The Impact of Joyce & Finnigan on Multi-State Combined Groups with Intangible Sales

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I. INTRODUCTION

The California State Board of Equalization decisions of *In the Matter of the Appeal of Joyce, Inc.*[1] ("*Joyce*") and *In the Matter of the Appeal of Finnigan Corporation*[2] ("*Finnigan*") have had an impact that reaches far outside California. *Joyce* and *Finnigan* both addressed issues surrounding the calculation of a unitary group's California sales apportionment factor numerator. Many states have adopted these decisions as the basis for the calculation of their own sales apportionment factors.

Many companies consider the tax implications of these cases when making business decisions. Typically, the goal is to minimize the sales of tangible property apportioned to a particular state. Because Joyce, Inc. and Finnigan Corporation were themselves sellers of *tangible* property, the impact of these decisions on the sale of *intangible* property is not as widely discussed. However, it should be.

This article will provide a brief background of the *Joyce* and *Finnigan* decisions and also discuss the general rules for sourcing sales of tangible and intangible property. Using scenarios based on the fictional company Super Corp, this article will compare and contrast how the sales factor is calculated for a typical non-unitary taxpayer who has tangible sales and a non-unitary taxpayer who has intangible sales. Then it will demonstrate

[1]*See In the Matter of the Appeal of Joyce, Inc.,* 66-SBE-070, 11/23/1966
[2]*See In the Matter of the Appeal of Finnigan Corporation,* 88-SBE-022, 08/25/1988

the effect of *Joyce* and *Finnigan* on the sales apportionment of combined unitary groups with sales of tangible and intangible property. This article will conclude with planning recommendations for sellers of intangible property and a discussion of state-specific items that could impact the application of *Joyce* and *Finnigan*.

II. SALES OF TANGIBLE PROPERTY

Two concepts typically involved in the determination of the sourcing of sales of tangible property are Public Law 86-272 and Throwback. These rules are covered here as they were critical pieces of law that were analyzed in the *Joyce* and *Finnigan* decisions.

P.L. 86-272 generally states that no state shall have power to impose an income tax on income derived within the state if the business activity within the state is limited to the solicitation of sales of tangible personal property. To qualify for protection under P.L. 86-272, orders must be sent outside the state for approval and filled by shipment or delivery from a point outside the state.[3]

The concept of Throwback stems from the Uniform Division for Purposes of Taxation of Income ("UDITPA") rules for sales apportionment, which state, in relevant part, "Sales of tangible personal property are in this State if…the taxpayer is not taxable in the State of the purchaser."[4] Total sales that are "in this state" become the numerator of the sales apportionment factor; the denominator of this factor is sales everywhere.

Since it is a federal law, P.L. 86-272 is applicable to all states, but Throwback is elective. Some states adopt Throwback provisions, but some do not. If a state does adopt Throwback, a taxpayer is "not taxable in the State of the purchaser" if that taxpayer is protected by P.L. 86-272 in the state of the purchaser. For example, if a taxpayer limits its activities within California to the solicitation of sales and the Throwback rule applies, sales in California must be sourced to the state from which the property is shipped. They are not sourced to California. Furthermore, the throwback rule is generally not impacted by whether the state imposes an income tax. If a taxpayer has physical nexus in Nevada, sales in Nevada are still

[3] *See* P.L. 86-272 §381

[4] *See* Article IV DIVISION OF INCOME (UDITPA—UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT) § 16.

considered *taxable* even though the state does not actually impose an income tax. Thus, sales in Nevada would not be required to be thrown back.

III. SALES OF INTANGIBLE PROPERTY

States generally use one of two methodologies to apportion sales of intangible property: "Cost of Performance" or "Where Used" (also called "Market-Sourcing"). Neither P.L. 86-272 nor the general Throwback rule is applicable to intangible property; both explicitly state that they cover sales of tangible property only.

