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0100 INTRODUCTION

This Multistate Audit Technique Manual (MATM) is designed to aid auditors in the performance of multistate audits. It is intended both as a tool to familiarize auditors with multistate issues and audit techniques, and as a quick reference for more experienced auditors. The MATM contains discussions of the laws, cases and department policies affecting multistate taxpayers, as well as audit steps and techniques for examining multistate taxpayers.

As explained in FTB Notice 1994-8, manuals provided for the guidance of the audit staff are not authoritative, and may neither be cited to support an audit position nor relied upon by a taxpayer. In addition, the MATM should never be considered to be a substitute for researching the laws and court or SBE decisions pertinent to an audit issue. Instead, the manual should be used as an initial step in understanding the issues. Proper use of the manual should provide direction for subsequent research, and will cut down on the time that would otherwise be needed.

The auditing methods and techniques suggested in this manual are intended primarily for guidance, and may not be necessary or applicable for every audit. Auditors should use discretion in deciding which techniques should be used in a particular audit. Furthermore, auditors are strongly encouraged to use their creativity and initiative to develop additional techniques.

Finally, the audit process is continually evolving as the tax law changes, as new SBE and court cases are decided, and as audit policies and techniques are developed and refined. To ensure the continued relevance of this manual, it is important that it be updated to reflect these changes. Any suggestions or corrections are welcomed, and may be provided via EMC, fax, or interoffice mail.

Reviewed: September 2003

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0115 AUDIT OBJECTIVES

The primary responsibility for determining the correct amount of tax rests with taxpayers. In accordance with California Revenue and Taxation Code Sections 19501 - 19504, the department has developed an audit program. The goal of the department is to complete cases within 2 years of initial contact, 4 years from the date filed, or within a reasonable period as dictated by the circumstances of the case.

Purpose Of An Audit

The purpose of an audit is to effectively and efficiently determine the correct amount of tax based on an analysis of relevant tax statutes, regulations and case law as applied to the taxpayer's facts. The procedures and techniques needed to successfully complete an audit assignment will depend on the circumstances in each case. In all cases, established audit objectives and resource considerations govern how the procedures and techniques are utilized, and also the manner in which they are applied. Experience has shown that the best results are achieved through cooperation, effective communications, and setting and adhering to goals throughout the audit process. The BAP Audit Techniques Team, made up of our most successful and experienced auditors, has developed tools that will assist auditors in incorporating Best Audit Practices into their workloads. For further details regarding the following areas, see the appropriate Multistate Audit Procedures Manual section as referenced.

- Opening Conference (see MAPM 5015)
- Audit Plan (see MAPM 4070)
- Status Conferences (see MAPM 5050)
- Information Document Requests (see MAPM 5030)
- Audit Issue Presentation Sheets (see MAPM 5065)
- Position Letters (see MAPM 5080)
- Closing Conferences (see MAPM 5090)

Reviewed: September 2004

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0125 AUDIT STANDARDS

As recognized professionals, auditors are expected to conduct themselves and their work in a manner that is both fair and effective. Auditors are expected to correctly apply and administer the tax laws in a reasonable, practical, fair and impartial manner. Audits should be conducted in a reasonable manner within the bounds of the law, with sound administration, minimal delay, courtesy and respect to taxpayers. To achieve these objectives, auditors should conduct audits in a manner, which is not unnecessarily burdensome, costly or intrusive to taxpayers. Our goal is to continually strive for quality, effectiveness, and economy in the services provided to taxpayers.
The audit process consists of identifying issues, obtaining, evaluating, and documenting information, and arriving at the correct determination, which is supported by a reasonable interpretation of the tax laws. Audits are to be conducted in adherence with the following audit standards in all cases:

- LEGALITY - Audit activities and conclusions must agree with established laws and legal interpretations.

- OBJECTIVITY - An objective examination of sufficient relevant, available factual data be made in a fair and unbiased manner.

- TIMELINESS - Audits must be conducted and completed promptly, with a minimum of inconvenience to taxpayers.

- SUPPORTABILITY - Recommendations must be adequately supported, consistent with both the facts and the law.

Reviewed: December 2002

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0150 TO ORDER THE MULTISTATE AUDIT TECHNIQUE MANUAL

FRANCHISE TAX BOARD STAFF

The Multistate Audit Technique Manual is available on the Franchise Tax Board Inside Net. Consequently, FTB staff should seldom require hard copies of the Multistate Audit Technique Manual. On those rare occasions when printed copies are needed, they may be ordered from Technical Design.

PUBLIC CUSTOMERS

The Multistate Audit Technique Manual is available on the Franchise Tax Board Website at [http://www.ftb.ca.gov/aboutFTB/manuals/index.html]. Printed copies of the Multistate Audit Technique Manual may be ordered by sending a check or money order payable to the Franchise Tax Board to:

FRANCHISE TAX BOARD
TECHNICAL DESIGN
P.O. BOX 1468
SACRAMENTO, CA 95812-1468

For the current price, call (916) 845-3280 or write to the above address. You may also request Form FTB 4012 PUBLICATIONS PRICE LIST for a list of publications available for purchase.

Reviewed: September 2004

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0500 TERMS AND DEFINITIONS

The following terms are used extensively in all phases of multistate audits, and in many cases the terms are statutorily defined. The field auditor should develop a working knowledge of these terms and definitions.

Abbreviations Used

- **MATM**:
  Multistate Audit Technique Manual
- **MAPM**:
- Multistate Audit Procedures Manual
- **SBE**
  State Board of Equalization

Allocation

Allocation is the assignment of nonbusiness income to a particular state (CCR §25121(a)(3)).

Apportionment

Apportionment is the process by which business income is divided between states by the use of a formula containing apportionment factors (CCR §25121(a)(2), MATM 7000).

Apportionment Formula

An apportionment formula is a formula composed of a property factor, a payroll factor, and a sales or revenue factor. The formula calculates the percentage of business income, which is derived from or attributable to sources within this state (R&TC §25128, MATM 7000).

Business Activity

Business activity refers to transactions and activity occurring in the regular course of a particular trade or business of a taxpayer (CCR §25121(a)(4)).

Business Income

Business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the

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acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations (R&TC §25120(a), MATM 4000).

Combined Report

A combined report is a report in which the business income and apportionment factors of a unitary group of corporations are combined for purposes of determining each taxpayer's share of the California unitary business income. On July 13, 1999 the first phase of the combined reporting regulations under R&TC §25106.5 went final. This regulation provides a description of how the combined report is determined. The regulation is retroactive and is applicable to all audits.

Commercial Domicile

The commercial domicile is the principal place from which the trade or business of the taxpayer is directed or managed (R&TC §25120(b), MATM 1500).

Compensation

Compensation includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services (R&TC §25120(c), MATM 7320).

Doing Business

"Doing business" in a state means actively engaging in any transaction for the purpose of financial gain or pecuniary profit (R&TC §23101).

Fiscalization

Fiscalization is the process of placing the income and formula factors of unitary corporations with differing accounting periods onto a common taxable year-end in order to compute a combined report. The computations necessary to perform the fiscalization are described in MATM 5200.

Foreign Corporation

A foreign corporation is any corporation other than a California corporation.

Formula Factors

The Uniform Division of Income for Tax Purposes Act provides that all business income shall be apportioned to this state by use of property, payroll, and sales factors (R&TC §25128).

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1. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used everywhere during the taxable year (R&TC §25129, MATM 7100).

2. The payroll factor is a fraction, the numerator of which is the total amount of compensation paid by the taxpayer in this state during the taxable year, and the denominator of which is the total compensation paid everywhere during the taxable year (R&TC §25132, MATM 7300).

3. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. For taxable years beginning on or after January 1, 1993, the sales factor is double-weighted (R&TC §25134, MATM 7500).

Intrastate Apportionment

Intrastate apportionment is the process of determining the California income apportioned and allocated to each California taxpayer in a combined group. This process is necessary in order to determine the individual tax liability for each taxpayer, as well as to properly compute items such as NOLs, AMT and tax credits. Intrastate apportionment is discussed in MATM 7900.

Multistate Tax Compact, Multistate Tax Commission

The Multistate Tax Compact is an agreement among participating states to facilitate the uniform administration of state taxes for multistate taxpayers. The Compact incorporates UDITPA, and establishes the Multistate Tax Commission (MTC). The MTC is charged with studying state and local tax systems, developing and recommending proposals for improvement and increased uniformity of state and local tax laws, and administering the Multistate Tax Compact. States join the MTC by enacting the Multistate Tax Compact (including the UDITPA provisions). California is a member state.

Nexus

Nexus is the connection with a state which gives the state jurisdiction to impose a tax. See MATM 1100.

Nonbusiness Income

Nonbusiness income is all income other than business income (R&TC §25120(d), MATM 4000).

Public Law 86-272

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Public Law 86-272 (15 USCA 381) was enacted in 1959 to limit the states' ability to tax interstate commerce. It provides that a state cannot impose a net income tax on a business if the only business activities within the state are limited to the solicitation of sales of tangible personal property. (MATM 1200 - MATM 1240)

Sales

Sales means all gross receipts of the taxpayer not allocated under R&TC §25123 through R&TC §25127 as nonbusiness income (R&TC §25120(e), MATM 7510.)

State

State includes any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof (R&TC §25120(f)).

Taxable In Another State

For purposes of apportionment and allocation of income, the taxpayer is taxable in another state if either of two conditions exist. A taxpayer is taxable in another state if within that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax. A taxpayer is also taxable in another state if that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether the state actually imposes such a tax upon the taxpayer (R&TC §25122).

A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in such other state pertaining to the production of nonbusiness income or business activities relating to another separate trade or business (CCR §25122(a)).

Taxpayer

A taxpayer is any person or bank subject to the tax imposed under Chapter 2 or Chapter 3 of the Bank and Corporation Tax Law (CCR §25121(a)(1); 23037).

Throwback Sales

When sales of tangible personal property are shipped from an office, store, warehouse, factory, or other place of storage in a state where a corporation is taxable to a state where the corporation is not taxable, those sales are assigned to the state from which the goods were shipped (the state of origin).

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(R&TC §25135(b), MATM 7530). Sales subject to this exception to the general rule of assigning sales to the destination state are referred to as throwback sales. If the taxpayer is not taxable in the state from which the property was shipped, the double throwback rule is applicable (see MATM 7532).

Uniform Division Of Income For Tax Purposes Act (UDITPA)

UDITPA was drafted by the National Conference of Commissioners on Uniform State Laws to provide rules for the allocation and apportionment of income of multistate businesses. Once the tax base (eg. net income) has been defined by a state, UDITPA operates to define business and nonbusiness income, to define the apportionment formula which is used to apportion business income, and provides specific rules for the allocation of nonbusiness income.

The model UDITPA sections have been incorporated into the Multistate Tax Compact, which may be found in both the CCH and Prentice Hall editions of the California Income Tax Laws. California adopted UDITPA with some modifications in 1966 with the enactment of R&TC §25120 to R&TC §25139. Some of the deviations that California has made from the model UDITPA are:

- California applies the UDITPA rules to banks, financial corporations and public utilities, although such entities are excluded under the model UDITPA.

- Although California had previously adopted Section 6 of UDITPA dealing with the allocation of capital gains and losses (R&TC §25125), this section was modified in 1988 to provide special rules for allocation of gain or loss from the sale of a partnership interest (MATM 4040).

- In 1993, California departed from the equally weighted three-factor formula used in the model UDITPA by instituting a double-weighted sales factor (R&TC §25128, MATM 7500).

Unitary Method Of Taxation

The unitary method of taxation is not a tax. It is a method by which the business income of a unitary business is divided among the taxing jurisdictions in which it operates. (MATM 3000.)

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1000 RELEVANT LAW

Subsequent sections of this manual will cover specific, detailed aspects of the apportionment and allocation procedures applicable to multistate businesses. In order to set those rules into the proper perspective, this section of the manual is intended to provide an overall understanding of the framework of the California Bank and Corporation tax system as it relates to multistate businesses.

In order for a state to have jurisdiction to tax a bank or corporation, that bank or corporation must have a minimum connection or "nexus" within the state. Since this is a prerequisite to tax, this section of the manual will begin with a discussion of nexus, followed by coverage of the additional jurisdictional limitations imposed by Public Law 86-272. Once jurisdiction to tax has been established, a discussion of the distinction between the California Corporate Franchise and Income taxes is the logical next step. The concept of commercial domicile and its affect on many of California's sourcing rules will then be introduced. Finally, the Revenue and Taxation Code provisions dealing with combination, apportionment and allocation will be identified and summarized.

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1100 NEXUS AND A STATE'S RIGHT TO TAX

The term "nexus" refers to the level of activity or presence that a taxpayer has established within a taxing jurisdiction. In order for a state (or other taxing jurisdiction) to impose a tax, the Due Process and Commerce Clauses of the U.S. Constitution require that the taxpayer have a certain minimum connection, or nexus, within the state. The point at which sufficient nexus is reached has not been precisely defined, but a number of court cases have addressed the issue and have provided some parameters.

For many years, the standard for establishing nexus was considered to be physical presence within the state. This standard was supported by the U.S. Supreme Court's decision in *National Bellas Hess Inc. v. Department of Revenue of Illinois*, 386 US 753, L.ed 2d 505, 87 S Ct 1389 (1967):

In *National Bellas Hess*, the state of Illinois attempted to impose a use tax on the Illinois sales of an out-of-state mail order house whose only contacts with the state were via the mail or common carrier. Catalogues and advertising flyers were mailed to customers in Illinois. The customers mailed merchandise orders to the Missouri headquarters, and the goods were then sent to the customers either by mail or by common carrier.

The Court stated that allowing states and other jurisdictions to impose use tax burdens based upon such minimal connections could entangle interstate businesses in a "virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose `a fair share of the cost of the local government'". The Court concluded that the mail order house did not have sufficient nexus in Illinois, and the requirement that they collect and pay the Illinois use tax therefore violated the due process and commerce clauses.

More recently however, the U.S. Supreme Court revisited the issue and issued a decision that suggests that physical presence may not always be necessary for nexus:

Quill Corp v. North Dakota (112 S.Ct. 1904, 119 L.Ed.2d 91 (1992)), involved whether a mail order house had sufficient nexus within North Dakota for that state to impose a use tax. The facts in this case were similar to those in *National Bellas Hess*. Quill solicited its sales of office equipment through catalogs and flyers, advertisements in national periodicals, and telephone calls. All of its merchandise was delivered to its North Dakota customers by mail or common carrier from out-of-state locations. Quill's only property within the state consisted of computer software programs that were licensed to some of its North Dakota customers that enabled them to check on Quill's current inventories and prices and to place orders directly (the trial court found this physical connection to be insignificant for nexus purposes).

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The Court explained that the Due Process Clause concerns the fundamental fairness of government and requires (1) "some definite link, some minimal connection, between a state and the person, property or transaction it seeks to tax," and (2) that the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing state." The Court held that the minimum connection would exist so long as an out-of-state corporation purposefully availed itself of the benefits of an economic market in the taxing state, even if it had no physical presence in the state. Since Quill had purposefully directed a substantial amount of its activities at North Dakota residents, it was clearly receiving benefits from its access to the state, and clearly had fair warning that its activity may be subject to North Dakota's jurisdiction. The Court therefore found that North Dakota's use tax did not violate Due Process.

In contrast to the "minimum connections" test for due process, the Court observed that the test under the Commerce Clause was a "substantial nexus" test. The Commerce Clause was intended to be a means of limiting state burdens on interstate commerce. In this context, the Court found the physical presence test of Bellas Hess to be appropriate. The artificiality of the bright-line physical presence rule was found to be more than offset by the benefits of firmly establishing boundaries of legitimate state authority. Furthermore, the *Bellas Hess* physical presence standard for state sales and use taxes had become part of the basic framework of the mail order industry. In the interest of "stability and orderly development of the law," the Court upheld physical presence as the relevant standard for substantial nexus under the Commerce Clause. The Court concluded that the facts in Quill did not constitute substantial nexus.

The implication of this decision on state franchise taxes is unclear. Although the Court admitted the physical presence standard to be artificial, they did not find that fault to be compelling enough to reject the long-standing rule that *Bellas Hess* had established in the area of sales and use taxes. Since there is no Supreme Court precedent on this issue for franchise tax purposes, an argument may be made that a less artificial standard should apply for franchise tax purposes. The South Carolina Supreme Court in Geoffrey, discussed below, has taken this position.

(437 S.E.2d 13 (1993), Cert. Denied, U.S. S.Ct., 11/29/93) was a South Carolina state income tax case involving the existence of nexus. Geoffrey was a Delaware company with no offices, employees or tangible property in South Carolina. Geoffrey executed a license agreement, which gave its parent, Toys R Us Inc., the right to use the "Toys R Us" trade name (as well as other trade names, trademarks, merchandising skills, techniques and know-how) in all but five states. In consideration for the licenses, Geoffrey received a royalty of 1% of the net sales of Toys R Us, Inc. Subsequent to the agreement, Toys R Us began doing business in South Carolina, and made royalty payments to Geoffrey based upon their sales in that state. The State of South Carolina assessed income tax on Geoffrey's royalty income. Geoffrey filed a claim for refund, arguing that it did not have sufficient nexus in South Carolina for its royalty income to be taxable there. The South Carolina Supreme Court disagreed, holding that Geoffrey's presence in South Carolina satisfied both the Due Process and Commerce Clause tests.

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Geoffrey had asserted that it had not purposefully directed its activity at South Carolina, pointing out that Toys R Us had no South Carolina stores when the license agreement was executed and that the subsequent expansion was purposeful on the part of Toys R Us, not Geoffrey. The Court responded that by electing to license its trademarks for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. By licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey was found to have the minimum connection required by due process.

The Court also found the "minimum connection" to have been satisfied by the presence within the state of Geoffrey's intangible property (the agreement resulted in a franchise in South Carolina; and when Toys R Us made sales, accounts receivable were generated for Geoffrey). With respect to the due process requirement that the tax be rationally related to benefits that have been conferred, the Court stated that by providing an orderly society, South Carolina had made it possible for Geoffrey to earn income from Toys R Us customers in that state.

In analyzing the Commerce Clause aspects of the case, the Court reiterated that the physical presence requirement of *Quill* was decided in the context of a use tax, and did not consider the issue for purposes of a franchise or income tax. The Court therefore did not consider physical presence to be the standard in this case, and concluded that by licensing intangibles for use in the state and by deriving income from their use there, Geoffrey had substantial nexus with South Carolina.

Note: Geoffrey is a South Carolina case and may not be cited as precedent for California purposes. The case is instructive, however, because it indicates how at least one Court has interpreted *Quill*.

Clearly, a significant physical presence within a state will be enough to constitute nexus under both the Due Process and Commerce Clauses. The level of physical presence that is required is not as clear. For example, the existence of some floppy disks within the state was not found to be significant in Quill. If an auditor is asserting nexus in a case where the physical connections are arguably minor, the audit narrative should explain the importance of those connections to the business activity.

Constitutional nexus standards have been the subject of a good deal of controversy lately because of the new ways that business is being conducted in today's electronic age and because of recent court decisions that suggest that the traditional concepts of nexus may be expanding. Some of the controversy involves nexus through agency relationships. Another area of speculation centers around the level of physical presence that is required to establish nexus, and the possibility that nexus standards may be expanding to the point where nexus can exist for state franchise or income tax purposes in some situations even without the taxpayer having a physical presence within the state.

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The trend in the courts appears to be a de-emphasis of the physical presence requirements in recognition of the changing business environment. For example, in the New York Court of Appeals cases of Orvis Company, Inc. and Vermont Information Processing, Inc. (86N.Y.2d 954 (1995)), the court stated that the "substantial *nexus*" that is required in order for a state to have jurisdiction to tax under the Commerce Clause does not necessarily mean "substantial *physical presence*." In the facts of those cases, the Vermont corporations marketed products to New York through mail order and had a substantial customer base in New York. Although visits by employees of the corporations to New York were described by the taxpayers as sporadic and occasional, the court believed that those visits significantly enhanced sales and benefited the business. Therefore, because there was a substantial economic presence in New York, the fact that the level of physical presence was "more than a slightest presence" was considered enough to establish nexus. (Note that these were sales tax cases, so Public Law 86-272 did not apply.)

The Orvis and Vermont Information Processing cases were decided in a New York court and do not establish precedent for California, but the analysis used by the court may be helpful to an auditor attempting to establish nexus. For example, if a foreign corporation makes sales to a California destination and that the corporation's ties to the state are at least as strong as the ties that Orvis and Vermont Information Processing had with New York, then the auditor could use the rationale explained in the decision to assert that nexus has been established.

When a California taxpayer makes sales to a foreign destination, auditors are usually looking at the nexus issue from the opposite perspective because the sales may only be thrown back to California if the corporation does not have nexus in the foreign jurisdiction. Auditors should consider the *Orvis* and *Vermont Information Processing* cases in determining the strength of the taxpayer's connections in the foreign country. Remember, however, that the case law is still developing in this area so there is no bright-line threshold. If the auditor does not believe that substantial nexus has been established in the foreign country, it will be important to fully develop all of the facts and clearly explain the rational supporting the nexus determination.

In some cases, nexus may be established by activities of an agent rather than by activities of the taxpayer. This issue is discussed in MATM 1110.

When a taxpayer is first entering a taxing jurisdiction or when the taxpayer's activities within a jurisdiction are increasing, it may be necessary to establish the date upon which nexus was established. Although a taxpayer may establish nexus during the taxable year, the state will not have authority to tax income earned prior to the date upon which nexus was achieved. An example of this concept may be found in MATM 1210.

When considering the materiality of a nexus issue, auditors must remember to take into account the effects of P.L. 86-272 limitations and other exemptions from tax (such as the exemptions for insurance companies -- see MATM 3085). If a corporation will be immune from state taxation under

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P.L. 86-272, nexus will be a mute point. In situations that do not involve sales of tangible personal property, P.L. 86-272 will not apply, but the sales factor rules will need to be carefully considered in order to determine whether nexus within a particular state will have a significant tax effect. For example, even if a corporation derives income from intangible property used within the state, that income may only be included in the sales factor if the greatest proportion of the income producing activity occurs within the state (see MATM 7560). Without factor representation to assign income to California, the establishment of nexus may not result in any more than the minimum tax.

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1110 Nexus Through An Agency Relationship

Activities performed within a state may establish nexus even if an agent of the taxpayer, instead of by the taxpayer itself, performs those activities. The fact that an agent performs activities does not diminish the fact that the taxpayer is realizing benefits from within the state. Even the fact that the agent might also work for other principals is unimportant (although only the activities performed on behalf of the taxpayer may be considered in determining whether the threshold for nexus has been met). The relevant test for determining nexus therefore focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent on the taxpayer's behalf. (*Scripto Inc. v. Carson, 362 U.S. 207* (1960); *Illinois Commercial Men's Association v. State Board of Equalization*, (1983) 34 Cal.3d 839; *Dresser Industries, Inc*., Cal. St. Bd. of Equal., Opinion on Petition for Rehearing, October 26, 1983).

California Civil Code §1793.2 provides that every manufacturer of consumer goods sold within California with express warranties must maintain repair facilities reasonably close to the sales location. To comply with this provision, the warranty work can be subcontracted to an independent third party. Since performing warranty work through a subcontractor may be enough to establish taxability within the state, auditors should request copies of the manufacturer's warranty provisions. In addition, the auditor should determine how the warranties are honored and if the repairs are subcontracted or not. Copies of contracts for subcontracting of warranty services should be requested. The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller’s business, creates nexus (*Scripto Inc. v. Carson*, 362 U.S. 207 (1960); *General Trading Corp. vs. Iowa*, 322 U.S. 327 (1966); *Tyler Pipe Industries, Inc. vs. Washington Department of Revenue*, 483 U.S. 232 (1987)). Depending on the facts of an audit, the out-of-state manufacturer may have nexus in California by providing for repair facilities.

Corporations will often act as agents for unitary affiliates. For example, assume that Corporations A and B are unitary. Corporation A manufactures power tools in Wisconsin, and has no employees and engages in no direct activities in California. Corporation B is a building supply distributer operating in California. When B's employees solicit sales from building supply retailers in California, they also solicit sales of power tools on behalf of Corporation A. When power tool orders are taken, the orders are forwarded to Corporation A, and B's employees receive a commission. Corporation B's activities in California on A's behalf will cause A to have nexus within this state.

The Courts have been fairly liberal in finding an agency relationship to exist, as is illustrated in the following case:

In *Scholastic Book Clubs, Inc. v. State Board of Equalization*, (1989) 207 Cal.App.3d 734, the taxpayer had no property or employees in California. It conducted business by mailing catalogs to

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teachers and librarians in schools throughout the United States. Each catalog included "offer sheets" for the teachers to distribute to their students, but the teachers were under no obligation to do so. The teachers would consolidate the orders and payments made by their students, and submit them to the taxpayer. Orders were filled and shipped from a Missouri warehouse to the teacher, who then distributed the materials to the students. To encourage teachers to place orders, the taxpayer gave them "bonus points" based upon the size of their orders. The bonus points could be used to obtain merchandise from a gift catalog.

The taxpayer argued that they had no real agency relationship with the teachers, therefore the activities of the teachers should not cause the taxpayer to have nexus within California. The Court disagreed, finding the relevant fact to be that the teachers served the function of obtaining sales within California from local customers. The Court noted that the taxpayer depended on the teachers to act as its conduit to the students. Moreover, the Court found an implied contract to exist between the taxpayer and the teachers as evidenced by the fact that the taxpayer rewarded the teachers with bonus points if they obtained and processed orders. The taxpayer attempted to minimize the payment of bonus points by claiming that the teachers could not earn their living through bonus points. The Court responded by stating that "neither the form of the remuneration, the amount thereof, nor the fact that the teachers and librarians were not formally employed by, or dependent upon appellant for their primary income has any legal significance in determining whether they acted as appellant's representatives in soliciting orders for appellant's products in California." The Court held that the taxpayer was exploiting or enjoying the benefit of California's schools and employees to obtain sales, and thus had nexus within the state.

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1120 Free Trade Zones

Corporations that operate in a Free Trade Zone (also called Foreign Trade Zones) within California are not exempt from Franchise or Income tax. Corporations can warehouse, assemble and manufacture goods within a Free Trade Zone. Such goods are exempt from U.S. customs duties and federal excise taxes until sent from the zone.

As a general rule, storing property within the state will be sufficient to establish taxable nexus. The value of such property is then included in the numerator of the property factor of the taxpayer's apportionment formula for this state. Note that if inventory is simply warehoused in this state for a brief period of time awaiting further transportation of the goods to the ultimate destination (e.g the goods pass through the state as part of a "stream of commerce"), generally neither the inventory nor the sale would be assignable to this state. Alternatively, if the purchaser takes possession (or constructive possession through an agent or bailee) so that the goods leave the stream of commerce within this state, such as for inspection or minor assembly work, the inventory and the sale are assignable to this state. For a further discussion of this issue, see *Appeal of Mazda Motors, Inc*., Cal. St. Bd. Of Equal., November 29, 1994. Also see Legal Ruling 95-3, July 20, 1995 and *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal. App. 4th 1789.

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1200 PUBLIC LAW 86-272

Public Law 86-272 was enacted by Congress as of September 14, 1959 to prohibit states from imposing an income tax upon a taxpayer whose only activity within a state is solicitation of orders for the sale of tangible personal property (15 USCA §381). Since such activity is generally sufficient to establish nexus (MATM 1100), the business community was concerned that interstate commerce would be burdened because businesses would be subject to tax in many states in which they had minimal activities. Public Law 86-272 was enacted in response to this concern. Public Law 86-272 established the following provision in the U.S. Code:

TITLE 15: COMMERCE AND TRADE
CHAPTER 10B: STATE TAXATION OF INCOME FROM INTERSTATE COMMERCE -- NET INCOME TAXES
§381

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, the following:

the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to --

any corporation which is incorporated under the laws of such state, or

any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

For purposes of this section --

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The term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and the term "representative" does not include an independent contractor.

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1210 Key Provisions Of Public Law 86-272

Immunity in a state does not apply to any corporation incorporated within the state. (Note that a corporation will be eligible for immunity if it is qualified to do business in the state, so long as it is not incorporated there. Since immunity only applies to taxes based on net income, a taxpayer qualified to do business in California would still be liable for the minimum tax.)
Immunity under P.L. 86-272 only applies to sellers of *tangible personal property*. Activities related to sales of real estate or intangibles, to the leasing, renting, or licensing of property, to the provision of services, or to any other transactions not specifically protected under P.L. 86-272 will cause a loss of immunity.

Activity within the state must not go beyond solicitation of orders for sales of tangible personal property. (An exception is made for de minimis activities.) Activities that are considered to fall within the meaning of "solicitation" are discussed in MATM 1220.

Approval of the orders must be made outside the state.

Deliveries to customers must be made from a point outside the state.

Certain in-state activities conducted on behalf of the taxpayer by an independent contractor will not cause loss of immunity even though such activities would not be allowed if performed by the taxpayer directly. This topic is covered in more detail in MATM 1230.

A single event during the taxable year can cause the loss of immunity for the entire year so long as the taxpayer had nexus within the state. If nexus is established mid-year, then the taxpayer would not be taxable prior to the date of nexus. The following example will illustrate this concept:

Example:

ABC Corporation is a manufacturer of recycling equipment headquartered in Arizona. ABC made sales to California customers throughout 1994, but from January to June the sales were ordered over the telephone by the California customers, and were shipped by common carrier from the Arizona headquarters. ABC had no other connections with California during this time period. On July 1, 1994, ABC assigned an employee to live in California and solicit sales from California customers (this act established nexus). On December 1, ABC's employee exceeded the activities allowed under P.L. 86-272 by assembling a large recycling system at a customer's California location.

Although the employee's activity on December 1 caused loss of immunity under P.L. 86-272 for the entire year, ABC did not have nexus in California until July 1. Assuming that ABC is a calendar year taxpayer, California would have the right to tax ABC on its income attributable to California sources

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from July 1 to the end of the year.

The loss of immunity in one year does not carry over to a subsequent year. Therefore, if the employee's activities did not exceed allowable solicitation during 1995, ABC would again be immune from California tax in that year.

P.L. 86-272 only applies to interstate commerce and not to foreign commerce. See MATM 1240 for further discussion of this issue.
(a) Taxability in any particular state under P.L. 86-272 must be determined separately for each corporation in the combined group. Thus, the activities of one member of the combined group may not cause loss of immunity for another member. (An exception may arise when one member of the combined report acts as a representative or independent contractor for another member (see MATM 1230).)

(b) For sales factor purposes, sales to a state in which the taxpayer is immune from taxability under P.L. 86-272 will be "thrown-back" to the state from which the goods were shipped (MATM 7530). For apportionment purposes only however, if any member of the combined group is taxable in the destination state, then the sales will be included in the combined group's sales factor numerator for that state (MATM 7530 & MATM 7905).

