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CORPORATION FRANCHISE TAX APPEAL

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CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of:

CRAIGSLIST, INC.

Case No.'s 725838, 843070

Oral hearing date: December 16, 2015
Decision rendered: January 15, 2016
Publication due by: May 14, 2016

Representing the Parties:

For Appellant: Robert L. Mahon, Perkins Coie LLP

For Franchise Tax Board: Katie M. Frank, Tax Counsel III

Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel IV

LEGAL ISSUE

Whether, in determining the percentage of appellant's business income that is apportioned to California, sales attributable to certain states and the District of Columbia[1] should be excluded from appellant's sales factor on the ground that appellant was not taxable in such states pursuant to Revenue and Taxation Code (R&TC)[2] section 25122.

BACKGROUND AND FINDINGS OF FACT

Appellant allows users to post classified advertisements on its website. Appellant charges a fee for a relatively small portion of those advertisements.

Appellant filed an original return for 2007 that assigned its gross receipts from the advertisements pursuant to the general sourcing rule at that time, which assigned the receipts to the state

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[1] The relevant jurisdictions are the District of Columbia, Illinois, Massachusetts, New York, Oregon, and Washington, which, for ease of expression, are collectively referred to herein as "the States at Issue."

[2] Unless otherwise indicated, all references to the Revenue and Taxation Code are to provisions effective as of the year at issue (viz., 2007).

with the greatest income-producing activity. This resulted in all or substantially all of its gross receipts being assigned to California.

Appellant petitioned the Franchise Tax Board (FTB or respondent) to use a special apportionment formula pursuant to R&TC section 25137. In a letter dated June 29, 2010 (Determination Letter), the FTB partially granted appellant's request to use an alternative apportionment formula for tax years from 2007 to 2010. Pursuant to the alternative formula, the FTB allowed appellant to source its gross receipts from advertising on a "market basis." Specifically, the FTB allowed appellant to source its gross receipts to the state where the advertisement generating the income was targeted. However, the FTB provided that appellant's receipts would be subject to "the throw-out rule," stating as follows:

> There is a concern regarding income earned in states and countries where the taxpayer is not taxable, i.e., "nowhere" income. For that reason, the throw-out rule will be utilized meaning that gross receipts sourced to a location in which the taxpayer is not taxable, as defined in RTC section 25122, will be excluded from the sales factor calculation. This will more accurately represent the taxpayer's business in California. Based on [the] Appeal of Dresser Industries, 83-SBE-118, June 29, 1982, aff'd Oct. 26, 1983, United States constitutional standards for nexus will be used to determine whether a foreign country or state has jurisdiction to tax. Taxpayer will bear the burden of proving nexus in all cases.

Appellant filed an amended California tax return for 2007 claiming a $789,799 refund applying the alternative apportionment methodology based on its view of where it was taxable pursuant to R&TC section 25122. The amended tax return included sales from the States at Issue in the denominator of its sales factor (which reflects sales everywhere), which reduced appellant's California sales factor. The amended tax return, thus, apparently reflected appellant's view that it was taxable in the States at Issue based on having more than $500,000 in sales in those states (i.e., based on its economic presence in the States at Issue). Respondent audited the amended tax return and determined that appellant was not taxable in the States at Issue because it lacked a physical presence in those states. On this basis, respondent determined that the sales sourced to the States at Issue should be thrown out of the sales

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factor calculation. As a result, respondent denied the claim for refund.[3] Appellant subsequently filed a timely appeal from this refund denial.

On appeal, appellant points to amendments made to R&TC section 23101, subdivision (b) by the California Legislature.[4] Among other amendments, the Legislature provided that a business will be considered to be "doing business" in California, and therefore subject to California taxation, if it has more than $500,000 in California sales. Although the amendments were enacted early in 2009, the Legislature provided that the amendments are only effective for tax years beginning on or after January 1, 2011. Citing the amendments, appellant argues that an economic presence standard should be applied to it for the 2007 tax year in determining whether it is taxable in the States at Issue for purposes of the throw-out rule set forth in the Determination Letter.

