner advertising marketing exposure in the arena in addition to earning revenue from selling beverages. To obtain banner-advertising rights, Company Z approaches arena management and proposes that in exchange for a large banner ad in a prominent location, Company Z will reduce the per-unit beverage price by 8 percent for the minimum required purchases for the remaining term of the contract. Company Z estimates that the 8 percent reduction on a present value basis approximates the amount Company Z would pay for a similar banner in a similar venue with an unrelated party that is not a beverage customer. In making that estimate, Company Z considered what it would cost to have similar banner ads at other similar venues, the historical amount of beverages sold, and the projected future sales. Arena management agreed to this modification of the original contract. There was no other reason for modifying the contract other than Company Z's desire to have its banner in the arena, and no other contract change (for example, term extension) was included in the modification. No service issues (such as customer dissatisfaction) exist with respect to Company Z's performance under the arrangement.

Result:

Company Z is receiving an identifiable benefit (banner advertising) in return for the price reduction; however, the benefit to Z is not separable from the underlying sale of beverages to the venue because Company Z could only obtain a banner ad if a vendor at the arena. Since the identifiable benefit is not separable from the sale of beverages, there is no sale of a product/service back to the vendor that would give rise to revenue/gross receipts for California sales factor purposes. If the venue did not require that a business purchasing a banner ad be a vendor, then the result would be that the identifiable benefit (banner ad) to the vendor would be separable and measurable and therefore the vendor's revenue/gross receipts from the beverage sales would not be reduced for California sales factor purposes.

F) **Beverage Company Pays for Minor League Stadium Scoreboard:** Company O is a major beverage distributor. Minor League Baseball Team's (MLBT) previous scoreboard was destroyed by a storm. The MLBT offers to allow Company O to be the exclusive beverage supplier for at least 5 years if Company O pays for a new scoreboard that will cost $100,000. The scoreboard will have Company O's logo, slogan, and colors. Company O sells its products to the stadium at the same prices it charges other stadiums of comparable size regardless of whether Company O pays for signage or receives other benefits from any stadium. Once completed, MLBT submitted the invoice for the new scoreboard to Company O and received a check from Company O for $100,000, the amount of the invoice. The MLBT pays the contractor's bill in due course.

Result:

Company O receives an identifiable benefit (promotion and advertising with scoreboard display of logo, slogan, and colors) in return for the $100,000 paid by Company O to MLBT because (1) this benefit is sufficiently separable from the MLBT purchase of Company O's products, and (2) Company O could have purchased similar promotion and advertising from another party that does not purchase Company O's products. Company O also receives a second benefit from its $100,000 payment to MLBT and that is the right to be the exclusive beverage supplier. However, Company O does not receive an identifiable benefit that is separable from the MLBT purchase of Company O's beverages because (1) the consideration for this benefit is not separable from Company O's arrangement to sell beverages to MLBT, and (2) a similar benefit could not be purchased from another party that does not purchase Company O's products.

For the promotion and advertising benefit, Company O must be able to reasonably estimate the fair value of the benefit it receives from having its logo, slogan, and colors on the scoreboard. Reliance on the amount charged by the contractor is insufficient evidence of fair value because the fair value of promotion and advertising may be substantially different from the cost of scoreboard construction. The fair value of promotion and advertising may be less than the fair value of the scoreboard. (For example, even if a more lavish scoreboard were purchased for $500,000, the fair value of the promotion and advertising would remain the same.) If Company O is unable to make a sufficiently reasonable, objective estimate of the fair value of the promotion and advertising benefit, then the $100,000 payment by Company O to MLBT would reduce revenue/gross receipts for California sales factor purposes for Company O. If Company O is able to estimate the fair value of the promotion and advertising benefit, that amount is an expense for Company O up to $100,000 of consideration given and would not reduce revenue/ gross receipts for California sales factor purposes for Company O. If the fair value of the advertising benefit exceeds the $100,000 consideration, then that excess would reduce revenue/gross receipts for California sales factor purposes for Company O.

6. **Salary/Payroll Allowance:** When a vendor pays an allowance to a retailer in return for the retailer's promise to provide more space and sales staff dedicated to promoting the vendor's products, the allowance must be broken into its components of (1) payroll and (2) shelf space.

A) **Payroll**: Amounts paid for payroll might be an expense for the vendor that does not reduce the vendor's revenue/gross receipts for California sales factor purposes if (1) the retailer provides an identifiable benefit to the vendor that is separable from the product (separable in that vendor could pay a temporary employee agency for extra employees) and (2) measurable (can estimate the fair value of paying extra employees). Any amount paid that exceeds the identifiable benefit to the vendor would reduce the vendor's revenue/gross receipts for California sales factor purposes. If the above 2 requirements are met, the retailer is providing a service back to the vendor under CCR §25134(a)(1)(C) and the revenue/gross receipts received by the vendor in payment for the sale of underlying products/services are not reduced by the amount of the allowance.

B) **Shelf Space**: Vendor Allowances for shelf space reduce revenue/ gross receipts for California sales factor purposes for the vendor because the identifiable benefit received by the vendor (shelf space for product) cannot be separated from the actual product sold to the retailer. Therefore, the amount of revenue/gross receipts that the vendor receives is reduced by the amount of the allowance for California sales factor purposes under CCR §25134(a)(1)(C).

Example:

Reimbursement of Promotion-Related Payroll Costs: Company B is a major producer of snack foods. Company B plans to issue coupons good for a two-week period that will represent a significant discount on all of its products and are expected to result in a dramatic increase in demand for its products during the promotional period. It negotiated an arrangement with its largest grocery store customer that during the promotional period Company B will reimburse the grocery store customer for all promotion-related payroll costs, to be determined by comparing payroll costs during the promotional period to average payroll costs during the three months preceding the promotion.

Result:
There is no identifiable benefit to Company B that is separable from Company B's sale of products to the grocery store customer because Company B is simply paying some of the grocer's operating costs and is doing so only because the grocer is a customer, not because there is another benefit to Company B. The payroll reimbursements therefore reduce revenue/ gross receipts for California sales factor purposes for Company B.

7. **Product Launch:** When a vendor pays a retailer for product launch activities, there may be a market research component and a promotion component. If there is an identifiable benefit that is separable from the product being sold and measurable, then the allowance is an expense for the vendor that does not reduce the vendor's revenue/ gross receipts for California sales factor purposes for the amounts the vendor receives from retailer for the sale of the underlying product. Any amount paid to the retailer for product launch activities that exceeds the value of the benefit received by the vendor would reduce the vendor's revenue/gross receipts for California sales factor purposes. If there is no identifiable benefit that is separable or measurable, then the amount of the allowance reduces the revenue/gross receipts for California sales factor purposes for the vendor.

8. **Merchandise Display Allowance:** When a vendor pays an allowance to a retailer as an incentive for the retailer to provide space and assets to display vendor's products, there is a presumption that the amount of the allowance reduces the sales price of the products the vendor sold to the retailer unless the vendor can show that the vendor received an identifiable benefit that is separable from the product being sold and measurable. If the vendor can show those 2 things, then (1) the allowance is an expense for the vendor that does not reduce the vendor's revenue/ gross receipts for California sales factor purposes for the amounts the vendor receives from retailer for the sale of the underlying product, (2) the retailer has sold products/services back to the vendor which is a sale under CCR §25134(a)(1)(A) or (C). Any amount paid to the retailer for merchandise display products or services that exceed the value of benefit received by the vendor would reduce the vendor's revenue/gross receipts for California sales factor purposes.

Examples:

A) **Payment for Custom Fixtures:** Company F designs domestic products like bed linens, bath towels, and accessories. After presenting its new line of products to National Department Store Chain (Chain), Company F and Chain agree that Company F will pay for the remodeling of a 1,600 square foot alcove in each of 30 retail stores for Chain for Company F products. Company F will provide specifications (within specified boundaries) for design, layout, and signage in the alcoves so that they have the look and feel that is consistent with Company F's displays in other stores. Chain will engage an external, unrelated contractor to construct the alcoves. Company F will reimburse Chain for all remodeling and fixture costs that Chain incurs, but Company F has no ownership in the improvement and fixtures. Chain is the primary obligor to the contractor selected to construct the improvements. No store is obligated to make that space available to Company F for a minimum period of time, although both parties understand that the new product line will receive a reasonable period of time to gain market share. Regardless, a store has the right to redirect the use of that space. Company F has maintained a presence in Chain's stores for over 40 years.

Result:

Company F does not receive an identifiable benefit that is sufficiently separable from the arrangement to sell goods to the retailer because (1) any benefit received by Company F cannot be separated from the arrangement to sell goods to Chain, and (2) Company F could not enter into such an arrangement with a party other than a reseller of its products. The vendor allowance paid to the reseller is related to how that reseller displays or features the vendor's products and is not a benefit that is separable from the reseller's purchase of the vendor's products. The allowance paid by Company F to Chain therefore reduces revenue/ gross receipts for California sales factor purposes for Company F.

B) **Installment of Custom Fixtures:** Same facts as Example (1) except that Company F engage an unrelated third-party contractor to construct the alcoves. Company F is the primary obligor to the contractor and therefore is directly responsible for the cost of all remodeling and improvements rather than being obligated to reimburse Chain.