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1220 "Solicitation Of Sales" Defined

In *Wisconsin Department of Revenue v. William Wrigley Jr., Co.*, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992), the U.S. Supreme Court established a standard for interpreting the term "solicitation." Under that standard, "solicitation of orders" means activities that are essential or entirely "ancillary" to making requests for orders.

The Court explained ancillary activities to be those activities that serve no independent business function apart from their connection to the soliciting of orders. If a company would engage in certain activities for reasons other than solicitation, the fact that they have assigned those activities to salespersons does not make the activities ancillary to solicitation of orders. The Court presented the following example:

"*Providing a car and a stock of free samples to salesmen is part of the `solicitation of orders' because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the `solicitation of orders,' since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into `solicitation' by merely being assigned to salesmen.*"

Another example of how the Courts have limited the interpretation of "solicitation of orders" to mean activities directly related to making requests for orders is shown in the following case:

In *Brown Group Retail v. Franchise Tax Board*, 44 Cal.App.4th 823 (1996), the taxpayer sold shoes to independent retailers. In addition to sales personnel who solicited sales within California, the taxpayer also employed two individuals within the state whose function was to help shoe retailers establish and enhance their stores. This involved providing assistance and advice regarding everything from site selection and store lease negotiations to improving inventory turnover, trimming windows and setting up bookkeeping systems. These services were provided free of charge, and the employees who provided the services were not allowed to take orders for sales. The purpose for providing these services was to increase the retailers' sales, which would in turn benefit the taxpayer. The Court held that while this activity was ultimately intended to increase the taxpayer's sales, it did not facilitate requests for sales. Therefore, it was not a protected activity under P.L. 86-272.

The language of P.L. 86-272 (15 USCS §381(c)) implies that maintenance of an office within the state goes beyond solicitation, even if that office is maintained exclusively to facilitate requests for purchases. In the *Wrigley* case however, the Court distinguished between offices that are formally attributed to the company, and in-home offices used by sales personnel to complete paperwork or hold occasional meetings. The in-home offices maintained by Wrigley's salespeople were found to serve no purpose apart from their role in facilitating solicitation, and so did not cause loss of immunity.

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The Court in *Wrigley* also concluded that a de minimis exception should be applied. Even if a taxpayer performs activities within a state that are not "ancillary to solicitation," those activities should not cause the taxpayer to lose immunity if they are de minimis or trivial. In determining whether such activities are trivial enough to be considered de minimis, the nonprotected activities should not be looked at individually, but should be considered as a whole. The facts in *Wrigley* serve as an illustration of how the de minimis exception should be applied:

In *Wrigley*, the Court found the following activities of the taxpayer to go beyond solicitation of orders: (1) replacement of stale gum in customers' displays; (2) "agency stock checks" (This consisted of directly selling gum to fill customers' display racks); and (3) storage of gum within the state for the primary purpose of stale gum replacement and agency stock checks. The taxpayer argued that these activities were minimal, and emphasized that the gum sold in agency stocks accounted for only .00007% of Wrigley's annual sales within that state, and amounted to only several hundred dollars a year. The Court did not agree that the activities were de minimis:

"*We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through `agency stock checks'. Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State."*

The Multistate Tax Commission has adopted guidelines for applying P.L. 86-272 that reflect the standards established by the *Wrigley* decision. Contained in those guidelines are examples of activities that are generally considered to exceed solicitation, as well as examples of protected activities. Auditors should keep in mind that these rules are not intended to cover all possible situations. Each case will have to judged on its own facts. More importantly, those facts must be considered in the context of the taxpayer's activities within the state as a whole.

Examples of Unprotected Activities:
The following activities are not generally considered to constitute solicitation of orders or to be ancillary to solicitation, and are not otherwise protected under P.L. 86-272. If the performance of any of these activities within a state exceeds a de minimis level, immunity under P.L. 86-272 may be lost.

- Making repairs or providing maintenance or servicing. (The SBE confirmed that performing warranty repairs within the state went beyond solicitation of orders in *Appeal of Aqua Aerobic Systems, Inc*., Cal. St. Bd. of Equal., 11/6/85.)
- Collecting current or delinquent accounts, whether directly or through third parties.
- Investigating credit worthiness.

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- Installation of the product, or supervision of installation. (In *Appeal of Riblet Tramway Company*, Cal. St. Bd. of Equal., December 12, 1967, the SBE found that a contractual right to inspect and approve the installation of a product will also cause loss of immunity.)
- Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.
- Providing any kind of technical assistance or service including engineering assistance or design service, when one of the purposes thereof is other than facilitating the solicitation of orders.
- Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
- Approving or accepting orders.
- Repossessing property.
- Securing deposits on sales.
- Picking up or replacing damaged or returned property.
- Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
- Using agency stock checks or any other process by which sales are made within the state by sales personnel.
- Maintaining a sample or display room in excess of two weeks at any one location within the state during the tax year.
- Carrying samples for sale, exchange or distribution in any manner for consideration or other value.
- Owning leasing, using or maintaining any of the following facilities or property in-state:
- Repair shop.
- Parts department.
- Any kind of office other than an in-home office as described below.
- Warehouse.
- Meeting place for directors, officers, or employees.
- Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
- Telephone answering service that is publicly attributed to the company or to employees or agents of the company in their representative status.
- Mobile stores (vehicles with drivers who make sales from the vehicles).
- Real property or fixtures to real property of any kind.
- Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
- Maintaining, by any employee or other representative, an office or place of business of any kind. An exception to this general rule applies only with respect to an in-home office located within the residence of the employee or representative that is not publicly attributed to the company. Even then, the use of such an in-home office is limited to soliciting and receiving orders from customers, for transmitting such orders outside the state for acceptance or

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rejection by the company, or for other activities that are protected under P.L. 86-272. For this purpose, it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining the in-home office.

A company will normally be determined to be maintaining an office or place of business within the state if they have a telephone listing or other public listing within the state (including a listing for an employee or representative if the listing identifies them in their representative capacity). Similarly, advertising or business literature that indicates that the company or its employee or representative can be contacted at a specific address within the state shall normally be construed as the company maintaining an office or place of business within the state. However, the normal distribution and use of business cards and stationary identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.
Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license.
Shipping or delivering goods into this state by means of private vehicle, rail, water, air or other carrier, irrespective of whether a shipment or delivery fee or other charge is imposed, directly or indirectly, upon the purchaser.
Conducting any other activity, which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

Examples of Protected Activities:
The following activities will not cause the loss of immunity:

- Soliciting orders for sales by any type of advertising.
- Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described in #18 above.
- Carrying samples and promotional materials only for display or distribution without charge or other consideration.
- Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.
- Providing automobiles to sales personnel for their use in conducting protected activities.
- Passing orders, inquiries and complaints on to the home office.
- Missionary sales activities (the solicitation of indirect customers for the company's goods). For example, a manufacturer may sell only to wholesalers, but it may solicit retailers to buy its products from the wholesale customers. Such solicitation would be protected.
- Coordinating shipment or delivery without payment or other consideration.

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- Checking of customer's inventories without charge (for reorder, but not for other purposes such as quality control).
- Maintaining a sample or display room for two weeks or less at any one location within the state during the tax year.
- Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.
- Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.

Owning, leasing, using or maintaining personal property for use in the "in-home" office or automobile of an employee or representative, so long as the use of the property is solely limited to the conducting of protected activities. Therefore, maintaining personal property such as cellular telephones, facsimile machines, duplicating equipment, personal computers and computer software shall not, by itself, remove the protection of P.L. 86-272 as long as such equipment is used only to carry on protected solicitation and activity entirely ancillary to such solicitation.

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1230 Activities Of Independent Contractors

P.L. 86-272 extends protection to certain in-state activities if an independent contractor conducts them, even though immunity would be lost if those same activities were conducted directly by the taxpayer. Independent contractors may engage in the following limited activities within the state without causing the taxpayer to lose immunity:

1. Soliciting sales;
2. Making sales; and
3. Maintaining an office.

Except for purposes of display however, the taxpayer may not maintain any inventory or stock of goods within the state under consignment with the independent contractor. Maintenance of such inventory will cause loss of immunity.

Sales representatives who represent a single principal are not considered to be independent contractors, and are subject to the same limitations as an employee.

In *Appeal of Nardis of Dallas, Inc*., Cal. St. Bd. of Equal., April 22, 1975, a salesman solicited orders in California for a Texas-based company, and maintained a showroom within California for that purpose. The taxpayer argued that the salesman was an independent contractor; therefore the maintenance of the showroom should be a protected activity under P.L. 86-272. The SBE disagreed, stating that the salesman was not an independent contractor under the tests developed at common law. Factors that the SBE found to be significant in determining that an employer/employee relationship existed included the taxpayer's right to discharge the salesman upon notice, and the fact that the parties themselves believed that they had created an employment relationship, as evidenced by the payment of unemployment taxes. As an employee of the taxpayer, maintenance of the showroom went beyond the minimum activities allowed under P.L. 86-272.

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1240 Public Law 86-272 Does Not Apply To Foreign Commerce

The immunity provided by Public Law 86-272 is expressly limited to interstate commerce. No such immunity applies with respect to foreign commerce. Although CCR §25122(c) states that U.S. jurisdictional standards shall be applied to determine whether a foreign country has jurisdiction to subject a taxpayer to tax, the SBE has held that this refers to U.S. Constitutional nexus; jurisdictional limitations of P.L. 86-272 are not considered. (*Appeal of Dresser Industries, Inc*., Cal. St. Bd. of Equal., June 29, 1982.)

If sales are made from California to a foreign destination, the relevant question is whether the taxpayer has constitutional nexus in the foreign country using the standards discussed in MATM 1100 and MATM 1110. If nexus is determined to be present, the sales may not be thrown back to the California sales factor numerator (see MATM 7530) even if the taxpayer's activities within that country do not go beyond solicitation of orders for sales.

Conversely, if sales are made from a foreign country to a California destination, the sales will be included in the sales factor numerator as long as the taxpayer has constitutional nexus within California. P.L. 86-272 will not apply, and the taxpayer will be taxable on their California income regardless of whether their California activities exceed solicitation of orders. This issue may arise when foreign entities with nexus within the state make sales directly to customers within the U.S. (as opposed to indirect sales through a domestic sales affiliate). Information from the foreign entities will usually have to be requested if the auditor suspects that this issue exists.

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1300 CORPORATION FRANCHISE TAX

The corporation franchise tax is found in Chapter 2 of the Bank and Corporation Tax Law. This tax is paid for the privilege of doing business within California, and the amount of the tax is the greater of (1) the franchise tax under R&TC §23151 or the (2) the minimum franchise tax under R&TC §23153.

A minimum franchise tax is imposed on all corporations, which are incorporated or qualified to do business in this state, which are not expressly exempted under the Bank and Corporation Tax Law (such as credit unions or charitable organizations) or the Constitution of California (such as insurance companies). The minimum tax is a flat fee that is imposed regardless of whether the corporation is active, inactive, operates at a loss, or files a short period return. Effective January 1, 1994, the minimum franchise tax is also imposed on limited partnerships doing business within the state or which have filed a certificate of limited partnership with the Secretary of State (R&TC §23081). The amount of the minimum tax is generally $800 for taxable years beginning on or after January 1, 1990 (R&TC §23153).

The franchise tax is imposed upon all banks and corporations "doing business" in California. See MATM 1310 for a definition of "doing business." This is a prepaid tax that is measured by the net income of the preceding year (the "income year") for the privilege of doing business in the following year (the "taxable year"). The rate of tax for general corporations is prescribed by R&TC §23151.

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1310 "Doing Business" For Purposes Of The Franchise Tax

The term "doing business" is defined in R&TC §23101 to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." A very limited exception to this standard is provided by R&TC §23101.5 if a corporation's only activities within the state are either:

the purchase of personal property or services solely for its own use (or for use by its affiliate) outside the state, provided that certain restrictions regarding the presence of employees within the state are met; or
the presence of employees in the state solely for the purpose of attending a public or private school, college or university.

In addition, R&TC §23102 provides that a holding company organized to hold stock or bonds will not be considered to be "doing business" if its *only* activities are the receipt of dividends or interest, and the disbursement of those receipts to shareholders. To qualify under this exception, the holding company may not engage in trading the stock, bonds or other securities that it holds.

If a partnership is doing business within the state, then all of the general partners of that partnership are also considered to be doing business within the state. However, in the *Appeal of Amman & Schmid Finanz AG, et. al*., Cal. St. Bd. of Equal., April 11, 1996, the SBE held that a limited partner would not be considered to be doing business merely because it owned a limited partnership interest in a partnership that was doing business within the state.

Outside of these limited exceptions, the definition of "doing business" is very broad. Also, since the language of R&TC §23101 refers to "any" transaction, it is not necessary that the corporation conducts business or engages in transactions within the state on a regular basis. An isolated transaction during the year may be enough to cause the corporation to be doing business (see Carson Estate Co. v. McColgan, 21 Cal.2d. 516). Even negotiations that are an integral part of entering into a transaction may be considered to be doing business (*Appeal of Ebee Corp., Taxpayer, and Bacciocco, Assumer and/or Transferee*, Cal. St. Bd. of Equal., February 19, 1974).

There have been several Court and SBE decisions dealing with activities that will constitute doing business, and when a commencing or liquidating corporation will be considered to be doing business. Many of these cases are listed in the annotations under R&TC §23101. Auditors faced with these issues should consult those cases as well as the regulations under R&TC §23101.

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1320 Determining Whether The Franchise Tax Applies

The first step in ascertaining California's power to tax a corporation is to determine whether there is constitutional nexus to tax (MATM 1100). If so, and if interstate commerce is involved, then the auditor must determine whether the activities within the state fall under the immunity offered by P.L. 86-272 (MATM 1200 - MATM 1240). Finally, if the corporation is determined to be taxable in California after the first two steps, the auditor must determine whether the taxpayer is doing business within the state in the context of R&TC §23101. If so, then the taxpayer will be subject to the franchise tax under Chapter 2 of the Bank & Corporation Tax Law. If the taxpayer is not doing business in California, but derives income from sources within the state, then the corporation income tax under Chapter 3 of the Bank & Corporation Tax Law will be imposed. The corporation income tax will be discussed below.

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1400 CORPORATION INCOME TAX

Under Chapter 3 of the Bank and Corporation Tax Law, an income tax is imposed on all corporations which, while not "doing business" in California, do "derive income from sources within this state" (R&TC §23501). "Income derived from or attributable to sources within this State" is defined in R&TC §23040 to include income from tangible or intangible property located or having a situs in California, and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate, or foreign commerce.

For taxable years beginning on or after January 1, 1993, R&TC §23040.1 provides an exception to the general definition of "income derived from or attributable to sources within this state" for a partner's distributive share from an investment partnership of interest, dividends, and gains from the sale or exchange of investment securities. This exception will not apply if the partner or any of its unitary affiliates or partnerships has any income derived from or attributable sources within the state other than qualified investment partnership income. Furthermore, the exception will not apply if the partner or any of its unitary affiliates or partnerships participates in the management of the investment activities of the investment partnership. Additional requirements and definitions regarding this exception are contained in R&TC §23040.1.

In most cases, a corporation with sufficient activities to have nexus within the state will also be considered to be "doing business" within the state, so the franchise tax will be applied. Some examples of when the income tax under Chapter 3 would be applicable are:

When the income from sources within California is derived entirely from passive investments. Even then, the taxpayer will probably be considered to be "doing business" in the years in which they negotiate or enter into transactions to acquire or dispose of the investments.

CCR §23040(b) provides that a foreign (non-California) corporation will be subject to the income tax rather than the franchise tax if its activities within the state are exclusively in interstate or foreign commerce. For example, a foreign corporation will be subject to the income tax if it ships goods from outside the state to fill orders taken by its employees in California (assuming that the corporation is not immune under P.L. 86-272, see MATM 1210). Foreign corporations will also be subject to the income tax if they maintain inventories of goods within the state for the exclusive purpose of filling orders taken by independent dealers or brokers.

On the other hand, if a foreign corporation maintains an inventory in California for purposes of filling orders taken by *employees*, then the corporation is considered to be engaged in *intrastate* business within California, and is therefore subject to the franchise tax.

If a corporation's only connections with this state are as a limited partner in a partnership that is doing business within the state, then that corporation will be subject to the income tax rather than the franchise tax (MATM 1310).

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Both the franchise and income taxes are subject to the allocation and apportionment provisions of California law. The primary differences between the two taxes are that:

Corporations subject to the income tax do not have a minimum tax if they are not incorporated or qualified within the state. (If a taxpayer is incorporated or qualified within California however, it will be subject to the minimum franchise tax as well as the income tax. In such cases, R&TC §23503 allows the minimum franchise tax to be offset against the income tax.)

U.S. government income is exempt from income tax. (Since the franchise tax is not a tax on net income, but is only *measured* by income, U.S. government income may be included in the tax base for the franchise tax. MATM 6065.)

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1500 COMMERCIAL DOMICILE

Certain items of nonbusiness income from intangibles, such as interest and dividend income, are allocated to the state in which the corporation's commercial domicile is located. The commercial domicile of a corporation is defined in R&TC §25120(b) to mean the principal place from which the trade or business of the taxpayer is directed or managed (also see CCR §23040(a)). The commercial domicile may be distinguished from the legal domicile, which is merely the state of incorporation.

In most cases, the commercial domicile of a corporation will be the state in which the headquarters or principal offices are located. In some situations however, it will not be as easy to identify where the actual control of the corporation took place, and the auditor will have to analyze the facts and circumstances. The SBE pointed out some of the relevant factors to consider in the following decision:

In *Appeal of Norton Simon, Inc*., Cal. St. Bd. of Equal., March 28, 1972, the taxpayer had formerly been engaged in the manufacture of plywood in Washington. Although it had sold most of its plywood operations by the appeal years, the taxpayer still held some interests and rights related to those operations and oversaw the management of those rights. The taxpayer's only office was in Washington. The taxpayer also had a large investment portfolio that was managed by an executive committee of the Board of Directors in California. Because of the magnitude of its investment activity in relation to its remaining plywood-related activity, the SEC required the taxpayer to register as an investment company. Although the certificates evidencing the taxpayer's investments had originally been kept in a safe-deposit box in California, the executive committee transferred the certificates to Washington in order to avoid becoming subject to California tax.

The taxpayer argued that its commercial domicile was in Washington for the following reasons: (1) its officers and employees were Washington residents; (2) its books and records were located in Washington; (3) most of its intangible assets were located in Washington; (4) its stockholders met in Washington, (5) it filed its federal returns in Washington; and (6) it owned timber rights and security interests in property in that state.

Although the SBE acknowledged that the facts relied upon by the taxpayer are often mentioned in case law as tending to establish a commercial domicile, the SBE went on to state that those facts are not decisive in this particular case. During the appeal years, the taxpayer's entire income was from its investment activities, and the executive committee in California managed those activities. Although the executive committee met only once in a two-year period, they were responsible for the day-to-day investment decisions on an informal basis. Stating that the "essence of the concept of commercial domicile is that it is the place where the corporate management functions, the place where real control exists with respect to the business activities," the SBE held that the real control of the business had shifted to California when the plywood operations were sold.

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In *Appeal of Vinnell Corporation*, Cal. St. Bd. of Equal., May 4, 1978, VIC was incorporated in Panama, and was engaged in construction contracting in several foreign countries. None of its contracting activities were performed in California. Management of the business was conducted through regional offices located overseas. The dominant figure in VIC's management was a California resident, but he exercised his duties as president during his constant travels to the regional offices. All of VIC's directors and 11 of its 16 officers were California residents, and they met periodically in California to review and approve (after the fact) the management decisions made by the overseas officers. VIC also maintained a California bank account for receiving the ultimate profit from the foreign construction work, and maintained a general ledger here. The FTB took the position that although VIC did no business in California, it maintained sufficient contacts in California for this state to be considered the commercial domicile.

The SBE disagreed, pointing out that it is the location of actual control that is important, not the location of *ultimate* control. The evidence in the case indicated that all of VIC's business activities were controlled regionally, and there was no documentation to support a center of active operational control. With respect to the board of directors meetings within the state, the SBE stated that passive acquiescence, after the fact, is not the active management and control required to establish a commercial domicile.

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1600 OVERVIEW OF LAW SECTIONS PERTINENT TO DETERMINING THE NET INCOME OF A MULTISTATE TAXPAYER

R&TC §25101 Basis of Allocation
Section 25101 provides that when the net income of a taxpayer is derived from or attributable to sources both within and without the state, the tax shall be measured by the net income derived from sources within the state. This section authorizes the determination of California income by reference to the combined income of a group of unitary corporations (*Edison California Stores v. McColgan*, 30 Cal.2d 472; this case involved Section 10, the predecessor to R&TC §25101). Also, the California Supreme Court has stated that the language in this section *requires* the use of formula apportionment when the business activities are conducted both within and outside the state (*Superior Oil Co. v. Franchise Tax Board* (1963) 60 Cal.2d 406, 386 Pac.2d 33). See MATM 3005.

R&TC §25105 Determination of ownership of control
This section provides the ownership requirements for inclusion in a combined report. The ownership requirements changed significantly for taxable years beginning January 1, 1995. See MATM 3050.

R&TC §25106 Income from intercompany dividend distribution
This section provides that dividends paid from one corporation to another shall be eliminated to the extent that those dividends are paid out of combined unitary business income. This section was enacted to prevent income from being taxed more than once as it flowed up through the combined group. See MATM 6032.

At the time that this section was enacted, two cases involving intercompany dividends were being litigated (*Safeway Stores, 3 Cal.3d 745 (1970); Pacific Telephone Co. v. Franchise Tax Board*, 7 Cal.3d 544). It was because of these cases that the last paragraph of R&TC §25106 was included to indicate that no inference in any pending litigation cases was intended to be drawn from enactment of that section.

R&TC §25108 Net operating loss
This section provides the rules for applying the net operating loss provisions to taxpayers filing a combined report or taxpayers with income derived from sources within and outside the state. See MATM 8000.

R&TC §25120 Definitions
Section 25120 contains definitions for terms that are used in the UDITPA §§25120 - 25139.

R&TC §25121 - R&TC §25122 When allocation and apportionment applies
The general rule in §25101 provides that the apportionment and allocation provisions apply to corporations with net income derived from or attributable to sources within this state. Section 25121

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restricts this rule somewhat by requiring that income be *taxable* outside California before the apportionment provisions will apply. Section 25122 explains when a taxpayer will be considered to be taxable in another state.

R&TC §25123 - R&TC §25127 Allocation of nonbusiness income
These sections provide the rules for allocation of nonbusiness income. See MATM 4000.

R&TC §25128 - R&TC §25136 Apportionment formula
R&TC section 25128 sets forth the apportionment formula, and R&TC §25129 - R&TC §25136 provide the rules for determining the property, payroll and sales factors. See MATM 7000.

R&TC §25137 Equitable adjustment of standard allocation or apportionment
In cases where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state, this section permits the taxpayer to petition the Franchise Tax Board for the use of separate accounting, the exclusion or inclusion of one or more factors, or the use of any other method that will more equitably allocate and apportion the taxpayer's income. This section also provides authority for the FTB to require such a deviation from the standard formula. The Regulations under this section provide special formulas that have been developed to apportion income for certain industries. See MATM 7700.

R&TC §24344(b) Interest offset
The interest offset provision assigns interest expense deductible against business and nonbusiness income. See MATM 4065.

R&TC §24402 Dividends already subjected to tax
This section provides for dividends to be deducted by the recipient if California has already taxed the income from which the dividends have been paid. The purpose of this provision is to assure that such income is not taxed more than once. See MATM 6030.

Comparable treatment for dividends paid by insurance companies is provided by R&TC §24410. See MATM 6034.

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2000 PREAUDIT PROCEDURES

The preaudit phase is vital to the audit process. This is the phase where the auditor determines whether to proceed with the examination or accept the returns as filed. If the determination is made to proceed, this is also the phase where the auditor plans the audit and performs the preliminary work. Proper attention to the preaudit procedures will improve the quality of the audit and help reduce total audit time.

The preaudit steps discussed in this section are fairly universal for all multistate audits. Once specific audit issues have been identified, the preaudit procedures may be expanded to specifically address those issues.

Care should be taken to keep an open mind throughout the preaudit phase. The information available during this phase is seldom sufficient to make any conclusive determinations. By becoming prematurely convinced of the outcome of issues, auditors can fall into the trap of only gathering information that supports a predetermined conclusion.

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2100 REVIEW OF TAX RETURNS UNDER AUDIT

The auditor should review all parts of the return in detail. The purpose for this review should be to become familiar with the return, and to make a preliminary identification of audit issues. Special attention should be paid to audit instructions transmitted on FTB Form 7024, *Request for Field Action*, and other data transmitted with the returns or contained in the audit file. Auditors should ensure that they have obtained all amended returns for the taxable years being addressed.

As the returns are being reviewed, auditors should take preliminary notes to record any questions or potential audit issues. Many of the questions contained in these notes will be resolved as the auditor progresses further through the preaudit procedures. Any remaining questions are issues that may be incorporated into the audit plan. For easier workpaper reference, notes on each subject matter should be started on a new page. For example, any notes on the property factor should be on a separate sheet from notes concerning the payroll factor. When the working papers are assembled in final form, the notes can then be included in the appropriate workpaper section.

If the auditor encounters any unfamiliar issues on the return, preliminary research should be conducted to become familiar with the issue. Such research during the preaudit stage will assist the auditor in determining the audit potential of an issue, and in planning the audit procedures, questions and types of records necessary to develop the issue.

Certain industries have unique issues and may require special apportionment rules. In such cases, research of the industry should be conducted in addition to research of the particular tax return items. Information on several industries that require special apportionment treatment is included in MATM 7700 - MATM 7815. FTB also has a separate manual for Banks & Financials.

The Water's-Edge Manual is available to assist auditors in identifying issues.

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2110 Domestic Disclosure Spreadsheet For Pre-1994 Years

Prior to 1994, water's-edge taxpayers were required to file a domestic disclosure spreadsheet (DDS) if the total assets of the related group exceeded $250 million, or if the total property, payroll or sales in foreign countries exceeded $10 million (a de minimis exception applied if the property, payroll and sales within the U.S. were each less than $500,000) (former §25401(d)). The DDS requirement was repealed for taxable years beginning on or after January 1, 1994.

The DDS was useful for identifying the taxpayer's affiliates and understanding the ownership chain. Auditors should be aware, however, that the information disclosed on the DDS was not necessarily accurate. Therefore, although the DDS should have been obtained when practical as a starting point for identifying unitary issues, the auditor should have also corroborated that information through other sources such as SEC filings and corporate directories. However, since years have passed since the repeal of the DDS filing requirement, the information on a pre-1994 DDS may no longer reflect the ownership structure for the year under audit, if auditing a post-1993 year.

Eventhough the DDS filing requirements have been repealed, the auditor should obtain the DDS if a pre-1994 year of a water's-edge taxpayer is under examination and the taxpayer had a DDS filing requirement. For audits of post-1993 taxable years, auditor judgment should be used in determining if ownership information contained on an old DDS would be useful for preliminary analysis of unitary issues or other issues present for the taxable year under audit. It may be more feasible to look to other information sources that may provide pertinent information.

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2200 REVIEW OF PRIOR AUDITS

Prior audit reports, protests, and appeal files should always be reviewed. If a copy of the prior audit report is not retained in the program office or associated with the returns, it should be requested. Not only should the prior audit report help identify prior year adjustments which may be applicable to the current years, it should also help determine the extent of the audit scope. For example, if the sales factor numerator was extensively tested in prior years and no adjustments resulted, it might be possible to minimize the testing in the current years if business operations have not changed. Also, if an audit adjustment was made in prior years, the auditor **may** be able to use the factual development from the prior audit as a roadmap to streamline the verification of current year facts by directing the auditor's focus to the key areas. Although you may use the prior audit as a roadmap, audits that are based solely upon facts developed in a prior audit cycle without adequate factual development for the current period are not acceptable. This policy applies to unitary adjustments and any other issues that recur over more than one audit cycle. **The facts for the current audit cycle must be fully developed unless the taxpayer advises the auditor they agree with the adjustment. In such cases, if the taxpayer is willing to sign a statement confirming their agreement, there is no reason to require the taxpayer to undergo an extensive examination of the issue for the current years. (See MATM 2225 and MATM 2800).**

IMPORTANT: Prior audit reports can help to streamline the audit process and avoid duplication of efforts between audit cycles. On the other hand, improper reliance on a prior audit can result in audit adjustments that are unsupported. Judgment needs to be used in determining the degree of additional information that will be needed for the current years, and the auditor needs to keep in mind that facts often do change from year to year. Also, court decisions or changes in the statute or regulations can reverse prior interpretations.

Once the auditor has determined that some reliance may be placed on facts developed in the prior audit report, the auditor must determine the amount of additional information that will be necessary for the current cycle. If a unity issue was fully developed in the prior audit, the amount of additional information required to be verified may be limited. For example, such items as updating the amounts of intercompany sales, updating the amounts of intercompany financing, updating the number of personnel transfers between corporations, and addressing any new unitary ties may be all that is necessary. In other cases, the auditor will need to more fully develop weak facts or facts that were not addressed in the prior audit.

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2225 Reliance On Prior Audits

Generally, auditors may not rely solely upon facts developed in a prior audit cycle. An exception may be made in cases where the taxpayer agrees that the prior year facts are applicable for the current years and agrees to the adjustment. The agreement must be included in a statement signed by an officer of the taxpayer (See MATM 2800).

Prior year audit results should only be used as a starting point, not as the primary basis for an audit recommendation on the current audit cycle. Although auditors should strive to achieve consistent treatment from year to year (as long as the taxpayer continues to operate in the same manner), prior year determinations that were incorrect or based upon incomplete information should not be followed. The facts for the current cycle must be developed because facts often do change from year to year. Independent development of the current year facts will prevent an adverse protest or appeal resolution of the prior years from automatically applying to both audits, especially if the factual record for the current cycle is even stronger than in the prior cycle. For example, if the auditor can develop a more compelling case for unity in the current audit cycle, then the current audit may be sustainable even if the prior cycle was not. Assume, for example, that a prior audit found a taxpayer to be unitary with its affiliate based on strong centralized management as evidenced by internal memos, committee minutes, management reports, and documentation concerning centralized departments for various functions. If the auditor for the current years merely obtains a letter from the taxpayer confirming that the relationships between the corporations are the same as in the prior years, then a protest determination that the corporations are not unitary in the prior years will probably require that the current year adjustment also be withdrawn. On the other hand, by developing the current year facts, the auditor may discover that the level of management interaction has increased. Or, by discussing the case with the hearing officer, the auditor may learn that the taxpayer's arguments have minimized the importance of unitary ties such as centralized departments, so the auditor may be able to strengthen the case by focusing additional attention in the current years to developing the benefits realized through the centralized services.