Cost of Performance stems from a UDITPA rule that states, "Sales, other than sales of tangible personal property, are in this State if: (a) the income-producing activity is performed in this State; or (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance."[5] Like Throwback, Cost of Performance is not required for all states, and some states choose not to adopt it. Those states that do not adopt Cost of Performance often use a market-based approach; sales are assigned to a state based on where the intangible property is used or the service is received. For example, in Maine, "receipts from the performance of services must be attributed to the state where the services are received."[6]

Joyce and *Finnigan* make no mention of the sourcing of intangible property, and yet the decisions do impact the how intangible property is sourced, as the next section will explain.

IV. JOYCE AND FINNIGAN

Joyce, Inc. ("Joyce") was a California corporation deemed to be part of a unitary business with several non-California corporations, including U.S. Shoe, Inc. ("U.S. Shoe"). U.S. Shoe's only business within California was the solicitation of sales of tangible property, which was exempt from in-state taxation because of P.L. 86-272. Thus, the California State Board of Equalization concluded that the California sales of U.S. Shoe should not be included in the measure of the tax (i.e. should not be included in the numerator of the sales apportionment factor), even though Joyce was not

[5] *See* IV DIVISION OF INCOME (UDITPA—UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT) Section 17
[6] *See* Me. Rev. Stat. Ann. § 5211(16-A)

protected by P.L 86-272. Generally speaking, the *Joyce* rule is that individual corporations that are protected by P.L. 86-272 in a state do not have to include sales attributable to the state in the numerator of the sales factor of the combined unitary group, even if an affiliate corporation does have nexus within the state.

Finnigan Corporation ("Finnigan") was a California corporation engaged in a unitary business with subsidiary Disc Instruments ("Disc"), also a California corporation. Disc had no presence other than making sales of tangible personal property to other states. Finnigan, however, did have a presence in the states that Disc sold to. Finnigan's California unitary return did not include a throwback of Disc's sales to these states, under the theory that Disc, as part of the unitary group that included Finnigan, was taxable in those states, despite not having its own separate presence there. The California State Board of Equalization agreed with Finnigan's approach, holding that "'taxpayer' means all corporations within the combined unitary group. To hold otherwise would result in an apportionment formula which produced a different tax effect where the unitary business was conducted by the divisions of a single corporation than where it was conducted by multiple corporations." Generally speaking, the *Finnigan* rule is that a corporation does not have to throwback sales that are made to a particular state if one of its unitary affiliates has nexus within the destination state.

Since the reasoning behind the *Finnigan* decision concentrated on the Throwback rule and P.L. 86-272, the two decisions are often seen as two different ways to approach the Throwback requirement. However, the conclusions reached in each of these decisions can be extrapolated to issues that cover *all* property, both tangible and intangible. *Finnigan's* idea that a group of corporations engaged in a unitary business should not have a different tax result than the same business would have as part of a single corporation is unharmonious with *Joyce*. *Joyce* requires that corporations within the same unitary group calculate their apportionment differently depending on whether each corporation has nexus within the state. If all corporations were instead part of a single corporation with multiple divisions, that corporation as a whole would either have nexus or not have nexus and the apportionment factor would be calculated in the same manner across divisions, i.e., the *Finnigan* approach.

States adopt either the *Joyce* approach or the *Finnigan* approach. Sometimes the rule is stated in statutes or regulations. Sometimes the adoption is more subtle, laid out in the state's own case law. To correctly

calculate sales apportionment, a multi-state combined taxpayer should be aware of the rules adopted in its filing states.

V. THE IMPACT OF TANGIBLE AND INTANGIBLE APPORTIONMENT RULES ON A SINGLE MULTI-STATE CORPORATION

This section will illustrate how a state's adoption (or lack thereof) of Throwback and Cost of Performance rules affects tax planning answers. A corporation that sells tangible property may not reach the same conclusions as a corporation that sells intangible property. These first scenarios assume that a multi-state business is conducted in a single corporation. The next section will illustrate how a business with the same sales will be affected by *Joyce* and *Finnigan* if the business is split into multiple corporations.

Assume that Super Corp is a corporation that sells tangible property: a Super Widget. Super Corp's corporate headquarters is located in Nebraska next to its primary Super Widget factory. Super Corp also has a Super Widget office and factory in Nevada, but is not required to file a corporate income tax return in that state. Because of the close proximity of its Nevada office to Arizona, the super-ness of Super Corp's Super Widget has spread by word of mouth to that state. Therefore, even though Super Corp does not solicit sales in states other than Nebraska and Nevada, it does have sales that are shipped to Arizona. However, sales to Arizona are shipped from the Nebraska factory.

