Sourcing of Income to California and "Economic Nexus" Consequences for Nonresidents

When it comes to the taxation of nonresidents, the California tax agencies—the Franchise Tax Board and the Office of Tax Appeals ("OTA")—have held that a nonresident business owner, who never set foot in California (hereafter, the "State"), owed personal income taxes to the State. This is based on application of rules that look to the place where customers receive the benefit of services, not where services are performed. These rules differ greatly from the state sourcing rules that apply to income of employees from employment.[1]

Economic nexus—the idea that a person may owe taxes to a state even if not physically present—is not new, and California has applied this concept since 2011. This article addresses California's sourcing rules and the economic nexus thresholds applicable to nonresident businesses and individual business owners who operate through sole proprietorships or flow-through entities, such as LLCs, partnerships, or S corporations. As we will show, a nonresident individual may have nexus and owe taxes to California if that individual generates even $1 of California-source income under the State's personal income tax laws.

Case Study – The Problem

Max and Jane live and work in Puerto Rico. For federal tax purposes, they are bona fide residents of Puerto Rico. For California tax purposes, they are nonresidents.

Max and Jane are 50/50 owners of a Puerto Rico Corporation ("PRCo") that qualifies for Puerto Rico "Act 60" tax benefits. PRCo is an LLC that is taxed as a corporation for both U.S. and Puerto Rico tax purposes.[2] PRCo bills its customers for the services that Max and Jane perform entirely in Puerto Rico as employees of PRCo. In 2021, PRCo generated $9 million in consulting fee income from its primary customer, who is headquartered in California.

PRCo just received a notice from California, indicating that the Franchise Tax Board will be opening an audit on the company to determine whether, and how much, it owes in California taxes for income generated in 2021. Max and Jane are bewildered and simply can't understand why California would think it can tax income from a foreign corporation that performed work solely in Puerto Rico.

[1] For California tax purposes, the Franchise Tax Board generally sources wages and other forms of employee compensation to the location where services are performed, not to the place where a customer benefits from performance of services. See generally Cal. Code Regs., tit. 18, § 17951-5 and FTB Publication 1100 (Revised: 05/2020).

[2] The vast majority of Act 60 companies are established as LLCs. A Puerto Rico LLC that has not elected to be classified as a flow-through entity for U.S. purposes is classified as a corporation for U.S. purposes. See Treas. Reg. §301.7701-3(b)(2)(i)(B). California conforms to this treatment. See Cal. Code Regs., tit. 18, § 23038(b)-3(a).

Unfortunately, some or all of the $9 million of PRCo's consulting fee income may be subject to California corporate income tax at a rate of 8.84% if its customer directly or indirectly received value from delivery of that service in California and the amount received exceeds statutory thresholds.[3]

California Tax Decision and Further Background

In 2019, California's administrative tax appeal body, the OTA, issued a precedential opinion applying a state tax concept known as market-based sourcing together with an assertion of jurisdiction over the taxpayer based on economic connections. In that appeal, the Franchise Tax Board issued assessments of additional California taxes to a self-employed Arizona screenwriter who, according to the decision, performed all services in Arizona to write screenplays for two motion-picture producers headquartered and registered in California.

Upon review, the OTA concluded that the customers of the Arizona screenwriter were in California, and thus the benefit of the screenwriting services was received in California. Although the nonresident performed all the screenwriting services in Arizona and none in California, the income was sourced to California after applying market sourcing rules that look to the location of customer benefit. The OTA affirmed the assessments of income taxes against the Arizona screenwriter.[4]

- ***The Change in Sourcing of Sales and the "Doing Business" Standard Applicable to Corporations***

The potential to owe taxes in the absence of physical presence ("economic nexus") greatly expanded when California modified state apportionment rules that apply to sales of services and intangibles.[5] For years beginning on or after January 1, 2011 and before January 1, 2013, taxpayers could elect to source their sales of services or intangibles to the locations where income-producing activities were performed. **For years beginning on or after January 1, 2013, taxpayers must consider the location of the customer benefit and use "market sourcing" to source income.**[6]

[3] See Cal. Code Regs., tit. 18, § 25136-2(b)(1) and Cal. Rev. & Tax. Code § 23101(b).

[4] *Appeal of Blair S. Bindley* (2019) 2019-OTA 179P (2019 WL 3804280), hereafter *Appeal of Blair S. Bindley.*

[5] The state sourcing rules for sales of tangible goods were not impacted when California changed the sourcing rules for sales of services and intangibles. However, a finding of economic nexus relating to sales of services or use of intangibles may impact the in-state measurement of sales of tangible goods through consideration of throwback for taxpayers generating different kinds of receipts.