Even if the prior audits are not being protested, the auditor should develop the current year facts rather than relying on facts developed in the prior audit. Otherwise, if the taxpayer decides to protest the current year determination, the audit adjustments will not be adequately supported. A hearing officer needs specific evidence in order to sustain a protest case; unsupported statements indicating that particular facts exist are neither persuasive nor reliable, and are not generally sufficient to support audit determinations.

Note: When audit determinations are not consistent with prior periods, the reasons for the change in position must be clearly explained to the taxpayer. Auditors need to develop the current year facts in order to arrive at the correct determination for the current period. In some cases, changes in the underlying facts or in the relevant case law may cause an auditor to reach a conclusion for the current years that is different from the determination reached in the prior period. In other cases, the auditor may conclude that an adjustment is appropriate for the current period even though the prior year adjustment was based upon incomplete information, or has been modified, or withdrawn at protest. This situation sometimes occurs when the significance of an issue has increased over the years. For example, assume that no material tax effect would

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have resulted from decombination of a newly acquired corporation in the prior audit cycle. The prior auditor, therefore, made a few general observations regarding possible unity, and allowed the newly acquired corporation to be included in the group. In the current years, however, inclusion of the subsidiary has a significant tax impact. In this type of situation, following the prior audit determination without independently developing the facts would be inappropriate because the prior audit did not adequately develop this issue. (This example also illustrates the importance of informing taxpayers when issues that were included in the scope of the audit are accepted without being fully examined. In such cases, the taxpayer should be warned that no determination with respect to the issue has been made, and that the issue is subject to audit in subsequent years.) To avoid a perception that the department is being inconsistent in those situations, the auditor must clearly explain why the current year determination differs from the prior period outcome. This explanation should be included in the closing letter to the taxpayer.

In some cases, an audit issue will not be material enough in the current audit cycle to warrant the resources that would be necessary to develop the facts regarding that issue. If that is the case, then the auditor should inform the taxpayer that the issue is not being included within the scope of the current year examination. When evaluating the materiality of the issue however, consideration should be given to the fact that audits are usually far less time-consuming in the subsequent cycles because the prior audit can be used as a roadmap that will direct you to the key areas to focus on, the specific documents that were found to be relevant, etc. Therefore, the materiality threshold for the subsequent audit of an issue will generally be lower than it would be for an initial examination of the same issue. In unusual circumstances, cases may arise where it will be beneficial to achieve consistent treatment of a unitary issue from year to year, but the materiality of the issue for the current audit cycle is not sufficient to justify an extensive examination. For example, assume the prior audit cycle combined a particular subsidiary, but the issue of combining the subsidiary in the current audit cycle is not material enough to warrant pursuing. On the other hand, you have discovered that the subsidiary was sold after the current audit period, so it will be necessary in the next audit cycle to determine the business or nonbusiness character of the stock gain or loss. (A similar situation could occur if, in a later year, the subsidiary paid a large dividend out of E&P of the current audit period, because the dividend would only be subject to elimination under R&TC §25106 if the subsidiary were included in the combined report when the E&P was incurred.)

On a case-by-case basis, it may be acceptable in these types of situations for the auditor to obtain the taxpayer's agreement that the current year facts are the same as in the previous audit cycle. This agreement as to the facts can be obtained even if the taxpayer does not agree with the auditor's conclusion itself. If you believe that you have a case in which this exception would be appropriate, contact the Manager of Technical Resource Section so that the circumstances of the case may be evaluated before the taxpayer is approached regarding the agreement.

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2300 COORDINATION WITH PENDING PROTESTS, APPEALS, ETC.

* *

Generally, action pending on the prior years will not preclude the auditor from beginning the current audit. In addition, a pending protest for prior years is not an acceptable reason for delaying an audit. Some taxpayers will resist providing information to an auditor until the prior year protest is resolved. As time passes, taxpayer personnel often change and information is no longer available or becomes much harder to retrieve. Therefore, the audits become more difficult for both the taxpayer and the auditor, and the ultimate development is often much less satisfactory. Auditors should explain to the taxpayer that each year stands on its own facts and should be prepared to issue demands and the failure to furnish information penalty if necessary.

Whenever prior years are still being worked, however, the auditor will need to be familiar with the status of the action and how the issues and possible resolutions of the prior audit report might affect the current years under audit. In addition, auditors are strongly encouraged to contact the hearing officer or attorney assigned to the case. By discussing the case, the auditor can learn the direction in which the hearing officer or attorney is headed with an issue and can plan the audit accordingly. The auditor can also inquire about any weak areas in the prior audit that have been identified by the hearing officer or attorney, and can make sure that those areas are strengthened in the current cycle.

If prior years have been resolved at the protest or appeal level, auditors must be aware of following final determinations without discovering the basis for those determinations. Occasionally, a Notice of Proposed Assessment will be revised or withdrawn at the protest or appeal levels because of lack of factual development in the file to support the audit position. This resolution will not prevent the auditor from fully developing the issue in the subsequent years and recommending appropriate adjustments.

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

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2400 REVIEW OF PUBLIC INFORMATION

By taking advantage of the public information that is available, a great deal of preliminary information can be gathered during the preaudit stage. Although the auditor should confirm information received from public sources before any adjustments are proposed, public information is invaluable for identifying issues and for determining the audit-worthiness and potential tax effect of unity issues. Since time at the taxpayer's location is limited, public information can also enable the auditor to complete a good deal of the groundwork prior to arriving at the taxpayer's place of business.

Much of the public information available can be obtained through the program office libraries, Lexis/Nexis and other databases, the state library, and other public libraries.

The auditor may choose to request documents such as annual reports or SEC Form 10-Ks directly from the taxpayer. If, after reviewing the information provided by the taxpayer, the auditor decides that the returns are not good candidates for audit, a letter should be sent to the taxpayer informing them that an examination will not be conducted at the present time, but that the returns are still subject to audit at a later date.

The next few sections describe some of the most common sources of public information.

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2410 Annual Reports

Companies that trade their stock on any United States exchange supply their shareholders with a copy of the annual report. Annual reports provide a good background on the business operations of the taxpayer, and often comment on management goals, major acquisitions or dispositions, transfers of key personnel, flows of goods and other interaction between the affiliated entities. This information can serve as a starting point for a unitary investigation.

The financial statements that accompany the annual report are an excellent source of financial data for preaudit test checks. In addition, the notes to the financial statements often disclose unusual transactions or accounting adjustments such as additions to reserves or asset writedowns. A review of the notes can be useful in identifying potential audit issues.

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2420 Sec 10-Ks And Other Sec Filings

The Securities and Exchange Commission requires a variety of filings that may provide extensive unitary and financial information. Following are some of the more common filings that may be of use to the auditor:

Form 10-K
Publicly traded corporations are required to file an annual SEC 10-K with the Securities and Exchange Commission. Although much of the information found in a 10-K is similar to the information included in the annual report, there are some significant differences. Annual reports tend to be written from a public relations perspective, and may contain comments regarding the centralization or integration between the affiliates, or similar subjects with unitary implications. On the other hand, the 10-K will usually contain more detail of the business activities and financial data than is generally disclosed in the annual report. Consequently, the auditor should review both the annual reports and 10-Ks.

SEC 10-Ks may provide a detailed description of the corporation's divisions or lines of business. Often, they also identify the geographic regions where the taxpayer's property and markets are located. This data should be noted and may be useful in identifying potential nexus or throwback sales issues. For example, assume a company has divisions in California and Oregon. The 10-K might discuss the business activity of each division and also disclose that the Oregon division makes sales to customers in Washington, Oregon and California. This information should alert the auditor that some of the total Oregon division sales should be in the California numerator.

The SEC 10-K contains a list of the exhibits that were included in the filing. The auditor should review this list and request any of the exhibits that may be relevant to the examination.

Form 10-Q
The 10-Q is the quarterly report required to be filed with the SEC. The 10-Qs are also filed as transitional reports when the registrant changes its fiscal year-end. Although the data in these reports is unaudited, the Form 10-Qs may be useful in preparing fiscalization calculations or in other situations were interim financial data is necessary.

Form 8-K
The 8-K is titled the Current Report, and is used to report significant events that are deemed to be of importance to securities holders. Reports concerning the following types of events may be of particular assistance to auditors:

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- When significant acquisitions or dispositions of assets occur other than in the ordinary course of business, the registrant is required to file an 8-K with a description of the transaction and the assets involved, the nature, amount and source of consideration given or received, and any material relationships that existed between the registrant and the other party to the transaction. If the registrant acquired plant, equipment or other physical property, the 8-K will disclose the nature of the business in which the assets had been used, and whether the registrant intends to continue such use or intends to devote the assets to other purposes. The filing requirement is triggered whether the acquisition or disposition has occurred due to purchase, sale, lease, exchange, merger, consolidation, assignment, abandonment, destruction, etc. Information reported on the 8-K may be valuable for verifying basis or computing gain with respect to assets that have been acquired or disposed of; and also may provide some clues to pursue in an instant unity or business/nonbusiness examination.

- When a change in control of the registrant has occurred, information must be reported concerning the details of the transaction (including the amount and source of the consideration used), the basis for the control, and the percentage of voting securities of the corporation owned directly or indirectly by the controlling shareholder(s). This information may be useful for determining whether unity of ownership exists in complex ownership structures.

Form 20-F
Form 20-F is the annual report required to be filed by foreign companies whose securities are registered with the SEC. The report is similar to the Form 10-K used by domestic entities and should be requested in lieu of the 10-K in foreign parent cases. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP, or must disclose the variations from GAAP and contain a schedule, which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used. This information is useful for reconstructing worldwide income for foreign-owned groups (see MATM 5120).

Schedules 14A and 14C
Whenever a corporate action is taken which requires the authorization or consent of the shareholders, an information statement must be provided those shareholders. If proxies are solicited, the information statement is filed on Schedule 14A. Schedule 14C requires substantially the same information as 14A, but is used when proxies are not being solicited. Transactions that may be subject to shareholder approval include mergers and major acquisitions of stock or assets. The information statements will often contain information regarding the reasons for the transactions that may be useful in a unitary examination. The 10-Ks and 10-Qs filed by the registrant should identify whether there have been any matters submitted to a vote of the shareholders for which a Schedule 14A or 14C would have been required.

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2430 Corporate Directories

Moody's Industrial Manuals and similar corporate directories provide brief descriptions of the business activities, corporate histories, lists of affiliates, summaries of financial statement data, and similar information. These directories are useful for identifying affiliates that may not have been included in the combined report, and for gleaning financial data for test combinations (see MATM 2530). Some of the directories specialize in certain areas (such as international companies), and may therefore contain more detailed information than some of the more generalized directories. Auditors should become familiar with the various directories available in their office or public library, and the types of information that those directories offer. Following is a list of some of the corporate directories that are available:

- Moody's Investors Service
- Standard & Poor's Corporations
- Hoppenstedt International Reports
- Directory of Corporate Affiliations
- Japan Company Handbook
- Janes Major Companies of Europe
- Diamonds Japan Business Directory
- Directory of Foreign Firms Operating in the U.S.
- Funk & Scott Index to Industries & Corporations
- Directory of Japanese Companies in the U.S.A.

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2435 Business Periodicals & Trade Journals

Business periodicals and trade journals are often a good source of information about a taxpayer. Articles in these publications may cover anything from the business activities and history to the CEO's management style to the technologies that are utilized in production to the reasons behind the acquisition of a subsidiary. Information contained in periodicals is not written in a tax context, and may be misleading or incorrect in some respects. On the other hand, such articles can provide good background information and may produce leads for the auditor to pursue further during a unitary investigation.

Publications such as the Wall Street Journal and New York Times publish indexes identifying the companies that have appeared in articles. Many libraries will also have business periodical indexes that reference articles in a variety of publications. For taxpayers in specialized industries, trade journals are a good source for finding articles on even relatively small companies.

The Harvard School of Business distributes a catalog of research papers, which have been written by its students. The papers are indexed by company name, and the catalog contains a brief description of the subject matter of each paper. The papers may be ordered for a relatively low cost. As with other third party articles, the information in the papers should not be relied upon as a basis for an audit determination, but it may provide valuable leads for the auditor to pursue.

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2440 Industry & Business Ratios

Auditors may consider performing an analysis of the taxpayer's financial ratios against the average ratios for the industry. Some sources for obtaining industry averages are:

- Dun & Bradstreet Industry Norms & Key Business Ratios;
- Robert Morris Associates Annual Statement Studies; and
- Almanac of Business and Industrial Financial Ratios by Leo Troy, PhD.

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2445 Lexis/Nexis

There is a tremendous amount of information available through LEXIS/NEXIS, and once an auditor becomes familiar with the service, its use can greatly cut down on preliminary research time while providing access to a tremendous array of research materials.

Use of LEXIS/NEXIS is encouraged as a standard procedure in multistate audits. It is a very powerful research tool.

Some pointers for finding taxpayer information on the LEXIS system include:

Search more than just the taxpayer's name; search the parent corporation, affiliates and top corporate officers.
Use the combined (two or more) libraries whenever possible; the focus can always be narrowed later.
The "COMPNY" library is the most widely used by auditors, and is an excellent source for background information.
LEXIS customer service is available to answer questions about the system and to provide assistance in putting together searches and selecting libraries and files. The phone number is 1-800-543-6862.

The following table contains suggestions for locating specific types of information on LEXIS:

IF YOU WANT TO FIND:	**SEARCH CRITERIA**	**SEARCH LIBRARY/FILE**
Business and financial information on the taxpayer	Taxpayer	COMPNY/COMPNY NEWS/ALLNWS
Background of executives	Executive name	COMPNY/EXECDR BUSREF/BIOS
Annual Report for 1992	Taxpayer Parent	NAARS/AR COMPNY/SEC,ARS
Taxpayer property in other states (for property factor or nexus issues)	Taxpayer Parent Affiliate	ASSETS/ALLOWN
Affiliates not included in the combined report	Taxpayer	COMPNY/SEC,10-K or 20-F
Transfer pricing information on the taxpayer's industry	Taxpayer Parent Competitor Product	MARKET/CMPNWS
Bankruptcy information	Taxpayer	COMPNY/BDS
Acquisition information	Taxpayer	M&A/ACQUIS

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Article in the San Francisco Chronicle on the taxpayer	Taxpayer	NEWS/SFCHRN CAL/ CANEWS,SFCHRN
Copy of B of E decision before hardcopy is distributed	Appellant	CAL/CASBE
Status of pending California legislation	Subject Bill No.	CAL/CABILL

Exhibit C lists some commonly used LEXIS libraries and files, and describes the content of those files.

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2460 Reports Of Privately Held Companies

If a company is privately held, it may or may not have supplied an annual report or certified statement to its shareholders. In most instances however, financial statements of some type will be furnished to either the shareholders or to a financial institution, which has provided funds to the corporation. Although these financial statements may not describe the business operations, the footnotes generally do include important information in regard to related party transactions.

Obtaining financial statements from privately held companies may be more difficult than from publicly held companies. If financial statements exist but the taxpayer refuses to supply the statements, the auditor should follow the standard steps recommended for failure to furnish information (MAPM 8040).

If an auditor believes that financial statements exist but has been told none were prepared, a review of the general ledger account "Legal and Accounting Fees" along with the supporting invoices can help identify if statements have been prepared.

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2480 Review Of Federal Tax Returns

Complete copies of the Federal Form 1120 tax returns (along with all supporting schedules) should always be reviewed during the course of the audit. Depending upon the level of detail contained in the California Form 100 return, it is often a good idea to perform this review during the preaudit phase. In some cases, the Federal 1120 and California 100 will be the same and no new data will be discovered. Most often, the Federal 1120 will contain detail that was not included in the California return. A company-by-company breakdown of income, balance sheet and M-1 data is necessary to perform the test checks and reconciliations discussed at MATM 2500. If not disclosed in the California return, that information can usually be found in the Federal 1120. A comparison between federal and state returns will also highlight any differences in income resulting from the taxpayer using different treatment for state and federal purposes.

When reviewing the Federal 1120s, the auditor should ensure that all the federal returns for the members of the combined group have been provided. This may include returns filed on Federal Form 1120-DISC, 1120-FSC or 1120F U.S. *Income Tax Return of a Foreign Corporation* (the 1120F is filed by foreign corporations with income effectively connected to the United States).

Form 851:
The California return will generally not contain the Federal Form 851 *Affiliation Schedule*. A review of this form is important because it contains the data needed to determine if there are any newly acquired domestic corporations or changes in stock ownership. Domestic companies, which have been sold, will be disclosed on the Federal Form 851 as well as on Schedule D.

Form 5471:
When auditing a domestic parent with foreign subsidiaries, the auditor should ensure that copies of any Forms 5471 filed by the taxpayer are provided along with the Federal returns. Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, can be a valuable source of income and apportionment data for foreign subsidiaries. This form contains information regarding income, balance sheet data, earnings and profits, stock ownership, distributions, federal subpart F income, and related party transactions involving the foreign subsidiary. This data will be useful for developing unitary information, preparing test combinations and factor reconciliations, and verifying dividend deductions.

Form 5472:
Form 5472, *Information Return of a Foreign Owned Corporation*, discloses information regarding a foreign-owned corporation's transactions with its foreign affiliates, and is useful for identifying unitary ties and intercompany transactions.

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For federal purposes, Form 5472 is required to be filed by domestic corporations that have at least 25% direct or indirect foreign ownership, unless no reportable transactions exist (IRC §6038A). Reportable transactions generally include transactions between the domestic corporation and a foreign related party for monetary or nonmonetary consideration or for less than full consideration. Generally, most domestic corporations with a foreign parent will have a Form 5472 filing requirement for federal purposes.

For taxable years beginning on or after January 1, 1990, R&TC §19141.5 (formerly §25940) requires California taxpayers to file photocopies of the Federal Forms 5472 with the California return. (Note that this requirement only applies to *taxpayers*, not to members of the combined report that are not taxable in this state.) If the California taxpayers have failed to file all of the Forms 5472 with their state return, R&TC §19141.5 provides that a penalty of $10,000 per required form might be assessed. See FTB Notice 1992-1 for information regarding an amnesty period for filing the form. Also note that the penalty may be waived for reasonable cause, or if the situation is deemed to fall under the penalty relief provisions of R&TC §21015 (effective for penalties imposed on or after January 1, 1996). FTB Legal Ruling 96-3 provides examples of situations where FTB will, or will not, waive penalties under R&TC §21015.

NOTE: The Federal Forms 5471 and 5472 are informational returns that must be attached to the Federal Form 1120. Although the forms are used by the IRS during an audit, the Forms 5471 and 5472 themselves are not actually audited. Any adjustments found by the IRS are made to federal taxable income, not to the Forms 5471 and 5472. As a result, although the Federal Forms 5471 and 5472 may provide good leads for identifying issues, the accuracy of those forms cannot be relied upon without obtaining and auditing the underlying supporting workpapers.

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2490 Setting Up The Audit Workpapers

If the auditor has not yet begun to set up the audit workpaper package, this is the point where that task should be started. By setting up the workpapers very early in the audit process, cross-referencing can be done as soon as data is added to the file and as schedules are prepared. Immeasurable amounts of time will be saved during the audit if the auditor does not have to hunt around for the documents that support the adjustments or the figures that tie to the audit schedules. The end result is usually a much better organized file.

Cross-referencing is not only a time-saving device for the auditor, but it enables reviewers, hearing officers, attorneys and other users of the file to access the information to support the auditor's determinations. Without adequate referencing, information contained within the file may never be discovered. In addition, the users may not understand the purpose or significance of the documents that are found in the file.

When cross-referencing workpapers, the following guidelines should be followed to ensure that the information contained in the package will be easily retrievable for all users:

In addition to the overall index of the workpaper sections, any individual section with more than 10 pages should contain an index of the documents contained within that section.

If a document is important enough to include in a file, it's purpose and source should be clearly explained. All documents should be labeled to identify: (1) the source of the document (e.g., the taxpayer's apportionment workpapers, the general ledger summary, etc.); (2) who provided the document; (3) the date received; and (4) what the information on the document represents. If the auditor verifies the information on the document (for example, if totals on the apportionment workpapers are traced to the financial statements), that fact should be noted. If the document is a schedule prepared by the taxpayer, the auditor should note whether it was prepared in the normal course of business, or whether it was prepared specifically in response to an audit inquiry.

This step is particularly important when corporations are reluctant to provide the information needed to perform the audit. By documenting when and how documents were obtained, evidence is present in the audit file to demonstrate that the taxpayer was not timely responding, or to support any failure to furnish information penalties.

All related documents should be cross-referenced to each other. For example, an IDR should contain a reference to the taxpayer's response, the response should be referenced to the IDR, and the appropriate program item should reference both the IDR and the response. As another example, audit schedules should reference the documents from which the figures were derived, and those documents should contain references to the audit schedules where the information is utilized.

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When the taxpayer sends a letter with several documents attached, the letter should be included in the correspondence section, but the file is often easier to follow if the various documents are placed in the program item sections to which they relate. If the documents are separated, they should be cross-referenced to the letter. To maintain a proper record of what the taxpayer actually provided, a note should then be attached to the letter with a description or title of all separated documents and the workpaper number where they can be located.

Sometimes, a figure on an audit schedule will represent the sum of more than one number from a supporting document. For example, assume a document identifies the California sales of each division of Corporation X. Auditors may aggregate those figures, and carry the total to the audit schedules as "total California sales of Corporation X." In such a situation, merely referencing the supporting document may not be sufficient because the reader may not be able to figure out how the total was computed. The auditor should either prepare a supporting audit schedule to show how the figure was compiled, or should show the computation on a note attached to the supporting document.

References to a multi-page document such as an annual report are not very helpful unless the reference identifies the page, footnote number, etc. in which the relevant information is located. For example, the reference should indicate "1995 Annual Report, page 27, footnote 6."

Auditors should be careful when writing on significant original documents (such as letters from taxpayers) that may later be used as evidence in litigation proceedings. Markings on such documents may cause them to be inadmissible in court. In such cases, explanatory notes may be written on a separate page that is attached to the document. Alternatively, notes may be made on copies of the documents (but be sure to reference both the original and the copy so that readers are aware that both documents exist).

While the preaudit procedures are being performed, the auditor should keep in mind that copies of all documentation relevant to the audit issues should be included in the audit file. If it is later determined that an issue will not be pursued, any documentation that the auditor has already collected with respect to that issue can remain in the file with an indication that it has become irrelevant. This will save the auditor from having to re-request an item or re-perform an audit step if the information later becomes necessary for any reason.

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2500 PREPARATION OF PREAUDIT SCHEDULES

Information extracted from the federal and state returns, annual reports and SEC filings can be used to prepare certain schedules to highlight problem areas. Preparation of these schedules during the preaudit phase will help keep audit time to a minimum and enable the auditor to focus field time on reviewing taxpayer records rather than on setting up schedules. Many of these schedules are available on PASS.

- These preaudit schedules are:
- Summary of Returns (Form FTB 6860)
- Tax Effect Computations
- Test Check for Combination (Form FTB 6685)
- Book Income Reconciliation
- Analysis of Schedule M-1
- Property Factor Test
- Sales Factor Test
- Tests of Federal/State Differences

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2510 Summary Of Returns (Form FTB 6860)

This form is used to compare the computations of Net Income for State Purposes and the apportionment factors over several taxable years. By making this comparison, unusual fluctuations between the years can be easily identified and noted for further investigation. For example, if the Summary of Returns reveals that a state adjustment for excess depreciation was made for only one year, this will alert the auditor to the fact that special attention should be given to the review of the federal and state depreciation differences.

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2520 Tax Effect Computations

The tax change potential of a case is a key factor in justifying the commitment of department resources to a case. Usually, if an issue will not result in a material tax change in relation to the audit work that will be required to develop the issue, the lack of materiality should be noted in the file and the issue should be passed. During the course of the audit, the relative materiality of the audit issues will influence how the auditor allocates field time.

A Relativity Sheet (Form FTB 6861) is available that will indicate the amount of income or factor adjustment that will be necessary to generate a specified tax change. This form may be used as a guide to estimate the materiality of potential adjustments. Significant factor adjustments will have an impact on the materiality of income adjustments and vice versa, so care must be taken in using this form when multiple adjustments are considered.

Although the Relativity Sheet will assist the auditor in determining whether a potential adjustment will be material, it will not calculate the tax potential of a specific adjustment. A good way to calculate tax potential is to run potential adjustments through standard computerized audit schedules that have been set up using "as reported" income and factors. Again, it is important to remember that significant changes to income or factors (such as combination or decombination) will affect materiality of other issues. If combination or decombination is an issue, the auditor should consider determining the tax effect of other issues both ways (under the taxpayer's reported method of filing, and also assuming that the audit results in combination or decombination).

When calculating the materiality of issues, do not forget to consider the impact of variables such as the interest offset, NOL carryovers, and AMT effects.

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2530 Test Check For Combination (Form FTB 6685)

If a company is publicly traded, a quick check with Moody's, SEC 10-Ks, or a similar source will usually disclose whether all of the majority-owned affiliates have been included in the combined report. If the auditor determines that some affiliates have been excluded, and it appears that combination of those affiliates may be appropriate, Form FTB 6685 can be used to make a test check of the tax effect. A video search of the excluded affiliates (by corporation name) can be done to determine whether any of those affiliates are California taxpayers. In some cases, not all of the data necessary to calculate the income and factors is available during the preaudit phase (for example, payroll information is not always disclosed in the annual reports or 10-Ks). In order to test the tax effect of combination in those cases, the auditor may have to make estimates of the missing information based upon ratios, prior year information, or other reasonable methods.

If the tax returns (federal or state) disclose income and apportionment data on a company-by-company basis, the auditor may also be able to perform test checks for combinations that do not include the entire worldwide group, or for decombination of certain affiliates. This approach is particularly useful in determining the tax effect of decombining newly acquired subsidiaries (see MATM 3090 for a discussion of "instant unity"). These test checks may be computed by preparing the standard audit schedules using available information.

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2540 Book Income Reconciliation

A basic procedure for every audit is to reconcile the annual report income to the Schedule M-1 book income used in preparing the return. This reconciliation is *not* designed to reconcile book income to taxable income per the return. Instead, its purpose is to validate a starting point for the income computation. An analysis of the Schedule M-1 adjustments is only meaningful once the auditor is assured that the starting number is valid. Income reconciliations will also help to verify which entities' income has been included in the combined report, and may identify book/tax differences that have bypassed the Schedule M-1.

To perform this audit step, a reconciliation is made between the annual report book income and the book income used as a starting point on the Schedule M-1. The specific steps involved in performing this reconciliation are discussed in detail at MATM 5130. Although the auditor may sometimes need to examine the taxpayer's records in order to complete the reconciliation, in other cases the reconciliation can be prepared from data contained in the return and annual reports. It will therefore save time later on in the audit if this step is completed during the preaudit phase. Preparation of this reconciliation early in the audit is also important because it will identify how the taxpayer computed its income, and may highlight other areas that will need examination.

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2550 Analysis Of Schedule M-1

The Schedule M-1 adjustments should be analyzed, preferably on a company-by-company basis. The Schedule M-1 discloses the difference between book income and federal taxable income. If sufficient detail is disclosed in the tax returns, this analysis should begin during the preaudit phase.

Unusual Schedule M-1 adjustments should be examined, particularly if the IRS has not already audited the Schedule M-1. A Schedule M-1 item should not be ignored simply because it is small or appears to be in the State's favor. Taxpayers will often net positive and negative adjustments, so a seemingly minor adjustment may actually have very material components. It is therefore important to gain an understanding of what the Schedule M-1 items represent. Even if the IRS has examined the Schedule M-1, large, unfamiliar items should be explored to determine whether the adjustments are applicable for California purposes.

Frequently, Schedule M-1 adjustments relate to areas where state and federal treatment is also different (i.e., interest on municipal obligations, safe harbor leases, depreciation, etc.). The presence of these Schedule M-1 adjustments should alert the auditor to the fact that a state adjustment should also have been reported.

When an unfamiliar Schedule M-1 adjustment is noted during the preaudit stage, it may be helpful to consult a GAAP Guide to understand how the transaction was reported for book purposes. Financial statements of foreign parent operations will generally be prepared using the accounting principles of the home country rather than U.S. GAAP. The AICPA publishes a series entitled "*The Accounting Profession in (particular country)*" which summarizes the significant accounting principles of most major countries. Tax Management Portfolios and several "Big Five" accounting firms publish similar handbooks. These summaries will provide a good starting point for understanding how the financial statements have been prepared. Also see Exhibit J for general information regarding issues to look for when financial statements have been prepared under foreign accounting principles.

If research into the financial accounting treatment of the transaction does not resolve the auditor's concerns with respect to a particular Schedule M-1 adjustment, then the item should be flagged as a potential audit issue.

Further discussion of the Schedule M-1 analysis may be found in MATM 5140.

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2555 Property Factor Test

A test of the property factor denominator can be made during the preaudit phase if the combined group is the same as the consolidated group for financial statement purposes. To perform the test, beginning and ending property disclosed in the annual report or 10-K is averaged and compared to the average fixed assets reported on Schedule R of the return. Differences resulting from this reconciliation may be attributable to improper reporting of intercompany profits in fixed assets and inventories, construction-in-progress, etc. Any material differences should be pursued and resolved. See MATM 7110 for further discussion of property factor verification.

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2560 Sales Factor Test

If the combined group is the same as the consolidated group, the sales per the annual report should be compared to the sales reported in the denominator of the sales factor. Although there are valid reasons for differences, such as use of installment sale reporting for tax purposes, differences may also be attributable to failure to exclude intercompany sales, omission of sales from one of the entities, etc. If significant differences do exist, they should be pursued to determine if they are appropriate. See MATM 7505 for further discussion of sales factor tests.

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2570 Tests Of Federal/State Differences

Information available during the preaudit phase is often sufficient to enable the auditor to conduct preliminary tests to verify the reasonableness of various state adjustments. Techniques for verifying the various state adjustments are covered in MATM 6000 - MATM 6100. These sections should be referred to when material state adjustments are present, or when the auditor suspects that material adjustments should have been made.

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2600 DEVELOPMENT OF AUDIT PLAN

Once the preaudit procedures have been performed, a preliminary audit plan should be developed. The audit plan will form the basis for a decision whether to commit valuable department resources to the audit, and will help to ensure that the audit progresses as efficiently as possible. In addition to conserving department resources, an efficient audit plan will minimize the cost and inconvenience for the taxpayer.