For taxable year 20X2, Super Corp had sales of Super Widget shipped to each state as follows:

Exhibit 1, Super Corp's Sales by State:

	Fulfilled from Nebraska factory	Fulfilled from Nevada factory
Sales to Nebraska	400,000	200,000
Sales to Nevada	150,000	150,000
Sales to Arizona	100,000	-

Since Nebraska does not require the throwback of sales of tangible property shipped to states in which the entity is not taxable,[7] the sales

[7] *See* Neb. Rev. Stat § 77-2734.14(2)

apportionment factor for Nebraska would only include the sales shipped to Nebraska and thus be calculated as follows:

Exhibit 2, Super Corp's Nebraska Sales Factor (as a single corporation selling tangible property):

Numerator	400,000 + 200,000	=60%
Denominator	1,000,000	

Now assume that Super Corp is headquartered and has factory in Wisconsin instead of Nebraska. The sales are the same as in Exhibit 1, but sales that were fulfilled from/shipped to Nebraska are now fulfilled from/shipped to Wisconsin. Since Wisconsin requires the throwback of sales shipped to destinations in which the taxpayer is not taxable,[8] the sales to Arizona would need to be thrown back to the state from which they were shipped (i.e., Wisconsin). Note that Nevada's sales would not be thrown back because the company is not protected by P.L. 86-272 in that state. The sales are taxable in Nevada (even though no income tax is imposed on them). Super Corp's sales factor for Wisconsin would therefore be:

Exhibit 3, Super Corp's Wisconsin Sales Factor (as a single corporation selling tangible property):

Numerator	400,000 + 200,000 + 100,000	=70%
Denominator	1,000,000	

These exhibits demonstrate that if Super Corp was a seller of tangible personal property and deciding whether its main factory should be located in Nebraska or Wisconsin, then based on the calculation of the sales factor alone, Nebraska would be the better choice for a factory location (since 60% is less than 70%). This, of course, does not consider other factors that might come into play when making a decision to move into a state, such as the state income tax rate, the apportionment factor formula, and non-tax issues. Some of those other factors will be discussed in a later section.

Assume now that instead of selling Super Widgets, Super Corp instead sells advisory services. This Super Advice consists of consulting other manufacturing companies on how to create their own Super Widgets.

[8] *See* Wis. Stat. § 71.25(9)(b)(2m)

Rerunning the same scenario with Super Corp as a seller of Super Advice (intangible property) creates a different tax result, as illustrated below.

Nebraska is a state that followed the Cost of Performance rules in tax years beginning before 1-1-2014.[9] Therefore, if Super Corp was a seller of advisory services (with offices in Nebraska and Nevada, and sales of the same amounts and to the same states as in Exhibit 1, replacing "fulfilled from" with "performed in"), the Nebraska sales factor would be:

Exhibit 4, Super Corp's Nebraska Sales Factor (as a single corporation selling intangible property):

Numerator	400,000 + 150,000 + 100,000	=65%
Denominator	1,000,000	

Wisconsin, on the other hand, sources gross receipts from services within the state "if the purchaser of the service received the benefit of the service in this state."[10] If Super Corp was located in Wisconsin, its apportionment factor would therefore be:

Exhibit 5, Super Corp's Wisconsin Sales Factor (as a single corporation selling intangible property):

Numerator	400,000 + 200,000	=60%
Denominator	1,000,000	

Hence, as a seller of intangible property, from a sales apportionment standpoint, Super Corp would be better off located in Wisconsin (60% sales apportionment factor) than Nebraska (65% sales apportionment factor).

The above is a typical illustration of how tax planning depends on the type of property the taxpayer sells. Now it is time to add another dimension to the state tax planning puzzle: *Joyce* and *Finnigan*.

VI. THE EFFECT OF JOYCE AND FINNIGAN ON APPORTIONMENT OF INTANGIBLE SALES OF COMBINED UNITARY GROUPS

[9] *See* Neb. Rev. Stat § 77-2734.14(3) (version effective until 12-31-2014).
[10] *See* Wis. Stat. § 71.25(9)(dh).