APPLICABLE LAW

Apportionment of Business Income

Article 2 of Chapter 17 of the Corporation Tax Law sets forth the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) as adopted by California and set forth in R&TC sections 25120 through 25141. For the year at issue (2007), California's version of UDITPA generally required that a taxpayer's business income be apportioned by a four-factor formula composed of a property factor, a payroll factor, and a double-weighted sales factor. (Rev. & Tax. Code, § 25128.) The numerators of the respective factors represent the taxpayer's property, payroll, and sales in California, while the denominators represent the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, 25134.)

R&TC section 25136 addresses how to assign or source sales of other than tangible personal property for purposes of determining whether the sales are inside California. If sales are assigned to California, such sales are included in the numerator of the sales factor as well as the denominator,

[3] The FTB also determined that appellant owed $274,427 of additional tax and a penalty of $43,005 as a result of an unrelated income adjustment and issued a Notice of Action (NOA). Appellant appealed the NOA because, if appellant was successful in the arguments it raises in its refund claim, no additional amounts would be due for 2007. However, appellant did not contest the underlying adjustment to income set forth in the NOA or that the penalty would be owed if appellant was unsuccessful in its refund claim. Accordingly, as we sustain the FTB's denial of appellant's refund claim, we also sustain the additional tax and penalty set forth in the NOA.

[4] Stats. 2009-2010, 3rd Ex. Sess., ch. 17, § 7, eff. Feb. 20, 2009 (S.B.15).

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which includes sales everywhere. However, if sales are assigned outside of California, the sales are excluded from the numerator of the sales factor and are only included in the denominator. As a result, the assignment of sales outside of California generally reduces the percentage of unitary business income of a multistate business that would be taxable by California (or reduces any business loss that is apportioned to California where the business has a unitary business loss).

Determining Whether a Taxpayer is Taxable in a Jurisdiction

As noted above, the Determination Letter provides that, under the special apportionment methodology approved by the FTB, the throw-out rule would be applied to exclude appellant's sales that were not taxable pursuant to R&TC section 25122. Under that provision, as relevant in this appeal, a taxpayer is "taxable" in a state if "that state has jurisdiction to subject the taxpayer to a net income tax *regardless of whether, in fact, the state does or does not [subject the taxpayer to a net income tax]*." (Rev. & Tax. Code, § 25122 [emphasis added].) Whether the state has "jurisdiction to subject the taxpayer to a net income tax" is determined by examining whether the taxpayer could constitutionally be subject to a net income tax by the state. (Cal. Code Regs, tit.18, § 25122, subd. (c); *Appeal of Dresser Industries, Inc.*, 82-SBE-307, June 29, 1982, rehg. den., 83-SBE-118, Oct. 26, 1983 (*Dresser Industries*).) Specifically, California Code of Regulations, title 18, section (Regulation) 25122, subdivision (c) states that the jurisdiction to tax is present "if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States."

In FTB Chief Counsel Ruling 2012-03,[5] the FTB states that, for tax years beginning on or after January 1, 2011, a taxpayer would be considered to be taxable in another state, for purposes of the throwback rule,[6] if the taxpayer's activities in that state exceeded any of the conditions set forth in R&TC section 23101, as amended effective January 1, 2011, for taxation by California law. Thus, for example, for tax years beginning on or after January 1, 2011, if the taxpayer had more than $500,000 of

[5] Chief Counsel Rulings are taxpayer specific and may not be cited as precedent.

[6] Under R&TC section 25135, shipments of tangible personal property from California to a state in which the taxpayer is not "taxable" are "thrown back" to California in determining the sales factor. Like the throw-out rule, the throwback rule determines whether the taxpayer is "taxable" by reference to R&TC section 25122 and the regulations thereunder.