Result:

The consideration that Company F pays to Chain is "free" property because Company F is directly obligated to the contractor for the cost of constructing all improvements. As a result, the "free" item is a deliverable in the transaction rather than a refund or rebate of the amounts charged to Chain. The consideration is therefore an expense for Company F and does not reduce revenue/gross receipts for California sales factor purposes.

C) **Payment for Generic Fixtures:** Company A is a supplier of automotive filters and has been a nonexclusive supplier for Auto Parts Chain (APC) for over 20 years. The APC continues to build new stores, and when a location for a new store is identified, all of the APC major suppliers, including Company A, are required to make a payment for fixtures in the new store based on the total estimated cost of fixtures and the relative amount of shelf space expected to be allocated to Company A's products. The fixtures to be built in the new stores are not unique and are not customized in any way to a specific supplier's products. If a supplier fails to make the required payment, the supplier's products will not be carried in the new location, and it is expected that the supplier's products eventually would be removed from all APC stores.

Result:

Company A receives no identifiable benefit that is sufficiently separate from the sale of products to APC stores because (1) any benefit received by Company A cannot be separated from the arrangement to sell goods to the retailer, and (2) Company A could not enter into such an arrangement with a party other than a reseller of its products. The payments reduce revenue/gross receipts for California sales factor purposes for Company A.

9. **Slotting Allowance:** When a vendor pays a retailer an allowance and in return the retailer stocks and displays the vendor's products, these fees and similar product development or placement fees are generally not separable from the underlying product that a vendor is selling to a retailer and therefore will generally reduce revenue/gross receipts for California sales factor purposes for the vendor. There is no separate sale of a product/service by the retailer back to the vendor that can give rise to gross receipts to the vendor under CCR §25134(a)(1) or (C).

Examples:

A) **Nonrefundable Slotting Fees with Exclusivity Arrangement:** Company U sells a line of canned meats to retailer grocery chains. One of its retailers demands slotting fees from Company U totaling $100,000 per year or that retailer will discontinue selling Company U's products. Through negotiations, Company U agrees to pay those fees provided that Company U serves as the exclusive provider of canned meats, although the retailer is not required to make a minimum level of purchases.

Result:

Company U receives no identifiable benefit that is sufficiently separable from the sale of products to the retailer because (1) any benefit received by Company U cannot be separated from the arrangement to sell goods to the retailer and (2) Company U would not enter into such an arrangement with a party other than a reseller of its products. Even the exclusivity right is solely related to the arrangement to sell goods to the retailer, and, therefore, the slotting fees, including the portion paid for exclusivity, reduce revenue/ gross receipts for California sales factor purposes for Company U.

B) **Payment for Product Placement**: Company Y produces a line of dolls sold to major toy retailers. The dolls have been on the market for years and compete with certain other dolls that are currently in greater demand. As a result, retailers are not displaying Company Y's dolls as prominently as the other dolls. To increase demand for its dolls, Company Y negotiates with one toy retailer for end-cap placement during the next holiday shopping season. The retailer demands a rack payment of $500,000 for end caps in all its stores. This agreement does not require the retailer to purchase a minimum quantity of dolls from Company Y. The end caps will not be specially modified for display of Company Y's products.

Result:

Company Y receives no identifiable benefit in return for the payment that is sufficiently separable from the arrangement to sell products to the retailer because (1) any benefit received by Company Y cannot be separated from the arrangement to sell goods to the retailer, and (2) Company Y could not enter into such an arrangement with a party other than a reseller of its products. The end-cap payment reduces revenue/ gross receipts for California sales factor purposes for Company Y.

10. **Payments by Service Provider to Customer:** When a vendor/service provider enters into an agreement promising to reimburse a customer for costs associated with the customer purchasing a service from the vendor, the amount paid by the vendor to the customer cannot be separated from the underlying sale of the service by the vendor to the customer. Since there is no identifiable benefit to the vendor that is separable from the service provided by the vendor, there is no separate sale of a product/service by the customer back to the vendor under CCR §25134 and the amount of the allowance paid to the customer reduces revenue/gross receipts for California sales factor purposes for the vendor.

Example:

Company A is a security firm that sells alarm-monitoring services. Retailer R wants to install an alarm system and purchase those services from A. Company A provides a $100 discount on R's installation costs.

Result:

Company A receives no identifiable benefit that is sufficiently separable from the sale of services to Retailer R because (1) any benefit received by Company A cannot be separated from the arrangement to sell services to Retailer R and (2) Company A would not enter into such an arrangement with a party other than a customer for its services. Therefore, the $100 discount reduces revenue/ gross receipts for California sales factor purposes for Company A.

11. **Short-Term Promotional or Buy-down Allowance:** When a vendor agrees to reimburse a retailer for offering a temporary reduced selling price on certain products for a short-term promotional period, the vendor is not receiving an

identifiable benefit that is separable and measurable since the vendor would not have made the payment without the sales arrangement for the products. There is no sale of products/services by the retailer back to the vendor under CCR §25134(a)(1)(A) or (C), hence the allowance reduces revenue/gross receipts for California sales factor purposes for the vendor.

12. **Margin Protection or Markdown Participation Allowance:** When a vendor pays an allowance to a retailer to cover shortfalls when products must be sold at a discount, the amount of the allowance reduces the vendor's sales price and revenue/gross receipts for California sales factor purposes as the vendor has not received an identifiable benefit that is separable and measurable nor has there been a separate sale by the retailer back to the vendor under CCR §25134 that would give rise to gross receipts for the vendor.

13. **Up-Front Cash Payments and Long-Term Agreements:** When a vendor pays the retailer cash up-front in exchange for the retailer agreeing to commit to purchase a targeted volume of products over a period of time, these allowances are generally treated as trade discounts. Since the vendor is not receiving an identifiable benefit that is separable and measurable, the amount of the allowance reduces the sales price of the products sold by the vendor to the retailer and also reduces the vendor's revenue/ gross receipts for California sales factor purposes.

14. **Reimbursement Based on Units Purchased:** When a vendor reimburses a retailer for certain costs based on the amount of units that the retailer purchases from the vendor during a designated time period, the vendor is not receiving an identifiable benefit that is separable and measurable. The amount of the allowance reduces the sales price of the products sold by the vendor to the retailer and also reduces the revenue/gross receipts for the vendor for California sales factor purposes.

Example:

Reimbursement of Floor Plan Interest: Auto Manufacturer F has an ongoing dealer assistance program where auto dealers are reimbursed at the end of each month for a portion of their floor plan interest costs incurred in connection with purchase of Manufacturer F's automobiles. The amount of interest cost to be reimbursed each month is determined using a contractually specified formula based on purchases from Manufacturer F during the most recent 3-month period (including the current month). If a dealer ceases doing business with Manufacturer F during the month, that dealer is not eligible to receive the floor plan interest subsidy for that month.

Result:

There is no identifiable benefit to Manufacturer F that is separable from Manufacturer F's sale of automobiles to the dealers because Manufacturer F is simply paying some of the dealer's operating costs and is doing so only because the dealers are customers. The reimbursements of floor plan interest reduce revenue/gross receipts for California sales factor purposes for Manufacturer F.

Vendor Allowances – Retailer Perspective

Retailers whose business activity includes the resale of products obtained from manufacturers of products (vendors) sometimes receive allowances or incentives from the vendors. These vendor allowances can be various types of credits, rebates, or cash that the vendor pays the retailer who sells their product or service. The retailers may have arrangements with more than one vendor and may have more than one arrangement with the same vendor. The retailer and the vendor negotiate the terms and conditions of these vendor allowances. The issue is whether the vendor allowances are gross receipts for the retailer for California sales factor purposes for the retailer.

CCR §25134(a)(1)(A) provides the rules for when a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products has "sales" that are considered to be gross receipts. "Sales" in those situations includes all gross receipts from the sales of the goods or products to customers in the ordinary course of its trade or business.

CCR §25134(a)(1)(C) provides the rules for when a taxpayer engaged in providing services has sales that are considered to be gross receipts. "Sales" in those situations include the gross receipts from the performance of those services including fees, commissions, and similar items.

For taxable years beginning before 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(e), emphasis added.)

For taxable years beginning on or after 1/1/2011: "'Sales' means all gross receipts of the taxpayer not allocated under Sections 25123 to 25137, inclusive." (R&TC §25120(f)(1).) In addition, " 'Gross receipts' means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital . . . in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code, as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold." (R&TC §25120(f)(2), emphasis added.)

a. **FEDERAL TREATMENT:**

- Treasury Regulation §1.471-3(b) that provides the rules for trade discounts stating that trade discounts reduce the invoice price.
- Treasury Regulation §1.471-3(e) that provides the rules for sales-based vendor allowances stating that these decrease the cost of goods sold (COGS), but only in very specific chargeback fact patterns.

b. **OPTIONS:** There are three options for treatment of vendor allowances, with only one giving rise to a gross receipt for California sales factor purposes.

1. Reduce COGS: The allowance paid by the vendor to the retailer reduces COGS for the retailer (i.e. purchase price) and does not give rise to a gross receipt when received.
Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If a retailer receives an allowance for $10 per item sold and that $10 is treated as a reduction of COGS, the retailer will still have $100 in gross receipts for the one item sold, but income will be $60 instead of $50 when that item is sold. The question for sales factor purposes is whether the gross receipt is the $100 received from the customer, or if there is an additional gross receipt of $10 for the vendor allowance received. The retailer receives the $100 gross receipt when the item is sold to a customer. The fact that there is a certain amount of income (whether $50 or $60) does not change the fact that there is $100 in gross receipts. Even though there is additional income upon final sale to a customer due to the $10 allowance that reduces COGS, the gross receipt for sales factor purposes is still $100.