Assume that Super Corp had decided to break into two unitary corporations: Super Corp, the parent, holds the Nebraska operations, while Super Sub holds the Nevada operations. This section will consider the effects of *Joyce* and *Finnigan* on the unitary group if Super Corp & Sub sells Super Advice as opposed to Super Widgets.

The distribution of sales is the same as in Exhibit 1. Sales fulfilled from/performed in Nebraska are Super Corp's sales; sales fulfilled from/performed in Nevada are Super Sub's sales.

For purposes of this scenario, assume that Super Corp only has nexus in Nebraska and Super Sub only has nexus in Nevada. The implications of P.L. 86-272 and the possibility of economic nexus will be discussed later in this article.

Nebraska is a state that follows the *Joyce* rule. The statutes state, "Only the sales of those corporations with nexus in Nebraska are included in the numerator of the computed apportionment factor."[11] Recall, from above, that Nebraska does not require Throwback and does follow Cost of Performance. Accordingly, the sales factor under the following scenarios would be:

Exhibit 6, Super Corp's Sales Apportionment in Nebraska (as two unitary corporations):

Super Corp & Sub as Sellers of Super Widgets (Tangible Property)

	Super Corp	**Super Sub**	**Total**	
Numerator	400,000	0	400,000	=40%
Denominator	650,000	350,000	1,000,000	

Super Corp & Sub as Sellers of Super Advice (Intangible Property)

	Super Corp	**Super Sub**	**Total**	
Numerator	400,000+150,000+100,000	0	650,000	=65%
Denominator	650,000	350,000	1,000,000	

Note that the sales apportionment for intangible property is the same as in Exhibit 4. The fact that the company is now organized as a combined group has no effect on the intangible property apportionment, even though

[11] *See* Neb. Admin. R. & Regs. 24-053(C).

the apportionment factor for the combined group as a seller of tangible property is significantly less than the apportionment factor in Exhibit 2.

Now assume again that Super Corp is located in Wisconsin instead of Nebraska. Wisconsin is a state that follows the *Finnigan* rule.[12] Recall, from above, that Wisconsin requires Throwback and sources receipts from services based on where the services are received. Accordingly, the sales factor for Wisconsin under the following scenarios would be:

Exhibit 7, Super Corp's Sales Apportionment in Wisconsin (as two unitary corporations):

Super Corp & Sub as sellers of Super Widgets (Tangible Property)

	Super Corp	Super Sub	Total	
Numerator	400,000+100,000	200,000	700,000	=70%
Denominator	650,000	350,000	1,000,000	

Super Corp & Sub as sellers of Super Advice (Intangible Property)

	Super Corp	Super Sub	Total	
Numerator	400,000	200,000	600,000	=60%
Denominator	650,000	350,000	1,000,000	

Exhibits 6 and 7 illustrate how the layer of *Joyce* and *Finnigan* makes an impact on the sales apportionment factor for tangible property (reducing Nebraska's sales factor from 60% to 40% simply because of the split into two corporations, and thus making a strong case for locating the office in Nebraska over Wisconsin). On the other hand, for intangible property, both Exhibits 6 and 7 yield the same results as Exhibits 4 and 5 did. Does it follow then that *Joyce* and *Finnigan* do not impact sellers of intangible property?

[12] *See* Wis. Admin. Code Tax 2.39(2)(b) ("For a combined group, the activities of the combined group are taken as a whole in determining if the combined group is engaged in business in and outside this state").