[6] See Cal. Rev. & Tax. Code section 25128.7: "[F]or taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business, other than an apportioning trade or business described in subdivision (b) of Section 25128, shall be apportioned to this state by multiplying the business income by the sales factor."

Dakessian Law is challenging the validity of the ballot initiative that created mandatory single-sales-factor apportionment (Proposition 39) on grounds that it violated the California Constitution's single subject rule. The case is currently pending

Another change in California law, effective for corporations beginning in 2011, established property, payroll, and receipts thresholds ("factor-presence thresholds") that would constitute "doing business" in the State under California's Corporate Tax Code.[7] With this amendment, the Legislature provided clear guidelines: corporations with activities exceeding these factor-presence thresholds would be "doing business" within California.

The California factor-presence thresholds, as first enacted and as they currently stand, are these:

Connections with California	2011	2021
Sales in California	Exceed $500,000 or 25 percent of a taxpayer's total sales	Exceed $637,252 or 25 percent of a taxpayer's total sales
Property in California	Exceed $50,000 or 25 percent of a taxpayer's total real and tangible personal property	Exceed $63,726 or 25 percent of a taxpayer's total real and tangible personal property
Payroll in California	Exceed $50,000 or 25 percent of the total compensation paid by the taxpayer	Exceed $63,726 or 25 percent of the total compensation paid by the taxpayer

To the extent a corporation's only connections with California were the presence of California customers, the change to market sourcing, whether elected in 2011 or 2012, or required in 2013 and later years, would implicate an economic presence and consideration of the "doing business" thresholds.

For example, if a taxpayer (PRCo in our example) sold its services to purchasers that "received the benefit of the services" in California, and these sales exceeded either $637,252 or 25% of a taxpayer's total sales made everywhere, that taxpayer would be doing business in California **even if the business had no other presence (no facilities, property, or employees) in the State.**

- ***What if PRCo Elected to be Taxed as a Partnership for U.S. Tax Purposes?***

The factor-presence thresholds do not apply to all taxpayers. For example, the factor-presence thresholds do not apply to nonresident business owners (i.e., partners in partnerships or sole proprietors). That is because California places the factor-presence thresholds to identify when corporations are "doing

before the Second District California Court of Appeal, following the Los Angeles Superior Court's decision in *One Technologies, LLC v. Franchise Tax Board of the State of California* (Case No. 21STCV21844).

[7] See Cal. Rev. & Tax. Code section 23101. Of note, there are other grounds California may use to assert jurisdiction to tax, even if corporations or other taxpayers do not exceed the doing business thresholds applicable to corporations, discussed in brief below.

business" in Part 11 of the Revenue and Taxation Code (the Corporation Tax Law).[8] But individuals are subject to tax under Part 10 of the Revenue and Taxation Code (the Personal Income Tax Law), a different taxing system using different standards.

California's market sourcing rules expand the potential for nonresident individuals, who own interests in partnerships or other flow-through entities, to have not only an economic presence in California, but a taxable economic presence in California.

- ***The Economic Nexus Standard <u>Applicable to Nonresident Individual Business Owners</u> and the Change in Sourcing of Sales***

In general, businesses with either property or employees ("payroll") within California generally have nexus under good, old-fashioned physical presence nexus.[9] Indeed, prior to the enactment of market-sourcing rules, businesses selling services or intangibles would have had income sourced to California if income-producing activities were conducted in the State.[10] Under the historic rules, the performance of income producing activities in California led to the sourcing of income to the State.

[8] Although tax statutes frequently use the term "taxpayer," this word is a term of art and in Part 11 applies to "any person subject to the tax imposed under Chapter 2 (commencing with Section 23101 [the Corporate Franchise Tax], Chapter 2.5 (commencing with Section 23400 [the Alternative Minimum Tax], or Chapter 3 (commencing with Section 23501 [the Corporate Income Tax])." See Cal. Rev. & Tax. Code section 23037. Since individuals are not "taxpayers" under Chapters 2, 2.5, or 3 of Part 11, they do not appear to be governed by the doing business standard articulated by the Legislature and codified in Revenue and Taxation Code section 23101.

[9] The notable exception being for taxes measured by income imposed on taxpayers whose only connection to California is the sale of tangible goods within the state and whose presence is limited to solicitation of sales or the conduct of other activities that are ancillary to solicitation. These taxpayers, conducting limited activities, selling only tangible goods, that do have physical presence may nonetheless be protected, meaning that California would not have jurisdiction to impose income taxes pursuant to federal law under Public Law 86-272 (15 U.S.C., section 381), as interpreted by *Wisconsin v. Wrigley*, 505 U.S. 214 (1992), 112 S.Ct. 2447, 120 L.Ed.2d 174.