2. Income: The retailer immediately recognizes income when the allowance is received. This only occurs when the retailer is selling a product or a service back to the vendor that is separate from the product or service that the vendor is selling to the retailer. These are gross receipts for California sales factor purposes.

Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If the retailer receives an allowance of $10 per item sold and that $10 is treated as a separate item of income, then the amount of total gross receipts increases from $100 to $110 when item X is sold. The sourcing for the $10 (service) would likely be different than that for the $100 (sale of tangible personal property). In addition, the total income would increase from $50 to $60 when the item X is sold to a customer due to the $10 allowance.

3. Contra-Expense: The vendor allowance does not reduce the retailer's COGS and there is no immediate income recognition, but rather a positive expense entry offsetting the retailer's expense. There is no current income for the retailer and no deferred income from the vendor allowance.

Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If the retailer receives an allowance of $10 per item sold and that

$10 is treated as a contra-expense, then there is no change in the gross receipt of $100.

c. GENERAL GUIDELINES:

1. **Presumptions:** Vendor allowances are presumed to reduce COGS for the retailer and not to be gross receipts for California sales factor purposes. This presumption is overcome when the vendor allowance is either of the following:

A) Payment for Products or Services (revenue): If the payment from a vendor to a retailer is for products or services delivered to the vendor, the vendor allowance paid by the vendor is revenue and a gross receipt for the retailer provided the vendor receives an identifiable benefit (products or services) in exchange for the allowance paid to the retailer. The identifiable benefit must be both:

1) Separable: The benefit to the vendor must be sufficiently separate from the retailer's purchase of the vendor's products or services so that the vendor would have entered into an exchange transaction with a party other than a retailer to provide the benefit.

2) Measurable: The retailer must be able to reasonably estimate the fair value of the benefit provided to the vendor. If the vendor allowance paid by the vendor exceeds the estimated fair value of the benefit received by the vendor, that excess amount reduces COGS for the retailer and is not revenue or a gross receipt for that amount.

B) Reimbursement of Costs (contra-expense): When a payment by a vendor to a retailer reimburses costs incurred by the retailer to sell the vendor's products, then the vendor allowance is a reduction of that cost for the retailer (contra-expense). If the vendor allowance paid by the vendor to the retailer exceeds the cost incurred by the retailer that is being reimbursed, that excess amount reduces COGS for the retailer. In either case, the vendor allowance is not revenue or a gross receipt to the retailer.

2. **Condition Precedent:** A rebate or a refund of a specified amount of vendor allowance payable under a binding arrangement that is only to be paid when the retailer completes a specified cumulative level of purchases or remains a customer for a specified period of time reduces, COGS. The reduction in COGS is allocated to each underlying transaction that results in progress toward earning the rebate or refund if the amounts are probable and can be reasonably estimated. If the rebate or refund is not probably and reasonably estimated, it should be recognized as the milestones are achieved. Factors that may impair a retailer's ability to determine whether a rebate or refund can be probably or reasonably estimated include:

A) The rebate or refund relates to purchases that will occur over a relatively long period.

B) There is no historical experience with similar products or lack of ability to apply experience due to changing circumstances.
C) In the past, significant adjustments to expected cash rebates or refunds were necessary.

d. TYPES OF ALLOWANCES:

Examples:

1. **Cooperative Advertising**: The vendor manufactures toys that are sold by a retailer. The vendor offers a cooperative advertising arrangement where the retailer receives an allowance for qualifying advertising costs of up to 2% of the total purchase from the vendor if certain qualitative criteria are met. The retailer must maintain documentation of advertising performed and related costs.

   Result:

   The vendor allowance received by the retailer for cooperative advertising, to the extent that it represents a reimbursement of specific, incremental, and identifiable costs incurred by the retailer to sell the vendor's products, would be characterized as a reduction of those costs on the retailer's income statement (contra-expense), provided that the vendor allowance received does not exceed the costs incurred. If the amount of the vendor allowance exceeds the costs being reimbursed, that excess amount reduces the COGS for the retailer. If the retailer can show that the vendor received an identifiable benefit that was separable and measurable, then the vendor allowance may be revenue and a gross receipt for California sales factor purposes. If the result is neither contra-expense nor revenue, then the allowance reduces COGS and is not a gross receipt.

2. **Product Launch (Market Research Services):** The retailer enters into an agreement with a vendor to perform a significant amount of market research for the vendor related to the launch of a new product. The vendor believes that it is paying for the expertise and knowledge available to the retailer. The retailer believes the vendor is electing to purchase the retailer's knowledge of the market rather than internally develop such knowledge. The retailer would offer these services to a nonvendor.

   Result:

   The vendor allowance received is in return for services that provide an identifiable benefit to the vendor that is sufficiently separate from the retailer's purchase of the vendor's goods. Since the retailer offers those research services to nonvendors and the fair value of the research services is determinable, the vendor allowance received from the vendor represents revenue or gross receipts provided the vendor allowance received does not exceed the estimated fair value of the benefit received by the vendor. If the amount of vendor allowance paid by the vendor exceeds the estimated fair value of the related benefits received, that excess amount reduces COGS and that excess is not a gross receipt for the retailer.

3. **Cash Discount:** On 1/1/2011, in a binding agreement, the vendor offers a cash refund of $1,000 to the retailer if during 2011 the retailer purchases 1,000 units. The retailer on average purchases 1,700 units each year.

   Result:

   Since the retailer is entitled to the refund from the vendor based on the purchase of 1,000 units of inventory, the retailer should accrue the refund offer over the purchase of 1,000 units as an incremental reduction to COGS, provided it is probably and reasonably estimated that the retailer will purchase 1,000 units during 2011. This vendor allowance is a trade discount and not a gross receipt. There has been no sale of a product or a service from the retailer back to the vendor under CCR §25134(a)(1)(A) or (C) that would give rise to gross receipts to be included in the retailer's California sales factor.

4. **Payroll Allowance:** A retailer enters into an agreement with a vendor. The vendor agrees to pay an allowance to the retailer to have sales staff dedicated to promoting the vendor's product in the cosmetic department. The allowance is intended to cover a portion of the cost of in-store representatives. Certain marketing considerations, such as counter space, product placement, staffing, and pay incentives must be met to qualify for the credit. The contract is a multi-year agreement. The allowance is calculated as a percentage of actual sales of the vendor's products.

   Result:

   The analysis of this type of an allowance should be divided into its components between payroll, shelf space, and marketing.

   A) Payroll:

   1) <u>Contra-Expense</u>: If the allowance reimburses the retailer for costs that are specific, incremental, and identifiable then it is a contra-expense. Any amount paid that exceeds the identified retailer costs would be a reduction of COGS for the retailer. In either case, these are not gross receipts.

   2) <u>Revenue/Gross Receipt</u>: If the allowance for payroll gives rise to an identifiable benefit to the vendor that is separable from the products being sold and measurable, then the allowance received by the retailer is income/revenue for the retailer and a gross receipt for California sales

factor purposes. Any amount paid by the vendor that exceeds the benefit to the vendor reduces COGS for the retailer.

3) Reduction of COGS: If the result is neither a. nor b. above, then the allowance for payroll reduces COGS and is not a gross receipt for the retailer.

C) Shelf Space: The portion of the vendor allowances for shelf space is not income/revenue because the benefit received (shelf space for product) cannot be separated from the actual product purchased from the vendor. Accordingly, this would be either a contra-expense or would reduce COGS, but in either case, it is not a gross receipt for California sales factor purposes.

Marketing: If there is marketing required that gives rise to a benefit to the vendor that is separable and measurable, this is income/revenue to the retailer and a gross receipt for California sales factor purposes. Generally, services (marketing) are provided in return for the payment by the vendor. Any excess benefit received by the vendor over the fair value of the services provided to the vendor is reduces COGS for the retailer and is not gross receipt for California sales factor purposes. If the services provided are not separable or measurable, then the allowance for marketing reduces COGS and is not a gross receipt for California sales factor purposes.

5. **Merchandise Display Allowance**: A retailer enters into an agreement with a vendor that requires the retailer to provide space and tangible items for display of vendor's products. The display space is designed to be unique and project a particular image of the vendor and the vendor's products. The design, layout, and signage are based on the vendor's specifications. The required features could include shelving racks, display cases, free-standing display units, and decorative items such as: track lighting, upgraded ceilings, walls and floors. The retailer is required to pay the full cost of the fixtures and build-outs up front and provide the vendor with documentation to receive reimbursement. The retailer will own the assets.

Result:

If the allowance paid by the vendor to the retailer is for purchase of products or services that are separable from the underlying product the vendor is selling to the retailer and is measurable, then this allowance is revenue to the retailer and a gross receipt for California sales factor purposes. To be sufficiently separate from the retailer's purchase of the vendor's products, it needs to be that vendor would have entered into an exchange transaction with a party other than the retailer to provide the benefit. This test would be met if the vendor would have purchased the necessary items for display from other than the retailer. To be sufficiently measurable, the retailer must be able to reasonably estimate the fair value of the products and services being provided to display the vendor's products. If these can be reasonably estimated, then the display allowance would be measurable. If both separable and measurable, then the display allowance is payment to the retailer for sale of products or services, revenue to the retailer, and a gross receipt for California sales factor purposes.