The audit plan should list the potential issues that were identified during the preaudit stage, and should indicate the tax effect of each issue. If certain items on the returns appear to be questionable, but the tax effect of those issues does not justify their inclusion in the scope of the audit, this should be stated in the audit plan to avoid questions later on. The auditor should keep in mind that the issues defined in the audit plan are not set in stone. As the audit progresses, some issues will be resolved, and new issues may be identified.

After defining the preliminary audit issues, the general approach to the audit and the initial procedures and types of information that will be used to develop the issues should be planned. The auditor should give consideration to the order in which the issues will be examined. For example, since the income reconciliation and Schedule M-1 analysis often lead to the identification of other issues, they should be completed as early as possible in the audit. As another example, assume that a certain apportionment factor issue will only have material tax potential if the unitary examination results in combination. The auditor should therefore not spend a lot of time on the factor issue until they have a good idea of the direction that the unity issue will take.

A time plan should be developed for the fieldwork. This will allow the auditor to estimate the amount of time that will be needed at the taxpayer's location, and to determine how to most efficiently allocate that field time between the issues. When time at the taxpayer's location is limited, it is important that the auditor concentrate on the issues that have the most significance, and address the less significant issues as time allows.

The time plan should also take into account any statute of limitations constraints. Statutes of limitations are discussed in detail in the next section.

A sample audit plan for certain large cases selected by each office is described at MAPM 4070.

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2620 Statute Control

It is the auditor's responsibility to assure that statutes of limitations do not expire. Therefore, the auditor should review each return as soon as it is assigned to determine the statute. The earliest statute date should be noted and reviewed on a monthly basis, or as required by the statute check procedures used by the auditor's program office. Once a waiver has been executed to extend the statute for the earliest year, the statutes for all of the years should again be reviewed to identify the next earliest statute date. To avoid overlooking statute dates, particularly when several years or taxpayers are involved, a chart can be prepared to show at a glance the statute for each return.

Waiver policy: 1992 and subsequent years
In 1992, the terms and conditions of the Schedule R-7 "*Election to File a Unitary Taxpayers' Group Return*" were revised to clarify that a state SOL waiver signed by the key corporation would be binding on all members electing to be included in the group return. Therefore, beginning with taxable years filed with the 1992 Schedule R-7, auditors may obtain blanket waivers for taxpayers that were included in the original Schedule R-7 group return. The taxpayer name on the waivers should be shown as "*(key corporation) and Schedule R-7 Electing Members.*"

As long as a Schedule R-7 for 1992 or subsequent was executed, the blanket waiver will generally be acceptable even if the auditor is proposing to decombine the taxpayers or if one or more of the taxpayers has been sold. Judgement should be used of course -- if a taxpayer is asking to terminate their R-7 relationship, the auditor should obtain separate waivers to avoid potential problems. (Likewise, single notices can be mailed to taxpayers filing on a 1992 or subsequent Schedule R-7 regardless of whether a taxpayer has been decombined or sold, but the auditor should consider issuing separate notices if the taxpayer so requests.)

Separate waivers will be needed for taxpayers who did not file as part of the Schedule R-7 group return. If the audit includes returns from more than one R-7 group of corporations, the key corporation of each Sch. R-7 group must execute a separate waiver on behalf of that group.

Waiver policy prior to 1992
Prior to 1992, the terms of the Schedule R-7 did not include an express authorization by the taxpayers for the key corporation to sign waivers on their behalf. In order to avoid potential controversy, the department's waiver policy was revised to require auditors to obtain either separate waivers from each taxpayer in the combined report, or powers-of-attorney authorizing the corporation handling the audit to execute waivers on behalf of the other members. An exception to this policy is permitted if all of the following criteria are met:

The audit is not expected to result in decombination; *and*
all of the taxpayers are still affiliated with the key corporation; *and*

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the key corporation is a California taxpayer qualified with the Secretary of State; *and*
the key corporation is financially stable, has substantial net assets to pay the affiliates' deficiencies, and has not shown any indication that they would be unwilling to pay the affiliates' portion of the tax; *and*
the key corporation has acted in good faith in fulfilling its obligations to pay under the terms of the Schedule R-7 in the past (i.e., they have not tried to terminate an R-7 relationship, refused to pay the tax of a combined subsidiary, attempted to disregard a waiver executed on behalf of a subsidiary, etc.).

If all of the above criteria are met, the auditor may accept a blanket waiver signed by the key corporation on behalf of taxpayers included in the Schedule R-7 election. Separate waivers must still be obtained from any taxpayers which have been disaffiliated or which are expected to be decombined. An explanation of how the above criteria were satisfied should be included in the audit narrative. Even if the above criteria apply, auditors should still consider obtaining separate waivers in cases where intrastate apportionment would result in a large potential tax liability being attributed to a taxpayer other than the key corporation.

Note: This policy applies to all pre-1992 taxable years with open SOLs, including years that are open under previously executed state waivers. However, for pre-1992 taxable years that are already under a blanket state waiver, the auditor may continue to accept a signature by the parent or key corporation on behalf of its affiliates. Although such waivers are still valid, if there is an open federal waiver the auditor should obtain separate state waivers in order to comply with the department's waiver policy.

Waivers should be signed by a principal officer (president, vice-president, secretary, treasurer, etc.) or duly authorized agent of the taxpayer. A tax manager is not often a principle officer, so before accepting a waiver signed by a tax manager (or other corporate official other than a principal officer), the auditor should obtain a power of attorney or other evidence that the corporation has duly authorized the official.

In lieu of repeatedly obtaining separate waivers from each taxpayer every time a SOL extension is needed, auditors may obtain a power of attorney from each taxpayer. If the taxpayers designate a common agent to sign the waivers, then single waivers can be obtained from that point onward. The FTB Form 3520 is a power of attorney form designed specifically for this purpose. If several taxpayers in a combined report have a principal officer or other authorized individual in common, then those taxpayers may use the form to execute a single power of attorney. In most cases, the appointee who is granted the authority to sign waivers should be the member of the combined report that is handling the audit.

See MAPM 9010 – MAPM 9110 for more statute information and instructions on securing waivers.

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2700 PRELIMINARY AUDIT APPOINTMENT

Although not technically a preaudit procedure, the preliminary audit appointment is appropriate for discussion in this section because it establishes the framework for the rest of the audit. The preliminary audit appointment should accomplish several purposes:

- The verification procedures set forth in the audit plan should be initiated;
- the questions and issues identified during the preaudit phase should be addressed (and resolved if possible);
- the auditor should become familiar with the nature of the taxpayer's business and accounting system; and
- the auditor should continue to be alert for new issues.

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2710 Initial Information Document Request

The specific information needed will vary depending upon the issues identified during the preaudit phase, the level of information obtained prior to scheduling the audit appointment (i.e., through annual reports, 10-Ks, Federal Form 1120s, etc.), prior experience with the taxpayer, and the planned scope of the audit. At a minimum, the following items should generally be requested:

Corporate minutes.

Workpapers used to compile the state adjustments and apportionment factor. The supporting workpapers will help the auditor gain an understanding of how the taxpayer computed its income and factors. **Important**: Such workpapers are *not* a substitute for books and records when it comes to verifying the figures reported on the return.

Consolidating workpapers used to compile the annual report. The consolidating workpapers may assist the auditor in completing the book income reconciliation and Schedule M-1 analysis. It will also show the intercompany eliminations made for financial statement purposes. The highest level of consolidation will often show enough detail. If not, copies of supporting workpapers should be obtained. Enough detail is needed to enable the auditor to determine income and eliminations on a company-by-company basis. Occasionally, taxpayers will consolidate on a basis other than by entity (by product line, for example). In such cases, the taxpayer should be asked how company-by-company information may best be obtained under their accounting system.

Chart of accounts. A review of a detailed chart of accounts may identify any intercompany accounts that are maintained and might also assist in determining the proper rent expense. The chart of accounts might also provide clues to help identify nonbusiness items.

Federal Forms 940 or 941 (list specific companies to be tested). The uses of these payroll reports are discussed in MATM 7310.

California DE-6's (list specific companies to be tested). The uses of these payroll reports are discussed in MATM 7310.

Federal Revenue Agent's Reports.

Complete Federal 1120s with all supporting schedules (including Forms 1120-DISC, 1120-FSC, 1120F, 5471s, 5472s, and 851s) (if not already obtained during the preaudit phase);

Annual reports and SEC filings (if not already obtained during the preaudit phase), or audited financial statements if the taxpayer is not publicly held.

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Organizational charts or ownership charts. These charts may provide information that will be valuable in a unity examination. Even if unity is not an issue, an understanding of the organizational structure is helpful for identifying issues, analyzing intercompany activities, and providing some additional perspective on the case.

Record retention policy and an index. This will assist the auditor in determining what records are available, and titles of those records.

If unity is an issue, the taxpayer should be informed that a unitary investigation will be conducted. Information that should be requested in connection with a unitary audit is discussed at MATM 3500 - MATM 3595.

The letter to the taxpayer should make it clear that the scope of the audit is not limited to the information requested, and that additional information may be necessary.

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2730 Preliminary Discussion With Tax Department Personnel

The initial meeting with the taxpayer can have a significant impact on the entire information gathering process of the audit. An auditor who is not prepared is likely to be perceived by the taxpayer, as being incompetent and the taxpayer may therefore not furnish data as readily. Conversely, a well-prepared auditor is much more apt to obtain what is needed and in a much quicker fashion. Preparation for the meeting should include becoming familiar with the annual report information and any other information obtained during the preaudit phase so those relevant questions can be framed.

There are many different approaches and styles that can be successful in the initial meeting. The auditor should generally use an approach with which they feel comfortable. A successful discussion will complete the auditor's orientation with the taxpayer by confirming, expanding or eliminating preliminary conclusions reached during the preaudit phase. The key areas that should be covered in the initial meeting are discussed in this section. Additional techniques are discussed in MAPM 5010.

Familiarization with tax department:
The auditor may begin the initial meeting by establishing the working environment and becoming familiar with the tax department personnel. The taxpayer should be asked to designate the person or persons who will receive the IDRs and who may be contacted to secure additional records or information. Turn around time for IDRs should also be discussed. The auditor should inquire about the location and accessibility of the records. It can be expected that records stored in a third party storage facility will take longer to retrieve than records stored in the basement of the taxpayer's premises. This information can assist the auditor in planning the completion of other audits in progress and avoid "down time."

Inquiring about who prepared the returns, how long they have worked for the company, and their experience prior to coming to the company will provide insight into the degree of expertise of the individual preparing the return. The level of knowledge that the tax preparer has with respect to apportionment matters may be a consideration in planning the scope of the audit. Knowing the number of tax department personnel and their general duties will provide insight as to whether the tax preparer is under a great deal of pressure to complete the return. If so, there is a possibility that adjustments or corrections, which would normally have been made, might be passed.

The tax department personnel should also be asked about the status of any protests or federal audit activity.

Nature of business, products, California operations:

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The auditor should use the preliminary meeting with the taxpayer to become familiar with the taxpayer's business, organization, personnel, record system, California operations, etc. The auditor should indicate a desire to learn about the taxpayer's operations and procedures in order to facilitate the audit with a minimum of time and effort expended by both parties. Rather than starting with general questions about the business operations, it is often a good technique to begin by asking the taxpayer to expand on the general statements made in the 10-Ks or annual reports. This approach will prevent the taxpayer from wasting his time commenting on information already available to the auditor. If this approach is not taken, the taxpayer may develop the idea that the information already supplied to the auditor was not properly reviewed.

Becoming familiar with the taxpayer's operations is a very important step in any audit. It is essential that auditors do not short cut this step by satisfying themselves with information gleaned from annual reports or similar documents. Even more importantly, auditors should not fall into the trap of assuming that they already know how the taxpayer operates based upon examinations of taxpayers with similar operations, or upon their general knowledge of the industry in which the taxpayer operates. Such assumptions quite often prove to be false, and in no event can they be relied upon to support an audit determination.

Plant tours:
If possible, the auditor should schedule a plant tour. Seeing the operations in progress is useful for identifying unitary ties. Questions about specialized machinery and the possibility of company wide usage, specialized processing or technical procedures, personnel transfers, and a host of other questions can readily be asked during a plant tour.

Accounting procedures and controls:
The auditor should become familiar with the taxpayer's accounting system. Is accounting centralized or decentralized? To what extent? Is it automated in regard to the apportionment factor? If so, how is the factor compiled and what audit trail is available? Are there standardized accounts and procedures throughout the organization? Is there one or more outside auditing firms? Are there intercompany transactions? If so, is there a flow of goods, financing, administrative or service charges; and how are they handled on the records? Most large corporations maintain a document retention index that lists the records or documents retained by the business, and identify the storage location. A copy of this index can assist the auditor in determining what records are available and what document titles to use in requesting the information. Reviewing the taxpayer's instructions for preparing the returns and correspondence with the accounting department might also be helpful.

Audit program:

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The taxpayer should be informed of the planned audit program or scope during the initial meeting. This does not necessarily mean revealing every single item that will be examined (although the auditor may prefer to use this approach). Generally, informing the taxpayer that the audit program will cover the unitary issue, state adjustments, the apportionment factors, etc. is acceptable. If any unusual items have been noted, these could also be mentioned. It should be explained that additional records might be required, and that the audit scope might be narrowed or expanded if unexpected problems arise. By presenting an open approach, without pre-judging issues, the auditor may avoid an early confrontation and a resistance to producing records.

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2800 PREPARATION OF AGREEMENT STATEMENT FOR TAXPAYER

An exception to the requirement of complete factual development for the current audit cycle applies if the taxpayer agrees with the adjustment. If the auditor develops an appropriate amount of preliminary information which indicates that an adjustment is likely to be appropriate, and the taxpayer is already in agreement, then there is generally no reason to put the taxpayer through the inconvenience of an extensive examination of the issue. In that circumstance, the auditor may ask the taxpayer to sign a statement confirming their agreement with the adjustment and with the preliminary facts that have been developed (this may include confirming the presence of facts developed in the prior year). For an example of the elements that should be included in such a statement, see Exhibit K. (Also see MATM 3520).

NOTE: It is important that the statement not be characterized as a "stipulation." A stipulation has a specific legal meaning, and binds both parties to a set of facts. The statements that auditors should be asking the taxpayers to sign are merely to confirm the taxpayer's representation of the facts and their agreement with the adjustment; they should not purport to bind the department to anything. Only in very rare situations would the department enter into any sort of bilateral agreement at the audit level, and only after the case has been evaluated by the Multistate Program Consultant and the agreement reviewed and approved by the Technical Resource Section and the Legal Branch.

If the taxpayer refuses to sign a statement confirming their agreement, then there is no assurance that the audit issue will not ultimately be protested. Therefore, the auditor must fully develop the facts.

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3000 UNITY

Revenue and Taxation Code §25101 provides that when the income of a taxpayer is attributable to sources both within and without California, the taxpayer is required to measure its franchise tax liability by its income attributable to sources within the state. The portion of the total income that is considered to be attributable to California is determined in accordance with unitary business principles.

Under the unitary method, all of the activities comprising a single trade or business are viewed as a single unit, irrespective of whether those activities are conducted by divisions of a single corporation or by commonly owned or controlled corporations. The business income from all of the unitary business activities is combined into a single report (the combined report). An apportionment formula is then applied to the combined business income to determine the portion attributable to California.

Although R&TC §25101 provides the general authority for use of the unitary method, the application of this concept has not been defined by statute. Instead, the law has evolved through a series of judicial decisions.

This section of the manual will discuss the development and application of the unitary concept and some of the key court and SBE decisions that have helped to shape the current interpretation of a unitary business. The following sections (beginning with MATM 3500) will focus on specific audit steps and techniques for performing a unitary audit.

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3005 DEVELOPMENT OF THE UNITARY CONCEPT

The theory underlying the unitary business principle has its roots in real property tax law, where it arose in the context of railroad taxation. In *Union Pacific Railway Co. v. Ryan* ((1884) 113 U.S. 516), the United States Supreme Court recognized that the value of a railroad could not be measured merely by looking to the value of the property located within a specific geographic area. The Court found that the value of a railroad depends upon the whole line as a unit, to be used as a thoroughfare and means of transportation. A separate mile or two of its length is almost valueless. The Court approved a method enacted by the city of Cheyenne that taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. In 1897, this concept of "unit" taxation was expanded to apply to a non-rail business that was operated in several states (*Adams Express Co. v. Ohio* (1897) 165 U.S. 194).

The next landmark in the development of unitary theory was the 1920 Supreme Court decision in *Underwood Typewriter Co. v. Chamberlain*, (1920) 254 U.S. 113, 65 L.Ed. 165, 17 S.Ct. 305. This was the first case in which the use of an apportionment formula for income tax purposes was approved. In approving the formula used by Connecticut to determine the amount of income from a multistate business that was attributable to that state, the court commented that the profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. At no time, however, did the Court refer to the operation as being "unitary."

The first express classification of a unitary business for state income tax purposes was made by the court in the case of *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission* (1924), 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. In that case, the Court stated:

"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places - the process of manufacturing resulting in no profits until it ends in sales - the state was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business." (emphasis added.)

Edison California Stores v. McColgan ((1947) 30 Cal.2d 472) was the first case to extend the unitary concept to multiple entities. In that case, the business activity was carried on by a group of corporations rather than by divisions of a single corporation. The Court validated the use of the unitary business concept to allow apportionment of the combined income of a multi-corporate group. (The constitutionality of applying this concept to multiple corporations was later confirmed in Container Corporation v. Franchise Tax Board (1983) 463 U.S. 159, aff'g 117 Cal. App.3d 988 (1981).)

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In Superior Oil Co. v. Franchise Tax Board (1963), 60 Cal.2d 406, 386 Pac.2d 33, the FTB had argued that the unitary concept was only applicable if the in-state activities could not reasonably be computed separately from the out-of-state activities. The California Supreme Court disagreed, holding that if a unitary business derives its income from sources within and outside the state, then formula apportionment is mandatory under the language of former §24301 (now R&TC §25101). (Also *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417.)

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3010 Direct Integration Between Each Subsidiary Unnecessary

In Appeal of Monsanto Company, Cal. St. Bd. of Equal., November 6, 1970, the SBE held that it is not necessary for the taxpayer's activities in California to be directly integrated with the activities of each other subsidiary everywhere in order for the subsidiaries' activities to be included in the California combined report. In that case, the taxpayer argued that its subsidiary, Chemstrand Corporation, was not a part of the unitary business because it did not contribute to or depend upon the California operation. Although Chemstrand had significant dealings with the taxpayer's operations outside the state, it had no direct dealings with the California facility, and none of the products sold by the taxpayer to Chemstrand had any connection with the taxpayer's California locations. The SBE rejected this argument and concluded:

"This argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separate from either Chemstrand or the California operations."

Although the subsidiary in the Monsanto appeal had no direct connections with its parent's California operations, it did have connections with its parent's out-of-state divisions. This concept was applied to separate corporations in *Appeal of Aimor Corporation*, Cal. St. Bd. of Equal., October 26, 1983. In *Aimor*, both a U.S. subsidiary and a Japanese subsidiary had ties with the Japanese parent, but neither subsidiary had any connection with one another. Citing *Monsanto*, the SBE held that all three corporations were engaged in a single unitary trade or business.

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3015 Business Operating Entirely Within California

By its terms, R&TC §25101 applies only to taxpayers with income derived from or attributable to sources both within and outside the state. That section therefore does not extend the authority for combined reporting to corporations operating entirely within California. For taxable years beginning on or after January 1, 1980 however, R&TC §25101.15 was enacted to allow wholly in-state corporations to elect to determine their income in accordance with R&TC §25101. Currently, the department allows taxpayers to elect on a year-by-year basis.

When two or more corporations conduct a unitary business wholly within California, the taxpayers have the option whether to file a combined report or use separate accounting. In order to be eligible to file a combined report however, the corporations *must be unitary* under the same standards as are applied to multi-jurisdictional businesses.

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3020 Application Of The Unitary Method To International Businesses

Unitary business principles are applied whether the unitary business is carried on over state lines or over international boundaries. The United States Supreme Court first sanctioned application of the unitary method to the worldwide activities of a single corporation in *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission* (1924), 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. Since then, the Court has upheld the constitutionality of worldwide application of the unitary method to both domestic-owned and foreign-owned groups of corporations (*Barclays Bank Plc v. Franchise Tax Board, Colgate-Palmolive Co. v. Franchise Tax Board*, 114 S.Ct. 2268 (1994), aff'g 10 Cal. App. 4th 1742 (3d Dist., 1992) and 10 Cal.App.4th 1768 (3d Dist., 1992)).

In the *Barclays Bank and Colgate-Palmolive* decision the U.S. Supreme Court addressed both Commerce Clause and Due Process arguments concerning the constitutionality of worldwide combined reporting. This decision consolidated the *Barclays Bank* case (a foreign parent of a multinational group) and the *Colgate-Palmolive* case (a domestic parent with subsidiaries operating worldwide). In reaching its decision, the Court cited Complete *Auto Transit, Inc. v. Brady* (430 U.S. 274, 279 (1977)) in holding that, absent congressional approval, a state tax on interstate commerce would violate the Commerce Clause if it:

1. applies to an activity lacking a substantial nexus to the taxing state;

2. is not fairly apportioned;

3. discriminates against interstate commerce; or

4. is not fairly related to the services the state provides;

   The Court went on to hold that a tax affecting foreign commerce would be subject to two additional criteria. Such a tax would not survive Commerce Clause scrutiny if it:

5. enhances the risk of multiple taxation; or

6. prevents the federal government from speaking with one voice in international trade

The Court found that Barclays and Colgate met the nexus requirement, had not demonstrated the lack of a "rational relationship between the income attributed to the State and the intrastate values of the enterprise" and had not shown that the income attributed to California was "out of all appropriate proportion to the business transacted by the [taxpayers] in that State." The taxpayer's claim of

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unconstitutional discrimination was rejected because it had not been demonstrated that California's tax system imposed inordinate compliance burdens on foreign enterprises. (California's "reasonable approximations" method of reducing the compliance burden for foreign multinationals was also held to satisfy the Due Process requirement.) The Court then held that California's use of the worldwide unitary method did not inevitably result in multiple taxation, and observed that some risk of multiple taxation may occur in whatever taxing scheme the State adopts. The fact that Congress did not prohibit worldwide combined reporting reinforced the Court's conclusion that Congress "had implicitly permitted" that method. The implication to be drawn was that Congress did not believe that worldwide combined reporting prevented the federal government from speaking with one voice. The ultimate holding was that "the Constitution does not impede application of California's corporate franchise tax to Barclays and Colgate."

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3030 DEVELOPMENT OF TESTS FOR DETERMINING UNITY

A unitary business was first defined by the courts in the case of *Butler Bros. v. McColgan* (1941), 17Cal.2d 664; affd, 315 U.S. 501, 86 L.Ed. 991, 62 S.Ct. 701. In that case, the California Supreme Court established the "three unities" test for determining the presence of a unitary business. Butler Bros. was engaged in a wholesale dry goods and general merchandising business that operated in various states. Although each of the distributing outlets kept its own books of account, made its own sales, and otherwise handled many of its own functions, a central buying division ordered the goods for the outlets and thus received favorable prices because of volume purchases. Indirect expenses of the business such as executive salaries, corporate overhead, and the costs of operating the central buying division and a central advertising division were allocated to each outlet by recognized accounting principles, the accuracy of which was stipulated by both parties. By using separate accounting, the California operations would have resulted in a loss, but overall the corporation made a profit. The sole question before the court was whether a three-factor formula of property, payroll, and sales should be used to apportion a part of the overall profit to California, or whether separate accounting should be allowed. The courts, including the United States Supreme Court, which affirmed the California court decision, held that the use of a formula was proper. The California Supreme Court stated:

" . . . it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operations."

The Court was again required to determine whether or not a business was unitary in the case of *Edison California Stores v. McColgan* ((1947) 30 Cal.2d 472). In analyzing the presence of unity in that case, the Court formulated the "contribution or dependency test" under which a business will be unitary if the operations in California contribute to or are dependent upon the operation of the business outside the state. Specifically, the Court stated:

"If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate."

The California courts have consistently applied the three unities test and the contribution or dependency test over the years. In the early eighties however, the United States Supreme Court also began to refer to a unitary business as one that exhibits "contributions to income resulting from functional integration, centralization of management and economies of scale." (*F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.,* (1982) 458 U.S. 354, 366, 73 L.Ed.2d 819, 102 S.Ct. 3128; *Mobil Oil Corp. v. Vermont* (1980) 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223.) Such

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contributions are evidenced by a flow of *value* (not necessarily a flow of goods) between the components of the business operations (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). These judicial interpretations are often viewed as variations of the contribution or dependency test.

In FTB Notice 1992-4, the department stated its policy that each of the above judicially acceptable tests apply with equal force, and that a finding of unity will result when any one of the tests has been met. The Notice also pointed out that the test in CCR §25120(b), which requires a determination of unity "if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole," has been interpreted as consistent with the judicially established tests. In *A.M. Castle & Co. v. FTB*, 36 Cal.App4th 1794 (1995), the California Court of Appeal confirmed that the three unities and contribution or dependency tests are alternative tests, and that as long as one of the tests has been met, unity will not be denied just because the other test is not also met.

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3035 Application Of The Unitary Tests

Although the focus of the analysis may differ slightly between the unitary tests, the factual development that will be necessary in order to make a unitary determination will be essentially the same for each test. Unity of ownership is always required, and this aspect of the unitary analysis will be discussed in MATM 3050. Once ownership has been established, the level of integration existing with respect to the functions and activities of the business will need to be established. The unitary test that best fits the unique facts of each case should then be applied in order to determine whether the activities are unitary.

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3040 Three Unities Test

The three elements of unity set forth in the Butler Brothers decision are unity of ownership (MATM 3050); unity of operations as evidenced by central purchasing, advertising, accounting and management divisions; and unity of use in a centralized executive force and general system of operations. The test is satisfied if all three of the unities are found to be present.

The Court in *Chase Brass & Copper Co., Inc. v Franchise Tax Board* (1970) 10 Cal.App.3d 496 observed that:

"Although there is not a clear demarcation between what is `operation' and what is `use,' in general it may be said that the acts falling within the category of `operation' are the staff functions, and those within `use' are the line functions."

Note: The role of the auditor is to develop all the facts pertaining to unity. Although a discussion of the distinction between unity of use and unity of operation is being presented to help auditors to recognize when these unities are present, an actual demarcation of the facts between unity of use and unity of operation is not critical at the audit level.

Unity of Operations:
Examples of staff functions that are considered in determining the presence of unity of operations may include functions such as:

- central purchasing;
- manufacture and intercompany sale of products by one corporation to another member of the group for use as supplies, raw materials, component parts, packaging or production equipment;
- sharing of technology or information relating to products produced by the group;
- joint distribution or storage of products;
- transfers of equipment used in the business;
- common advertising;
- centralized accounting, legal, or personnel functions;
- common insurance policies, pension plans or employee benefits; and
- intercompany financing, when such financing serves more than a mere investment function.

This list is by no means considered to be all-inclusive. Furthermore, the auditor must realize that the mere listing of central operating departments will carry little value in the audit report if the taxpayer is successful in arguing that the connections are of little importance. ***The auditor must describe the***

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extent of the centralization, and document the benefits derived by the corporate group from the centralized operating departments.

For example, common purchasing might be a very significant unitary factor if the key raw material used by each member of the group is centrally purchased at a substantial volume discount. On the other hand, if the products that are centrally purchased consist only of miscellaneous supplies, the centralization of the purchasing function will carry much less importance.

By the same token, centralized accounting may be significant if a single accounting office performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each subsidiary in the group. Often however, the term "centralized accounting" is used to describe a situation where a parent corporation compiles the data to prepare the consolidated Form 1120 tax return and retains the services of an outside accountant to perform the annual audit. These are tasks that are necessarily performed by a single corporation on behalf of virtually any affiliated group, regardless of the level of integration that otherwise exists between the members. Consequently, common tax return preparation and common financial statement preparation will not carry any weight in a unitary context.

Intercompany financing has often been held to be "substantial evidence of unity of operation" (Chase Brass). It is important, however, that the auditor determine the purpose of the financing. As explained in *Tenneco West, Inc. v. Franchise Tax Board* ((1991) 234 Cal.App.3d 1510, 1532), financing is not a unitary factor when it primarily serves to diversify the corporate portfolio and reduce the risks inherent in being tied to one industry's business cycle. The Court distinguished such financing from an investment in subsidiaries which functions to make better use of business-related resources through economies of scale, operational integration, or sharing of expertise. In *Allied-Signal, Inc. v. New Jersey*, (1992) 504 U.S. __, 119 L.Ed.2d 533, 112 S.Ct. 2251, the U.S. Supreme Court confirmed that capital transactions must serve an operational rather than an investment function.

Taxpayers may argue that the centralized functions performed by one corporation on behalf of another corporation did not result in any cost savings because the service or product could have been purchased for the same price from an outside source. Even if quantifiable cost savings are not present, the corporations may realize intangible benefits from the centralized functions. For example, in the *Chase Brass* decision, the taxpayer purchased approximately 20% of the copper produced by its parent corporation. Although the copper was sold for the same price charged to the taxpayer's competitors, the Court stated, "to have a buyer of a substantial portion of the parent's production throughout the years must be assumed to be an advantage."

In order to anticipate and overcome this argument, the auditor needs to pinpoint the benefits achieved by the centralized function. Although it is difficult to isolate an intangible benefit such as an assured source of supply, documentation of as many facts surrounding the function as possible will help to

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demonstrate the benefits and may prevent the taxpayer from minimizing the importance of the function as a unitary factor. For example, the auditor may try to determine why the taxpayer established a particular type of centralized function and how long the function has been centralized in that manner. At the time that a function becomes centralized, there will usually be a good deal of documentation concerning the transition. Corporate minutes, internal correspondence, reports identifying or justifying the need for centralization, and company newsletters are all sources that may reveal the benefits achieved by the centralization.

Unity of Use:
Unity of use relates to executive forces and operational systems. The presence of unity of use is reflected in the integration of executive control over the major policy matters of the business. A centralized executive force will control the direction of the various activities and will ensure that they are operated in a manner that will be most advantageous to the unitary business as a whole. The development of vertical (e.g., manufacturer/distributor) or horizontal (same type of business) relationships in order to maximize the profitability of the group is an example of how common executive control binds the operational systems of the business. Substantial intercompany sales or product flow, or the intercompany transfer of knowledge and know-how also constitute unity of use.

The general operation of a group of affiliates for the benefit of the group as a whole may be contrasted with a situation where common officers and directors are concerned only with maximizing the profitability of each individual corporation but without regard to each corporation's role in the group as a whole.

In order to determine where the major policy matters for each entity in the group are decided, it is necessary for the auditor to look beyond the organization charts. Although the organization charts will identify the chain of command and show the reporting lines from the president down through the business segments, the auditor will need to gain an understanding of the involvement and control that takes place at each level of management. Audit techniques for obtaining this information are discussed in MATM 3500 - MATM 3595.