[10] As described above, prior to the change to market sourcing, the sourcing of income from services or intangibles would generally locate those receipts at the place where greater costs of performance, or in some instances proportional costs, were incurred by the taxpayer or on the taxpayer's behalf. See section 25136 (sometimes referred to as section 25136-1) of title 18 of the Cal. Code of Regs.

It is the change to market sourcing applicable for most kinds of businesses in 2013 that presents traps for the unwary. For this, the OTA decision in the *Appeal of Blair S. Bindley* is instructive.[11] In reviewing the California taxes owed by the nonresident independent contractor, the OTA's analysis was as follows[12]:

- First, nonresident individuals are taxable to the extent of their California source income.[13]

- Second, unlike the corporate tax law, the personal income tax law provides no economic nexus minimum thresholds, which means that even *de minimis* activities conducted entirely outside California may result in the generation of California source income.

- Third, the sourcing of the multistate income of nonresident individual business owners is addressed in large part by regulations enumerated under section 17951 of the Revenue and Taxation Code. To the extent income is generated from the conduct of a business, trade, or profession, the regulation addressing the method used to apportion that income is section 17951-4 of the California Code of Regulations (hereafter, "Regulation"). Under Regulation section 17951-4, the personal income tax laws apply certain corporate apportionment rules *including market sourcing* to nonresident individual business owners conducting business as sole proprietors or owners of flow-through entities.[14]

Although the presence of services or of intangibles sourced to California under market sourcing concepts does not automatically equate to the generation of taxable income, the fact of California source income governs taxability of nonresidents. Putting these statutes together, it appears this statutory and regulatory framework assigns California the right to tax **even a dollar ($1) that is California source income**.[15]

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[11] See the discussion section in the *Appeal of Blair S. Bindley*.

[12] Procedural points regarding FTB estimates of tax and further discussions regarding the burden of proof are omitted from the following discussion. This article also omits other notable points from the decision, such as confirmation that the individual was carrying on business within and without California and that the business was "unitary."

[13] Cal. Rev. & Tax. Code, § 17041, subd. (b).

[14] Taxpayers should monitor the FTB's unlawful attempts to tax nonresident individuals on income from intangibles based on California's corporate apportionment scheme. Dakessian Law is currently litigating this issue before the Fourth District California Court of Appeal in *Metropoulos v. Franchise Tax Board* (No. D078790). Regulation 17951-4's incorporation of the corporate apportionment scheme into the personal income tax law does not apply to a nonresident individual's income from intangibles. Instead, this income is generally allocated outside of California under Revenue and Taxation Code Section 17952. The FTB seems to recognize the separation of the corporate and personal income tax codes when it suits them—e.g., when applying the differing nexus standards—but ignores such differences where they favor the taxpayer (e.g, in *Metropoulos*).

[15] There is a practical limit on the State's ability to demand the filing of tax returns built into the California statutes and that is the income filing threshold. Unfortunately, this filing threshold is not keyed to minimum levels of California source income but instead to total federal adjusted gross income ("AGI") from all sources. The statute provides that "every individual" that is taxable under the California Personal Income Tax laws must file a return showing all gross income, all deductions, and all

Case Study for PRCo - Revisited

Unfortunately for PRCo, the rules on market sourcing in California have been difficult to apply.

California's implementing regulation would assign the benefit of the services to California if the "books and records kept in the normal course of business… indicate the benefit of the service" is in California.[16] While this seems relatively straightforward, in practice very few taxpayers keep contemporaneous records that track state tax concepts such as "market sourcing" and the location where customers receive the benefit of services. In the absence of detailed records tracking this information, the regulation allows the Franchise Tax Board and taxpayers to "reasonably approximate" the location where the benefit of services was received.[17]

What this means for PRCo is that *depending on the nature of the services provided and the benefit to its customer* it is possible California may source all of the $9 million to the State. It is also possible California will source much less than $9 million to the State. But the fact that all services were performed outside California does not answer the question of taxability and taxation in California as to PRCo. If the amount of sales sourced to California exceeds either $637,252 or 25 percent of PRCo's total sales, then California may have jurisdiction to tax PRCo.

So unfortunately, as a practical matter Max and Jane will face the challenge of explaining to the Franchise Tax Board the nature of services PRCo rendered and the place where its California customer in fact received the benefit of those services.

The fact that PRCo and its two members performed all services for the business in Puerto Rico, and that the income may be sourced for either federal or Puerto Rico tax purposes under very different rules, does not determine the sourcing of PRCo's income for California tax purposes.