A) If the display allowance pays for specific, incremental, and identifiable costs incurred by a retailer in selling the vendor's products, then the allowance is a contra-expense for the retailer and not a gross receipt for California sales factor purposes. If the retailer is being reimbursed for specific, incremental, and identifiable costs incurred in selling a vendor's products, then the retailer would not be considered to be engaged in a sale of products or services separate from the products being sold for the vendor and as a result there is no gross receipt for California sales factor purposes.

B) For portions of the allowance paid to the retailer that exceed the fair value of the benefit to the vendor and for those allowances not shown to be income/revenue or a contra-expense, the allowance reduces COGS and not a gross receipt for California sales factor purposes.

6. **Slotting Fees**: A retailer enters into an agreement with a vendor where the retailer agrees to stock and display the vendor's new product. There are specific requirements for how and where the product must be displayed. The allowance is one up-front payment paid before the vendor sells any products to the retailer.

Result:

Slotting fees generally do not meet the separability requirement as the retailer is not providing an identifiable benefit to the vendor that is separate from the underlying product sold to the retailer. That is, the vendor would not purchase display space from a retailer that was not selling the vendor's product. This allowance is unlikely to be payment for specific, incremental, and identifiable costs incurred by the retailer so the allowance would not be a contra-expense. As a result, the fees (allowance) reduce COGS and are not gross receipts for California sales factor purposes.

7. **Short-Term Promotional Price or "Buy Down":** A retailer enters into an agreement with a vendor where the vendor agrees to reimburse the retailer for offering a temporary reduced selling price on certain products for a short-term promotional period. The allowance is based on the number of goods sold by the retailer to its customers rather than the number of products purchased by the retailer. The retailer takes the reduced price from the customer and then waits

for the vendor credit or payment. At the end of the promotion the retailer submits the records of sales to the vendor and receives either a credit or a payment.

Result:

There is no product or service that the retailer is selling to the vendor that is separate from the underlying product that the vendor is selling to the retailer. This allowance reduces COGS for the retailer and is not a gross receipt for California sales factor purposes.

7513 NUMERATOR ASSIGNMENT – OTHER THAN TANGIBLE PERSONAL PROPERTY (GROSS RECEIPTS FOR PERFORMANCE OF

It is common for service providers to provide different types of services. The first step in auditing the sales factor of a service company is to identify and understand the different revenue streams. Each revenue stream should be analyzed separately. It is possible that different revenue streams are assigned differently. Depending on the taxpayer's election and years in your audit cycle, the method in which the sales from sales of services are assigned differs significantly.

Market Assignment

Apportioning trades or business that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or business for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign receipts from sales of services as follows: R&TC §25136(a)(1):

Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state.

CCR § 25136-2(b)(1):

"Benefit of a service is received" means the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service.

CCR § 25136-2(b)(8): "Service" means a commodity consisting of activities engaged in by a person for another person for consideration.

It is important to identify and define the type of service that is being provided in order to determine where the benefit of that particular service is being received. CCR Section 25136-2(c) provides for different cascading rules on how to determine the particular location where the benefit of service is received depending on whether the service is provided to a customer that is an individual or a business entity.

When the customer is an individual, the benefit of service is presumed to be received in this state if the billing address of the taxpayer's customer is in this state. However, when the customer is another business entity, including a government entity, the Regulation uses cascading rules for determining the particular location of where the benefit is received. For complete explanation of the cascading rules, see CCR § 25136-2(c)(1) and (c)(2).

Cost of Performance/Income Producing Activity

For taxable years beginning before January 1, 2011 and before taxable years beginning on or after January 1, 2013 for apportioning trades or businesses that do not elect to use the single-sales factor apportionment formula, the income producing activity/greater cost of performance rules for assigning sales of intangibles and services must be used.

> R&TC §25136(a) states:
>
> [S]ales, other than sales of tangible personal property, are in this state if:
> > (1) The income-producing activity is performed in this state; or
> > (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Former CCR §25136 provide rules and examples for the sales other than sales of tangible personal property in this state for taxable years beginning on or before January 1, 2013 for those taxpayers who did not elect the single sales factor.

For taxable years beginning on or after January 1, 2008, former CCR §25136(b) provides that an "income-producing activity" includes transactions and activities performed on behalf of a taxpayer by an agent or independent contractor . Former CCR §25136(d)(3), entitled "Services on Behalf of Taxpayer" states that the income producing activity is attributable to a state if such income-producing activity is in such state and provides the rules and examples to demonstrate this .

COST OF PERFORMANCE - PERSONAL SERVICE

As set forth in former CCR §25136(d)(2)(C), gross receipts received by a taxpayer for the performance of personal services by its employees are includable in the sales factor. If the services were performed in California, the receipts would be assigned to this state. If the services relating to a single item of income were performed partly within and partly outside this state, then the gross receipts from the services must be assigned to this state only if the greater proportion of the cost of performance of the services was located in this state. However, often the services performed in each state are separate income producing activities and thus may be assigned separately based on cost of performance for each income producing activity. In the case of personal services, the gross receipts from the performance of the services attributable to this state shall be measured by the ratio that time spent performing such services in this state bears to total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation, which gave rise to the gross receipts. However, personal services not directly connected with the performance of the contract or other obligation, such as negotiating the contract, are excluded from the computation. The determination of whether receipts from personal services should be assigned to the numerator of the sales factor is made separately for each item of income.

Income producing activities associated with service receipts are identified separately for each item of income, and include the rendering of personal services by employees or the use of tangible and intangible property by the taxpayer in performing a service. For TYB on or after 1/1/08, income-producing activities include the rendering of personal services by employees, agent, or independent contractor acting on behalf of the taxpayer or the use of tangible and intangible property by the taxpayer, agent, or independent contractor acting on behalf of the taxpayer in performing a service. Thus, for TYB on or after 1/1/08, such income-producing activities are no longer limited to just employees and/or taxpayer, but includes agents and independent contractors as well.

Former CCR §25136(d)(2)(C) provides the following example to illustrate this assignment of receipts from services:

Example
The taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in this state for a sum of $9,000. The project required 600 person hours to obtain the basic data and prepare the survey report. Two hundred of the 600 person hours were expended in this state. The receipts attributable to this state are $3,000.

200 person hours
over **X** $9,000 = $3,000
600 person hours

Gross receipts from personal services might not necessarily be assigned to the same state to which the corresponding payroll is assigned. In the above example, if the base of operations for the employees performing the public opinion surveys were in California, all of the payroll would be assigned to the payroll factor numerator even though the gross receipts are allocated amongst the states in which the services were performed. For information regarding the numerator of the payroll factor, see MATM 7370.

Some contracts may involve elements of both personal services and other types of activities. For example, although an architect performs a service by creating blueprints for a structure, the end product is the blueprints, a tangible item. You should address this issue by examining the substance of the transaction: Is the client paying for a service or purchasing the end product? If the end product is only incidental to the service being performed, then the fee should be treated as compensation for the performance of services. Similar rationale is used for determining whether printers sell property or perform services (MATM 7785). On the other hand, the *Appeal of Babcock and Wilcox Co*., 78-SBE-01, January 11, 1978, dealt with a situation where a contract for the fabrication of a steam generating system did involve service elements, but the SBE held that the contract as a whole was a sale of property. This case is summarized in MATM 7522. Resolution of this issue will depend on the facts and circumstances of each case. Factors that you should consider in making the determination include how the transaction is characterized in the contracts as well as in the taxpayer's representations to others (i.e., annual reports, 10-Ks, etc.), and the relative costs of the various elements of the contract.

In some situations, contracts can be broken down between receipts for services and receipts from sale of property. For example, a contract for the sale of machinery may include a maintenance agreement for the servicing of the machine by the seller's employees. Where such a situation exists, the contract price should be severed between the payment for services and the payment for property. You will be able to identify this issue by reviewing the contract evidencing the transaction in question.

Incidental personal service receipts, such as from a maintenance contract, are not always evident on the return. The income may appear as gross receipts in "other income," or may be netted with any applicable expenses. In other cases, the income may be buried as a reduction in cost of sales or "other deductions." The taxpayer's type of business may indicate the possibility of such income. For example, a computer manufacturer could very easily have this type of income while a tire manufacturer would not. If a taxpayer is likely to have material personal service income but a scan of the tax return does not reveal the existence of such income, the taxpayer should be questioned directly.

7514 NUMERATOR ASSIGNMENT – OTHER THAN TANGIBLE PERSONAL PROPERTY (INCOME FROM INTANGIBLES

Gross receipts from intangible property that are properly classified as business income are included in the sales factor. The primary issue with respect to receipts from intangibles in the sales factor involves the proper assignment of the receipts for numerator purposes.

Market Assignment

Apportioning trades or businesses that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or businesses for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign receipts from sales of intangibles as follows:

Sales from intangible property are assigned to this state to the extent the property is used in this state.

- For sales involving complete transfer of all property rights, the Regulation provides for cascading rules on how to determine where the intangible property is used, CCR § 25136-2(d)(1).

