Tax Considerations for California's Harsh Business Environment

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In this installment of Woodcraft, Wood and Brown examine the circumstances in which both in-state and out-of-state taxpayers may be subject to income taxes in California and the Franchise Tax Board's guidance on the issue.

This discussion is not intended as legal advice.

The concept of "doing business" in a state for tax purposes is often associated with franchise taxes. However, California, like many other states, often requires business income received by businesses or individuals to be apportioned for state income tax purposes as well. California's business income apportionment rules also look at where business is conducted.

If you run a business from outside California but have customers in the Golden State that send you money for virtually anything, you might be surprised at how aggressive California can be about collecting income taxes. The Franchise Tax Board often takes aggressive positions about residency, income allocation, and apportionment — especially regarding what it means to carry on or conduct a business in California. The FTB's tough stance was affirmed in at least one case by the Office of Tax Appeals (OTA), the independent administrative court that can review and overturn FTB rulings.

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.[1]

As outlined here, the FTB often says that business income is subject to income tax if it comes from California customers who received the benefits of your services in the state — even if you have never set foot in California and have no employees or offices there. If the FTB makes such a claim, even appealing to the OTA may not help.

California Taxes Many Out-of-State Businesses

The apportionment of business income to California by nonresidents generally involves a two-step test.[2] First, look at where you carry on or conduct your business.[3] If you carry on your business entirely outside 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, then all your net business income is taxable in California.

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[1] *See, e.g.*, Cal. Code Regs., tit. 18, section 17951-4.

[2] *Id.*

[3] *Id.* at (a) and (b).

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 includes the rules for how to apportion your business income based on the type of business income you receive.[4] Under the apportionment rules, compensation for services that your business performs is apportioned to California (that is, taxable in California) to the extent your customer receives the benefit of your services in California.[5] Unless facts suggest that a California customer received the benefits of your services exclusively outside the state, this usually means to the extent that your customers reside in or are based in California.[6]

For example, suppose you are a lawyer and a California-based client asks you to represent them in litigation occurring entirely outside the state. You may be able to say that the benefit of your services for your representation was received by your client entirely in the other state, even though your client was based in the Golden State. But if your services also involve traveling to California, taking depositions there, or filing documents in a California court, it may be much more difficult to overcome the presumption that the benefit of your services for your client was received in California.

Service and Other Businesses

There are other apportionment rules for different types of businesses.[7] But providers of services to customers are often most surprised to discover that California expects them to pay income tax on amounts they received for services performed outside the state. Perhaps it is the fact that they can provide their services entirely out of state that makes the apportionment rules such a surprise.

An accountant working from a home office in Florida or Massachusetts may not expect California to say that she is carrying on her business in California, where she may not be licensed to practice. And she may have never even visited California, so it may not seem right to be told she is in fact conducting business (at least partially) within California.

Unfortunately, key terms like "carry on" or "conduct" are defined by neither California statute nor regulation. A reasonable interpretation of the rules is arguably that this refers to where you actually conduct your business — that is, where you work and perform services. However, the FTB has a different view about its meaning.

Taxed Without California Presence

The income tax apportionment rules do not use the term "doing business" in California. However, there is a natural analogy to the term "doing business in California" that is applied to determine whether a non-California business entity is subject to the state's franchise tax. Under the more developed rules, several tests can independently qualify a company as doing business in California for franchise tax purposes.[8]

Notably, not all these tests require the business to actually own or store property, have employees, or provide services within California. Under one franchise tax test, "doing business in California" can be triggered solely by the location of the business's customers.[9] A business is subject to state franchise tax if its income from California customers exceeds 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 in 2024), or on a relative proportion of the business's income, which does not change from year to year (25 percent or more of the business's total sales proceeds).

[4] *See id.* at (c)-(g). *See also* Cal. Rev. & Tax. Code sections 25120-25139; Cal. Code Regs., tit. 18, sections 25120-25139.

[5] *See* Cal. Rev. & Tax. Code sections 25128.7, 25134, and 25136(a)(1). *See also* Cal. Code Regs., tit. 18, sections 17951-4(g), 25136, 25136-2.