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sales in the other state, it would be considered taxable in that state under R&TC section 25122, just as a taxpayer making sales into California would be considered taxable under R&TC section 23101, as amended.

In FTB Technical Advice Memorandum (TAM) 2012-01,[7] the FTB states that, for tax years beginning prior to January 1, 2011, a taxpayer is required to have a physical presence in a jurisdiction in order to be considered taxable in that jurisdiction under R&TC section 25122, citing the *Appeal of John H. Grace*, 80-SBE-115, decided October 28, 1980 (*Grace*) and *Dresser Industries*, *supra*, 82-SBE-307, petition for rehearing denied, 83-SBE-118. The TAM further explains as follows:

> By enacting legislation providing that a taxpayer is doing business in California where a taxpayer's only contact with this state are sales exceeding $500,000, California's Legislature determined for the first time that substantial economic presence meets U.S. Constitutional standards under California law. In enacting this statutory provision, California's Legislature determined that under California law, physical presence is no longer required in order for the state to subject a business to tax. However, the amendment to section 23101 specifically provides that the newly enacted circumstances applied only to taxable years beginning on or after January 1, 2011.
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> Accordingly, for taxable years beginning before January 1, 2011, California law required physical presence (either directly or through agents or independent contractors) to establish substantial nexus under the commerce clause. Thus, for throwback purposes in taxable years beginning before January 1, 2011, a taxpayer must demonstrate physical presence (either directly or through agents or independent contractors) in the destination state to establish that it is subject to taxation in that state and avoid the application of the throwback rule under section 25122 and Regulation 25122(c).

<u>*Grace*</u>

In *Grace*, *supra*, the taxpayer was an Illinois corporation that leased railroad cars to industrial companies that then arranged for railroads to ship their products on the cars. This Board stated that the taxpayer "conducts no business in California, has no agents in California, does not solicit leasing customers in California, and does not have any leasing customers in this state." This Board further stated that the taxpayer's only contact with California was that some of the leased railroad cars passed through or into California. The FTB sought to tax the taxpayer, arguing that the leased railroad cars provided sufficient nexus to subject the taxpayer to income tax. This Board declined to find that sufficient nexus could be found based on economic presence alone, summarizing the nexus

[7] The FTB's TAMs are informational only and may not be cited as precedent.

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requirements as follows:

> . . . no barrier exists to prevent the taxation of income derived wholly in furtherance of interstate commerce so long as the corporation's in-state business activities have some regular, systematic and substantial connection with, *and physical presence within*, the taxing state [emphasis added]. The controlling test which the United States Supreme Court has repeatedly noted as underlying minimally sufficient nexus is whether by the practical operation of the tax the state has exerted its taxing power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society. . . .

Applying the foregoing principles, this Board found that the taxpayer had insufficient nexus with California for the imposition of income tax and reversed the action of the FTB.

This Board also noted that, while it is constitutionally prohibited from ruling that a statute is unconstitutional or unenforceable, and has a long-standing policy of abstention from deciding constitutional issues, these limitations do not prevent it from considering constitutional limitations when interpreting applicable statutes.[8]

Dresser Industries[9]

In *Dresser Industries*, *supra*, this Board considered whether the FTB properly applied the throwback rule to products that were shipped from California to foreign countries. During the years at issue, the taxpayer, through subsidiaries, sold pumps in foreign countries, and shipped them from California. In its Opinion on Petition for Rehearing, this Board found that constitutional nexus standards were satisfied because the taxpayer, through its subsidiaries, engaged in regular and systematic sales in the foreign jurisdictions at issue. Accordingly, this Board affirmed its prior determination that the taxpayer was taxable in the foreign jurisdictions.