- For sales of shares of stock in a corporation, the sale of an ownership interest in pass-through entity, dividends received, or payment attributed to goodwill, the Regulation provides for a special rule using the factors of the entity sold or entity paying the dividends to determine the amount attributable to California, see CCR § 25136-2(d)(1)(A)(1) and MATM 7514.1. These rules, with respect to dividends and goodwill, are applicable for TYB on or after 1/1/15. See CCR 25136-2(i)(2).

- For interest received, the Regulation provides for special rules depending on whether the interest was from investments or from loans, see CCR 25136-2(d)(1)(A)(2) & 25136-2(i)(2). This rule is applicable for taxable years beginning on or after 1/1/2015. Also see MATM 7514.2.

- For marketable securities, the receipts from the sale is in this state if the customer is an individual and the customer's billing address is in this state. Where the customer is a corporation or another business entity, the receipts from the sale is assigned to this state if the customer's commercial domicile is in this state. These rules are applicable for TYB on or after 1/1/15. See CCR 25136-2(i)(2).See CCR § 25136-2(e) for complete cascading rules. Marketable securities are specifically defined under CCR § 25136-2(b)(5) and (6).

- For receipts from licensing, leasing, rental and other use of intangible property, the location of the use of intangible property is determined by the type of intangible. The Regulation provides for different cascading rules for marketing intangibles, non-marketing and manufacturing intangibles, and mixed intangibles. Thus, the first step is to determine the type of intangible that is under audit. It is possible the taxpayer may have different types of revenue streams and/or contracts. Each revenue stream and/or contract must be analyzed separately. Generally, for marketing intangibles, the receipts from sale is in this state to the extent the fees are attributable to the sale or other provision of goods, services or other items purchased or otherwise acquired by the ultimate customers in this state. For non-marketing and manufacturing intangibles, the receipts from sale is in this state to the extent the use for which the fees are paid takes place in this state. For example, if the licensing agreement is for the manufacture of customer products that incorporates the patent owned by the taxpayer, the receipts from sales are assigned in California if the manufacturing facility is in California. Where there are no manufacturing facilities in this state, no receipts from sales will be assigned to this state under that license agreement. For mixed intangibles for which the fees are separately stated in the contract, the fees will be separately assigned according to each appropriate cascading rules. However, when the fees are not separately stated, the regulation provides that it is presumed that the licensing fees are paid entirely for the license of marketing intangibles. See CCR § 25136-2(d)(2) for the complete cascading rules. Also see MATM 7514.3.

- For more detailed information on other types of income from intangibles, i.e. dividend income, sales of stocks or interest in PTE, interest, royalties, rents, etc., see MATM 7514.1 to 7514.5.

To ensure that you are applying the correct rules, it is important to refer to the definitions provided in the Regulation, see CCR § 25136-2(b).

Cost of Performance/Income Producing Activity

For taxable years beginning before January 1, 2011, or for taxable years beginning on or after January 1, 2011 and before January 1,2013 for apportioning trades or businesses that do not elect to use the single-sales factor apportionment formula, the income producing activity/greater cost of performance rules for assigning sales of intangibles and services must be used.

R&TC §25136(a):

[*S*]*ales, other than sales of tangible personal property, are in this state if:*

(1) The income-producing activity is performed in this state; or

(2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

For taxable years beginning on or after January 1, 2008, former CCR § 25136(b) provides that an income-producing activity includes transactions and activities performed on behalf of a taxpayer by an agent or independent contractor. Former CCR §25136(d)(3) entitled "Services on Behalf of Taxpayer" states that the income producing activity is attributable to a state if such income-producing activity is in such state, and provides rules and examples to demonstrate this rule.

Income-producing activities performed by an agent are attributable to the principal, and are considered income-producing activities of the principal. In addition, the Regulation specifically states that the mere holding of intangible personal property is not, of itself, an income-producing activity.

The first issue with respect to assigning income from intangibles involves the identification of the income producing activity, which gave rise to the income. In some instances, no income producing activity can be identified, or the item of business income cannot be attributed to any particular income producing activity of the taxpayer. Where receipts cannot be assigned to the sales factor numerator of any state, CCR §25137(c)(1)(C) provides that the receipts shall be excluded from both the numerator and the denominator of the sales factor. This adjustment is discussed in MATM 7516. Special problems with respect to various types of income from intangibles will be discussed in the following sections.

The examples in the Regulation indicate that where the income producing activities are performed in this state, the receipt is assigned to the numerator of the sales factor. Alternatively, where the income producing activity occurs both within and outside this state, the receipt is assigned to the location where the greater proportion of income-producing activity occurs, based on costs of performance. Not all receipts generated in more than one state from a single contract require a cost of performance analysis. Often there are separate income-producing activities in each state for which specific payments are received. In such cases, it would not be necessary to determine the state in which the greater proportion of the income-producing activity was performed based on cost of performance. The receipt would be assigned to the state where the underlying income producing activity occurred.

You should review the underlying contractual agreement to determine whether a cost of performance analysis is required. In the cases where this determination is necessary, the proportion of the income producing activity within the state is measured by costs of performance. Former CCR §25136(c) defines costs of performance as direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the taxpayer's trade or business. Only costs of performance that have a clearly identifiable beneficial and causal relationship to the income from the intangible should be considered in the analysis.

One of the issues in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989, involved the numerator assignment of margin interest. Under margin account contracts, some of the taxpayer's customers left their securities on deposit with the taxpayer. The taxpayer would advance funds in connection with the customer's trading activity, and the customer would be charged interest on any such advances. The FTB auditor revised the sales factor numerator to include the portion of the margin interest attributable to California customers. The taxpayer argued that the margin interest should not be included in the numerator of the sales factor because the income-producing activities giving rise to the income occurred in New York.

The SBE disagreed with the taxpayer's position, stating that the recordkeeping and billing functions that occurred in New York were primarily ministerial functions. It was the local brokers' taking and placing orders directly from the California customers that created the debts upon which the interest was paid, and the brokers handled most other day-to-day transactions which affected the balance of the customer's margin accounts. The SBE determined that it was the rendering of personal services by the brokers that was the relevant income producing activity. The SBE concluded that the margin interest paid by California customers should be included in the California numerator.

When the relevant income producing activity is performed in more than one state, the general rule is that receipts from intangibles should be assigned to the state in which the greater proportion of the income producing activity is performed. This is an "all or nothing rule." The decision in the *Merrill Lynch* case supports the position that the income-producing activity and costs of performance must be determined on a transaction-by-transaction basis, rather than by aggregating the transactions. If the test were applied to the aggregate margin interest, then all of the margin interest would have been assigned to the one state with the greatest costs of performance as measured by the brokers' services.

Subcontractors

FTB Legal Ruling 2006-02 explained that due to the effects of combined reporting groups 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 performing a contract will be considered income-producing activities directly engaged in by the contractor for purposes of the sales factor of the apportionment formula in order to more accurately assign the receipt to the place where the services were performed. Consequently, the subcontractor's income-producing activity is not excluded as performed by an independent contractor or third parties under the “on behalf of” exclusionary rule of former CCR §25136(b), so that payments made by the contractor to the subcontractor are for costs incurred in performing the service and are assigned to the state where the subcontractor performed the service, even if the intercompany income and expense for that item are not reflected in the combined report. However, the “on behalf of” rule operates to exclude the activities performed by entities that are not included in (and thus not impacted by the effects of) the combined report as a result of a water's-edge election. To the extent that entities are excluded from a combined report by this election, they are treated as third parties for combined reporting purposes.

7514.1 Sale of Stocks or Partnership/LLC Interest & Dividend Income

Apportioning trades or businesses that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and for all apportioning trades or businesses for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign dividends as follows:

When determining how to assign the receipts from sale of stocks or dividends received from corporations, it is important to understand the source of the income:

- If stock sale or dividends are from Treasury Function, sales are excluded under CCR § 25137(c)(1)(D) for taxable years beginning on or after 1/1/2007 and R&TC § 25120(f)(2)(K) for taxable years beginning on or after 1/1/2011.
- If sale of stock or interest in a partnership/LLC is substantial and occasional, sales are excluded under CCR § 25137(c)(1)(A).
- If stock sale or dividends are from marketable securities, follow the rules under CCR § 25136-2(e). Make sure to check the definition of marketable securities under § 25136-2(b)(5).
- If stock sale or dividends is none of the above or for the sale of partnership or LLC interest, then follow market assignment under CCR § 25136-2(d)(1)(A)(1) using the asset test.

Cost of Performance/Income Producing Activity

As discussed above in MATM 7514, for taxable years beginning before January 1, 2011 and for taxable years beginning on or after January 1, 2011 and before January 1, 2013 for which the taxpayer has not elected to use the single sales factor, income from intangibles is attributed to the state where the greater proportion of costs for each income producing activity is located. With respect to dividend income, the income producing activity is often difficult or impossible to identify with any certainty. Because the mere holding of stock is not an income producing activity, the dividend income should be excluded from the sales factor if the taxpayer does not engage in any other identifiable activity with respect to the stock (see MATM 7516 and Legal Ruling 2003-3). On the other hand, if the taxpayer has an active treasury department, which manages a stock portfolio, the treasury function activities may be considered to be income-producing activities with respect to dividend income arising from that portfolio.

The audit techniques for examining this area are similar to the techniques for examining interest income in the sales factor. These techniques are covered in MATM 7514.2.