The three unities test is often easiest to apply in a horizontally integrated enterprise. Since the various segments of the business are engaged in the same activity, they are most likely to have significant centralized staff functions such as centralized advertising or purchasing that are designed to give advantages to the business despite geographic differences (*Chase Brass*).

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3045 Contribution Or Dependency Test

The Court in Edison California *Stores* stated that unity was present when the operation of the business done within California is dependent upon or contributes to the operation of the business done outside the state.

The contribution or dependency test is most easily satisfied by the presence of intercompany sales of tangible personal property. An example of this would be a parent corporation manufacturing the product that is sold by a subsidiary to customers in this state. However, in Superior Oil Company, the court found that contribution or dependency existed with respect to areas that included executive policymaking, coordination of activities, training of personnel, research, financing, and numerous other functions. As can be seen from this decision, the contribution or dependency test is generally based on the same functions and activities used to determine a unitary business under the "operations" and "use" tests.

The contribution or dependency test was clearly endorsed as an alternative test for unity in A.M. *Castle & Co. v. FTB*, Cal. Court of Appeal, 36 Cal.App.4th 1794 (1995). In this case the question was whether a parent company, which sells metal products, was unitary with a subsidiary, which distributes metal alloy shapes. In sustaining FTB's finding of unity, the court stated that this "...is a classic case of a larger parent purchasing a smaller subsidiary to better utilize its existing resources, and to capitalize on the synergy between the two companies." The court considered whether the taxpayer was unitary under the three unities test. It stated that the taxpayer can make "a colorable issue that there was no unity of operation." However, the court decided not to rule on unity of operation, as Castle and Hy-Alloy were unquestionably unitary under the dependency or contribution test. The court also found that there was no constitutional constraint that requires use of the three unities test. The court can apply any test to determine unity as long as there is a flow of value between the segments in question. The Court of Appeal's decision is consistent with FTB Notice 1992-4. FTB Notice 1992-4 stated that unity can be established under any one of the judicially accepted tests, and unity "cannot be denied merely because another of those tests does not simultaneously apply."

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3050 UNITY OF OWNERSHIP

Unity of ownership is a prerequisite to unity. In order to satisfy constitutional requirements, it is necessary that there be "some bond of ownership or control" uniting the otherwise unitary business (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). Unity of ownership allows the corporations to be commonly controlled in a manner whereby the interests of a single corporation can be made subservient to the interests of the entire unitary group.

Generally, unity of ownership will be present if there is common ownership or control of more than 50% of the voting stock of each corporation (R&TC §25105). The ownership or control may be direct or indirect as shown by the following examples:

Example 1
Corporation A owns 50% of the stock of Corporation B and 25% of the stock of Corporation C. Corporation B owns 50% of the stock of Corporation C.

Corporation A does not own more than 50% of B, and B does not own more than 50% of C. Since A does not have a controlling interest in B, B's shares of C are not indirectly controlled by A. Therefore, A's direct and indirect interests in C are not sufficient to meet the ownership requirement. Unity of ownership is not present with respect to A, B or C.

Example 2
Assume the same facts as in Example #1, except that A now owns 51% of the stock of B. All three corporations would now meet the ownership test. Since A now has a controlling interest in B, it indirectly owns 50% of C through B. When this indirect interest is added to A's 25% direct interest in C, ownership of more than 50% is established.

Example 3
Corporation A owns over 50 percent of the voting stock in Corporations B, C and D. Corporations B, C and D are unitary amongst themselves, but not unitary with Corporation A. Since Corporations B, C and D are commonly owned, the ownership requirement has been satisfied and B, C and D should file on a combined reporting basis even though A will not be included in the combined report. (FTB Legal Ruling 410.)

In the majority of cases, the ownership determination is relatively straightforward. Occasionally, however, issues arise concerning family ownership, joint venture corporations, and other situations for which treatment under the code is not clear-cut. Prior to 1995, California's policy regarding unity

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of ownership was based upon the interpretation of (former) §25105 that had evolved over the years through SBE and court decisions. For taxable years beginning on or after January 1, 1995, §25105 was amended to establish a bright-line test for unity of ownership.

Pre-1995 Ownership:

The department's position regarding unity of ownership has shifted several times over the years as conflicting SBE and court decisions have been handed down. Since many of these cases have been overturned or invalidated by subsequent decisions, they can no longer be relied upon as authority in this area.

For many years, the department had advanced the position that unity of ownership required ownership by a single entity of more than 50% of the voting stock of a corporation (the single entity bright-line test). Although two SBE decisions in the 1970s (*Appeal of Shaffer Rentals*, Cal. St. Bd. of Equal., September 14, 1970; and *Appeal of Signal Oil & Gas Company*, Cal. St. Bd. of Equal., September 14, 1970) found effective control in situations where stock ownership did not exceed 50%, since that time the SBE has consistently upheld the single entity bright-line test (*Appeal of Revere Copper and Brass*, Cal. St. Bd. of Equal., July 26, 1977; *Appeal of Hugo Neu-Proler, Cal. St. Bd. of Equal*., June 29, 1982; *Appeal of Douglas Furniture*, Cal St. Bd. of Equal., January 31, 1984; *Appeal of Rain Bird*, Cal St. Bd. of Equal., June 27, 1985; and *Appeal of Envirocal*, Cal St. Bd. of Equal., November 15, 1988.)

In the 1980s, a series of court decisions reversed the SBE holdings:

In *Hugo Neu-Proler International Sales Corp. v. Franchise Tax Board* (1987) 195 Cal.App.3d 326, two unrelated corporations were equal 50% partners in a partnership which owned 100% of a domestic international sales corporation (DISC). Both corporations filed California returns that reported one-half of the net income of the partnership and DISC. The FTB argued that since no single entity owned or controlled over 50% of the DISC, the DISC should be taxed separately. The Court applied principles of attribution and the concept of indirect control developed under IRC §482 to the language of R&TC §25105 ("direct or indirect ownership or control of more than 50% of the voting stock"). Their conclusion was that while neither corporate partner alone had a controlling interest in the DISC, together they had absolute sovereignty over it. Unity of ownership was found to be present between each partner and its proportionate interest in the DISC.

In *Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Board*, (1991) 229 Cal.App.3d 784, closely related family members owned a majority interest in 18 corporations, but most of the corporations were not owned more than 50% by any one family member. The Court confirmed that R&TC §25105 was the controlling section with respect to ownership requirements for purposes of R&TC §25101. The Court then stated that the statutory language of R&TC §25105 (direct or indirect ownership or control by the same interests) clearly implies a legislative intent that the principles of attribution should apply.

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Nothing in the language of that statute required ownership by a single entity, nor precluded the ownership test from being met where ownership is held by members of a closely related group acting in concert. Unity of ownership was found to be present in this case.

In the wake of these decisions, FTB Legal Ruling 91-1 was issued to re-examine the requirements for unity of ownership under R&TC §25105 and to set forth the policy that the department would follow in this area. The points established in the Legal Ruling include the following:

R&TC Section 25105 is acknowledged as the operative section for unity of ownership.

The meaning of "voting stock" is clarified to be that stock which confers the power to control the operations of the corporation through election of the board of directors. Situations involving more than one class of voting stock and transfers of voting rights are also addressed in the Ruling. Some examples may also be found in MATM 3550.

The meaning of direct and indirect ownership and direct and indirect control is defined. The *Rain Bird* concept of control through concerted action is adopted and its application is discussed.

Reliance on IRC §482 practical or economic control principles (cited in *Hugo Neu-Proler* and commented upon with approval in *Rain Bird*) will only be applicable to R&TC §25105 to the extent that the "more than 50%" threshold is met. Also, since the attribution rules of IRC §318 have not been expressly incorporated into R&TC §25105, they have no application to that section. The *Hugo Neu-Proler* decision shall only be applied in situations with substantially identical facts.

For taxable years beginning before January 1, 1995, Legal Ruling 91-1 reflects the current department policy with respect to unity of ownership.

Taxable years Beginning On or After January 1, 1995:
For taxable years beginning on or after January 1, 1995, R&TC §25105 was amended to re-establish a bright-line test for unity of ownership. Following is an overview of the new ownership requirements. For detailed explanations and definitions relevant to an ownership determination, auditors should refer to the statute.

Ownership requirements for combined reporting will only be met with respect to corporations that are members of a "commonly controlled group," defined as follows:

A group of corporations that is connected through stock ownership (or constructive ownership) with a parent corporation. This criterion will be met if the parent owns more than 50% of the voting stock of at least one corporation, and if more than 50% of the voting stock of each other corporation is cumulatively owned by the parent and/or by another corporation that meets the ownership

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requirements. (Examples #1 and #2 in the first part of this MATM section are illustrative of how this rule works.)

Any two or more corporations whose voting stock is owned (or constructively owned) more than 50% by one person. (Corporations are included in the definition of "person" found in R&TC §25105(f)(2).)

Any two or more corporations that constitute "stapled entities" as defined in R&TC §25105(b)(3).

Any two or more corporations whose voting stock is owned (without regard to family constructive ownership rules) by members of the same family. An exception to this rule may be made if the taxpayer establishes that the family ownership does not constitute direct or indirect control by the same interests, within the meaning given to that term in IRC §482.

If a corporation is eligible to be treated as a member of more than one commonly controlled group under these rules, then it must elect one group with which to be recognized as a member. Once the election is made, it will remain in effect unless revoked with the approval of the FTB. If a corporation, which was a member of a commonly controlled group, ceases to meet the ownership requirements for a period of time, but meets the requirements again within two years, the FTB may treat that corporation as a member of the commonly controlled group for the entire time.

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3060 UNITARY INDICATIONS UNDER REG §25120(b)

CCR §25120(b) provides guidance regarding what is considered to be a unitary business. Most significantly, the Regulation sets forth three factors, the presence of any one of which will create a strong presumption that the activities of the taxpayer constitute a single trade or business. These factors are as follows:

"(1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer, who operates a chain of retail grocery stores, will almost always be engaged in a single trade or business.

"(2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

"(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing."

The SBE discussed the application of this Regulatory presumption in *Appeal of Sierra Production Service, Inc*., Cal. St. Bd. of Equal., September 12, 1990. When the party seeking the benefit of the presumption establishes by "specific, concrete evidence" that one of the CCR §25120(b) factors apply, then the business is presumed to be unitary. This presumption may be rebutted, but the burden is on the opposing party to demonstrate "concrete evidence sufficient to support a finding that a single integrated economic unit did not exist." In other words, the presumption may only be overcome with evidence that the activities are not unitary under any of the established tests (e.g., three unities, contribution or dependency). If the presumption is successfully rebutted, then it disappears, and the burden shifts back to the party seeking combination to provide evidence to compel a determination that a unitary business exists. In FTB Notice 1992-4, the department acknowledged that it is following these procedures for applying the presumption.

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The fact that a taxpayer does not meet any of the three factors under CCR §25120(b) simply means that no presumption of unity applies. No presumption of non-unity is created.

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3065 Same Type Of Business

The regulation uses a chain of grocery stores as an example of activities that are in the same line of business. In practice however, various activities may have similarities, but may not be as identical as a chain of grocery stores. In the following decision, the California Court of Appeal expressed their interpretation of what it takes for two corporations to be engaged in the same type of business:

In *A.M. Castle & Co. v. FTB*, 36 Cal.App.4th 1794 (1995), the parent company's (Castle's) business involved buying bulk metals from various mills, and then warehousing and processing those metals for resale to industrial customers. The parent acquired a subsidiary (Hy-Alloy), which distributed specialty metal alloy shapes. In arguing that the Castle and (Hy-Alloy) were not in the same general line of business, the taxpayer relied on SBE decisions which construed 'activities in the same general line' in an extremely narrow manner (*Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., December 5, 1990, and *Appeal of Mohasco Corporation*, Cal. St. Bd. of Equal., October 14, 1982). The Court pointed out that precedents made by administrative tribunals such as the SBE do not bind them. But even if the cited decisions did have precedential value, the Court indicated that it would decline to follow them.

The Court then expressed its view that "two corporations are engaged in the same 'general line' of business when: (1) the two businesses are similar (but not necessarily identical); and (2) after the two corporations are combined, it permits the parent corporation to make better use of its existing business related resources. This may be done through 'economies of scale,' 'operational integration,' or 'sharing of expertise.'"

In this case, the acquisition of Hy-Alloy "permitted Castle to use its existing distribution system to service a new (though closely related) market." Therefore, the Court found that Castle made "better use of its existing business related resources" when it purchased Hy-Alloy.

The following SBE decisions also provide some guidance in determining what is considered the "same type of business":

CAUTION: The *Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., December 5, 1990, had contained a discussion of the SBE's interpretation of the term `same line of business.' This decision has since been de-published, and should not be cited. Furthermore, the California Court of Appeals declined to follow the SBE's interpretation of "same general line of business" expressed in *Doric Foods* and *Appeal of Mohasco Corporation*.

The *Appeal of Unitco*, Inc., Cal. St. Bd. of Equal., June 21, 1983, involved a taxpayer that was engaged in the rental of improved real property. The taxpayer's investments included rentals of warehouses, office buildings, an apartment building, a shopping center, a bowling alley operation,

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and two real estate partnerships. Although the taxpayer had managed its properties in the past, by the appeal years another company was managing the properties for a fee. During the appeal years, the taxpayer's three officers played a very limited role in the decision-making for the properties.

The FTB sought to combine the various rental activities into a single unitary business, stating that the case presented a vivid example of a single corporation engaged in identical activities in four separate states, totally dependent upon the three officers to make the major policy decisions and, in some cases, to provide day-to-day guidance. The FTB also emphasized that where a taxpayer is engaged in the same type of business, a strong presumption of unity is created. The SBE disagreed, finding that each rental activity was separate and distinct.

"In no way do any of appellant's rental activities contribute to or depend upon any of the others for their success or failure. Due to the disparate nature of each of appellant's property interests and the lack of any significant common relationship between them, we cannot conclude that these activities constitute a single economic unit."

The SBE dismissed the FTB's arguments with respect to the CCR §25120(b)(1) presumption, stating, "the simplest answer to this contention is that the presumption is not conclusive. When read in its entirety, the record will not support a conclusion that appellant's rental activities constitute a single unitary business."

The *Appeal of The Hearst Corporation*, Cal. St. Bd. of Equal., June 18, 1992, was another case in which the taxpayer successfully overcame the CCR §25120(b)(1) presumption. The taxpayer was engaged in various businesses such as television and radio broadcasting, cable communications, real estate, and the publication of newspapers, books and magazines such as Cosmopolitan and Good Housekeeping. A wholly owned subsidiary of the taxpayer operating in the United Kingdom also published books and magazines, including U.K. editions of Cosmopolitan and Good Housekeeping. Pursuant to a licensing agreement, the taxpayer received royalties from the U.K. subsidiary for Cosmopolitan sales. The U.K. subsidiary was locally managed, had its own editorial staff, and its own accounting, advertising, legal, purchasing, insurance and marketing divisions. The cover designs, layouts and photographs for the magazines were done separately. Although the U.K. subsidiary was entitled to use material published in the U.S. edition of Cosmopolitan, less than 4% of the U.K. articles consisted of the U.S. material. Common advertisements and intercompany sales were minor.

The SBE was not persuaded by the similarities in format between the U.S. and the U.K. editions of Cosmopolitan and Good Housekeeping. While portions of the publications were similar, the same format was also used by a number of similar magazines published by competitors and other unrelated companies. The taxpayer had demonstrated that very few ties existed between the U.S. and U.K. operations, and there was no evidence that the contributions and dependencies that commonly exist between similar activities were present in this case. The SBE concluded that the "same line of

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business" presumption had been overcome, and that the U.S. and U.K. operations were operated as independent, nonunitary operations.

In the *Appeal of Quaker State Oil Refining Corporation* (Cal. St. Bd. of Equal., October 6, 1987), the SBE also commented upon whether the taxpayer was in the same business as its subsidiary although the CCR §25120(b)(1) presumption was not applied. Because of lack of evidence of commonality of operations or transferability of technology between the activities, the SBE did not find activities in superficially similar businesses to be unitary.

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3070 Steps In A Vertical Process

In a vertically integrated enterprise, various components of the business perform successive steps necessary to produce a finished product. The Regulation contains an example of a taxpayer, which explores for and mines copper ores, and performs the processes necessary to transform that ore into consumer products. Other examples would be an integrated oil company; or a timber company which cuts and logs timber, mills the lumber, makes plywood and other products, and sells the finished lumber products. In the following case, vertical integration took the form of a soft drink concentrate manufacturer that acquired a bottler and distributor of its products:

In *Appeal of Dr Pepper Bottling Company of Southern California*, et al., Cal. St. Bd. of Equal., December 5, 1990, the taxpayer produced, bottled, canned and distributed soft drinks, including Dr Pepper. The taxpayer was acquired by Dr Pepper Company (DPC), a company which manufactured, marketed, sold and distributed nationwide soft drink concentrates and syrups, primarily Dr Pepper and sugar-free Dr Pepper. Over 50% of the taxpayer's concentrate and syrup purchases were from DPC, and more than 50% of the taxpayer's sales were of Dr Pepper soft drink products. The taxpayer argued that the taxpayer was not unitary with DPC, and attempted to minimize the importance of its intercompany sales by pointing out that the sales amounted to only 1% of DPC's total annual sales, and only 9-13% of the taxpayer's total purchases.

Citing *John Deere Plow Co. v. Franchise Tax Board* ((1951) 38 Cal.2d 214) and CCR §25120(b)(2), the SBE observed that the taxpayer's arguments ignored the fact that a vertically integrated business enterprise has consistently been regarded as a classic example of a unitary business. The Dr Pepper syrup was an essential component for a product, which made up a substantial part of the taxpayer's sales, and the taxpayer could not get that syrup from any other source. Also, the taxpayer provided an outlet for DPC's product. The SBE found that the fact that DPC maintained similar licensing agreements with 500 different bottlers (most of which was not company owned) did not diminish the unitary significance of the arrangement. Basing their decision primarily on the existence of vertical integration, the SBE sustained the FTB's determination that the companies were unitary.

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3075 Strong Centralized Management And Centralized Departments

A taxpayer seeking the benefit of the CCR §25120(b)(3) presumption must establish the presence of both "strong centralized management" and "centralized departments" for such functions as financing, advertising, research or purchasing. In footnotes to its decision in *Appeal of Sierra Production Service*, the SBE discussed its interpretation of these terms:

"5/ What constitutes `strong central management' will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of `common officers or directors' or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in *Container*."

"6/ There is no question that the regulation does not contain an all-inclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a `centralized department' requires something weightier than merely alleging, for example, that there was a `common accountant' who kept the books for each affiliate. Other trivialities like a `common insurance agent' will likewise be insufficient."

Unlike the first two presumptions, the CCR §25120(b)(3) presumption may be applied to diverse businesses that do not exhibit the more measurable indicators of unity such as intercompany product flow or sharing of product-related knowledge and expertise. In recent years, a great deal of controversy has surrounded the application of this presumption.

The following string of cases has shaped the department's approach for dealing with the CCR §25120(b)(3) presumption:

Appeal of Sierra Production Service, Inc., et al., Cal. St. Bd. of Equal., September 12, 1990, involved the decombination at audit of an oil and gas well-servicing firm and a general aviation sales and service firm. The FTB's position was that the lack of "functional integration" between the companies precluded a unitary determination. The SBE found the companies to be unitary based upon evidence of mutual interdependence and flows of value sufficient to establish that the companies were a "single integrated economic enterprise," rather than on the basis of the CCR §25120(b)(3) presumption. Notwithstanding this fact, the decision is important in the context of the (b)(3) presumption because of the relationship that the SBE found between that presumption and the combination of diverse businesses.

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Specifically, the SBE disagreed with the implication that diverse businesses are presumptively nonunitary if "functional integration" is lacking. The SBE stated that the (b)(3) presumption operates to put diverse businesses with strong central management and centralized departments on equal footing with affiliated entities engaged either in the same general line of business or in different steps in a large, vertically structured enterprise.

In *Mole-Richardson Company v. Franchise Tax Board* (1990) 220 Cal.App.3d 889, the taxpayer was primarily engaged in the design, manufacture, rental and sale of specialized lighting equipment in California, but also had farm and ranch operations in Colorado. Although the operations of these businesses were not integrated, the Court concluded that the companies were nonetheless "functionally integrated" and entitled to file a combined report.

The Court found that the evidence in the case "established that respondent had a strong centralized management in that all major business decisions were made by Warren K. Parker. All accounting, payroll, insurance, pension plans, primary banking, major purchasing and advertising for the Colorado business as well as the California business was conducted at the Hollywood offices. In managing certain operations from one location the enterprise was able to realize cost savings, resulting in economies of scale. Real property in Hollywood was mortgaged to fund improvement of the ranch property in Colorado. One California attorney acted as general counsel for all businesses . . . We are satisfied that based on the evidence in this case the operations of respondent were functionally integrated and respondent was entitled to tax treatment as one unitary business."

This was the first major "diverse business" decision, and it established that activities could be unitary based upon strong centralized management and centralization of non-operational functions.

In *Dental Insurance Consultants, Inc. v. Franchise Tax Board*, (1991) 1 Cal.App.4th 343, the issue was unity between a corporation (DIC) primarily engaged in providing review and advice regarding dental insurance claims for various insurance companies, and its wholly-owned subsidiary which operated a number of small farms. With one exception, the officers and directors of the farm subsidiary also served as officers and directors of DIC. Functions such as accounting, bookkeeping, purchasing insurance, and check-writing services were provided to the farm subsidiary by DIC. DIC lent the farms money, and provided guarantees for a number of farm obligations. Although unrelated management firms conducted the daily operations of the farms, the ultimate policy decisions were the responsibility of the common directors. The president and majority shareholder of DIC, Richard Guenther, had an active role in the farm operations. He approved all checks issued by the farms, and approved such decisions as deepening a well, repairing wind machines, establishing the mix of a product and installing a drip irrigation system. Guenther and another common officer negotiated and executed the farm management agreements. Guenther also applied for water delivery on behalf of the farms, and executed an agreement with the irrigation district regarding the installation of a pump.

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The Court found the management role played by DIC and Guenther to be much more than the occasional oversight any parent routinely gives to an investment in a subsidiary. Therefore, even though independent management firms performed the daily activities of the farms, the Court concluded that the farms were not operated independently. "The close control by DIC and the shared administrative functions, coupled with undisputed unity of ownership, establish the requisite economic, operational and managerial interdependence to establish the unitary nature of these businesses." This decision indicates that strong centralized management can exist even though the day-to-day management is independent.

In contrast, the Court in *Tenneco West, Inc. v. Franchise Tax Board* found that strong centralized management did not exist. The taxpayer had asserted that Tenneco and its subsidiaries were engaged in a single unitary business. The FTB had conceded that Tenneco was unitary with its oil-related subsidiaries, but determined that unity did not exist with respect to the remaining subsidiaries (excluded subsidiaries). The excluded subsidiaries were engaged in various activities, including shipbuilding, packaging, and manufacturing of automotive parts and construction equipment.

In numerous public documents, policy manuals and speeches, Tenneco had portrayed their operations as autonomous and highly decentralized. Although some centralization existed with respect to various functions, the Court found the substance of that centralization to be minimal. For example, although Tenneco had a legal department, each of the major divisions also had its own legal staff. Tenneco's tax department handled federal, ad valorem and property tax matters, but each subsidiary filed its own state tax returns. The subsidiaries' handled their own accounting and financial activities although those activities were reviewed and periodically audited by Tenneco's central accounting and internal audit departments.

The taxpayer attempted to establish strong centralized management through Tenneco's policy control, the Court found that control to be neither strong nor uniform. The Court stated:

". . . most of Tenneco's business strategy and activities -- including the annual planning process, weekly meetings between the chief executive officer and executive committee, internal audit, corporate-wide procedures manual, financial strategy with debt targets and dividend payout ratios, approval of major capital expenditures, external financing, cash management, real property disposition, guaranties, loans and advances to and from divisions, insurance, and overruling subsidiaries' ideas -- constituted `the kind of behavior that one would expect to find in any parent subsidiary or parent division relationship'."

Since strong centralized management and centralized departments were not present, the CCR §25120(b)(3) presumption of unity did not apply. The Court went on to find that the activities of the Tenneco excluded subsidiaries were not so integrated with Tenneco's oil related businesses or with each other so as to constitute a unitary business.

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Although the courts have not provided a precise definition of strong centralized management, the current court and SBE decisions appear to focus on involvement of managers in significant operational decisions with some regularity. This regular operational role may be distinguished from a lesser degree of management oversight over the results of a subsidiary's operations that is to be expected of any parent/subsidiary relationship. In order to determine whether there is strong centralized management, auditors must first acquire an in-depth understanding of the functions of the businesses under examination. The major operations of the businesses must be defined, and the major decisions affecting those operations must be identified. Then, the auditor must identify the purported central managers and determine whether and to what extent those managers were involved in the major operational decisions of the businesses under examination.

In addition to commenting upon centralized management, the cases summarized above also discuss the unitary significance of "centralized departments" in the context of the CCR §25120(b)(3) presumption. The following references to the issue may also be instructive:

In the *Appeal of Hollywood Film Enterprises*, Cal. St. Bd. of Equal., March 31, 1982, at 665 [3 SBE 664, 665]), the State Board of Equalization stated:

‘[W]here there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow, often will not exist. Therefore, factors, which might be considered relatively insignificant in a case of horizontal or vertical integration, take on added importance because they are the only factors present to consider. Each case must be decided on its own particular facts....’

In the *Appeal of Saga Corporation*, Cal. St. Bd. of Equal., June 29, 1982, the State Board of Equalization states:

‘[A]ppellant, rather than respondent, bears the burden of proof, i.e., appellant must establish by a preponderance of the evidence that the unitary connections present in the case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist.’

In F.W. Woolworth v. Taxation & Revenue Dept., 458 U.S. 354 (1982), the U.S. Supreme Court, in finding that related retailing operations were not unitary, stated inter alia:

‘The Woolworth parent did not provide 'many essential corporate services' for the subsidiaries and there was no 'centralized purchasing office...whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers.’ (458 U.S. at 370.)

In discussing the unitary significance to be attached to the fact that Woolworth's published financial statements, such as its annual reports, were prepared on a consolidated basis, the high court cited to

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the following passage from Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 43, 52 (1960):

'Central accounting, for instance, may result in some savings, but in most instances the amount is trifling in comparison with the income [involved]. Alone considered it is too weak a connecting link to bind into one business, what would otherwise, from an operational standpoint, be considered separate businesses.' (458 U.S. at 368, fn.22)

In view of the above authorities, there is no single, universally applicable listing of centralized departments rising to unitary significance. Therefore, each case must turn on its particular facts. As a general guide, the following list can assist the auditor in evaluating the centralized department issue. This list is not exhaustive; nor is the absence of any item cited in the list as generally significant or important conclusive of whether a particular case satisfies the element of centralized departments under CCR §25120(b)(3):

Generally Insignificant:

- Preparation of audited financial statements
- Preparation of tax returns
- Common purchases of insurance
- Centralized purchasing of office supplies
- Group discounts on items such as rental cars
- Legal services for matters such as SEC filing, shareholder relations, and public relations.

Generally Significant:

- Government relations (e.g. representing businesses to government regulatory entities)
- Centralized bookkeeping
- Pension and profit sharing
- Cash management, centralized borrowing or treasury
- Personnel: hiring, EDP and payroll
- Employee benefits
- Legal services for contract review
- Common headquarters building
- Labor relations
- Marketing and common use of logo (unconnected to common sales efforts)
- Central advertising offices (providing separate advertising services to each member, without common advertising of a product relationship between products of different members)
- Real estate construction
- Self-insurance

Generally Important:

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- Research and development
- Central purchasing of raw materials
- Shared sales force
- Use of common trade name substantially affecting customer purchasing decisions
- Common distribution systems
- Common inventory control

FTB Notice 1992-4:
The department has developed diverse business audit guidelines to conform the department's use of the CCR §25120(b) presumptions to the decisions in *Sierra Production Service*, *Mole-Richardson, Dental Insurance Consultants, and Tenneco West*. These guidelines have been published in FTB Notice 1992-4. The key points are as follows:

The tests for evaluating unity in diverse business cases are the same judicially established tests used for any other unitary determination (e.g., three unities, dependency or contribution, etc. -- see MATM 3030).

If strong centralized management and centralized departments are present, unity cannot be denied solely because of a lack of operational (functional) integration.

A unitary analysis must be based on evidence. While it may be useful to contrast the facts from one case to another, no two cases will ever be identical. Descriptive terms such as "strong centralized management" or "same type of business" are merely labels, and resolution of the unitary issue should turn on an application of the established tests to the unique facts of each case.

The CCR §25120(b) presumptions of unity are important, but not conclusive, considerations in determining unity. The presumptions may be rebutted, and this topic is discussed in more detail in MATM 3060.

The Court of Appeals decisions in *Mole-Richardson* and *Dental Insurance Consultants* are controlling of the diverse business issue. To the extent that SBE decisions are not in accord with these court cases, the SBE decisions should not be relied upon.

For further information relating to the evaluation of strong central management, see MATM 3570. That section also lists sources of information that may be useful in developing this issue

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3080 UNITARY COMBINATION OF HOLDING COMPANIES

A holding company may be entirely passive, or may provide management and oversight functions to its subsidiaries. In either case however, the activities of the holding company are generally limited. There are no unique unitary tests designed for holding companies; the standard unitary tests (e.g., three unities, contribution/dependency) must be applied. Because those tests were designed to fit the fact patterns that are typically found in operating companies however, their application to holding company fact patterns is not always readily apparent. Two 1995 legal rulings (discussed below) define the department's position with respect to certain fact patterns involving holding companies. In cases, which do not fall within those fact patterns, the auditor needs to carefully analyze the facts and circumstances of the case and determine the relative significance of the flows of value that can be identified.

Following are summaries of the decisions that are most influential in shaping FTB's current policy towards holding companies.

In *Appeal of Fibreboard Corporation*, Cal. St. Bd. of Equal., January 6, 1987, the parent operating company held a holding company, which, in turn, held another operating company. The parent sold the stock of the holding company, and the issue was whether the gain from the sale should be business or nonbusiness. In this particular case, the taxpayer was unable to establish that the two operating companies were engaged in a unitary relationship, therefore the gain was held to be nonbusiness. What is relevant in this context however, is the analysis that the SBE used to reach their conclusion.

Although the gain arose from the sale of the holding company stock, the SBE noted that the real issue was the lower tier operating company's relationship with the parent. The SBE's analysis focused upon whether the holding company stock "*or the assets it represented*" were integrally related to the parent's unitary business operations. Thus, the SBE apparently looked through the holding company to characterize the gain on the sale of holding company stock.