As for Max and Jane, California law taxes income from employment differently from income from business activities. In general, California sources wage and other compensation income of employees by

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credits earned worldwide if its "adjusted gross income from all sources" exceed the California filing threshold for a given year. Cal. Rev. & Tax. Code, § 18501, subds. (a) and (d). In 2021, the California AGI filing threshold for an individual filing a single or head of household return was $19,310. (See https://www.ftb.ca.gov/file/personal/residency-status/part-year-and-nonresident.html.) Thus, a nonresident filing a single return with $20,000 of federal adjusted gross income from all sources, and $1 of California source income may have a filing requirement under the statutes currently in place.

[16] Cal. Code Regs., tit. 18, § 25136-1(c)(2)(A). Also note, the Franchise Tax Board has proposed amendments to this regulation, which may or may not add clarity in determining the location where PRCo's customer in California receives the benefit of its services.

[17] *Id.*, at subd. (c)(2)(B). If a reasonable approximation is not possible, the regulation provides further cascading rules with alternatives, to use the location from which the customer places the order, or the customer's billing address.

reference to the performance of services in the State.[18] Since Max and Jane performed all services in Puerto Rico and none in California, they would source all their compensation as employees to Puerto Rico, for California purposes.

- ***Case Study - if PRCo Elected to be Taxed as a Partnership for U.S. Tax Purposes***

If PRCo operated as a partnership for U.S. tax purposes, the partnership may have had a minimum tax and information reporting requirement in California if any of its sales should have been sourced to the State under its market sourcing rules. But it would be Max and Jane that would owe personal income taxes to the State of California on the flow-through income of PRCo sourced to California. And Max and Jane would pay taxes at the highest marginal rate of tax in California, which was 13.3 percent in 2021.

Conclusion and Recommendations

Based on the California sourcing rules that look to the location of customer benefit or customer use, California may attempt to assert its taxing jurisdiction over nonresident corporations and nonresident individual business owners owning interests in flow-through entities, even in the absence of physical presence. Depending on the facts, nonresidents may nonetheless claim the Due Process and Commerce Clause protections, if implicated.[19]

The authors here find it strange that California's Legislature would provide clear standards to identify when corporations are doing business yet omit reference to any similar thresholds for nonresident individual business owners. In the absence of physical presence, the "doing business" statute gives guidance on the absolute and relative amounts of sales corporations may have that constitute an economic presence within California. But for nonresident individual business owners who generate income through partnerships or other flow-through entities there is no similar minimum standard. It does not serve tax policy that the statutes and regulations in California purport to give the State jurisdiction to tax $1 of a nonresident business owner's California source income when the in-state presence is an economic presence determined by complex rules. At a minimum, the Legislature should align the corporate and individual thresholds. If the Legislature chooses to implement different standards applicable to the determination of personal income taxes of nonresidents, the Legislature should establish thresholds that are reasonable and well understood by taxpayers and their preparers nationwide.

California is certainly not alone in its use of market sourcing. As states struggle to fill budget gaps, state legislatures have rolled out market sourcing in approximately 30 states over the last ten years. As state revenue departments implement these laws, taxpayers should consider their risk and prepare for audits or correspondence audits, particularly if they have customers located in states that have adopted market

[18] Cal. Code Regs., tit. 18, § 17951-5.

[19] For example, we question whether would $1 of California source income generated from business activities realistically equates with the substantial nexus required under the Commerce Clause of the United States Constitution.

sourcing rules. One of the worst things taxpayers can do is bury their heads in the sand. Being proactive is key with mitigating nasty state tax issues. It should be noted that the statute of limitations for all 50 states to assess tax does not begin to run until a taxpayer files a complete and accurate state return.

For more information, please contact the authors:

Marty Dakessian, Esq.
marty@dakessianlaw.com
213.516.5510

Kathleen Dill, Esq.
kate@dakessianlaw.com
213.516.5509

Tom Duffy, CPA
tduffy@tomduffycpa.com
312.237.1998

About Dakessian Law

Dakessian Law, widely known as one of the nation's preeminent state and local tax controversy law firms, was founded by Mardiros ("Marty") Dakessian in 2016. Our attorneys focus on the unique and often complex areas of state and local tax issues and the agencies that administer them to develop innovative solutions. We serve corporate clients in a broad range of industries such as healthcare, technology, real estate, finance, retail and consumer products, and energy. The firm's clients include Fortune 500 companies, global institutions, and other businesses.

Dakessian Law also represents high net worth individuals at all levels of the administrative process and in court regarding disputes over state tax laws pertaining to income through flow-through businesses, of changes in residency status, as well as issues involving the sourcing of income of nonresidents.

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Los Angeles, CA Office:	Sacramento, CA Office:
445 S. Figueroa St.	1215 K Street
Suite 2210	Suite 1700
Los Angeles, CA 90071	Sacramento, CA 95814
213.516.5500	916.307.6900

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