For taxable years beginning on or after January 1, 2007, interest and dividends generated from the treasury function are no longer included in the sales factor, so this will no longer be an issue.

Refer to CCR §25137(c)(1)(D)(1) for a definition of treasury function.

7514.2 Interest Income

Market Assignment

Apportioning trades or businesses that elected the single-sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or business for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign receipts from interest income using the following rules:

Where the interest is from an investment, the income is assigned to the sales factor numerator of the state where it is managed, or if the interest is from a loan secured by real property the interest is assigned where the real estate is located, or if the interest is from a loan not secured by real property, it is assigned where the borrower is located. See CCR § 25136-2(d)(1)(A)(2). Interest from transaction in intangible assets held in connection with a treasury function are excluded from the sales factor computation, see MATM 7510.

Cost of Performance/Income Producing Activity

For taxable years beginning before January 1, 2011, and for taxable years beginning on or after January 1, 2011 and before January 1, 2013, for which Section 25128.5 is in effect and the taxpayer has not made an election to use the single-sales factor, sales, other than sales of tangible personal property, are assigned to the sales factor numerator in this state if:

- The income-producing activity is performed in this state; or
- The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

The term “income-producing activity” applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income-producing activity includes but is not limited to the following:

- The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer, or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.

- The sale, rental, leasing, licensing, or other use of real property.

- The rental, leasing, licensing, or other use of tangible personal property.

- The sale, licensing, or other use of intangible personal property.

The key sales factor issue with respect to interest income is whether the income producing activity can be identified to make this determination, the source of the interest needs to be identified, and you need to consider the taxpayer's facts and circumstances.

If the taxpayer has an active treasury department, which manages its working capital, the treasury function activities may be considered to be income-producing activities, however CCR § 25137(c)(1)(D) excludes receipts from treasury function activities for taxable years beginning on or after January 1, 2007. For taxable years beginning on or after January 1, 2011, R&TC § 25120(f)(2) excludes certain receipts from the sales factor including those from treasury function activities. If not excluded from the sales factor pursuant to the above regulation or statute, interest income generated by those activities should be assigned to the state where the greatest proportion of the treasury activities was performed, based on costs of performance, in other words, where the greater proportion of costs of performing the treasury activities is located.

For taxable years beginning before January 1, 2008 interest earned from investments that are managed by banks or investment firms is generally not included in the sales factor because the income-producing activity is not performed directly by the taxpayer as required by former CCR §25136(b) for those years. Similarly, interest from long-term investments in bonds, debentures, and/or government securities, may not be included in the factor if the instruments are merely held by the taxpayer. For taxable years beginning on or after January 1, 2008, the costs associated with services performed on behalf of the taxpayer are included in the cost of performance calculation.

Interest income may not only be generated from investments, but also may be generated in connection with accounts receivable, goods sold on installment plans, deferred payment arrangements, and other routine transactions. This type of interest income is generally traceable to a particular sale, and the underlying sale is considered to be the income-producing activity. See MATM 7514 for a discussion of the SBE's analysis of this issue in the context of margin interest.

The principal difficulty in this area is segregating included from excluded interest. If the issue is material, the taxpayer should be asked to prepare a breakdown of its various types of interest income by activity, and identify the locations of those activities. Since the taxpayer's accounting system will generally segregate interest income by type or by source, the general ledger summaries can be used to verify the amount of interest from each source. You may want to question the taxpayer's methodology for assigning interest income that is incidental to sales transactions (such as interest on accounts receivable) to ensure that the assignment corresponds to the assignment of the sales themselves. If the taxpayer claims to have employees whose activities generate interest income (i.e., an active treasury function) you should first determine if these receipts are excluded pursuant to CCR § 25137(c)(1)(D) or R&TC § 25120(f)(2), and if not, then verify the activities of those employees. This may be accomplished by examining the job descriptions of the employees, reviewing any policy or procedure manuals related to their duties, and by interviewing the employees.

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer incurred to perform the income-producing activity that gives rise to the particular item of income. Included in the taxpayer's costs of performance are the taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.

Treasury Function

For taxable years beginning on or after January 1, 2007, interest and dividends from intangible assets held in connection with the treasury function, along with gross receipts and overall net gains from the maturity, redemption, sale, and exchange or other disposition of such intangible assets will be excluded from the numerator and denominator of the sales factor. (CCR § 25137(c)(1)(D)) Therefore, this will no longer be an issue.

7514.3 Royalty Income

Royalty income is included in the sales factor if it is unitary business income. As with other types of revenues, the gross royalties included in the sales factor are not reduced by related expenses such as depletion or amortization. There are basically three types of royalties:

- Royalties from natural resources such as oil and gas;
- Royalties from tangible personal property such as machinery; and
- Royalties from intangible personal property such as patents, licenses, and copyrights.

Royalties from natural resources and tangible personal property are assigned to the locations where the property is extracted or utilized (§25136(d)(2)). These types of royalties do not usually present any particular problems.

Market Assignment

Apportioning trades or business that elected the single-sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or business for taxable years beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign receipts from royalties as follows:

Royalties received from the use of intangible property are assigned to the sales factor numerator of this state if the intangible property is used in this state. The Regulation provides for different cascading rules for marketing intangibles, non-marketing and manufacturing intangibles, and mixed intangibles. See MATM 7514 and CCR § 25136-2(d)(2).

Cost of Performance/Income Producing Activity

For taxable years beginning before January 1, 2011, and for taxable years beginning on or after January 1, 2011 and before January 1, 2013, for which Section 25128.5 is in effect and the taxpayer has not made an election to use the single sales factor, sales, other than sales of tangible personal property, are assigned to the sales factor numerator of this state if:

- The income-producing activity is performed in this state; or
- The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

The term "income-producing activity" applies to each separate item of income and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income. Such activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income-producing activity includes but is not limited to the following:

- The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer, or the utilization of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service.
- The sale, rental, leasing, licensing, or other use of real property.
- The rental, leasing, licensing, or other use of tangible personal property.

- The sale, licensing, or other use of intangible personal property.

The term “costs of performance” means direct costs associated with each item of income, determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer incurred to perform the income-producing activity that gives rise to the particular item of income. Included in the taxpayer's costs of performance are the taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property which give rise to the particular item of income.

With respect to royalties from intangible property, there must be an identifiable income-producing activity, performed either by the taxpayer or on behalf of the taxpayer, for the royalties to be included in the sales factor (see MATM 7514.3). For taxable years beginning before January 1, 2008, the income-producing activity must be performed by the taxpayer. The mere holding of a patent or copyright is not considered to be an income-producing activity. Ministerial acts, such as the recording of payments onto the books and records or depositing the checks, are also not considered to be relevant income-producing activities. On the other hand, if a taxpayer licenses a number of patents to others and employs a staff to monitor and service the patents, then an income-producing activity may exist.

If the income-producing activity with respect to a single item of royalty income is performed in more than one state, then the income must be assigned to the state where the greater costs of performance for each income-producing activity occurred. Costs to consider in making this determination includes direct costs such as salaries, office costs, and other expenses incurred in direct connection with the servicing of the intangible property or the licensing agreement.

If royalty income is material, you will need to determine the source of the royalty and the activities involved in producing the income. The taxpayer may be asked to prepare a schedule of each type of royalty income, including a detailed description of the nature and location of the related income producing activities. Information on these schedules may be verified through interviews with the taxpayer's employees and by review of job descriptions or licensing contracts. The taxpayer should also have income and expense information for each profit center or location that may be useful in determining where the greater proportion of the costs of performance was incurred.

7515 NUMERATOR ASSIGNMENT – OTHER THAN TANGIBLE PERSONAL PROPERTY (SALES, RENTAL, LEASE OR LICENSING OF REAL OR TANGIBLE PERSONAL PROPERTY

Gross receipts from sales, rental, lease or licensing of real or tangible properly classified as business income are included in the sales factor.

7514.4 RENTS

Gross rents received by the unitary business are included in the denominator of the sales factor. The rules for assigning rents to the numerator of the sales factor are described in CCR §25136-2.

Market Assignment

Apportioning trades or business that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and all apportioning trades or business for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign rent receipts from real and tangible personal property to this state if the real or tangible personal property is located in this state. See the example provided for in the Regulation as described in CCR §25136-2(f) & (g).

Cost of Performance/Income Producing Activity

As the Regulation explains, the income-producing activity that generates the rents, is the actual rental or leasing of the property. Therefore, the gross rents are assigned to the sales factor numerator of the state where the property is located.

If the property is used both within and outside this state during the rental period, the rental amount assigned to each state is considered to be a separate income-producing activity. Gross receipts assigned to the California sales factor numerator in such cases will be measured by the following formula:

		Days property was physically present or used in this state
Total Gross Rents	**X**	**Over**
		Total time or use of the property everywhere

Rental income can usually be found on line 6 of the federal Form 1120 or CA Form 100. Occasionally, it may also be reported in the "other income" section of the return. Since this income is often reported net of any related expenses such as maintenance or depreciation, verify that the sales factor reflects gross amounts. The taxpayer will usually maintain records, that will identify the rental sources on a by-state basis, and these should be requested to verify the sales factor numerator. If necessary, the locations and amounts from the by-state records can usually be verified using the general ledger summaries and property ledgers. Rental income included in the sales factor should be net of intercompany payments.