In *Appeal of Lakeside Village Apartments*, Inc., Cal. St. Bd. of Equal., July 30, 1992, a holding company acquired an apartment complex through a merger with a subsidiary that had been formed for that purpose. The holding company also held a group of other subsidiaries, Reliable Stores, which were engaged in activities entirely unrelated and dissimilar to those of the apartment subsidiary. The officers and directors of the former apartment corporation remained as officers and directors of the new corporation after the merger, and also joined the board of directors of the holding company. The apartment subsidiary paid $25,000 annually pursuant to an agreement whereby they were required to look to the holding company for decisions regarding financial activities, tax matters and accounting policies. The terms of the agreement also stated that the holding company was to provide certain centralized functions to its subsidiaries on the basis that their activities were viewed

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as a "single unitary group." As a result of a successful condominium conversion, the apartment subsidiary distributed $5 million in dividends to the holding company.

The taxpayer failed to establish that the former officers of the apartment complex had managed anything other than the condominium conversion operations, just as they had done before the acquisition. The other officers and directors of the holding company had no involvement with the apartments, and their financial decision making power was insufficient to support a finding of unity since it was the type of occasional oversight that any parent gives to an investment in a subsidiary. The SBE questioned the credibility of the management agreement since it did no more than outline the types of decisions that any parent makes for its subsidiaries, and seemed to serve no other purpose than to create apparent evidence of unity. The "intercompany financing" asserted by the taxpayer actually consisted only of the payment of dividends from the apartment subsidiary to the holding company, and was rejected as a unitary feature. The SBE concluded that the holding company and the apartment subsidiary were not unitary.

Note that unity between the holding company and its Reliable Stores subsidiaries was not addressed in this case.

The operating company in Appeal of PBS Building Systems, Inc. and PKH Building Systems, Inc., Cal. St. Bd. of Equal., November 17, 1994, was found to be unitary with its holding company parent. The holding company was formed as a vehicle for a leveraged management buyout of the operating company's stock. The operating company made an interest-free loan to the holding company to fund the stock purchase. The holding company later refinanced the debt by issuing securities guaranteed by the operating company. The holding company also obtained a covenant not to compete from the former owners of the operating company.

The SBE emphasized that the standard unitary analysis (the three unities and contribution/dependency tests) is to be applied in determining whether a holding company and operating company are unitary. They rejected the generalization that "holding companies are essentially inactive and are per se incapable of providing or receiving a flow of value to or from an operating company." Instead, the SBE observed that since the typical characteristics of unity may not exist, the holding company context requires a focus on the economic realities of the particular corporate structure to determine whether unity is present. Citing *Appeal of Hollywood Film Enterprises* (Cal. St. Bd. of Equal., March 31, 1982), the SBE stated: "Factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider."

The flows of value that the SBE found in this case included intercompany financing of substantial value to the holding company, substantial amounts of money expended by the operating company for the holding company's public debt offering, and the covenant not to compete entered into by the holding company to protect the operating company from its former owner. The complete overlap of

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officers and directors, when considered in light of the other integrating factors, was seen as further evidence of the operation of the companies as a unitary business. The SBE concluded that there was substantial evidence to support a finding of unity.

The *Appeal of National Silver Co*., Cal. St. Bd. of Equal., October 28, 1980, and *Appeal of Allright Cal., Inc*., Cal. St. Bd. of Equal., January 9, 1979, both involved situations where the holding companies provided services for their subsidiaries, and were found by the SBE to be part of the unitary business. On the other hand, in *Appeal of Power-Line Sales, Inc*., Cal. St. Bd. of Equal., December 5, 1990, and Appeal of Insul-8 Corporation, Cal. St. Bd. of Equal., April 23, 1992, the SBE did not allow the holding companies to be included in the unitary group on the basis that the taxpayers had failed to meet their burden of proving a unitary relationship.

In November 1995, the department issued Legal Ruling 95-7 and Legal Ruling 95-8 explaining the department's position on combination of holding companies with operating companies in light of the SBE's opinion in the *Appeal of PBS/PKH*. Legal Ruling 95-7 deals with fact patterns in which a passive parent holding company holds one or more operating company subsidiaries, which are engaged in a single unitary business with each other. Legal Ruling 95-8 deals with fact patterns in which an intermediate passive holding company is held by a parent operating company and in turn holds one or more operating company subsidiaries, which are engaged in a single unitary business with the operating company parent. The rulings announce a broad rule of combination in the fact patterns described. Combination of passive holding companies in other fact patterns will depend upon the facts and circumstances of the case.

Legal Ruling 95-7 "Parent Holding Company"
FTB Legal Ruling 95-7 describes three fact patterns. In Situation 1, a passive parent holding company holds an operating company engaged in a single unitary business. In Situation 2, a passive parent holding company holds two operating company subsidiaries engaged in a single unitary business with each other. Situation 3 differs from Situation 2 in one respect: the holding company is held by an operating company which is not engaged in a single unitary business relationship with the holding company's operating company subsidiaries. In each situation the holding company dedicates virtually all of its activity to its operating subsidiary or subsidiaries.

L.R. 95-7 holds that in all three situations the holding company is unitary with and includable in a combined report with its operating company subsidiaries, but that in Situation 3, the holding company's operating company parent is not includable in the combined report.

The ruling applied the Edison California Stores contribution or dependency test articulated in the general provisions of CCR §25120(b) and in the SBE's decision in *Appeal of PBS/PKH*. It references PBS/PKH and the U.S. Supreme Court opinion in *Mobil Oil Corporation v. Commissioner of Taxes* (1980) on the importance of looking to the underlying economic realities in determining the propriety of apportionability. It also references the SBE's analysis in *Fibreboard Corporation* (1987), where the

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SBE looked through an intermediate holding company and focused on the absence of a unitary relationship between the holding company's operating company parent and operating company subsidiary.

Applying the above principles, LR 95-7 concludes that when a passive parent holding company holds one or more operating company subsidiaries which are engaged in a single unitary business with each other, the holding company's primary function is as a conduit between the shareholders and the single unitary business operations they indirectly own. The unitary business is what gives the holding company value to the shareholders. The holding company represents the unitary company or group. It thus is an integral part of a unitary system, the parts of which contributes to or depends upon each other. Separating the holding company from the unitary operating company or group for combined reporting purposes places too much emphasis on form, when in substance there is but one unitary business. That underlying economic reality is not altered when, as in Situation 3, a nonunitary operating company holds a majority of the holding company's stock as a nonbusiness asset.

Legal Ruling 95-8 “Intermediate Holding Company”

Legal Ruling 95-8 describes two fact patterns. In Situation 1, an intermediate passive holding company holds a single operating company subsidiary that is engaged in a single unitary business with the holding company's operating company parent. In Situation 2, an intermediate passive holding company holds two operating company subsidiaries, which are engaged in a single unitary business with the holding company's operating company parent. In each situation, the holding company dedicates virtually all of its activity to the operating company parent and subsidiary or subsidiaries.

Legal Ruling 95-8 holds that in both situations the holding company and operating companies are unitary and includable in a combined report with each other.

Legal Ruling 95-8 builds upon the reasoning of Legal Ruling 95-7. It applies the Edison California Stores contribution or dependency test, the economic realities principles articulated in Mobil Oil Corporation and PBS/PKH and the "look through" analysis of Fibreboard. In addition it cites *Appeal of Monsanto Co*., Cal. St. Bd. of Equal. (1970) and its progeny and the U.S. Supreme Court opinion in *Barclay's Bank v. Franchise Tax Board* (1994) for the proposition that the unitary relationship between corporations included in a combined report may be indirect.

LR 95-8 concludes that when an intermediate passive holding company owns one or more operating company subsidiaries, which are unitary with the holding company's operating company parent, the holding company's primary function is as a conduit which effectuates contributions or dependencies between the parent and the subsidiaries. The holding company performs a unitary function for the group by holding the stock of the lower tier operating company subsidiary or subsidiaries which would be a unitary business asset of the parent operating company if it were directly held by the parent.

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The holding company dedicates virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. It is an integral part of a larger unitary system, the parts of which contributes to or depends upon each other. To separate the holding company for combined reporting purposes places too much emphasis on the form of corporate structure when the substance and underlying economic reality is that there is but one unitary business.

Holding companies, which own non-unitary subsidiaries:

The department has announced that it will continue of follow the *Appeal of Lakeside Village Apartments*, Cal. St. Bd. of Equal. July 30, 1992. In Lakeside Village the SBE denied combination of a passive parent holding company with operating company subsidiaries, which were not unitary with each other. In contrast to the fact patterns presented in PBS/PKH and LR's 95-7 and 95-8, in Lakeside Village there were two lines of business: an apartment concern and a retail stores concern, and there was no showing of unity between those two concerns or of unitary linkage through strong central management and centralized departments.

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3085 INSURANCE COMPANIES

Insurance companies may not be included in the combined report.

The California Constitution (Article 13, §28) generally provides for a tax based on gross premiums of most insurance companies doing business in California. Subdivision (f) of that section provides that with the exception of taxes on real estate and motor vehicles, the gross premiums tax "is in lieu of all other taxes and licenses, state, county and municipal, upon such insurers and their property." The courts have held that this language effectively exempts insurance companies from the California franchise tax (*First American Title Insurance & Trust Co. v. FTB* (1971) 15 Cal.App.3d 343[93 Cal.Rptr. 177]). FTB Legal Ruling 385 (1975) explains that under authority of Article 13, §28, a corporate insurer operating in California is barred from inclusion in a combined report, even if it is unitary. To accord uniform treatment on basically similar facts, the legal ruling goes on to state that it will be the department's practice to exclude from the combined report any insurance company operating entirely outside California. This exclusion from the combined report applies to companies that are regularly engaged in an insurance business, and that are licensed as such and subject to regulation under the laws of the state(s) where they operate.

Before 1938, insurance companies were taxed on their gross premiums less amounts paid for reinsurance. The insurance company receiving the reinsurace premiums would pay tax on its premiums. State taxation of insurance companies was changed effective for 1938, in that insurance companies were taxed on their gross premiums without reduction for reinsurance premiums paid. Thus, reinsurance was not taxable on the basis that the insurance premiums had already been indirectly taxed. Accordingly, reinsurance companies are subject to the provisions of §28, and are therefore exempted from the franchise or income tax. (For an explanation of reinsurance, see MATM 5190.)

Note that an insurance company, which is excluded from the combined report under the California constitution, may still be unitary with or functionally related to its affiliates. The SBE has held that the stock of a unitary insurance company was integrally related to the unitary business operations of the corporate group even though the insurance company could not be included in the combined report. Therefore, the dividends received from the insurance company subsidiary were held to be business income. (*Appeal of Control Data Corp*., *Commercial Credit Corp*., Cal. St. Bd. of Equal., February 22, 1996.)

See MATM 5190 for a discussion of captive insurance companies.

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3090 INSTANT UNITY

Occasionally, the issue is not whether entities are unitary, but when they became unitary. When a corporation acquires another corporation, a period of time often elapses before enough ties are established between the activities to constitute unity. The following SBE decisions illustrate some of the factors that may affect determinations in this area:

In *Appeal of Atlas Hotels, Inc. and Picnic 'n Chicken, Inc*., a taxpayer engaged in a unitary hotel business acquired a corporation that owned and operated a chain of fast food outlets. Immediately upon acquisition, two of the hotel's top executives assumed positions as the two top executives of the fast food company, and began to run the day-to-day operations. Although ten-year employment agreements were signed with several of the top fast food executives as part of the purchase agreement, the duties of these "holdover" managers were restricted and their authority was very limited. Substantive changes to the overall operating philosophy of the fast food chain were immediately instituted, and several service functions were combined for the hotel and fast food operations. Since many of these managerial and operational changes were in the planning stage well before the actual acquisition date, implementation of the changes was commenced immediately upon acquisition. The FTB argued that the integration between the entities was not sufficient to demonstrate unity until the following year when the holdover management was discharged and the intercompany exchanges became more active. The SBE disagreed, and concluded that the activities were unitary immediately upon acquisition.

The *Appeal of The Signal Companies, Inc*., Cal. St. Bd. of Equal., January 24, 1990, also involved unity with a newly acquired subsidiary. The taxpayer acquired the subsidiary in May 1975. In June 1975, three of the taxpayer's directors were appointed to the subsidiary's board. By July, the taxpayer's directors formed a majority of the subsidiary's directors and had gained control of the most important committees. In October 1975, an executive from the taxpayer's unitary business was elected as president and CEO of the subsidiary. Over the course of the year, the taxpayer and subsidiary exchanged technical and research information on several projects, the taxpayer-controlled board rejected certain plans that had been made by the former management of the subsidiary and instituted changes, and the subsidiary was included in the central planning being done for the affiliated group.

The taxpayer had included the subsidiary in the combined report from the date of acquisition. Upon audit, the FTB conceded that the subsidiary had become unitary by January 1, 1976, but did not allow combination for 1975. The department argued that the subsidiary was clearly not unity on the date of acquisition, and the taxpayer had failed to establish a clear date during 1975 when unity was achieved. The SBE agreed that the taxpayer was not immediately unitary upon acquisition, and acknowledged that the ties between the companies were gradually established over a period of several months and that there was no single event or specific date upon which unity occurred. On

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the other hand, the SBE pointed out that all of the significant integrating factors upon which the FTB based its conclusion that the subsidiary was unitary as of January 1, 1976, were actually in existence by the beginning of the last quarter of 1975. Since the SBE found no basis for distinguishing between the unifying factors existing at January 1, 1976 and October 1, 1975, the SBE concluded that the taxpayer and its newly acquired subsidiary were unitary at least by October 1, 1975.

This case illustrates the importance of determining a date consistent with the unique facts of each case rather than by simply using an arbitrary benchmark.
In *Appeal of Dr Pepper Bottling Company of Southern California, et al*., Cal. St. Bd. of Equal., December 5, 1990, the taxpayer was a soft drink bottler which was purchased by Dr Pepper Company (DPC), a corporation which manufactured and distributed soft drink concentrates and syrups. The bottler had been a licensee of DPC for many years prior to the acquisition, and over 50% of its concentrate and syrup purchases were from DPC.

The taxpayer/bottler did not file its returns on a combined basis with DPC. Upon audit, the FTB determined that the bottler was instantly unitary with DPC as of the date of acquisition. The taxpayer's argument was that there was no difference in the relationship between the two companies before and after the acquisition other than unity of ownership, and unity of ownership, by itself, cannot compel a finding of unity. The SBE rejected this argument, stating that a "vertically integrated enterprise was pre-existing here, needing only unity of ownership to result in a unitary business." Unity was held to have occurred on the date of acquisition.

To determine the point in time when the integration between two activities has developed to the extent that the unitary tests are met, the auditor must determine the changes that have taken place and the dates upon which those changes occurred. The first step in the analysis should be a detailed description of the operations of the new affiliate prior to the date of acquisition. Any pre-acquisition relationships between the entities should be identified and explained in detail. When examining the details of the acquisition, the auditor should note the exact date on which it occurred, and review the purchase agreement and any other agreements related to the acquisition, which may indicate terms and conditions of the sale. In particular, the auditor should be looking for terms that may limit the acquiring corporation's ability to integrate the new company into its operations. For example, some acquisitions may require that existing officers be retained to continue to operate and manage the target corporation.

Once the background information has been obtained, the next step should be to describe the changes instituted by the parent at the newly acquired corporation, and the exact date that each change took place. Such changes might include:

1. Replacing officers, directors and key managers of the newly acquired subsidiary with individuals from the parent corporation (or from one of its existing subsidiaries);

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2. Providing centralized services such as accounting, legal services, pension plans or computer services to the newly acquired subsidiary;
3. Transferring funds through intercompany financing;
4. Imposing the parent company's policies and procedures on the newly acquired subsidiary (e.g., requiring a standard chart of accounts, standardized approval procedures for expenditures, etc.); or
5. Decisions to discontinue certain product lines, to target new markets, etc.

Suggestions for specific areas to develop and audit techniques to utilize are discussed in MATM 3570 and MATM 3575.

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3500 GUIDELINES FOR AUDITING UNITY

Unitary examinations are, by their nature, very fact intensive. Furthermore, the facts and circumstances will be unique in each case and even the relevance or weight attached to a particular unitary factor will vary in each case. This environment has several implications for the auditor. First, it is essential that the auditor and the supervisor make a judgement as to whether the potential deficiency or overassessment will justify the resources that will be necessary to adequately develop and support the unity issue. Second, the auditor must obtain a good overall understanding of the taxpayer's business before focusing on the details of the unitary relationships so that questions and information requests can be tailored to the specific taxpayer. Finally, the auditor must be prepared to present all of the relevant facts objectively. The importance of unitary factors may only be put into perspective when viewed in conjunction with the overall activities of the business. Therefore, to prevent the taxpayer from altering the unitary perspective at the protest or appeal level by presenting additional facts that were not rebutted at audit, the complete picture needs to be presented and explained in the audit report.

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3505 GENERAL CONDUCT OF THE AUDIT

The following guidelines are applicable to all audits, but are especially important for a successful audit of unity:

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3510 What Is Evidence?

Taxpayers can produce two types of evidence to support their contentions: (1) contemporaneous objective evidence, and (2) testimonial evidence.

Contemporaneous objective evidence:

Contemporaneous objective evidence is evidence fully supported by written documentation. At the appeal or litigation level, if the taxpayer produces contemporaneous objective evidence to support its unitary position, and if the FTB is unable to rebut that evidence, the taxpayer will prevail.

Contemporaneous objective evidence may include but is not limited to:

Internal office memoranda between key personnel and managers of either the parent or subsidiary. This may show a subsidiary's degree of autonomy from or dependence upon the parent.

External office memoranda between the key managers of the parent and the subsidiary. Who is making day-to-day operating decisions? Who is making major operating decisions? Who conducts the subsidiary's negotiations with outsiders, and who binds the subsidiary contractually?

Third party written communications regarding the subsidiary's transactions with outsiders.

Contemporaneous objective evidence will either corroborate the taxpayer's story or create FTB's side of the story. General requests such as for "correspondence that pertains to the relationship between the parent and subsidiary" may create an opportunity for a taxpayer to provide the auditor only the documents the taxpayer chooses to disclose. The auditor should therefore become familiar enough with the taxpayer's business to be able to request specific documentation. For example, the auditor should identify the potential strong central managers or key individuals of the parent, or autonomous officers of the subsidiary, and should review their business correspondence files. Information obtained from the correspondence files can also be used to develop specific interview questions for that individual or for others with whom that manager corresponds.

Testimonial evidence:

Key personnel of the taxpayer, by testimony, state certain matters to be as they believe them to be. This becomes the "story" of the taxpayer. Unless the FTB can offer another side of the story that is supported by documentation, the taxpayer's "story" will be controlling on the issue of unity.

A significant part of the evidence is likely to be testimonial. The FTB is charged with the responsibility of determining whether the taxpayer's story is correct or whether there is another side to the story.

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The best chance for discovering the other side to the story is at the audit level. Therefore, the auditor must often try to anticipate the arguments or testimony that the taxpayer is likely to make so that the documentation necessary to overcome the testimony will be in the audit file.

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3515 When Is Documentation Sufficient?

At what point has the auditor accumulated enough information to support an audit adjustment involving unity? The answer to this question will be different in each case, but the general guideline is that the auditor must develop enough facts to have a clear understanding of the relationships between the entities or activities. Although the auditor and taxpayer may interpret the facts differently, there should be agreement on the underlying facts.

The amount of documentation that is necessary may vary tremendously depending upon the fact pattern. In an extreme example, assume that a subsidiary sells 100% of its product to the parent corporation. This strong a unitary tie will almost always cause the corporations to be unitary. If the auditor is seeking to combine the entities, it will probably be sufficient to document the intercompany sales, and obtain a general enough understanding of the taxpayer's business to be comfortable that there are no extenuating circumstances that would preclude unity.

As another example, assume that a taxpayer publishes different editions of a magazine with the same title in the United States and in a foreign country. Although this is a factor that suggests a unitary relationship, it is not conclusive of unity. The auditor needs to develop enough information about the business to have a good understanding of the flows of value that are really taking place (e.g., are the same articles printed in both editions, are there common advertisers, is printing technology shared, etc.). If the taxpayer later provides documentation that highlights only the areas where the operations are autonomous, the FTB needs to be able to rebut the taxpayer's arguments with facts that demonstrate that the overall operations are unitary.

Finally, assume that a commonly owned group of corporations is engaged in diverse business operations, and asserts the presence of strong centralized management coupled with centralized departments. A unitary examination under these conditions will require in-depth development of the facts concerning managerial relationships and other flows of value that may be very difficult to quantify. This is one of the most difficult and time-consuming types of unitary examination.

When presenting the facts in the audit narrative, the auditor should avoid using generalizations and labels such as "common purchasing" or "centralized accounting," and should instead describe the manner in which the functions are integrated, the extent of the centralization, the benefits derived by the integration, and the significance of the unitary tie in relation to the overall operations. This point is discussed in more detail in MATM 3040. In addition to describing the centralized or integrated functions, the auditor should also describe the functions that each entity or business segment performs for itself, and explain how these functions impact or co-exist with any alleged centralization for the same or similar functions.

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The auditor should state the facts, as they exist. Auditors should not take weak facts and make them seem more important in the audit narrative. The auditor also should not leave facts out of the report if they seem to weaken the case for unity or nonunity. There is a perception that developing these facts is the responsibility of the taxpayer rather than the auditor. The reality, however, is that facts that support the taxpayer's position will invariably be brought up at the protest level, and at that point they may be given greater or less emphasis than they deserve. Therefore, the auditor is responsible for getting the facts and presenting all the facts in the audit file.

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3520 How Much Documentation Is Necessary If The Case Is Agreed?

Occasionally, taxpayers will agree to an adjustment to their method of filing before the factual development has been completed. It is difficult to expect a taxpayer to undergo the inconvenience and expense of a detailed unitary audit after they have already agreed to the adjustment. On the other hand, there have been instances where taxpayers have protested cases that were believed to have been "agreed." It may be difficult for the department to sustain these cases if the factual development is incomplete. To protect the state's interests while minimizing the inconvenience to the taxpayer, unitary adjustments resulting in a deficiency which are supported by incomplete factual development may only be made if the taxpayer provides a written statement with the following components:

1. the taxpayer's agreement to the adjustment, and

2. an acknowledgement that if the adjustment is protested or if a claim for refund is subsequently filed, the case will be returned to the auditor so that the audit may be completed.

The auditor is responsible for obtaining the appropriate amount of preliminary information prior to accepting such an agreement. It is at the discretion of the auditor as to the amount of preliminary information that is required and is based on the facts and circumstances of each case.

The statement should be signed by an officer or other individual with the authority to bind the taxpayer.

(See MATM 2800 and Exhibit K).

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3525 Recording The Paper Trail

The volume of information pertinent to these audits dictates that detailed workpaper files be kept, and that the information be clearly indexed and cross-referenced. Interview questions and IDRs should be cross-referenced to responses so that the reader can follow the actions that have been taken. Relevant data should be summarized and cross-referenced to the source documents in the file. Guidelines for setting up the audit package and cross-referencing files are discussed in MATM 2490.

Whenever possible, copies of all documentation relevant to the auditor's determination should be included in the file. In some cases however, the documentation is too voluminous to be easily copied. In such situations (and only if the auditor does not feel that the information is important to the case), the auditor should write a memo to include in the file for support. The memo should describe the document, including the name or title of the document, the date it was issued, the number of pages, and a description of the contents. In addition, the auditor should obtain a photocopy of the title page of the document for the audit file. If applicable, the name of the person who prepared the report and the distribution of the report might be identified. The relevant information from the document should be described, and a list of the applicable page numbers should be identified. In the event that it becomes necessary to request the actual document at the protest, appeal or litigation level, the auditor should also note the name and title/position of the person to contact regarding the document, and where it is maintained.

Occasionally, taxpayers will allow auditors to look at documents in their offices but will refuse to allow auditors to photocopy the documents (or to provide the auditor with photocopies). Auditors are entitled to photocopy documents. If the auditor is unable to obtain cooperation, the auditor and supervisor should contact the Multistate Specialist or International Specialist for assistance. Further suggestions for dealing with uncooperative taxpayers are discussed in MATM 3530.

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3530 Partial Responses And Demands For Information

It is not uncommon for auditors to experience problems with taxpayers providing only partial responses, which do not satisfy the IDRs. Auditors must then decide whether it is appropriate to issue a demand letter or whether it would be better to wait for the next response. This is often a difficult decision because of the conflicting goals of (1) maintaining a good working relationship with the taxpayer, and (2) maintaining control of the audit. In most cases however, the auditor should recognize that if the taxpayer is providing incomplete information, there is not a good working relationship already. It is usually better to document and monitor lack of cooperation as soon as it is suspected so that the taxpayer is immediately aware that such practices are not acceptable.

Auditors should recognize that uncooperative behavior may sometimes be more subtle than an express refusal to provide information. Taxpayer's representatives will sometimes attempt the following behaviors in order to control the progress of an audit:

- being vague about setting a time for the inspection of books and records;
- allowing only limited access or a trickling disclosure to records;
- absences of qualified personnel from the taxpayer's offices at the time of set appointments;
- absence of certain books and records due to their alleged necessity in other parts of the taxpayer's operation;
- limiting hours of inspection by late morning appointments, long lunch hours, and early closings;
- refusing to supply primary sources of information, thereby causing the auditor to accept something less than primary information;
- attempting to dictate to the auditor the records pertinent to the audit; or
- attempting to dominate the auditor with claims that the requests for information are irrelevant, immaterial and inapplicable to the audit.

It is very important that the auditor confront the taxpayer's representative as soon as possible with detailed evidence of the lack of progress. The actions of the representative that impaired the progress of the audit should also be memorialized in a letter to the taxpayer's representative, and be clearly documented in the file.

If the auditor has any doubt about what documents the taxpayer will provide and an out-of-town trip is involved, the taxpayer should be asked whether he intends to supply the documents before the auditor makes the trip. In this manner, the auditor may be able to save wasted time on a trip for which no documents are provided.

The auditor should make every effort to obtain the information necessary to conduct the audit and support its conclusions and recommendations. In most instances, requests for information should be in writing, and should contain only a single question or single issue per individual IDR. The need and

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relevance of the information should be clearly communicated to the taxpayer. If the specific information requested does not exist or is overly burdensome for the taxpayer to provide, the taxpayer should be asked if alternative documents exist which will provide the substantiation that the auditor needs. The information requests must establish the time frames within which the information is to be furnished. When requested information is not provided or is unreasonably delayed, the auditor should reevaluate the relevance and need for the information before making a formal demand. Is the request reasonable? Has the information already been provided in an alternative form? Is the information necessary to decide the issue? Is the taxpayer's failure to provide the requested information due to reasonable cause?

In order to support this type of audit, it is critical that the file contains a good record to support the fact that the taxpayer was uncooperative. The audit file should document the reasons why the information requested from the taxpayer was necessary for a proper audit determination. Since the auditor's rationale for asking particular questions may not be obvious several years later as the case is protested, appealed or litigated, this explanation will prevent the taxpayer from successfully arguing that the questions were unreasonable.

The unsatisfied aspects of each information document request should be regularly monitored so that timely demands or subpoenas can be issued. The fact that a taxpayer has provided some of the information requested in an IDR does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. For example, if a taxpayer is given an IDR requesting five items, and only items 2, 4 and 5 are provided, the auditor may issue a demand for items 1 and 3. Without this audit trail, subpoenas are unlikely to be issued, and the failure to furnish penalty will be difficult to support.

The use of single-question or single-issue IDRs is one method for issuing IDRs that will help to avoid receiving partial responses. Wherever possible the auditor should limit requests for specific documents to one per IDR. Similarly, requests for information or narrative-type responses should be limited to one question or one group of issue-related questions. In the event that the IDR requests are unanswered, use of the single question or single issue format will allow the auditor to send follow-up requests for each unanswered IDR. Separate IDRs make it easier to document the history of a request (i.e., date of the original request, follow-up dates, extensions granted, etc.) in the event that the auditor recommends a failure to furnish information penalty be assessed.

The department's policy for issuing demand letters and failure to furnish information penalties is stated in MAPM 8040. Foreign parent situations create special problems, and these are covered in MATM 3535. Taxpayers who question FTB's authority to demand information should be referred to R&TC §19504 (FTB's power to examine records) and the California Court of A*ppeal decision in Franchise Tax Board v. Firestone Tire and Rubber*, (1983) 139 Cal.App.3d 843, which upholds a trial court order enforcing an FTB subpoena and confirms that auditors have the right to photocopy information. If the taxpayer continues to be uncooperative after the auditor has issued a demand

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letter, the auditor and supervisor may seek the assistance of the Multistate Specialist and/or International Specialist to develop a joint plan of action.

In material cases, options for dealing with taxpayers include administrative subpoenas, and the penalties imposed under R&TC §25112 (water's-edge taxpayers) and R&TC §19141.6 (both water's-edge and worldwide taxpayers). Effective for taxable years beginning on or after January 1, 1994, if a taxpayer fails to maintain and make available upon request records pertaining to unity, business/nonbusiness treatment of income, apportionment factors or federal Subpart F or effectively connected income, R&TC §19141.6 will impose a penalty of $10,000 per taxable year. (An additional $10,000 may be imposed for each related party for whom the taxpayer fails to maintain records.) If the information is still not provided after 90 days, an additional $10,000 penalty will be imposed for each 30-day period during which the failure continues. The three-member franchise tax board must approve application of this penalty. Procedures for applying the penalty are explained in Chapter 20B, Water's-Edge Manual. Detailed regulations under R&TC §19141.6 were issued in April 1996, and should be reviewed before pursuing the imposition of the $10,000 penalty.

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3535 Failure To Furnish Information-Foreign Parent Situations

In the *Appeal of BSR USA, Ltd*. (Cal. St. Bd. of Equal., April 11, 1996), the SBE upheld the imposition of the failure to furnish information penalty against a foreign-owned taxpayer, concluding that the taxpayer had not shown reasonable cause for their failure. The SBE held the foreign-owned taxpayer to the same reasonable cause standard to which any other taxpayer would be held: the taxpayer must prove that they acted in the same manner as an ordinary, intelligent, and prudent business person would have acted under similar circumstances. In that case however, the taxpayer's actions had clearly established a pattern of "delay and misdirection." In less extreme cases, the extent to which FTB can enforce the penalty against taxpayers when information is under the control of uncooperative foreign parents is still untested. When contemplating failure to furnish information penalties in foreign parent situations, there are certain factors that auditors need to consider in addition to the normal guidelines and procedures set forth in MAPM 8040.

When setting a reasonable response time, auditors should consider the fact that the taxpayer may need to obtain translations if the data is in a foreign language.

