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How California's Tax Collector Collects From Out-Of-State Businesses

If you run a business outside of California, you might not think much about California income taxes. However, even if you never set foot there, if you have customers in the golden state, you might be surprised at how aggressive California can be about collecting taxes. California's Franchise Tax Board (FTB) often takes aggressive positions about residency, income allocation, and apportionment, with a particularly aggressive position what it means to carry on or conduct a business in California.

In *In re Bindley*, the FTB claimed that a self-employed screenwriter working exclusively from his home in Arizona was subject to business income apportionment in connection with screenwriting fee income he received from a California studio. The screenwriter challenged the FTB's interpretation of what it means to carry on or conduct a business in California, since it did not make very much sense to him that he could be considered as carrying on a business in California when he worked exclusively from Arizona.

But the FTB said that since the screenwriter's *client* was in California, he *carried on* his business at least *partially* within California. The FTB said he was subject to the apportionment rules, and since his client received the benefit of his screenwriting in California, the compensation from the California studio was subject to California income tax. On appeal to California's Office of Tax Appeals, the OTA sided with the FTB and the screenwriter lost.

The OTA could find no authorities that held that the terms "carrying on" or "conducting" a business for the California's business apportionment rules were limited to the physical location of the taxpayer. Also, the OTA felt it was obligated to give deference to FTB rulings. In effect, the screenwriter was out of luck because he could not cite any authority that showed that the FTB's interpretation was *wrong* as a matter of law. Therefore, he could not carry his

burden of proof to overcome the OTA deference to the FTB. The case shows that now, California can assess taxes no matter where you live.

Allocation or Apportion?

Some types of income are "allocated" for tax purposes, the term to describe which income is taxable for California income tax purposes for most types of income. However, as a formal matter, deciding how much of a taxpayer's *business income* is taxable in California is called "apportionment," not "allocation."

The FTB says business income is subject to California income tax if it comes from California customers who received the benefits of your services in California. This is so even if you have never set foot in California and have no California employees or offices. If the FTB makes such a claim, even appealing to the Office of Tax Appeals may not help.

Taxing Out-of-State Business

The apportionment of business income to California by non-residents generally involves a two-step test, described in Section 17951-4 of the California Code of Regulations. First, look at where you "carry on" or "conduct" your business. If you carry on your business *entirely outside* of California (which the regulation describes as "without the state"), then your net business income should not be subject to apportionment to California. If you carry on your business entirely within California, of course, then *all* of your net business income is taxable in California.

If you carry on your business partially within *and* partially "without" California, you have to move on to the second stage of the test, which contains

the rules for how to apportion your business income based on the type of business income you receive. Under the apportionment rules, compensation for services that your business performs is apportioned to California (*i.e.,* taxable in California) to the extent your customer receives the *benefit* of your services in California. Unless there are particular facts to suggest a California customer received the benefits of your services exclusively *outside* of California, this usually means to the extent that your customers reside in or are based in California.

Service Business Trap

There are other apportionment rules for different types of businesses. But it is often the providers of services to customers who are most surprised to discover that California expects them to pay income tax on amounts that they were paid for services they performed outside of California. Perhaps it is the fact that they can provide their services entirely outside of California that makes California's apportionment rules such a surprise.

The Arizona screenwriter who sold a script to a Hollywood studio probably never expected that California could tax him. An accountant working from home office in Florida or Massachusetts may not expect California to say they are carrying on their business in California. They may not be licensed to practice in California. And they may have never even visited California before, so it may not seem right to them to be told they are in fact conducting their business (at least partially) within California.

Unfortunately, key terms like "carry on" or "conduct," are not defined by California statute or regulation. It is arguable that a reasonable interpretation of the rules is that this refers to where you actually *conduct* your business,

i.e., where you do your work and perform your services. However, the FTB has taken a different view about what this means.

You Can Be Taxed Despite No California Presence

The apportionment rules for income tax do not use the term "doing business" in California. However, there is a natural analogy here to the term "doing business in California" that is applied for the purposes of determining whether a non-California business entity is subject to California's *franchise* tax. Under the much more developed rules for what is "doing business" in California for *franchise* tax purposes, there are several tests that can independently qualify a business as doing business in California.

