

INITIAL STATEMENT OF REASONS FOR THE  
ADOPTION OF CALIFORNIA CODE OF REGULATIONS,  
TITLE 18, SECTION 25136

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

The intent of the proposed amendments to the existing regulation is to treat activities performed on behalf of a taxpayer by an independent contractor in a similar manner as activities performed directly by a taxpayer, for purposes of determining the sales factor assignment of sales of other than tangible personal property.

SPECIFIC PURPOSE OF THE MODIFICATION OF THE REGULATION

Regulation section 25136 generally provides that gross receipts from sales of other than tangible property are assigned to this state if the income-producing activity which gave rise to the gross receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income-producing activity is performed within and without this state but the greater proportion of the income-producing activity is performed in this state, based on costs of performance.

Under subsection (b) of the current regulation, income-producing activity only includes "activity directly engaged in by the taxpayer in the regular course of its trade or business" and "does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." Franchise Tax Board Legal Ruling 2006-2 provides that income-producing activity engaged in by members in a combined report on behalf of a taxpayer are includable as activities directly engaged in by the taxpayer for the income-producing activity/cost of performance analysis.

The amendments adopted by the Multistate Tax Commission in 2006 reverse the rule that activity of an independent contractor is excluded and assign sales based upon the activities of both the taxpayer as well as those performed on behalf of the taxpayer. This change is accomplished through a series of amendments. Two of the amendments strike the word "directly" and the words "does not" from the language quoted above. Another of the amendments adds additional language, subsection (d)(3), to the regulation setting forth rules for determining the state where activities performed on behalf of a taxpayer are to be assigned.

Proposed amendments to Regulation section 25136 follow the amendments to the Multistate Tax Commission's model regulation and include examples to show how the rules operate for determining the state where activities performed on behalf of a taxpayer are to be assigned.

## NECESSITY

Currently, Regulation section 25136 does not assign gross receipts based on all activities related to the sale in question and excludes from the analysis the activities of third parties, such as those conducted by an independent contractor. This failure to include all activities in the analysis can result in a less accurate assignment of the sales. The inclusion of all activities related to the sale may better reflect the location of the market, which is the core purpose of the sales factor of the apportionment formula. The language of the amended Multistate Tax Commission's model regulation, which staff proposes that California follow in adopting new language into existing Regulation section 25136, addresses several issues: the cost of the activity performed by an agent or independent contractor on behalf of the taxpayer, the potential lack of information regarding the location of such activity, the preclusion of having to "look through" to the subcontractor's cost of performance, the potential for lack of nexus between the taxpayer and the state where the activity is performed, and the potential for lack of reliable and objective evidence as to the cost and/or location of the income-producing activity.

Adoption of the proposed amendments to Regulation section 25136 based on the amendments to the Multistate Tax Commission model regulation is important not only for the purpose of consistency among the states but also for purposes of a fairer reflection of the market states' contribution to the overall profitability of a multistate taxpayer and clearer guidance to taxpayers to determine the location of the taxpayer's costs for third party activities that would be included in the cost of performance.

## TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS.

The Franchise Tax Board examined and considered the history of the Multistate Tax Commission's 2006 adoption of amendments to the model regulation upon which Regulation section 25136 is based including notices, statements of reasons, public hearing documents, written comments and responses thereto, the reasoning and language of Franchise Tax Board Legal Ruling 2006-2, and the Virginia Supreme Court decision in *General Motors Corporation v. Commonwealth of Virginia* (2004) 602 SE2d 123. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

## ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS.

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small

businesses than the proposed regulation. In addition, the proposed regulation pertains to corporate taxpayers and therefore does not affect private individuals.

#### ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that proposed amendments to Regulation section 25136 of the California Code of Regulations will not have a significant overall economic impact on business. The regulation is a codification of existing Franchise Tax Board policy.