If the requested information is not required to be collected or maintained by any U.S. or California record keeping requirement, then there may be reasonable cause for failing to provide the information if the taxpayer can demonstrate that the data does not exist, has been discarded in the normal course of business, or is otherwise not available due to circumstances beyond the control of the entity who had possessed the information. Record retention policies and indexes should be requested to verify the taxpayer's contentions. (This guideline applies to all taxpayers, not just those with foreign parents.)

FTB follows the federal policy that reasonable cause is not shown by the fact that the law of the foreign parent's country may impose civil or criminal penalties for disclosure of the information. (IRC §982(b)(2); also Committee Reports on P.L. 101-239 [OBRA 1989] in regard to the reporting requirements of IRC §6038A.) The department's position will be stronger if the purpose for the foreign law is commercial rather than for reasons of national security. Therefore, if the taxpayer brings up foreign law as a reason for not providing information, the auditor should document the foreign law asserted by the taxpayer, try to determine its purpose, and identify whether the nature of the potential penalty is civil or criminal.

The taxpayer should be asked to provide evidence of its attempts to obtain the information from the uncooperative foreign parent, as well as the foreign parent's responses to those attempts. This will not necessarily excuse the failure to provide information, but may give the auditor a more complete picture to evaluate for purposes of determining whether a penalty is appropriate. If possible, a written statement of the reason the foreign parent will not provide the information should be obtained. If the objection has to do with the costs of compliance, the potential inaccuracy that will result from not

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obtaining the information should be weighed against the costs of compliance. If the lack of information relates to an item with minor tax consequences, then no penalty should be imposed. On the other hand, if no valid reasons are given for the failure to provide information, then the penalty should be considered (but see the next item regarding taxpayers that are minor subsidiaries).

If the officers of the subsidiary are also officers of the parent corporation, then those individuals should be able to obtain the information.

The auditor should look for indications that the taxpayer is able to obtain information from its foreign parent when it suits its needs in the course of its business or in litigation. This may be detected through the corporate minutes or through a Lexis/Nexis search. Such information may impact the credibility of a taxpayer's argument that they are unable to obtain the information requested by the auditor.

If the foreign parent does not want its subsidiary to have the information, the auditor should have the taxpayer ask its parent to provide the information directly to FTB. The auditor may prepare a letter for the taxpayer to forward to the parent that explains that any information provided during the audit is confidential. (In this type of situation, the audit file should clearly identify the sensitive nature of the information.)

In cases where the above procedures have been exhausted, the auditor and supervisor may consider the possibility of pursuing a subpoena. Each office should have a copy of the subpoena guidelines. Note that the issuance of a subpoena does not diminish the department's authority to issue the penalty for failure to furnish information.

If the taxpayer questions FTB's authority for issuing a failure to furnish information penalty with respect to information that is in the hands of a foreign parent, it may be helpful to refer to R&TC §19504 (FTB's power to examine records) and to explain that foreign parents who choose to operate in California cannot use subsidiaries to shield themselves from the responsibility of providing unitary information. The California Court of Appeal has recognized that foreign-based unitary groups must furnish the same kind of information as domestic-based groups, and reasonable costs of complying with a particular jurisdiction's taxation scheme are costs inherent in doing business in foreign lands (*Barclay's Bank International v. FTB*, 10 Cal.App.4th 1742 (1992)).

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3540 SCOPING PROCEDURES

A unitary examination begins with the scoping process. As discussed in MATM 2400 - MATM 2445, a great deal of public information can be gathered during the preaudit stage. By scanning public documents such as annual reports and SEC Form 10-Ks, and by searching databanks such as Lexis/Nexis for articles on the taxpayer, auditors can gain some general knowledge about the business operations. Test checks can be prepared based upon the initial impressions formed during this process (MATM 2530). If the materiality of the issue warrants further investigation, the public documents may contain leads for areas in which to focus the examination.

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3545 UNDERSTAND THE TAXPAYER'S METHOD OF FILING

It is important to understand how the taxpayer filed, and what their basis was for that method of filing. Simply asking the taxpayer why they filed as they did, and confirming the response can sometimes resolve potential unitary issues identified during the preaudit phase.

The prior audit report may be a good source for historical information. Once the auditor has determined how the taxpayer was reporting or required to report in prior years, any changes in the method of reporting can be easily identified. Information from the taxpayer's prior years can also assist the auditor in planning the amount of time necessary to complete the audit. For example, where unity is being established for the first time or where the membership of the group has changed, it is likely that much more audit time will be required then would be the case if the auditor merely has to confirm that the unitary facts existing in a prior period are still present, and use those facts as a building block for the current audit.

Prior audit reports should be reviewed during the preaudit phase. Suggestions for performing this review are covered in more detail in MATM 2200. Occasionally, the current audit will indicate a unitary determination that is contrary to the department's position in a prior audit. This circumstance is discussed in MATM 3590.

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3550 EXAMINING UNITY OF OWNERSHIP

The requirements for unity of ownership are discussed in MATM 3050.

Ownership information should be obtained in any audit of a corporation. Identification of parent and subsidiary corporations is necessary in order to ascertain whether those entities should have been included in the combined report. Even if an individual or a nonunitary corporation holds the stock of the corporation, the auditor will need to identify whether that individual or corporation owns other corporations that may be combinable with the taxpayer.

Both the Federal Form 1120 and the California Form 100 require that the taxpayer indicate whether the same interests hold more than 50% of its voting stock. The SEC Form 10-Ks are required to contain an exhibit listing all significant subsidiaries of the filing corporation. This listing will usually identify whether the subsidiaries are owned more than 50%. Corporate directories such as Moody's will also contain such lists. The Federal Form 851 *Affiliations Schedule* will list the 80%-owned domestic subsidiaries and should also identify whether any changes in stock ownership occurred during the year. Additional techniques for identifying related corporations are also discussed in the sections of this manual describing the income reconciliation (MATM 5130) and the pre-audit procedures (MATM 2000 et al.).

Wholly owned and closely held corporations will keep records regarding the ownership of their stock. If control issues arise with respect to a corporation with a SEC filing requirement, the SEC Form 8-K may contain information that will be useful in determining whether unity of ownership is present. Whenever a change occurs in the control of a corporation registered with the SEC, a Form 8-K is required to be filed to report the details of the transaction and the basis for the control.

Corporations may have several classes of stock with differing voting rights. In such cases, auditors will need to analyze the relative voting power of each class of stock in order to determine whether common control exists.

Example 1
A corporation has two classes of stock; one of which has 10 voting rights per share and the other 1 voting right per share. Although an individual might not own over 50% of the stock, that individual could control the corporation by controlling over 50% of the voting rights.

Example 2
Corporation N has two classes of stock. Holders of Class A stock are entitled to elect just two of five members of the board of directors. Holders of Class B stock are entitled to elect the remaining three of the five directors. Individual X holds 500 shares of Class A stock, and unrelated individual Y holds

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300 shares of Class B stock. No other shares are issued. Although X owns more than 50% of the stock, X cannot control the operations of Corporation N through election of the board of directors. The ownership requirement is therefore not met with respect to individual X.

The articles of incorporation will identify the various classes of stock. Since additional classes of stock may have been authorized after the original incorporation, any amendments to the articles should also be reviewed.

The corporate minute books may contain information regarding transfers of voting power or other factors that will affect the control of the corporation. If the auditor suspects that such agreements exist however, the details of the transaction will generally have to be obtained from the shareholders rather than from the corporation.

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3555 SEQUENCE OF UNITARY FACTUAL DEVELOPMENT

Factual development begins with obtaining a general familiarization with the business activities and operations (MATM 3560). Once auditors have this foundational knowledge of the taxpayer, it will be possible to target specific areas for more in-depth examination, and to develop specific requests for documentation that will form the basis for a unitary determination (MATM 3570, MATM 3575). Comprehensive written questionnaires and interviews may then be used to confirm or expand on the information that has been accumulated (MATM 3580). The questionnaires or interviews may also explore areas that were not adequately covered by other documents. Approaching the audit in this sequence will usually result in the most efficient use of resources.

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3560 UNDERSTAND THE TAXPAYER'S OPERATIONS

One of the first steps in any audit should be to become familiar with the taxpayer's operation. This involves asking questions such as:

- What do these companies do?
- What are the products and entities involved?
- Is there more than one business segment?
- Is the business organized in a divisional or multicorporate structure?
- What are the activities of each entity?
- What is involved in the major operations?
- What are the major operational decisions?
- Who are the key managers?

As this information is being obtained, the auditor should be thinking about the similarities or differences between the operations of the entities (or divisions), and the aspects of the operations where unitary ties might be expected to be present. An analysis of the background information should provide leads to follow in the unitary examination, and should enable the auditor to develop specific information requests that are tailored to the taxpayer's operations.

The initial interview with the tax department personnel is a good place to start becoming familiar with the taxpayer's business (suggestions for conducting this interview are in MATM 2730). Since the tax manager may not be knowledgeable about the way that the operations are conducted by the various entities however, it will probably be necessary to interview personnel that are involved in the operational side of the business.

Much of the background information can also be derived from organizational charts, annual reports, SEC 10-K Reports, company profiles, prior audit reports, magazine and newspaper articles (both about the corporations and about the key officers), and company publications and manuals.

As part of this audit step, the auditor should document the ownership and operational structure for the file. The following information should be listed for each entity:

1. The primary activities and products of the entity.
2. The location of the entity's operations.
3. The percentage of ownership and voting control.
4. Whether the entity has been recently acquired.
5. Whether the taxpayer included the entity in the combined report.
6. The names and positions of the directors and principal corporate officers. If the officers/directors changed during the audit period, this list should be prepared for each audit

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year. (If there is a large group of subsidiaries, the auditor may choose to present this information only with respect to the principal subsidiaries.) To aid a reader in interpreting this information, the auditor may also prepare a summary highlighting the common officers and directors.

An ownership chart is very helpful for the file, particularly if it is a complex, tiered ownership structure. Charts showing the divisional structure and/or reporting lines of authority are also very useful.

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3570 GENERAL SOURCES OF INFORMATION FOR DETERMINING MANAGEMENT INVOLVEMENT AND OTHER UNITARY DATA

The degree of management involvement is a very subjective factor, and the development of facts necessary to establish the degree of management involvement is very resource intensive. A general understanding of the business, as discussed in MATM 3560, is the starting point for evaluating strong centralized management. Once this has been accomplished, the following sources may be examined for indications of the management activity that took place. By piecing together the individual fragments, the level of management involvement can be determined. Once the documentation has been examined, interviews of key officers will generally be necessary to tie together the pieces and to expand upon the auditor's findings.

Consolidated CPA Workpapers: CPA firms maintain audit files that could be of significant help in the development of unitary data. Since much of this information is also helpful for income and factor verification, review of these files should be done early in the audit. CPA workpaper files contain:

- Index: Each file will contain a master index that discloses what is contained in the file. The workpapers are numbered and cross-referenced.
- Consolidation files: The intercompany account analysis contained in the workpaper files may provide data important to a unitary analysis. The consolidation files will also be used for conducting the income reconciliation discussed in MATM 5130.
- Tax accrual files: The tax accrual workpapers are sensitive and need only be requested in rare circumstances.
- Administrative file: This file might be called the Permanent File or some other name depending upon the CPA firm. This file should include an overview of how the corporation is structured. There may also be an analysis of corporate minutes and extracts of significant comments, or a notation if no minutes exist.
- Management comment letters (These are not required, but may be present.)
- Financial statements by entity: These statements are generally prepared in-house and provided to the CPA firm as a starting point for their audit. This is a good source for by-entity information. The auditor should work off of the final statement that will reflect all closing adjustments (but the auditor should be sure to take into account any adjustments made during the CPA audit).
- SEC, Regulatory and Government filings
- Foreign Audits: Generally, information on foreign operations will also be in the files of the CPA firm. If a foreign CPA firm has performed the audit on subsidiaries, copies of their work will be in the files of the firm which signs the audited financial statements.
- Tax Return Workpapers: Workpapers used to prepare the tax return may be separate from the financial workpapers. Specific workpapers on Schedule M-1 items should be obtained for the M-1 analysis (MATM 5140).

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One approach for reviewing this information is to request that the taxpayer contact the CPA firm and arrange for the auditor to visit the CPA firm to review the files. This will maximize the information that can be reviewed. Auditors might receive resistance to obtaining the CPA workpaper files, but we are entitled to them. (*U.S. v. Arthur Anderson & Co. et al*., 1980-2 USTC Para. 9515)

Corporate Minutes (Including All Committees) The minutes may reveal why major corporate actions have been taken, and why the organization is structured the way that it is. Centralized functions may be commented upon. The discussions of major policy decisions and the reports of segment managers may be helpful in ascertaining whether centralized management exists. Statements contained in the minutes will become building blocks for follow-up questions used in interviews of officers.

In addition to Board of Directors minutes, the auditor should review minutes of Committee & Sub-committee meetings. If the minutes are not very detailed, the agendas that are sent to the directors may be helpful.

Business Plans and Agenda Business plans and agendas provide insight into the degree of involvement of centralized management. Business plans may include strategic plans, budget plans, long-term plans, and mission & values statements.

Employee Communications In addition to information about general business operations, employee communications might be helpful in ascertaining the existence of employee transfers and management involvement in the various operations. Items to review include:

1. Bulletin announcements
2. Employee newsletters
3. Company orientation material/historical publications

Correspondence Files Correspondence files of key officers or managers should help determine the degree of management involvement in the various business segments. Because of the volume and sensitivity of this information, avoid making broad requests for correspondence files. Instead, request the entire correspondence files of specific individuals.

Manuals Manuals can provide information on the degree of centralized functions, common practices, and management involvement. A specific list of all manuals should be requested to insure that all manuals have been identified. When reviewing manuals, auditors should request the version that

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was in effect for the years under audit. If that version is not available, the auditor should ask the taxpayer to confirm or document whether the specific information relied upon from the manuals existed during the audit years.

1. Some types of manuals which taxpayers may have would include:
2. Policy and Procedure Manuals (these may include retention file requirements -- see MATM 3575)

3. Operating manuals such as:
    a. advertising
    b. accounting
    c. marketing
4. Forms Manual
5. Internal Audit Manual such as an Employee Handbook

Diaries, Calendars, Travel Expense Analysis Diaries and calendars of executives are useful in determining their involvement in the management of the various business segments. In addition, travel expense claims can help establish the location of travel and the purpose of the trips. Time reports might also be maintained to establish the amount of time that was spent on the various business segments. Airline manifests for company aircraft may also be helpful in this area.

Duty Statements of Key Officers and Management Personnel Duty statements will reveal the scope of authority and the responsibilities of the various officers. Some corporations may use employment agreements that will contain this information.

Court Actions Various court actions involving the taxpayer could provide information regarding the operations or about the inner workings of the company. Some of this information may be found in a Lexis search but a separate inquiry may also be made in this area along with a review of the annual report and SEC 10-K. Key officers or managers may be asked whether they have been deposed as to facts about company operations. If the answer is yes, the following steps should be undertaken:

1. Transcripts of testimony should be reviewed,
2. Depositions should be reviewed,
3. The nature of actions taken should be determined.

Deposition transcripts or exhibits are public in nature and not subject to the argument of attorney-client privilege.

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Speeches Speeches given by executives at conferences, stockholder meetings or other business gatherings provide valuable insight into company operations. Through the interviewing process, inquiries may be made to help determine what speeches were given. Some of the areas to explore include:

1. Transcripts of shareholder meetings. Transcripts of the meeting might contain more information than the Shareholder Minutes themselves.
2. Newspaper articles
3. Inquire as to business conventions attended and determining whether speeches were presented.
4. Employee newsletters
5. Videotapes shown to employees
6. Conference agendas.

Conference Materials, Press Releases, Testimony Before Congressional or Regulatory Agencies These sources might be helpful in understanding the interactions between companies and involvement of management. The existence of such information might be identified through a Lexis/Nexis search.

Internal Audit Reports Internal audit reports can be a very helpful source of information. Reports issued to management will set forth the level of compliance with established company policy and procedures. The following information may be obtained:

1. Internal audit reports along with the report to management.
2. Size of the internal audit department. (The greater the size in relation to the business, the more likely greater internal controls will exist.)
3. Internal audit manuals and procedures.
4. Scope of duty of the internal audit department.
5. Reports other than internal audit reports, if any, generated by internal audit and their significance.

Electronic Mail Electronic mail is rapidly becoming a significant means of communication. This area should be explored to:

1. Establish whether electronic mail exists and if so, determine what exists and what is retained by data processing.
2. Determine which personnel have authorized access.

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3. Determine levels of authorized access by officers and key managers.
4. Determine what hard copies are available.

Telephone Directory/Calls Made An examination of the telephone directory provides insight into overall company communications. A review of specific telephone bills for officers and key management personnel is of significant help in determining the amount of contact between organizations.

1. Obtain a company directory for years under audit.
2. Review telephone bills
3. Obtain information on faxes and telex's

Capital Expenditure Authorization Capital expenditure authorizations help determine the degree of centralized management. The policy and procedures manual should be reviewed to determine the levels of authorization and the approval procedures for capital expenditures. The approval limits at the subsidiary or divisional levels should be documented.

Visitor Logs An examination of visitor logs might be of assistance in determining which officers and key management personnel visited a particular entity. Although useful, such information is not necessarily complete because permanent passes might be held by many key personnel who are not required to sign the visitor log.

1. Determine dates visits were made.
2. Determine who made the visits and use this data to check travel expense claims for establishing the purpose of the visit.
3. Determine who had been issued permanent passes and would not have signed in on visitor logs.

Management Fee Allocation Workpapers Management fee allocations can be used for determining centralized management involvement.

1. Identify the amount of charges made to the specific subsidiary.
2. Analyze the charges to determine the components of the management fee.
3. Determine how the management fee is calculated.

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Regulatory Reports Regulatory reports required to be filed with various federal and state agencies can provide extensive information as to the background and operations of the company as well as financial information that will be useful for examining income, apportionment factors and other issues. Some types of regulatory reports are specific to an industry (i.e., banks are regulated by the FDIC and state banking agencies; electric companies are regulated by the Public Utilities Commission, Airlines are regulated by the Federal Aviation Administration, etc.). Other reports are required when a corporation takes certain actions. (For example, when large corporations are involved in mergers or acquisitions, they may file extensive information with the Federal Trade Commission pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Information provided by such filing includes details of intercompany sales, product lines, locations of factories, a description of the acquisition, and studies, surveys, analysis and reports prepared for the purpose of evaluating the acquisition.)

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3575 SUGGESTED AREAS OF UNITARY DEVELOPMENT

In addition to management involvement (discussed in MATM 3570), the following suggested areas of development might be applicable to large corporations. Not all of this information will be necessary (or relevant) in every audit. On the other hand, many taxpayers may have documentation or unitary features that are not covered by this list. This list is intended only as a guide for auditors to tailor to the specific circumstances of their audit.

It is important to understand the record retention practices of the organization. Most large organizations will have a retention file listing the records that are retained, and the location of those records. This can be valuable for identifying documents that will aid in the factual development. Unitary relationships are not always uniform throughout an affiliated group. Therefore, when developing facts involving multiple entities, it is important to identify which facts apply to which entities. For example, if a parent corporation provides a centralized service, the audit narrative should specify which entities used that service, and to what extent.

Intercompany Sales and Services

1. Review the intercompany accounts in the detail general ledger to determine the items, which are being charged to those accounts.
2. Identify the significance of the items that are sold intercompany (e.g., are they essential components of the purchasing company's product, can they be obtained from other sources, etc.).
3. For both the selling company and the purchasing company, list both the amounts of intercompany sales (purchases) for each year, and the percentage that those amounts bear to total sales (purchases) of the company. (This information will also be useful in verifying the sales factor -- see MATM 7518.)
4. Take a "big picture" look at the intercompany transactions occurring between all members of the group. Transactions that might seem minor when taken in isolation may acquire significance when viewed in conjunction with other transactions.

Technical Service or Licensing Agreements

Whether or not agreements have any unitary significance depends upon their importance to the business of the corporations involved. In order to understand the significance of such agreements, the auditor should develop information such as the following:

1. Percentage of licensee's sales that is based on the license.

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2. Purpose for the stock ownership of the licensee, for example a pre-condition for the agreement.
3. Other indicia of an operational relationship such as the number of visits from the licensor to the licensee or vice versa, the level and amount of product review and exchange of a technical/marketing information, and whether the two companies have common directors and common officers making operational decisions for the licensee.

Personnel Transfers/Hiring

The movement of personnel between corporations is one element of unity. In order to understand the process and determine the records that should be reviewed, interviews with Personnel Managers may need to be conducted. Based upon the information developed, the auditor should:

1. Review employee newsletters for hiring and transfer disclosures.
2. Develop employment dates, positions and employment history of officers and key management individuals (sometimes this information is summarized in annual reports or SEC Forms 10-K).
3. For transfers within the audit period, determine the old and new position and corporation.
4. Obtain the total number of employees and compare to the number of transfers to determine significance.
5. Evaluate the personnel level and classification of the transfers to determine the level of training and expertise that is being transferred along with the employee.

Research and Development

Common research and development can be an important element of unity. Before developing this element, it is important to have an understanding of the operations, as well as the products and processes that are involved. An interview with the R&D manager is a good first step in developing this area.

1. Determine licensing arrangements between parent and subsidiaries.
2. Obtain a list of issued patents and pending patents and determine whether these are being used within the group.
3. Determine whether R & D departments exist at subsidiary levels and determine their functions.
4. Determine the R & D expenditures by entity.
5. Determine how R & D is funded.

Marketing

Marketing of company products is a very significant element of unity.

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1. Interview the marketing manger to determine how the operation functions.
2. Determine whether there are central distribution facilities.
3. Determine how the channels of distribution function.
4. Obtain master customer lists and identify significant common customers.
5. Determine whether common logos and trademarks are being used.
6. Determine whether there are common procedures for customer relations, discounts, etc.
7. Determine whether there is a common sales staff.
8. Determine who generates sales literature, catalogs, etc.
9. Determine if there is a central 800 number for placing orders for parent and subsidiary products.
10. Determine who authorizes returns.
11. Determine how pricing strategies are determined.
12. Examine major marketing contracts.
13. Examine the sales commission structure to determine whether the parent's sales force is compensated for products sold belonging to subsidiary.

Centralized Purchasing

Centralized purchasing of major raw materials is a significant item, while the purchasing of more incidental items such as office supplies, rental cars or employee group discounts carries much less importance in a unitary context.

1. Determine whether a centralized purchasing department exists.
2. If the business segments use similar materials, but no centralized purchasing department is evident, supplier lists may be requested to determine whether common suppliers are used. For smaller operations, purchase invoices may be sampled to obtain this information.
3. If centralized purchasing or common suppliers are present, determine whether volume discounts result.
4. Determine whether centralized purchasing is operational (raw materials) or incidental (supplies, etc.).
5. Determine the types of national purchase contracts that exist.
6. Determine whether purchasing is required from an approved list of vendors.
7. Review policy manuals for requirements relating to purchasing.
8. Review purchase order requirements.
9. Determine who negotiates the terms for purchasing.

Intercompany Financing

Remember that intercompany financing used to further diverse businesses is not a significant item unless that financing serves to further a unitary cause (see MATM 3040). The detail general ledger

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can be reviewed to identify intercompany loan accounts. The loan files and the company's policy for intercompany financing may then be inspected to determine additional information. Items of inquiry would include:

1. Determine amounts advanced and repaid during year.
2. Identify amounts, terms and entities involved in intercompany financing.
3. Identify borrowing authorizations and restrictions.
4. Identify guarantees and collateral used.
5. Identify how excess funds are handled.
6. Identify uses and sources of funds.

Treasury Review

Many companies maintain Treasury Policy and Procedures manuals, which will provide information regarding the treasury function. The manager of the treasury department may also be interviewed to determine how the treasury function is operated. Information that should be obtained includes:

1. Determine how the cash management program functions.
2. Determine the types of financial reports that are required to be submitted.
3. Determine reporting controls on divisions and subsidiaries.
4. Determine the independent borrowing capacity of divisions or subsidiaries.
5. Determine how letters of credit are obtained and what securities are pledged.
6. Determine how credit is extended to major customers and who has the responsibility for this function.

Physical Facility Use

Sharing of common facilities is an element of unity. Steps to develop this item include:

1. Obtain a directory/location of corporate facilities.
2. Review facility use plans and determine who performs this function.
3. Determine whether there is a centralized real estate department, and what its functions are.
4. Determine which facilities are commonly used.
5. Determine who has the function of approving real estate leases.

Employee Benefits

1. Obtain an employee handbook, which explains benefits.
2. Determine which benefits are common throughout the organization.
3. Determine which benefits are not common throughout the organization.
4. Determine whether profit sharing exists and if so, how it is determined.

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5. Determine whether stock bonus plans are paid with stock of the parent or subsidiary.

Advertising

1. Interview the advertising manager and determine how the operation functions.
2. Determine if there is a centralized advertising department
3. Determine whether advertising is done on an international, national, or local basis. To the extent that advertising is not uniform throughout the markets served by the affiliated group, are there similarities as to advertising format, target market, common advertising agency, etc? Sample advertisements or advertising contracts from different geographic areas may be used to obtain this information.
4. Obtain copies of advertisements from different business segments to determine whether they stress corporate or subsidiary identity.
5. Obtain product brochures to determine whether uniform trademarks, tradenames, or logos are used.
6. Contrast subsidiary advertising cost with parent cost.

Accounting

Depending upon the nature of the activity, accounting may be a significant item if centralized bookkeeping types of services are provided. Items pertaining to the preparation of audited financial statements or consolidated federal tax returns are common to all investments and would not be a significant item. In order to evaluate this area,

1. Interview the controller or accounting manager to determine what operations are centralized.
2. Identify the records that are created
3. Review the Accounting Procedures Manuals
4. Determine the standard forms that are utilized
5. Determine reporting requirements of subsidiaries.
6. Determine collection procedures and establish who performs this function.

Insurance Review

1. Interview the risk assessment/insurance and loss control manager to determine the workings of the insurance department.
2. Determine common coverage.
3. Determine separate coverage.
4. Determine whether a centralized insurance department exists.
5. Determine whether the company is self-insured.
6. Document the savings from common coverage. Letters from the insurance agent to the company may set forth such savings.

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Legal Department Review

1. Determine whether a centralized legal department exists.
2. Determine the number of staff at corporate level.
3. Determine the number of staff at operating level.
4. Determine the degree to which outside counsel is used and for what items.
5. Determine whether the inhouse legal staff is acting in an advisory capacity or an operational role. Does this role differ at the corporate level versus the operating level?
6. Ascertain benefits involved in using inhouse versus outside counsel. In addition to cost savings, benefits may take the form of specialized knowledge or expertise regarding the company's legal environment.
7. Review the inhouse billing invoices to determine the types of services that were provided and how those services were billed.

Labor Relations

1. Interview the labor relation's manager and determine the department's function.
2. Determine who negotiates union contracts.
3. Determine if there is a centralized department dealing with labor relations such as EEOC.
4. Determine how employee grievances are handled.
5. Review employee personnel and hiring procedures and determine whether this function is centralized.

Management Information Systems (Computers)

Management Information Systems (MIS) provide a significant amount of computerized information for the organization. This area would be explored by:

1. Determining what the MIS system is and what reports are generated by interviewing the MIS manager.
2. Determine whether there is a central data processing center. (If there is more than one computer facility, identify the services that are provided at each location.)
3. Determine whether there is a central programming staff.
4. Determine whether there is a central software development center.
5. Determine whose tasks/projects are performed by the data processing center.
6. Determine how requests are referred to MIS.
7. Explore how hardware requirements are determined.
8. If subsidiaries maintain their own computer facilities, identify the services provided by those facilities. Explain the extent to which each of the subsidiary computer facilities is tied in with the parent's (or another subsidiary's) computer system to receive or exchange particular data.

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Training

Corporations may provide training to their employees through either training programs (such as management development or sales training) or manuals (for example, a training manual on internal accounting procedures). To develop this issue, the auditor must first determine what types of training programs or manuals the corporations use. The auditor must then develop the following information:

1. Obtain a list of training courses given.
2. Determine the nature of the training (management or technical).
3. Determine which personnel classifications attend the training.
4. Determine which subsidiaries send personnel to the training (or use the manuals).
5. Obtain names and history of the training staff.
6. Determine whether a centralized training facility exists.

Other State Audits

The results of audits done by other states may be requested. Although not controlling, such information might be useful in deciding whether supplied facts are consistent from state to state.

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3580 INTERVIEWING KEY EMPLOYEES

An important technique for developing information about a corporation's management and operational structure is to interview key employees. Tax managers frequently will not know the answers to questions about the various functions of the organization. Since the answer to one question will often generate other questions, written questionnaires can in many cases be an inefficient way to develop the information.

Since tax managers may be reluctant to allow the auditor to go outside the tax department for information, the auditor may have to be insistent about interviewing employees. Tax managers generally have responsibility for maintaining control over the audit, however they *should not be allowed to maintain control over the type or source of information necessary for resolving the audit*. Auditors should explain to the tax manager why the interviews are necessary, and should be flexible in order to minimize the inconvenience to the taxpayer. For example, it may be necessary for the auditor to travel to a subsidiary's location to interview an employee that does not work at the headquarters office. Alternatively, the auditor may consider scheduling a telephone interview.

In order to examine many of the key operational functions described in MATM 3575, it is necessary for the auditor to gain an understanding first of how the function is performed, and what types of documents or reports are available. This information is usually most efficiently obtained through an interview with the manager in charge of the function. For example, the development of facts concerning the research and development function might start with an interview of the R&D manager. The auditor should prepare for the interview by compiling a list of general questions such as what type of research is performed, what are the applications of that research to the various products produced by the group of corporations, what products or processes have been developed, which entities have directly benefited from the research, is all the research performed at one location or is there more than one research facility, what are the channels for a subsidiary to request a specific type of research project, what are the channels for research developments to be shared with the operating entities, how are the subsidiaries charged for R&D, what types of reports are generated by the R&D department, etc. The responses to these general questions will undoubtedly lead to additional, more detailed questions.

Sometimes, interviews will be held after the initial fact gathering process is completed rather than as a preliminary step in the factual development. The purpose of these types of interviews is to tie together and expand upon the facts that have been obtained, or to resolve apparent conflicts in information that has been developed. Interviews of key officers to determine the presence of strong centralized management will fall into this category. The types of questions asked in these interviews are based upon the auditor's analysis of the documents that have previously been obtained. Since the auditor will be asking the interviewee to comment specifically on the documentation, the auditor

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should prepare carefully for the interview and may consider presenting the interviewee with examples of the items upon which they will be asked to comment.

