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Tax Law Alert

A Corporate Department Publication

December 2010

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California Corporate Tax Law Changes and New Supply Chain Monitoring Law

All corporations—not merely California-based corporations—making sales to California consumers should be aware of two new California law changes, one effective at the start of 2011 and one effective at the start of 2012.

<u>Changes to the California corporate franchise tax</u>

As part of an effort to plug an estimated $42 billion state deficit, California has made a couple major changes to its corporate franchise (income) tax regime.

Effective January 1, 2011, the California corporate franchise tax will operate under a new "doing business" standard that broadens the scope of corporations subject to the tax. Under the new nexus statute, a physical presence in California is not required for a corporation to be considered "doing business" in California. Therefore, a corporation has California franchise tax exposure, and potentially California human trafficking monitoring law obligations (discussed below), if it has a significant economic presence in California even if it does not have a physical presence there.

Like most states, California's nexus (or "doing business") standard for corporate franchise tax purposes is broadly defined by statute. The revised "doing business" section provides that a taxpayer subject to the tax includes a corporation that meets one of four "bright line" tests. A corporation is subject to the California corporate franchise tax if it:

- is organized or commercially domiciled in California;
- has California sales in excess of $500,000 or 25 percent of the taxpayer's total sales, whichever is less;
- has California real property and/or tangible personal property that exceeds $50,000 or 25 percent of the taxpayer's total real property and tangible property, whichever is less; or
- has California payroll that exceeds $50,000 or 25 percent of the total compensation paid by the taxpayer, whichever is less.

Although California courts have not yet addressed the issue, most state supreme courts that have considered economic nexus standards, like the new California standard, for taxes other than sales taxes have ruled that an economic presence is sufficient to create tax liability. The U.S. Supreme Court has so far declined the opportunity to review these state court rulings, signaling that the U.S. Supreme Court likely would uphold an economic presence standard for California's corporate franchise tax.

California has also reversed course effective January 1, 2011 regarding sourcing of sales for its corporate franchise tax purposes. Under the readopted "*Finnigan* rule," all sales of tangible personal property of a combined corporate group that meet the definition of in-state sales must be included as California sales for allocation purposes, regardless of whether the specific entity selling the product has nexus with California itself. The *Finnigan* rule requires a reallocation of sales from entities without California nexus to those in the combined group with California nexus, raising an argument that the rule is constitutionally invalid as an indirect tax on entities without sufficient California nexus.

New California Transparency in Supply Chain Act

The expanded scope of the California corporate franchise tax will increase the number of non-California-based companies subject to a new regulation starting in 2012.

Effective January 1, 2012, a new California law will require certain large manufacturers and retailers to develop, maintain, and implement a policy setting forth the company's efforts to comply with federal and state laws regarding the eradication of slavery and human trafficking. A company covered by the law must post on its website its efforts to verify supply chains, audit suppliers, and obtain certifications about the origin of products.

The law applies to retailers and manufacturers "doing business" in California and having more than $100 million of worldwide gross receipts. "Doing business" in California is defined under the new California corporate franchise tax statute discussed above.