Although it is more difficult to obtain information regarding the location of mobile property, taxpayers will generally keep these records available because they are necessary for property tax purposes. If the materiality of the issue warrants reconstructing the location of mobile property during a rental period, the taxpayer should be asked to identify the types of documents, ledgers, job cards, etc., that it uses to track this information.

7514.5 Sale of Assets

Generally, the gross sales price of assets used in the business is included in the sales factor. Exceptions to this rule may be made to exclude substantial receipts from occasional sales, insubstantial receipts from incidental or occasional activities, and receipts from sales of intangibles for which no particular income-producing activity can be attributed. (CCR §25137(c).) These exceptions are discussed in MATM 7511.1 – MATM 7511.2.

Prior to January 1, 2011, R&TC §25120 simply referred to sales as gross receipts of the taxpayer not allocated under R&TC §25123 through §25127. Following the amendment to this section, for the taxable years beginning on and after January 1, 2011, §25120(f)(2) further clarifies that gross receipts refers to the gross amounts realized on sale or exchange of property. However, taxpayers will often include net gains from asset sales in the sales factor rather than the gross receipts. If the sales price is substantially higher than the net gain, this can result in material adjustments. The Schedule D or Form 4797 may identify the sales price for the asset sales. If not, you should request the supporting workpapers for those schedules. Unless the transaction meets one of the exceptions to inclusion in the sales factor computation, gross receipts from the sale of assets should be used in computing the sales factor.

Sales of tangible personal property are subject to the rules under R&TC §25135, and the numerator assignment of such sales is covered in detail in MATM 7512

Market Assignment

Apportioning trades or business that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and for all apportioning trades or business for taxable year beginning on or after January 1, 2013, see MATM 7005 for exceptions, must assign sales from rental, lease or licensing of real or tangible personal property to this state if the tangible or real property is located in this state, see CCR section 25136-2(f) and (g)

Cost of Performance/Income Producing Activity

For taxable years beginning before January 1, 2011 and for taxable years beginning on or after January 1, 2011 and before 1/1/13 when no single-sales factor formula election is made, receipts from sale of intangible property are assigned using Cost of Performance under R&TC §25136. If the income-producing activity that gave rise to the sale can be identified and attributed to a particular state, the sale will be assigned to that state. For example, if a taxpayer has a cash management department that buys and sells short-term securities on an ongoing basis, the gross receipts from those sales will be attributed to that location. If the income producing activity is both within and outside the state, then a cost of performance analysis may be required to determine whether the gross receipts from the sales are included in the numerator of the sales factor.
When the receipt from the sale of an intangible cannot be attributed to any particular income-producing activity, then CCR §25137(c)(1)(C) provides that the sales must be excluded from the factor altogether. See MATM 7516 for further details regarding this issue.

7516 SALES FACTOR OTHER CONSIDERATIONS

7516.1 DISC, FSC, and ETI

Federal Tax Laws That Provide Export Related Benefits

United States corporations are taxed on their worldwide taxable income, regardless of its source. In most European countries, however, corporations are taxed only on the income earned in the country imposing the tax, which arguably puts U.S. corporations at a competitive disadvantage in the international marketplace. In an effort to level the international playing field of corporations engaged in the exports of goods and services, the U.S. enacted three tax regimes to provide export-related benefits. However, each of these regimes has been deemed to be an illegal export subsidy, which violates international trade agreements. The three tax regimes are:

- Domestic International Sales Corporations (DISCs)
- Foreign Sales Corporations (FSCs)

- Extraterritorial Income (ETI)

For California purposes, DISCs and FSCs are treated as regular corporations and are fully included in the combined report whether the group files under worldwide or water's-edge. (For additional information see MATM section 5220.)

DISCs and FSCs present identical sales factor issues with respect to intercompany eliminations and throwback sales issues.

Regarding the ETI, California specifically does not conform to the federal ETI exclusion of foreign trade income as provided under IRC §114. (R&TC §17132.)

Domestic International Sales Corporations (DISCs)

DISC provisions were enacted in the Revenue Act of 1971 as IRC §991 through IRC §994. A DISC is a domestic corporation that meets certain requirements set forth in IRC §992, including the requirement that 95 percent or more of its gross receipts be "qualified export receipts." For federal purposes, DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales. Under this regime, U.S. corporations defer the tax on a portion of the DISC's export-related income. The profits of the DISC are not taxed to the DISC, but are taxed to the shareholders of the DISC when distributed or deemed distributed to them.

DISCs have been substantially phased out by FSCs, but they are still seen occasionally.

California does not conform to the federal provisions. Accordingly, DISCs are treated the same as any other corporation for state purposes.

Foreign Sales Corporations (FSCs)

FSCs were enacted in 1984 as IRC sections 921 – 927 and IRC §291(a)(4). The FSC rules largely replaced the DISC rules. Generally, FSCs are foreign subsidiaries of U.S. companies that export goods. The FSC sells products supplied by its U.S. parent. If a corporation qualifies for and elects FSC status, a portion of the FSC income is attributable to the U.S. parent, and the other portion is exempt from U.S. taxation. For federal purposes, FSCs file Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation.

California does not conform to the federal provisions. Accordingly, FSCs are treated the same as any other corporation for state purposes.

There are two types of FSCs:
- Commission FSCs
- Sales FSCs.

Different sales factor issues exist depending upon the type of FSC.

Commission FSCs: Commission FSCs are those that perform services for the U.S. affiliates, or that sell goods for the affiliates on a commission basis. Since the service fees or commission income received from members of the combined report are intercompany receipts, they are eliminated from the sales factor. Consequently, commission FSCs will generally have no sales to include in the sales factor.

Sales FSCs: Sales FSCs purchase goods from the U.S. affiliates to sell abroad. The primary sales factor issues involving sales FSCs will be verifying the FSC receipts, ensuring that intercompany eliminations have been made, and determining whether any throwback issues exist.

FSC gross receipts are not all reported in one place on the federal Form 1120-FSC return. The following computation illustrates the general method for reconstructing total gross receipts from the federal Form 1120-FSC. Since the line numbers and format of the form changes slightly from year to year, care must be taken to adapt the following computation if necessary.

Total foreign trading gross receipts (1120-FSC, Sch. B, line 6a)	$ xxxx
Nonexempt foreign trade receipts (1120-FSC, Sch. F, line 4)	xxxx
Nonforeign trade receipts (1120-FSC, Sch. F, line 17)	xxxx
Less excess receipts from small FSCs (already included in total foreign trading gross receipts) (1120-FSC, Sch. F, line 7)	(xxxx)
Total FSC receipts from 1120-FSC return	$ xxxx

If the FSC is selling goods purchased from the U.S. affiliate, the sales will be included in the factor when the goods are sold by the FSC to unrelated parties. Therefore, the intercompany sales from the U.S. affiliate to the FSC should be eliminated from the factor. If the intercompany items are material, the reconciliation of the sales factor denominator (MATM 7505) should identify whether eliminations have been made. If an issue is identified, the first step should be to interview the taxpayer to gain an understanding of exactly what the FSC does, and what types of intercompany items will be present. The federal Form 1120-FSC return (or the workpapers supporting that return) can be used to identify the intercompany items. This procedure is best performed in conjunction with the federal Form 1120-FSC reconciliation described in MATM 5220 so that the auditor has a clear understanding of what income is being reported.
Transactions involving FSCs are primarily paper transactions. Therefore, it is not uncommon for goods sold through a FSC to be shipped to the customer directly from an

affiliate's warehouse in California. See MATM 7512.3 or 7512.4 for a discussion of the throwback rules, and MATM 1240 for the rules regarding nexus in foreign jurisdictions.

Extraterritorial Income (ETI)

The ETI was enacted by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. The ETI did not provide for a new entity like a DISC or a FSC. Instead, it excluded all foreign trade income from a U.S. exporter's gross income. (IRC §114.) The European Union challenged the ETI regime at the World Trade Organization, an international body that administers trade agreements and settles trade disputes. Following the 2002 WTO's ruling that the ETI constituted a prohibited export subsidy, the ETI was repealed by the American Jobs Creation Act of 2004.

California specifically does not conform to the federal ETI exclusion of foreign trade income as provided under IRC §114. (R&TC §17132.) So, the repealed of the ETI has no effect for California purposes. For California purposes, taxpayers are required to add back any ETI excluded for federal purposes.

7516.2 Government Facilities/Cost Plus Fixed Fee Contracts

Some taxpayers will manage a U.S. Government-owned facility for the benefit of the government. The taxpayer sells the output of the facility to the government. Under a typical arrangement, the taxpayer will be reimbursed for all costs of management plus a fee. Costs can include reimbursable salaries, wages, manufacturing and operating costs. In some cases, the fee is the entire profit for managing the facility and selling the output to the government. In other cases, the fee may be nominal (such as $1) and the taxpayer's profit will be realized from the sale of goods or services to the government from the managed facility.

In any event, the sales factor should include any reimbursement, fee, and governmental sales proceeds. (CCR §25134(a)(1)(B).) Although the taxpayer does not own the facility, the taxpayer's business activity of operating the facility is reflected in the expense reimbursement and profit revenues included in its sales factor.