It does not. Say, hypothetically, that Wisconsin was a *Joyce* state instead of *Finnigan*.[13] In that case, Super Sub would not have a sales factor numerator, since the company does not have nexus within the state. The apportionment factor for intangible property, if Super Corp's office was located in Wisconsin, would be:

Exhibit 8, Super Corp's Sales Apportionment in Wisconsin as two unitary corporations (if Wisconsin was a *Joyce* state):

Super Corp & Sub as sellers of Intangible Property

	Super Corp	**Super Sub**	**Total**	
Numerator	400,000	0	400,000	=40%
Denominator	650,000	350,000	1,000,000	

Exhibit 8 yields a Wisconsin sales apportionment factor that is significantly lower than Exhibit 7, simply because of the switch from *Finnigan* to *Joyce.* Furthermore, Exhibit 8 yields a Wisconsin sales apportionment factor that is significantly lower than the apportionment factor in Exhibit 5, illustrating a change in apportionment factor that could come from simply separating the multi-state activities into two separate corporations. Lastly, Exhibit 8 yields a Wisconsin sales apportionment factor that is lower than the Nebraska sales apportionment factor in Exhibit 6, the only difference between the two exhibits being that Nebraska requires Cost of Performance while Wisconsin uses Market-Sourcing.

In summary, the preceding analysis of the fictional Super Corp illustrates several important results:

1. The same tax planning decisions that result from applying *Joyce* and *Finnigan* to sellers of tangible property may not be the same results as when *Joyce* and *Finnigan* are applied to sellers of intangible property.

[13] An example of a state that follows the *Joyce* rule and requires Market-Sourcing is Minnesota. See Minn. Stat. §290.17, Subd. 4(j); Minn. R. §8019.0405, Subp. 9, Minn. Stat. §290.191, Subd. 5(b); Minn. Stat. § 290.191Subd. 5(j).

2. A multi-state seller of intangible property could consider splitting its business into multiple corporations to be able to lower its sales factor in *Joyce* states.
3. Sellers of intangible property must also consider Cost of Performance versus Market-Sourcing when examining the impact of *Joyce* and *Finnigan.*

What if some corporations within a unitary business sell tangible personal property while others sell intangible (or the same corporation sells both tangible and intangible)? A state's treatment of three concepts (Throwback, Cost of Performance, and *Joyce* versus *Finnigan*) would need to be considered. From this menu, there are eight possible combinations of these concepts that a state could choose.[14] As illustrated above, a Market-Sourcing state (Wisconsin) provided a better result for Super Corp and Sub if it sold intangible property, but a non-Throwback state provided a better result for Super Corp and Sub if it sold tangible property. In both the tangible and non-tangible scenarios, however, *Joyce* provided a better answer than *Finnigan* (refer to Exhibits 6 and 8). Thus, if Super Corp and Sub sold Super Widgets and Super Advice, it would have the smallest apportionment factor not in Nebraska or Wisconsin, but in a state that a) does not require Throwback, b) uses a market-based approach for intangible income sourcing, and c) follows the *Joyce* rule.[15]

VII. THE IMPORTANCE OF NEXUS

Since the application of the *Joyce* and *Finnigan* rules rely heavily on the definition of nexus, a complete analysis of the effect of these rules also requires an examination of each corporation's nexus within a state.

What constitutes nexus for income tax purposes remains a subject of debate among state courts. The U.S. Supreme Court provided a brightline test for sales tax in *Quill,*[16] requiring that taxpayers must have a physical presence in the state for a taxpayer to have nexus there, but this same rule was not attached to income tax. For income tax nexus, P.L. 86-272

[14] *See* Throwback-Cost of Performance-*Joyce,* Throwback-Cost of Performance-*Finnigan,* Throwback-Market-*Joyce,* Throwback-Market-*Finnigan,* No Throwback-Cost of Performance-*Joyce,* No Throwback-Cost of Performance-*Finnigan,* No Throwback-Market-*Joyce,* No Throwback-Market-*Finnigan*

[15] Texas is one such state that follows this combination. See Tex. Admin. Code 3.591 and Tex. Tax Code Ann. § 171.103. However, the Market-Sourcing only applies to certain intangible property (e.g. use of patents and royalties).

[16] *See QUILL CORPORATION, Petitioner v. NORTH DAKOTA BY AND THROUGH ITS TAX COMMISSIONER, HEIDI HEITKAMP*, 504 US 298 112 S Ct 1904 119 L Ed 2d 91 (1992).

provides another brightline test for sellers of tangible property: if activities are limited to the solicitation of sales of tangible property, then a taxpayer is exempt from taxation in that state (essentially, it voids what would otherwise constitute nexus within the state). But for sellers of intangible property, no such brightline or P.L. 86-272 protection exists.