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[8] The California Constitution prohibits any agency, including this Board, from refusing to enforce a California statute on the basis that federal law prohibits the enforcement of the statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law. (Cal. Const., art. III, § 3.5.) As noted in *Grace*, *supra*, we also have a long-standing policy of abstaining from deciding constitutional issues, so that such issues may be litigated and definitively resolved in the courts. (See, e.g., *Appeal of Vortox Manufacturing Co.*, 30-SBE-017, Aug. 8, 1930; *Appeal of Benjamin R. Du and Carmela* Du, 2007-SBE-001, July 17, 2007, fn. 3.)

[9] 82-SBE-307, June 29, 1982, petition for rehearing denied, 83-SBE-118, Oct. 26, 1983.

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Appeal of Huffy Corp. (Huffy)[10]

In *Huffy*, the taxpayer argued that certain members of its unitary group were not taxable by California as such members either lacked a nexus with California or taxation was prohibited by P.L. 86-272. This Board held that, for tax years beginning on or after the date of the opinion, it would reverse its prior precedents and determine whether there was sufficient nexus to make a corporation taxable by considering whether the specific corporation was taxable rather than considering whether the unitary group was taxable. However, this Board explained that, in light of the reliance interests of those who had relied on its prior precedents and the need for stability, its ruling would apply on a prospective basis only.

In its Opinion on Petitions for Rehearing, this Board denied a rehearing. The Board rejected the taxpayer's argument that it apply one rule for determining whether a party was taxable to inbound transactions (in which sales were made into California) but apply another rule to outbound transactions (in which sales are made to other states). The Board explained that such an inconsistent approach "would allow clearly taxable income to escape taxation by all states and is contrary to the fundamental premise of [UDITPA] which is intended to assure that '100 percent of income, no more [and] no less,' will be subject to taxation." The Board further explained that "the treatment of both inbound and outbound transactions hinges on the same legal theory and must be resolved in a consistent fashion."

FURTHER FINDINGS OF FACT, ANALYSIS & DISPOSITION

The Determination Letter at issue in this appeal provides that, based on *Dresser Industries*, *supra*, "constitutional standards for nexus will be used to determine whether a foreign country or state has jurisdiction to tax." Notably, although the Legislature amended R&TC section 23101 prior to the date of the Determination Letter, the Determination Letter does not state that the standards for nexus set forth in the amendments to R&TC section 23101 will apply.[11]

Our prior decisions, including *Dresser Industries* and *Grace*, *supra*, have not found that

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[10] 99-SBE-022, Apr. 22, 1999, rehg. den., 99-SBE-005-A, Sept. 1, 1999.

[11] As noted previously, the amendments were enacted early in 2009 but only became effective for tax years beginning on or after January 1, 2011. Thus, the amendments allowed time for taxpayers, practitioners, and the FTB to plan and prepare for the change in the law.

constitutional standards for taxation are satisfied in the absence of a physical presence. As was the case in *Huffy*, *supra*, taxpayers, practitioners, and the FTB have relied on our precedents in planning their affairs and determining whether a taxpayer's activities could subject it to tax by California. We also note, as we did in *Huffy*, that it is important that the same standard be applied to sales outside of California (outbound sales) as is applied to sales into California (inbound sales) for the same tax year. In this respect, we note that, through TAM 2012-01 and FTB Chief Counsel Ruling 2012-03, the FTB has issued guidance to promote uniformity and consistency in this area.

In light of the reliance interests at stake, the need for caution in the consideration of constitutional issues, and to ensure the consistent application of the law, we decline to require that the FTB retroactively apply an economic presence standard when applying the terms of the Determination Letter. Accordingly, we sustain the FTB's finding that, under the Determination Letter, sales from the States at Issue should be thrown out in determining appellant's sales factor.

ORDER

Pursuant to the analysis of law and facts above, the Board ordered that the actions of the FTB for the year at issue, in denying appellant's claim for refund and affirming its proposed assessment, be sustained. Adopted at Sacramento, California, on this 29th day of March, 2016.

Fiona Ma, Chairwoman

George Runner, Member

Jerome E. Horton, Member

Yvette Stowers, Member*

*For Betty T. Yee, pursuant to Government Code section 7.9.