[6] *See, e.g.*, Cal. Code Regs., tit. 18, section 25136-2(c) (absent evidence of a particular location where the client receives benefit of service, the benefit of service is generally presumed to be the billing address of the client).

[7] *See generally* Cal. Rev. & Tax. Code sections 25120-25139; Cal. Code Regs., tit. 18, sections 25120-25139.

[8] *See* Cal. Rev. & Tax. Code section 23101.

[9] *Id.* at (b)(2).

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, just having California customers can be sufficient to be considered carrying on a business in the state, subjecting the taxpayer's business to California apportionment rules. The FTB's *Residency and Sourcing Technical Manual* says that even a business operated entirely outside California is still "carried on" or "conducted" in the state for the purposes of the apportionment rules if it has California customers.[10]

Harsh Rules, Harsher Interpretation

The *Residency and Sourcing Technical Manual* includes two examples of hypothetical sole proprietorships operated entirely outside California, but that the manual concludes are "carried on" or "conducted" partially within California because of the location of the businesses' clients. One example involves a web designer who lives and works outside California, but receives $600,000 of her $1 million total sales from California customers.[11] The manual concludes that her net business income must be apportioned to California 60 percent to match the proportion of her gross sales from California customers.

The second example involves an accountant in Nevada who received $550,000 in fees from California clients.[12] The *Residency and Sourcing Technical Manual* concludes that he conducts his business partially within California because of his clients there, and that the $550,000 in fees received from those clients is subject to California income tax. Notably, the manual is not binding authority and is internal guidance for FTB employees.

Nevertheless, the FTB has succeeded with its interpretation of carrying on a business in California in at least one published case. In *Bindley*,[13] 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 and argued that because he carried on his business entirely outside California, his business income was not subject to apportionment, regardless of his clients' location. To the screenwriter, it did not make sense that he could be considered as carrying on a business in California while working exclusively in Arizona.

However, the FTB asserted that since the screenwriter's client was in California, he carried on his business at least partially there. Consequently, he was subject to the apportionment rules, and since his client received the benefit of his screenwriting in California, the screenwriter was taxable in the state on the compensation he received from the California studio. On appeal, 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 California's business apportionment rules were limited to the taxpayer's physical location, and it referenced the "doing business" rules for franchise tax that allowed California to tax non-California entities based solely on the location of their customers. Also, the OTA believed it was obligated to defer to FTB rulings if the taxpayer could not affirmatively demonstrate that the board's ruling was wrong based on preexisting rulings and authorities.

In effect, the screenwriter was out of luck because he could not cite any authority showing 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's deference to the FTB.

[10] *See* FTB, *Residency and Sourcing Technical Manual*, section 3400 (Nov. 13, 2024).

[11] *Id.* at section 3400, Ex. 2.

[12] *Id.* at section 3400, Ex. 3.

[13] *Appeal of Bindley*, No. 18032402 (Cal. OTA May 30, 2019).

Catch 22

Businesses and professionals should be aware of the FTB's harsh interpretation. This interpretation of carrying on or conducting a business within California seems like 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 — suggesting they should be given their plain meanings. It is debatable whether using a computer or phone outside the state to agree to provide services to a California customer falls within the intuitive or natural definition of conducting a business within California.

If the regulations intended the terms to include that situation, then why not include a definition that clarifies that? If the regulations were intended to adopt the more expansive statutory definition of doing business for franchise tax purposes, why not use the term "doing business in California," which is used and defined for that purpose? Why not cite to the statutory definition of doing business in the franchise tax statutes?

Alternatively, why did the regulation not use language that more clearly captures the FTB's definition, such as "doing business for Californians or with California customers"? If the FTB intended to rely on the plain meanings of these undefined terms, it seems odd that it chose terms that do not as readily support the plain meanings the board has subsequently applied to them when there are so many other phrases the FTB could have used instead that would have made the (purportedly) intended meanings clearer.

