CALIFORNIA: NO NEXUS

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In a dispute with the California Franchise Tax Board, California retreated from its position that a Canco had taxable nexus for state income tax purposes. (Our firm acted for Canco in the dispute.) A company needs a requisite connection (nexus) with a state to attract state income tax, and the activities necessary to establish nexus are a frequent source of friction between a state and a would-be corporate taxpayer. Taxable connection comes in various forms, including employees or independent contractors
performing services in the state and the ownership or leasing of property within the state (such as an office or inventory).

California sent Canco a demand that it either file a California tax return or explain why it was not required to file. Canco completed an information questionnaire and argued that its activities were protected under federal Public Law 86-272 (Interstate Income Act), which prohibits a state from imposing tax on an out-of-state corporation in the following circumstances:

1. the tax at issue is an income tax;
2. the company engages in interstate commerce;
3. the company sells tangible goods (not services);
4. the company's in-state activities are "mere solicitation" at most; and
5. orders arising from the solicitation activity are approved or rejected outside the state, and approvals are filled by shipment or delivery from outside the state.

Each requirement has many underlying rules. The interstate commerce requirement is often pivotal for a Canco: some states argue that a Canco is engaged in foreign commerce, not interstate commerce.

Canco's only activity in California was the sporadic presence of a salesperson who was based outside California but occasionally entered the state to solicit California customers. The company shipped products to its California customers via common carrier. After receiving the company's reply, California concluded that the company had nexus with the state. PL 86-272 did not protect Canco: its transactions with California customers were foreign commerce, not interstate commerce. California

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issued a bill imposing tax, interest, and penalties.

In representations to California, we asserted that a claim that Canco was not engaged in interstate commerce was not supported by the facts. The term "interstate commerce" is not defined in the federal law. We argued that the corporation's location or domicile is not necessarily determinative and that one must look to the specific activities conducted by the business, an approach supported by the US Supreme Court. (See *Kraft Gen. Foods, Inc. v. Iowa Dept. of Revenue and Finance*, 505 US 71 (1992).) Evidence indicating the interstate nature of the business included the following:

1. All transactions with California customers required people and property to move across state lines. Canco shipped its products via common carrier trucks to its customers in California.
2. The shipments were sent to California locations, but the invoices for the transactions showed that the corporate headquarters of many customers were situated outside California. Thus, invoices for shipments to California locations were sent to and paid from another state.
3. Because the common carriers were hired by Canco to deliver the products, they paid highway use tax and fuel tax and made retail purchases of food and fuel in several states.
4. The sales representative who solicited California customers also made sales calls in numerous other western states.
5. A significant amount of the raw materials used to produce the finished goods sold to California customers originated with suppliers located in other states.
6. Canco maintained a US bank account and attended US trade shows outside California.
7. One California customer required Canco to deliver its manufactured goods to another state for additional processing by an unrelated third party.

Assuming that these types of activities qualify as interstate commerce, many Canadian companies should be able to benefit from the protection of PL 86-272. Most Canadian companies that do business in the United States engage in some combination of these activities as part of their normal course of business.

Alternatively, we argued that California's position discriminates between interstate and foreign commerce and is unconstitutional: under the US constitution's commerce clause, a state may not discriminate against foreign commerce in favour of interstate commerce (for example, by failing to extend the protection of PL 86-272 to income derived from so-called foreign commerce and extending that protection to so-called interstate commerce). The Multistate Tax Commission, a collection of state governments working toward the uniform application of taxing statutes, takes the position that PL 86-272 applies to both interstate commerce and foreign commerce.

California notified Canco that "[t]he Franchise Tax Board has considered your protest against the proposed assessment. As a result, we have withdrawn the proposed assessment." Unfortunately, that response does not shed light on the arguments that California found persuasive. Nonetheless, it seems that California did not want to risk unsuccessful litigation to test its position, a factor that may offer hope to similarly positioned Cancos.