The primary audit problem in this area is learning whether a taxpayer is involved in managing a government facility. As a first step, you can review the Schedule R-1, and the Schedule R-2, to see if the taxpayer reports any revenue from government sales to California. If the taxpayer is a public company, annual reports and SEC Forms 10-K will usually disclose any material contracts or business dealings with the government. Once you determine that the taxpayer has a cost plus fixed fee arrangement, the next step is to verify that the revenues have been reported correctly in the sales factor. You should ask the taxpayer about its treatment of the revenues. The taxpayer's apportionment workpapers will probably have some details of the revenue from these contracts. If the contract is not top-secret, you should examine it to verify the amounts that were paid and what the payments were for. Examine the taxpayer's sales journal or general ledger summaries to ensure that the proper amount of revenue has been included.

If the contract includes sales of tangible personal property to the U.S. government, those sales will be assigned to the numerator of the sales factor in accordance with the rules discussed at MATM 7512.6. All other types of sales related to cost plus fixed fee contracts with the government will be sourced in accordance with the normal sales factor rules. In most cases, revenues associated with the management of a government-owned plant will be assigned to the state where the plant is located.

See MATM 7138 for special property factor problems related to management of government-owned plants.

7516.3. Installment Sales

When a taxpayer reports sales under the installment method, gains are reported in periods subsequent to the year of sale. In contrast, because the apportionment factors are intended to reflect the activities that give rise to income, the entire gross receipts from installment sales are included in the sales factor in the year of sale. In the subsequent periods when the gains from the installment sales are recognized, those gains are apportioned using the factors from the year of sale (FTB Legal Ruling 413; upheld by the California Court of Appeal in *Tenneco West, Inc. v. Franchise Tax Board*, (1991) 234 Cal.App.3d 1510).

Example
In Year 1, Corporation X sells an asset on an installment basis. The sales price was $1,000,000, and X recognized a gain of $500,000. The installment proceeds were received in two equal payments in Years 2 and 3.

X had an apportionment factor for Year 1 of 20 percent, which includes the entire $1,000,000 installment sale. No portion of the installment sale is reflected in the factors for Years 2 and 3, and the apportionment factor was 10 percent for each of those years.

X's income apportioned to California for Years 1, 2 and 3 will be computed as follows:

Year 1:

Income other than installment sale:	$3,000,000	x	20%	=	$600,000
Installment gain:	0				0
Total apportioned to Calif.					$600,000

Year 2:

Income other than installment sale:	$2,000,000	x	10%	=	$200,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$250,000
Year 3:					
Income other than installment sale:	$4,000,000	x	10%	=	$400,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$450,000

Legal Ruling 413 indicates that dealers who regularly sell tangible personal property on an installment basis are not required to apportion installment gains using year-of-sale factors if the factors do not vary significantly from year to year. Since dealers are not permitted to use the installment method in most circumstances after 1987, this exception will not arise very often.

Since the installment method is used only for tax purposes and not for book or financial accounting purposes, the presence of installment sales should be reflected on Schedule M-1 or M-3, if applicable. If a material installment sale is detected, you should examine the taxpayer's apportionment workpapers to insure that the installment sale has been correctly reported in accordance with Legal Ruling 413.

7516.4 Offshore Sales

Offshore sales issues generally relate to oil and gas operations or ocean-going vessels. Discussion of this issue may be found in MATM 7795 (Oil & Gas Industry) or MATM 7760 (Sea Transportation).

7516.5 Partnership Sales

Unitary Partnerships

If a partnership's activities are unitary with the taxpayer's activities under established standards, disregarding the ownership requirement, then the taxpayer's share of the partnership's sales will be included in the taxpayer's sales factor. (CCR §25137-1(f).)

Intercompany eliminations – In general, the numerator and denominator of the sales factor are computed in accordance with CCR §§ 25134 – 25136 and 25137(c). These sales, net of any intercompany eliminations, are included in the sales factor based on the taxpayer's partnership interest.

Weighting of the sales factor – If under the provisions of R&TC §25128, a corporation is required to double weight its sales factor, the corporation's share of the gross business receipts of the partnership must also be considered, along with its own gross business receipts.

Example

Corporation A has a 20 percent interest in unitary Partnership P. Corporation A has $10,000,000 in California sales and $20,000,000 in total sales. P has $4,000,000 in California sales and $10,000,000 in total sales.

Corporation A's sales factor numerator is $10,800,000 ($10,000,000 plus 20 percent of $4,000,000) and its denominator is $22,000,000 ($20,000,000 plus 20 percent of $10,000,000).

CCR §25137-1(f)(3) provides special rules for eliminating intercompany sales between the taxpayer and the partnership. Although the rules are summarized here, that regulation contains numerous examples and should be consulted if intercompany sales exist. Also see FTB Publication 1061 for a more detailed unitary partnership example.

Sales by the taxpayer to the partnership

Sales by the taxpayer to the partnership are eliminated to the extent of the taxpayer's interest in the partnership.

> **Example:** Corporation A's interest in unitary Partnership P is 20 percent. Corporation A's sales were $20,000,000 for the year, $5,000,000 of which were made to P. Partnership P made sales of $10,000,000 during the same year, none of which were to Corporation A or to other partners. Corporation A's denominator is determined as follows:

Sales by Corporation A		20,000,000
Add:	A's interest in P's sales (10,000,000 x 20%)	2,000,000
Less	The intercompany portion of A's sales to P (5,000,000 x 20%)	(1,000,000)
	Sales included in A's denominator	21,000,000

(CCR §25137-1(f)(3)(C), Example 1.)

Sales by the partnership to the taxpayer

Sales by the partnership to the taxpayer are eliminated, but only to the extent that they do not exceed the taxpayer's interest in all partnership sales to partners.

Example: Corporation A's interest in unitary Partnership P is 20 percent.
Sales for the year were as follows:

Corporation A:			20,000,000
Partnership P:	To Corp A		3,000,000
	To other partners		6,000,000
	To nonpartners		1,000,000
Sales by Corporation A			20,000,000
Add:	A's interest in P's sales to nonpartners (1,000,000 x 20%)		200,000
A's interest in P's sales to all partners	(9,000,000 x 20%)	1,800,000	
Less: Intercompany sales from P to A[1]		1,800,000	0
Denominator of A's sales factor			20,200,000

[1] The intercompany sales may only be eliminated to the extent that they do not exceed A's share of P's sales to all partners, or $1,800,000. If A's share of P's sales to all partners had exceeded $3,000,000, then A would have been able to eliminate all of its $3,000,000 sales attributable from P.

Special rules for the apportionment of business income apply to unitary partnerships engaged in long-term construction contracts. (CCR §25137-1(h).)

Each corporate partner, whether general or limited, is considered to be conducting the trade or business activity of the partnership for purposes of sourcing income (see CCR §25137-1(a). Also see *Valentino v. Franchise Tax Board* (2000) 87 Cal.App.4th 1284, regarding the business activity attribution principles to an S Corporation shareholder). Therefore, if a partnership has activities in a state that exceed the P.L. 86-272 threshold (see MATM 1200 – MATM 1240), then the unitary corporate partner will be considered to be taxable in that state. Even if the corporate partner has no activities of its own in that state, sales to the state will not be thrown back.

A corporate general partner will be considered "doing business" in California if the partnership is "doing business" in the state. Accordingly, the corporate general partner is subject to the franchise tax. However, if a corporation's only connection to California is as a limited partner in a partnership that is doing business within the state, then the corporate partner will not itself be considered to be "doing business" for purposes of the franchise tax unless, in the aggregate (adding the limited partner's factors plus all distributive share of factors from partnership interests held), the total factors of the limited partner exceed any of the thresholds at R&TC §23101(b).

A partner in a limited partnership has no interest in specific partnership property. Therefore, without regard to whether the limited partner is doing business in California as set forth above, the corporate partner will be taxable under the corporate income tax rather than the franchise tax on its California source distributive income if it is not unitary with the partnership. (See *Appeal of Amman & Schmid Finanz AG,* 96-SBE-008, April 11, 1996 and MATM 1310.) Note that interest income from California and federal obligations is excluded from taxable income under the corporate income tax. Refer to MATM 1310 for an in depth discussion of "doing business" regarding partnerships.

Examine the items making up "Other Income" (line 10 of the Form 1120 return) to determine whether the taxpayer owns partnership interests. The annual reports or SEC Forms 10-K may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the sales factor to the annual reports or Forms 1120 will normally disclose whether partnership sales have been included in the factor. The partnership returns (California Form 565 or Federal Form 1065) can be used to verify the total sales amounts. If audited financial statements have been prepared for the partnership, they will usually disclose any material intercompany transactions between the partners and the partnership.

Non-Unitary Partnerships

If the activities of the partnership and the taxpayer are not unitary, the taxpayer's share of the partnership's trade or business is treated as another trade or business of the taxpayer. (CCR §25137-1(g).) However, under R&TC §23101(d), the taxpayer must include its pro rata share of factors from the partnership in determining whether the taxpayer is doing business in California, even if the taxpayer and the partnership are not unitary. The non-unitary partnership will:

- For taxable years beginning on or after January 1, 2011, add its pro rata share of factors from the partnership to its own factors to determine whether it is doing business in California under R&TC §23101(d).

- Apportion its own business income at its level, using its own apportionment factor(s).

- For taxable years beginning before January 1, 2013, double or single weight its sales factor by reference to its own gross business receipts.

- For taxable years beginning on or after January 1, 2013, apportion its own business income using a single sales factor.

- Distribute to the partners its respective share of the partnership's previously apportioned California source income.