

tax lawflash

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New California Corporate Tax Market-Based Sourcing Regulation

Finalized regulation provides guidance on sales factor sourcing affecting filing requirements and apportionment exposure.

California recently finalized new California Code of Regulations, title 18, section 25136-2 (the Regulation). The Regulation is the latest in a series of significant changes that impact whether certain out-of-state entities must file tax returns in California, as well as how California taxpayers apportion income for purposes of the Corporation Franchise Tax (Franchise Tax). The Regulation is generally effective for tax years beginning on or after January 1, 2011.

The Regulation provides guidance related to how taxpayers making a single sales factor election for purposes of the Franchise Tax must use market-based sourcing rules for sales of items other than tangible personal property, including services and intangibles. It provides a general rule before proceeding into a series of complex, cascading market-based sourcing rules and numerous examples.

It is important to note that the market-based sourcing rules will be used in applying California's new economic nexus standard under section 23101(b) of the California Revenue and Taxation Code. Under the new standard, a taxpayer is "doing business" within California if California sales for the applicable tax year exceed the lesser of (a) \$500,000 or (b) 25% of the taxpayer's total sales.

Taxpayers with national distribution should consider this Regulation in the context of sweeping changes in California's Franchise Tax rules, including the adoption of the single sales factor election, the new statutory economic nexus standard, and a reversion to the *Finnigan* rule of apportionment. Out-of-state taxpayers should carefully consider these changes to avoid unexpected California tax exposures and to determine whether benefits may be obtained from these new provisions.

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