Not all these tests require the business to actually own or store any property, have any employees, or provide any services within the geographical bounds of California. Under one test for "doing business" for California's franchise tax, doing business in California can be triggered solely by the location of the business's customers. A business is subject to California's franchise tax if its income from California customers exceeds certain statutory thresholds.

These thresholds are based *either* on an objective amount of sales from California customers during the year, adjusted annually for inflation ($735,019 of gross proceeds from California during the year for 2024), *or* on a relative proportion of the business's income, which does not change from year to year (25% or more of the business's total sales proceeds).

In the income tax context, the FTB has evidently adopted a similar interpretation for whether a business is conducting business or carrying on a business within California and is therefore subject to apportionment. Under the FTB's interpretation, merely having California customers can be sufficient

to be considered carrying on a business in California, subjecting the taxpayer's business to California's apportionment rules. The FTB's Residency and Sourcing Technical Manual says that even a business operated *entirely outside* of California is still "carried on" or "conducted" in California for the purposes of the apportionment rules if it has California customers.

Harsh Rules and Interpretation

California's Revenue and Sourcing Technical Manual includes two examples of sole proprietorships that were operated entirely *outside* of California, but that the Technical Manual concludes are "carried on" or "conducted" partially within California due to the location of the businesses' clients. One example involves a web designer who lives and works outside of California, but who receives $600k of her $1 million total sales from California customers. The manual concludes that her *net* business income must be apportioned to California 60%, to match the proportion of her gross sales that were from California customers.

The second example involves an accountant in Nevada who received $550k in fees from California clients. The Revenue and Sourcing Technical Manual concludes that he conducts his business partially within California as a result of his California clients, and that the $550k in fees received from California clients is subject to California income tax. Notably, the Revenue and Sourcing Technical Manual is not binding authority, and is internal guidance for FTB employees.

Catch 22

Businesses and professionals should be aware of the FTB's harsh interpretation. It is an aggressive definition to adopt since the terms "carrying

on" or "conducting" a business "within California" (unlike the "doing business" rules for franchise tax purposes) are not defined by statute or by regulation. It is debatable whether receiving an email from a California customer at your home computer outside of California and agreeing to provide services to them from your home, with communications by email and phone, falls within the intuitive or natural definition of conducting a business within California. If that were what the regulations intended the term to include, then why not include a definition that clarifies that?

The FTB has merged the two steps of the apportionment rules into a single test. The first prong of the apportionment rules is to determine whether your business conducts business entirely within, entirely "without," or partially within and partially outside of California. The second prong, at least for businesses that provide services to customers, is then for businesses required to apportion their income to apportion their business income based on where their clients received the benefit of their services.

But, in a vast majority of cases involving service-providing businesses, these are now effectively the same question. If you do not have California customers (and you otherwise would not be considered to conduct business in California), then you should not be subject to apportionment under the first prong of the rules. What is the point of that inquiry if you would not have to allocate any income to California (since you have no customers receiving the benefit of your services in California), even if you were subject to apportionment?

For the *franchise* tax, there is a minimum amount of income from California customers that is *required* for an out-of-state business to be considered as doing business in California based solely on the location of its customers. In 2024, for a business to be "doing business" in California solely on account of

the location of its customers, it had to have over $735,019 of California sales *or* over 25% of its total sales proceeds be from California customers.

Watchful Waiting?

Not every out-of-state business that sells *into* California voluntarily complies with these rules. That is particularly true if the California clients that a business has are a small portion of the total income for the business. Businesses that do not comply may wonder how likely they are to end up facing the music. One way the FTB can be alerted is by IRS Forms 1099 that are sent by California businesses to businesses or individuals outside of California.

That is what triggered the audit for the unfortunate Arizona screenwriter. When the FTB makes claims, they usually add penalties and interest too. And if you do not file a California tax return, the statute of limitations on a California audit never starts to run for that reporting year. Tax disputes in California are difficult, but here are some tips.