For Super Corp and Sub, this means that a slight change in facts could change the states in which the corporations have nexus. This can be illustrated by revisiting the scenario analyzed in Exhibit 8 (where Super Corp sold intangible property and Wisconsin was hypothetically a *Joyce* state). If each corporation solicited the sale of Super Advice in both Wisconsin and Nevada, Super Sub would not be exempt from taxation under P.L. 86-272 since the law applies only to tangible property. Thus, Super Sub would have nexus in Wisconsin. Super Sub would then be required to include its Wisconsin sales in its Wisconsin sales factor numerator.

Even in the absence of solicitation of sales of intangible property, the taxpayer should be aware of the possibility that a state will claim that a corporation has economic nexus within its borders. Since, for income tax, there is no brightline physical presence test, some states have ruled that a corporation's exploitation of the state's market is action enough to constitute the right to levy an income tax on the corporation. Because the U.S. Supreme Court has not yet ruled on this topic, states are left to their own discretion to decide. Since Arizona is a state that applies economic nexus principals,[17] Super Corp may also have a filing requirement in that state simply because it has Arizona sales of intangible property. Furthermore, if a *Joyce*, Market-Sourcing state applied the economic nexus principle, a unitary seller of intangible property would lose the *Joyce*-given advantage of excluding from the sales numerator the receipts of a corporation that does not have any other presence in that state.

VIII. OTHER CONSIDERATIONS

Variations in the apportionment rules for each state must also be considered. The states selected in the Super Corp scenario had relatively straight-forward sales apportionment rules, but variations of law in other states may amplify or diminish the effect of *Joyce* and *Finnigan*. Wisconsin and Nebraska both happen to be states that have a single sales

[17] *See* Arizona Corporate Tax Ruling No. 99-5, 05/25/1999; No. 200700083-C, 03/27/2008.

factor,[18] thus rendering the amount of payroll and property in those states irrelevant in this analysis. Although more and more states, including California,[19] are drifting towards a single sales factor, there are still states that use payroll and property in their formulas. For those states, these factors would need to be considered alongside the sales apportionment impact of *Joyce* and *Finnigan*.

Also, overall trends in the world of state taxes may complicate matters. A state that currently requires Cost of Performance may switch to a Market-Sourcing rule within the next few years.[20] Some states, such as Illinois, require Throwback regardless of whether the property is tangible or intangible.[21] States may also fluctuate between *Joyce* and *Finnigan*: California, for example, has gone from *Joyce* to *Finnigan* to *Joyce* and will be returning to *Finnigan* again shortly.[22]

IX. CONCLUSION

In conclusion, this article demonstrates that *Joyce* and *Finnigan* cannot be ignored simply because a corporation is a seller of intangible property. However, there are many other factors that a taxpayer needs to take into account before ultimately making state tax planning decisions. Super Corp's scenario illustrates just one of many possible situations that a taxpayer may encounter. The addition of sales in other states or a different distribution of sales among the same states may result in different answers. But the same holds true for sellers of tangible property as well. And just like sellers of tangible property, multi-state taxpayers who sell intangible property should consider *Joyce* and *Finnigan* in their tax planning analysis.

[18] *See* Wisconsin: Wis. Stat. § 71.25(6)(d); Nebraska: Neb. Rev. Stat § 77-2734.05(1).
[19] *See* Cal. Rev. & Tax. Cd. § 25128.7.
[20] States switching to Market-Sourcing are Arizona and California. *Apportionment Using Market-Based Sourcing Rules: A State-by-State Review* by Michael S. Schadewald, CPA, Ph.D. Published November 01, 2012, available at http://www.aicpa.org/publications/taxadviser/2012/november/pages/schadewald_nov2012.aspx. Nebraska also switched to Market-Sourcing beginning in 2014. Neb. Rev. Stat § 77-2734.14(3) is currently effective only for taxable years beginning before 1-1-14.
[21] *See* ll. Admin. Code 100.3380(c)(1).
[22] *See* California FTB Informational Publication No. 1050, 06/01/2011.