Both "carry on" and "conduct" imply the relevant consideration is the act of doing the work to operate the business, which is unrelated to the customer's location. Moreover, "within" implies being *inside* California. Given the lack of textual support for the FTB's position, one can reasonably wonder whether the FTB would have won in the screenwriter case if not for the deference the OTA believed it was required to give to the FTB's interpretation.

The FTB's definition also seems peculiar given the broader regulatory construction for the apportionment rules. Indeed, its effect seems to merge the two steps of the apportionment rules into one. 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 California. The second prong is only supposed to be applied if, after applying the first prong, the business is determined to carry on business both within and outside California. Only if a business is determined to be conducted partially within California do the regulations appear to require apportionment of business service income based on where the business's clients received the benefit of its services.[14]

However, in the vast majority of cases involving businesses providing services, these are now effectively the same question, only differently phrased. If you do not have California customers (and otherwise would not be considered to conduct business there), then you should not be subject to apportionment under the first prong of the rules. However, that should also mean in most cases that even if you were subject to the second prong, 0 percent of your business service income would be apportioned to California. Similarly, if 100 percent of your clients are in California, then you would likely be considered to conduct your business entirely within California under the FTB's definition, but that same result would be reached by simply applying the apportionment rules, which would generally result in 100 percent of your business service income being apportioned to California because that is the location where your clients received the benefits of your services.

What, then, is the point of the first prong if, in nearly all cases, it simply applies the same test that is applied in the second prong? In effect, all businesses providing services must apply the second prong and look at where their clients receive the benefit of their services, regardless of whether the businesses are carried on or conducted within or without California — or some mixture of the two.

Perhaps there are situations in which the two prongs of the test reach different results. But in

[14]*See* Cal. Code Regs., tit. 18, section 17951.

most cases, the FTB's interpretation of conducting a business in California seems to merge the two-prong apportionment analysis into one, the sales-based apportionment analysis. It is unorthodox to interpret a statutory or regulatory provision in a way that effectively renders it superfluous or surplusage to the application of the statute or regulation. Besides, it is disconcerting that the FTB is taking a more aggressive position with the apportionment rules than exists in the arguably analogous "doing business" definition for franchise tax purposes.

The California State Legislature created that definition. 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 the state 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 percent of its total sales proceeds be from California customers.

These thresholds help ensure that agreeing to take on a California customer or a relatively small portion of income from California customers does not always expose a company to franchise tax and its reporting obligations. However, the FTB has not interpreted "carrying on" or "conducting" business in California for income tax apportionment to have any similar minimum thresholds or safe harbors. For purposes of the apportionment rules, $1 received from a California customer could subject the business to apportionment on account of the business "partially" conducting the business within California.

For some businesses, there is a modicum of federal protection from California's rules. For example, for businesses that sell tangible personal property across state lines, Congress enacted the Interstate Income Act of 1959 (P.L. 86-272), which limits states' abilities to levy income tax on a qualifying business when the company's sole connection to the taxing state is the location of the customer.[15] Nevertheless, because this law is limited to the interstate sale of tangible personal property, it does not appear to benefit other types of businesses, such as service providers.

Perhaps the FTB will explain or defend its interpretation or consider formal guidance defining the terms "carrying on" or "conducting" a business and provide thresholds or safe harbors. If so, taxpayers conducting a trade or business could at least be better aware of what their exposure to California income tax might be. But for now, the FTB's definition remains the one that taxpayers conducting a trade or business with California customers should bear in mind.

Watchful Waiting

Not every out-of-state business that sells into California voluntarily complies with these rules — particularly if its California clients are a small portion of its total income. Noncompliant businesses may wonder how likely they are to face the music.

One way the FTB can be alerted is by IRS Forms 1099 sent by California businesses to businesses or individuals outside the state. Indeed, it was the Form 1099 issued by the California studio to the Arizona screenwriter that triggered his tax audit in *Bindley*. When the FTB makes claims, it usually adds penalties and interest. 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. ■

[15] *See* 15 U.S.C. sections 381-384.