Generally, the persons to be interviewed in connection with an evaluation of strong central management should be in charge of the companies under examination, be a common manager, or have knowledge concerning a potentially common department. Questions to ask someone from a potentially central department should address the nature of the services provided to the various entities in question. Other questions for potentially central managers could include: what is the interviewee's background, work experience, where do they fall in to the chain of command, etc; what is the person's area of responsibility and how is it performed in conjunction with other managers; how are differences and disagreements resolved between entities (examples should be requested); what are examples of major accomplishments or major decisions that cut across corporate entities; what types of decisions made by the subsidiary were overridden by the parent; and any other questions that will determine if the manager had a regular, operational role in the affairs of a subsidiary. If conflicting information was developed during the audit, the interviewee should be asked to resolve it.

Some techniques for conducting successful interviews are as follows:

Prior to the interview:

1. Obtain function descriptions and job descriptions of the relevant areas to determine who should be interviewed.
2. When selecting individuals to interview, ask if they were in their present position during the audit years. If the current manager of a department was not involved with that department during the audit years, it may be preferable to interview a former manager or another employee who is knowledgeable about that department's operation during the relevant time period.
3. Whenever possible, schedule interviews in the morning and leave the afternoon free to write up the summary of the interview while the conversation is still fresh in your mind. If you must interview two people on the same day, schedule the interviews so that there will be ample time in between to expand or clarify your notes.
4. Prior to the interview, ask the taxpayer if the interview can be recorded. This will enable you to concentrate on the interview rather than on note taking. Most taxpayers will not object to the recording as long as they receive a copy of the tape.
5. Consider scheduling a tour of the facilities relating to the job function prior to the actual interview. By obtaining a general understanding of the function, specific questions can be framed, and the responses can be placed into perspective.

During the interview:

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1. At the beginning of the interview, emphasize that the responses should reflect the facts as they existed during the audit years. It may be necessary to remind the interviewee of this focus during the conversation.
2. Obtain the names of relevant documents and reports so that you can later confirm the interviewee's statements.
3. Ask whether you may contact the interviewee directly to ask any follow-up questions. Some taxpayers prefer that such inquiries be first directed to the tax manager.

After the interview:

1. As soon as possible, prepare a summary of the interview from your notes or from the tape recording.
2. The summary of the interview should identify the name, position and area of responsibility of the person interviewed. To establish the credibility of the responses, it is also a very good idea to record the length of time that the individual has been in their present position, and any other positions that they held with the company.
3. Ask the interviewee to sign the summary after reviewing it for accuracy. This will prevent misunderstandings from arising over what was said.
4. Request documentation to confirm important information obtained orally during the interview. If any of the documentation conflicts with the information obtained during the interview, ask the interviewee to explain the discrepancy.

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3590 CHANGE IN POSITION FROM PRIOR YEARS AUDIT

Occasionally, the findings in a current audit will indicate a determination that is contrary to the position taken by the department in an audit of prior years. The interpretation of a taxpayer's unitary facts should be applied consistently from year to year. Consequently, a change in position from the prior audit is not a decision that should be taken lightly. On the other hand, there are circumstances where such a change is appropriate.

A taxpayer's method of filing is sometimes either allowed or adjusted by auditors based upon insufficient evidence (such as when an audit is closed as a result of a taxpayer's failure to furnish information or when an NPA is issued due to an impending SOL). In other cases, the prior audit determination may have been based upon theories that have been invalidated by the SBE or Courts (for example, many audits completed in the past denied combination based solely upon the lack of functional integration). If the current audits of these taxpayers indicate the taxpayer's method of filing to be improper, it is essential that the auditor make the necessary changes to place the taxpayer on the correct method of filing.

It is also possible that facts have changed from the prior audit that will clearly indicate a change in the filing requirement. The auditor must document these changes in detail within his audit report. It is very important to note the dates that significant events occurred.

Most of these cases are not black or white situations. Before the auditor makes a change in the filing method, a thorough discussion of the facts should be held between the auditor and supervisor.

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3595 HOW TO PROCEED AFTER A REFUND IS DETECTED

If the taxpayer has not been contacted:
Whenever possible, the auditor will perform a test check prior to the audit appointment to determine if a combination or decombination of a group of taxpayers will result in a refund (see MATM 2530). If the unitary issue will produce a refund but the auditor is not certain that the issue will be resolved in the taxpayer's favor, then the auditor may still continue with the audit of other items in the tax return. If the decision is made to pursue the audit however, the taxpayer *must* be notified that the potential for a refund exists and that they have the burden of developing the unitary facts and figures if they so choose (a specific time frame should be established for a reply).

If the taxpayer has been contacted:
There are occasions when the potential for a refund is not detected until the taxpayer has been contacted. Since one of the department's primary responsibilities is to perform audits on an equitable basis, the taxpayer must be notified that preliminary audit work uncovered the possibility of a refund. The taxpayer should be informed that if they wish to pursue the refund, they have the responsibility of developing the unitary facts.

If the auditor is not certain that the unitary issue will be resolved in the taxpayer's favor, then the auditor may still continue with the audit of other significant items in the tax return.
If the known facts *clearly* indicate that the method of filing which would generate the refund is correct, but the taxpayer for whatever reason expresses no interest in pursuing the refund, then the other audit issues should generally not be adjusted unless the tax potential of those issues is materially greater than the potential refund. (Even if the auditor is certain that a unitary relationship exists, it is not necessary to develop the taxpayer's refund if substantial effort will be required to put together the necessary numbers.) Any unadjusted issues should be disclosed in the narrative for further follow-up in the event the taxpayer subsequently decides to file a claim for refund. In all cases, Revenue Agent's Reports should be forwarded to central office for adjustment.

MAPM 6050 contains examples of letters to notify taxpayers of potential refunds ("Walker letters"). It is important that the auditor adapt the letters to the situations. For example, if the auditor has not yet begun to examine the unitary relationship of the corporations, the letter should not state that unity appears to exist. It should instead be stated that no determination has been made as to the unitary relationship of the corporations.

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4000 NONBUSINESS INCOME

In broad terms, net income, which arises from the conduct of the taxpayer's trade or business operations, is business income. The term "business income" is defined in R&TC §25120(a) to mean "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Nonbusiness income is defined in R&TC §25120(d) as "all income other than business income." Furthermore, CCR §25120(a) states that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income."

The classification of income as business or nonbusiness is essential to the determination of the California tax base for two reasons:

1. Business income is apportioned by formula to the various jurisdictions in which the trade or business activity is conducted, while nonbusiness income is allocated to a specific location under a series of statutory rules; and
2. Unitary business income is determined on a combined basis, while nonbusiness income may only be reflected in the measure of tax of the taxpayer incurring the nonbusiness income or loss.

The classification of income by labels such as interest, rents, royalties or capital gains is of no aid in determining whether that income is business or nonbusiness. The gain or loss recognized on the sale of property, for example, may be business income or nonbusiness income depending upon its relation to the taxpayer's trade or business. The auditor must therefore look beyond the labels and focus on the relationship of the income to the unitary business activity.

This portion of the manual will first describe the tests for determining whether income constitutes business or nonbusiness income, and then will discuss the application of those tests to various types of income and loss and the rules for allocating items of nonbusiness income or loss.

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4010 TEST FOR DETERMINING BUSINESS OR NONBUSINESS TREATMENT

The concepts of unity and business versus nonbusiness income came into existence due to the U.S. constitutional limits on the ability of states to tax interstate commerce. In simple terms, there must be some connection or nexus between the state and the taxpayer's economic activity that the state seeks to tax. That is why some income is apportionable (business income) among several states, while other income is allocated to a single location (nonbusiness income). The various states define business income and nonbusiness income either by statute or case law. Many states have adopted the business income definition found in the Uniform Division of Income for Tax Purposes Act (UDITPA), which is found in R&TC §25120(a).

The US Supreme Court in *Allied-Signal, Inc. v. Director, Div. Of Taxation* (1992) 504 U.S. 768 focused on the characteristics of an asset's use and its relation to the taxpayer's business activities to decide if the related income can be included in the tax base to be apportioned to the non-domiciliary state. The asset, stock of another company in the case of Allied-Signal, must have an operational versus investment function to be apportioned. The Court held that gain on the sale of stock was not apportionable because there has been no showing that the stock served an operational function, even though the asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions, since such a policy does not convert an otherwise passive investment into an integral operational one. The court also said that the short-term holding of the stock was not analogous to a taxpayer depositing temporary excess working capital in a bank account and receiving interest income. In the case of the bank deposit, the funds, working capital, serve an operational role. Therefore, the interest on the deposit is apportionable business income.

R&TC §25120(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income arising from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC §25120(d) defines nonbusiness income as "all income other than business income."

The department and the SBE have interpreted R&TC §25120(a) as providing two alternative tests for determining whether income constitutes business income: the "transactional test" and the "functional test." (*Appeal of CTS Keene, Inc.*, Cal. St. Bd. of Equal., February 10, 1993; *Appeal of DPF Inc.*, Cal. St. Bd. of Equal., October 28, 1980; *Appeal of Borden, Inc.*, Cal. St. Bd. of Equal., February 3, 1977.) Because nonbusiness income is defined as "all income other than business income" (R&TC §25120(d)), income that does not meet either one of the tests will be characterized as nonbusiness. The SBE has held that a determination of business or nonbusiness character made by FTB under one of these tests is presumed correct, and the taxpayer has the burden of proving error in that determination (*Appeal of Twentieth Century-Fox Film Corp.*, Cal. St. Bd. of Equal., March 2, 1989).

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The transactional test stems from the first part of R&TC §25120(a), that is, "income arising from transactions and activity in the regular course of the taxpayer's trade or business." The functional test stems from the words "and includes income from tangible and intangible property if the acquisition, management, and disposition constitute integral parts of the taxpayer's regular trade or business." The department's position is that the transactional test includes in business income such activity as inventory sales while the functional test includes such activity as sale of property, plant or equipment used in the unitary business.

Taxpayers have argued that the state is not required to tax all of the income that it is authorized to under the U.S. Constitution. States can define apportionable income more narrowly then U.S. constitutional standards (operational role). Some taxpayers interpreted R&TC §25120(a) as providing only one test for business income, that being the transactional test, arguing that the language of the "functional test" is subordinate to the language of the "transactional" test. Under this rationale, income from an extraordinary event such as the liquidation of a subsidiary or pension reversion is nonbusiness income, because the transaction is not a "regular" part of the taxpayer's trade or business. The issue of whether one or two tests exist for business income was resolved in a 2001 California Supreme Court decision, which held that there are two tests. On May 14, 2001, the California Supreme Court held that the California definition of business income contains both a transactional and a functional test in the case of *Hoechst Celanese Corporation v. FTB* [(2001) 25 Cal.4th 508, *cert. denied* (2001) 151 L.Ed. 2d 537].

Hoechst Celanese Corporation (Celanese) was in the business of manufacturing and selling a diversified line of chemicals, fibers and specialty products. Celanese employed a large work force. Since 1947, Celanese had maintained a pension plan for the general benefit of these employees in an effort to retain its current employees as well as to attract other qualified prospects. The pension fund assets were placed in a separate trust with an independent trustee. Celanese retained the power over selection of the trustee and general investment philosophy. The trust held title to the pension assets.

Because of sound investment policies and a robust stock market, by the mid-1980's the trust assets were far in excess of the future pension obligation. Celanese decided to recapture the surplus assets through a process known as a "reversion". Celanese reorganized the pension plan, funded all outstanding pension obligations, and reported the remaining balance, $388.8 million, as nonbusiness income in 1985 fully allocable outside of California. FTB issued an NPA treating the income as business income that was in part apportioned to California.

The California Supreme Court noted that the business income definition in R&TC §25120(a) consists of two clauses that could be interpreted either as two independent tests for business income, or as one test containing a second modifying clause. Due to ambiguity of the law, the Court examined legislative history. The Court concluded that separate transactional and functional tests existed because:

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- The UDITPA definition of business income adopted pre-UDITPA California SBE administrative case law language clearly applying a separate, independent functional test for determining business income.
- The Commissioners who drafted UDITPA contemplated the existence of a functional test, because they declared that business income includes income from the sale of property "used" in the trade or business.
- The SBE has thoroughly considered the business income issue, reached a well-reasoned conclusion, and consistently applied this conclusion for 24 years. The Court saw no reason to overturn this long-standing construction of the business income definition. (*Hoechst Celanese Corporation v. FTB* (2001) 25 Cal. 4th 508 at 525, citing *Yamaha Corp of America v. State Bd. Of Equalization* (1998) 19 Cal. 4th 1.)
- A separate functional test was consistent with the uniformity principles of UDITPA because, with the exception of Alabama, all states that have considered the issue now have a functional test in either judicial or legislative form.

After determining the existence of two tests, the Court set out the terms of these tests. When applying the transactional test, the Court stated that the controlling factor is the nature of the particular transaction or activity that generates the income. The transaction or activity must be in the regular course of the taxpayer's business and the relevant considerations include frequency and regularity of similar transactions (extraordinary, once-in-a-lifetime occurrences do not meet the transactional test), the former practices or typical practices of the business, and the taxpayer's subsequent use of the funds. (The department would question the significance of the subsequent use of funds. The mere flow of funds, by itself, is insufficient to change the character of income for apportionment purposes. For example, the taxpayer has a gain on the sale of a nonbusiness asset and invests the funds in the unitary business. Just because the funds are used in the unitary business is not enough to change the character of the income from nonbusiness income to business income. See *Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159, 166; see also *Appeal of Fairmont Hotel Company*, Cal. St. Bd. of Equal., June 29, 1995).

The Court applied the above factors to Celanese's pension reversion (the transaction that generated the income), and concluded that the reversion did not generate business income under the transactional test.

The functional test provides that "business income" includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. The Court in Celanese noted that the functional test focuses on the nature of the property, not transactions or activities. The crucial inquiry here is the

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relationship between the property under consideration and the taxpayer's business operations. This analysis involves interpretation of two key statutory phrases: "acquisition, management, and disposition of the property" and "integral parts of the taxpayer's regular trade or business operations."

In the first part of its analysis, the Court determined that because the phrase "acquisition, management and disposition" contained the word "and" it should be interpreted in the conjunctive. However, the Court also adopted broad, and inclusive definitions of the words "acquisition," "management" and "disposition" that dispelled any restrictive concept of property ownership or disposition. According to the Court, "acquisition" means" to obtain some interest in and control over property"; "management" means " to control or direct the use of that property"; and "disposition" means "to transfer, or have the power to transfer, control of the property in some manner".

In the second phase of its analysis of the functional test, the Court defined "regular", "operations" and "integral" in analyzing the phrase "integral parts of the taxpayer's regular trade or business operations": "Regular," the Court said, means "normal" or "typical." The Court also explained that "operations" means the whole process of planning for and operating a business or a phase of a business activity. The Court's interpretation effectively puts an end to taxpayers' argument that the acquisition, management, and disposition of property must be frequent or regular under the functional test. The Court defined "integral" as materially contributing to the apportioning business.

The Court applied the above analysis to conclude that the pension reversion income was business income as provided by the functional test of R&TC §25120(a). The pension plan and trust enhanced the quality and efficiency of Celanese's labor force and Celanese retained a significant role in administering the trust and plan. As a result, the pension plan assets were interwoven into and inseparable from Celanese's employee retention and recruitment efforts, an essential part of any business operation.

The Celanese decision is important for the following reasons:

- First, the decision validates the department's long-standing view that the business income definition does encompass both a transactional and a functional test.
- Furthermore, the decision validates the departments, as well as the SBE's, interpretation of the scope of the functional test.
- The decision recognizes that the language in the business income definition originated with pre-UDITPA SBE case law (*Hoechst Celanese Corporation v. FTB* (2001) 25 Cal. 4th 508 at 523-524), and notes with deference that the SBE has thoroughly considered the business income issue, reached a reasonable conclusion, and consistently applied this conclusion for the last 24 years.

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- The Court's decision puts to rest several arguments advanced by taxpayers in attempts to limit the scope of the business income definition.
- It specifically repudiates the definition of business income that other states such as North Carolina and Pennsylvania have adopted.

Celanese affirmed the department's position that the definition of business income contained two separate tests for business income, the transactional test and the functional test.

The following discusses various SBE decisions that help define the two specific tests – the transactional test and the functional test.

Transactional Test:

The relevant inquiry under the transactional test is whether the transaction or activity that gave rise to the income occurred in the regular course of the taxpayer's trade or business. If so, it is business income. For example, income from sales of inventory arises from transactions occurring in the regular course of a taxpayer's trade or business, and is therefore business income. Likewise, fee income received by a consulting firm for the performance of consulting services would be business income under the transactional test. The application of the transactional test to a less obvious situation can be found in the following SBE decision:

In the *Appeal of General Dynamics Corporation*, Cal. St. Bd. of Equal., June 3, 1975, Opinion on Rehearing Sept. 17, 1975, the taxpayer was in the business of buying and reselling aircraft. In 1959, the taxpayer purchased seven aircraft from two airlines for a price that was contingent upon the amount of proceeds received from the resale of the aircraft. The taxpayer resold the aircraft in 1960 and received installment obligations for part of the sales price. The buyer subsequently defaulted on the installment obligations, and entered into various refinancing arrangements with the taxpayer. In connection with the refinancing, the taxpayer received 1 million shares of the buyer's stock in 1963, but the agreement provided that the shares could only be sold with the approval of the buyer's management, and only in conjunction with a bona-fide public offering. When a public offering was proposed in 1967, the buyer permitted the taxpayer to sell its shares for a net gain. Pursuant to the terms of the contract with the airlines, the gain from the sale of the stock was treated as proceeds from the sale of the aircraft and the final purchase price paid to the airlines for the aircraft was adjusted to reflect that gain.

The taxpayer treated the gain from the sale of stock as nonbusiness income, claiming that when it received the stock the transaction was transformed into an investment. The SBE disagreed, pointing out that the acquisition, retention, and disposition of the stock were inextricably entwined with the transactions involving the purchase and sale of the seven aircraft. Because there was no question that the purchase and sale of the aircraft arose in the ordinary course of the taxpayer's business, the

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entire amount of income from the transactions, including the gain from the sale of stock, must be considered business income.

Functional Test:

Because the transactional test requires that the income be derived from transactions occurring in the regular course of the taxpayer's trade or business, it may not extend business treatment to income that is integrally related to the trade or business, but that arises from occasional or extraordinary transactions. Under the functional test however, all income from property is considered business income if the acquisition, management, and disposition of the property was an integral part of the taxpayer's regular business operations. For example, assume that a manufacturer sells equipment that was used in its production process. Because the manufacturer does not regularly sell its equipment, the transaction did not occur in the regular trade or business activity. The transactional test is therefore not met. Because the equipment was used as an integral part of the unitary business activity however, the functional test is met. The income from the sale of the equipment is business income.

In the *Appeal of Borden*, Inc., Cal. St. Bd. of Equal., February 3, 1977, the taxpayer sold all of the tangible and intangible assets of its western district operations. The sale resulted in a $12.8 million loss that was attributable to the western district's goodwill. The taxpayer treated the loss as nonbusiness, allocable entirely to California. Its first argument was that the test for determining business income required that the transactions be incurred in the regular course of the trade or business. The SBE dismissed this argument by confirming that there are two alternative tests for determining business income, and that the functional test may be applied even if the transactional test is not met.

The taxpayer then argued that the loss did not meet the functional test. Furthermore, it claimed that because no depreciation or other goodwill-related deductions had been charged against business income, the loss from the sale of goodwill should also not be considered to be business income. The SBE found that goodwill was undeniably an important asset of the business and contributed materially to the production of business income. Because the goodwill was acquired and maintained in furtherance of the unitary business activity, the loss on the sale should be treated as business income regardless of whether deductions relating to the goodwill had been claimed.

The long-standing view of the FTB and the SBE is that the transactional test and the functional test are two alternative tests, the satisfaction of either one of which will result in a determination of business income (*Appeal of DPF Inc*., Cal. St. Bd. of Equal., October 28, 1980; *Appeal of Borden, Inc*., Cal. St. Bd. of Equal., February 3, 1977). The California courts had not squarely addressed this point until the decision in *Times-Mirror Co. v. Franchise Tax Board* (1980) 102 Cal.App.3d 872, where the court clearly found the sale of stock of a unitary subsidiary to be business income under a

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functional test. (A transactional test would not have resulted in the same conclusion because the sale of a subsidiary was not a transaction in the regular trade or business of the taxpayer.)

CAUTION: The current definitions of business and nonbusiness income are UDITPA concepts. Prior to UDITPA (taxable years beginning before December 31, 1966), the term "unitary income" was used to describe the income to be apportioned by formula. Although the UDITPA definition was patterned after definitions of "unitary income" formulated in SBE cases such as *Appeal of Houghton Mifflin Company*, Cal. St. Bd. of Equal., March 28, 1946 and *National Cylinder Gas Co*., Cal. St. Bd. of Equal., February 5, 1957, the conceptual differences between unitary income and business income sometimes produce different results. Some pre-UDITPA SBE cases have reached results that may be contrary to the results that would be reached under current law, particularly with respect to the treatment of dividends and gain or loss from sales of stock. Consequently, auditors should be very wary of relying upon pre-UDITPA cases to support a determination of business or nonbusiness treatment of income.

Specific techniques for identifying nonbusiness issues will vary for the various types of income. In general however, auditors can often spot potential nonbusiness items during the normal audit procedures simply by being alert to activities or income items that seem unusual or unrelated to the taxpayer's trade or business. Some of the best sources for identifying such income or activities are the annual reports, SEC Form 10K's, corporate minutes, "other income" detail to the Form 1120, and Schedule D of the Form 1120.

A nonbusiness determination is based upon the facts of each particular taxpayer. When examining a nonbusiness issue, auditors should therefore develop as many facts as possible to portray a complete picture of the relationship between the nonbusiness activity and the unitary trade or business. Questions should be asked to discover why the property or activity was acquired, how it was related to the unitary business, and whether that relationship changed over the years.

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4012 Earmarking

As MATM 4010 points out, under the functional test, income from property is considered business income if the acquisition, management, and disposition of the property is an integral part of the taxpayer's regular business operations. In many instances where large amounts of liquid assets are involved it can be difficult for the auditor to determine whether the income derived from such funds qualifies as business income under the functional test or, alternatively, whether the income qualifies as nonbusiness income. As mentioned in MATM 4025, in *Appeal of Cullinet Software, Inc*., 95-SBE-002, May 4, 1995, the SBE held that funds set aside, "earmarked," for a nonbusiness purpose ordinarily generate nonbusiness income. It follows, then, that funds could also be "earmarked" for business purposes. (See CCR §25120(c)(3) Example (C), CCR §25120(c)(4) Example (B).)

From the taxpayer's point of view, the practical purpose of earmarking is to ensure that a source of funds will exist that can be used to pursue a specific endeavor. This endeavor can be either for a business or nonbusiness purpose. Accordingly, earmarking can be seen as a method by which specific funds are identified as those that are intended to be available to further either a future business purpose or a future nonbusiness purpose. The funds are "earmarked" so that they will not be used for other purposes.

A case in point is *Appeal of Consolidated Freightways, Inc*., 2000-SBE-001, September 14, 2000. In that case, the taxpayer sold a unitary subsidiary, invested the proceeds, and eventually classified the assets as long-term investments on its audited financial statements. The taxpayer claimed that it intended to use the funds to acquire another company in the same line of business in order to expand its share in the transportation service industry. Pursuant to its plans to reinvest the sales proceeds, the taxpayer employed a consulting firm to assist it in developing and implementing a redeployment plan. The taxpayer demonstrated that it did investigate several acquisition possibilities and began negotiations with several entities over the years. However, eight years passed before the taxpayer actually used the funds to make an acquisition. FTB took the position that the interest and dividend income earned from investing the funds were nonbusiness because the taxpayer held the funds for an extended period of time without earmarking them for a specific acquisition target.

The SBE found conclusively that the facts established that the taxpayer continuously looked for a complementary business and did ultimately acquire another company in the transportation service industry. The SBE found in favor of the taxpayer, stating that the facts supported a business income finding under the functional test.

The opinion outlines a two-pronged test for business income under the functional test: a working capital test and an earmarked for business purpose test. *Consolidated Freightways* did not meet the working capital test, but did satisfy the earmarked for a business purpose test. The taxpayer failed to meet the working capital test because the funds were well in excess of working capital needs. This

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was evidenced, among other things, by the taxpayer's transfer of these funds from short-term working capital accounts into longer-term investments, at which point, the funds were reported as "Other Assets" rather than "Current Assets." However, the taxpayer met the functional test because it showed that the long-term purpose for holding the funds was for a specific future expenditure or project, also known as "earmarking". In the SBE's opinion, it is not necessary to have a specific company targeted for acquisition for business income treatment, as long as the funds are readily available for the acquisition, the acquisition is in a specific line of business, and the taxpayer acts consistently with that purpose. Because the taxpayer was engaged in an active, ongoing effort to acquire a complementary business, the SBE found that to be strong evidence that the funds were earmarked for an acquisition target in the transportation industry.

The SBE's decision in *Consolidated Freightways* is consistent with the analysis utilized in FTB Legal Ruling 98-5. This case and FTB Legal Ruling 98-5 both emphasize that the relevant issue is not whether funds, in excess of ordinary business needs, are merely available for use, but whether these funds meet the transactional or functional tests of business income contained in R&TC §25120.

During audit fieldwork, it may be necessary to gather facts to determine whether certain funds have been earmarked. This is a "facts and circumstances" test, and the facts and circumstances of each case will control the result. However, overall guidance is warranted.

The examination should first focus upon whether the taxpayer has actually expressed an intent to pursue some future business or nonbusiness objective. Next, the auditor should determine whether the taxpayer specifically identified a source of funds that were to be used to achieve the future objective. Finally, depending upon the amount of time that has lapsed between the date when the taxpayer developed the objective and earmarked the necessary funds, the auditor should determine whether there is any evidence that shows that the taxpayer has taken affirmative steps to pursue its stated objective. If such steps cannot be identified, then the taxpayer has not acted consistently with the stated purpose and earmarking has not been established.

What follows are examples of the types of evidence that may indicate that the taxpayer has earmarked funds for a specific objective. Because, as mentioned above, the facts and circumstances surrounding each case will control, these examples should not be considered all inclusive. Other types of evidence, as noted in MATM 4025, may exist, and these examples are only being provided as guidelines.

Intent to pursue future business or nonbusiness objective: When reviewing the minutes of the board of directors meetings and internal correspondence, take note of discussions involving specific future projects. These will serve as evidence of the taxpayer's intent to pursue the stated objective.

Specific identification of funds: Placing funds in a separate account and identifying that account as the source of funds that will be used to achieve the future objective qualifies as earmarking. In

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addition to this, the taxpayer may reserve a specific portion from an existing pool of funds to be used to achieve the objective. For instance, assume that the taxpayer has a $10 million certificate of deposit: If an internal memorandum states that $5 million from this CD will be used toward a project, then the funds can be considered as being earmarked even though they have not been placed in a separate account.

Affirmative steps to achieve objective: This will depend upon the type of future endeavor the taxpayer has identified. For example, if the taxpayer has indicated that it wants to construct a new facility, assess whether the taxpayer has begun to identify sites for its new facility. If the taxpayer has indicated that it wants to develop a new product or service, assess whether the taxpayer has commenced the appropriate steps to achieve this objective.

To reiterate, these are merely examples that are intended to be illustrative rather than exhaustive. The types of evidence that the auditor will need to gather will depend on the specific identified project. For additional guidance and a more detailed list of potential audit steps, please refer to FTB Legal Ruling 98-5 and MATM 4025.

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4013 Tax-Motivated Investment Vehicles

A tax-motivated investment involves the acquisition of property or property rights that generate tax benefits for the taxpayer. The tax benefits, rather than the use of the property, are the primary reason for the investment. Hence, the underlying property or property rights are not used or expected to be used in the unitary business, or in any other trade or business of the taxpayer. The leased computers in *Appeal of Fairmont Hotel Co*., Cal. St. Bd. of Equal., June 29, 1995, are an example of a tax-motivated investment. As demonstrated in *Fairmont*, taxpayers will often seek business treatment of these losses. Auditors who encounter this issue may be required to make a determination as to the proper business/nonbusiness income treatment of losses generated by these tax-motivated investments.

In *Fairmont*, a taxpayer that was in the business of managing hotels purchased computer equipment subject to pre-existing triple net leases. Pursuant to the leases, the taxpayer received net rentals in excess of the debt service that, together with investment tax credits and depreciation deductions yielded a significant after-tax cash flow. These were passive investments and the taxpayer had no role in negotiating or administering the leases. The purpose for buying the leased computers was to generate working capital, and the funds thus generated were actually used to finance the operations of the unitary hotel business during the appeal years. The Board held that the computers served an investment function and not an operational function. According to the Board, if it followed the taxpayer's rationale, then income from virtually any investment would be classified as business income if the proceeds from the investment were put to use in the apportioning business. As the Board explained, that theory had essentially been rejected in *Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159, at 166 [103 S. Ct. 2933, 77 L. Ed. 2d 545], because “a mere flow of funds arising out of a passive investment or a distinct business operation” is not sufficient to constitute a unitary business activity. The Board held that this principle was further supported by *Allied-Signal, Inc. v. Director, Division of Taxation (New Jersey)* (1992) 504 U.S. 768, at 787 [112 S. Ct. 2251, 119 L. Ed. 2d 533], in which the U.S. Supreme Court held that an asset must serve an operational function, as opposed to an investment function, in order to be considered part of the unitary business.

The *Fairmont* decision will generally control when a taxpayer seeks business income treatment for a tax-motivated investment vehicle. However, taxpayers may argue that business income treatment is appropriate in circumstances that appear to fall outside of the parameters of the Fairmont holding. Taxpayers may attempt to demonstrate that the tax-motivated investment generated short-term cash flow for the apportioning trade or business. In that case, the auditor should consider all items that affect short-term cash flow, taking into account cash outflow related to the investment, debt acquisition, and debt service. A cash flow analysis is not likely to show that a taxpayer’s “working capital” was significantly enhanced by a tax motivated transaction, as that transaction is more likely to consume liquidity and cash position than create it.

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To illustrate, taking on debt to acquire an asset in a tax motivated transaction may create some cash flow from tax savings; however, the debt is usually much greater than the tax savings generated in the year of acquisition. For example, assume a taxpayer borrows $1000 to acquire an asset in a tax-motivated transaction that generates a $200 tax deduction. Assume that the combined state and federal tax savings attributable to the deduction is approximately $100. If the taxpayer needed $100 in cash flow, it need have borrowed only $100, not $1000. Thus, the primary function of the debt is to acquire an asset, not to generate cash flow. In addition, borrowing $1000 will significantly adversely affect a taxpayer's borrowing capacity, when compared to a $100 loan. Thus, the acquisition of such debt may actually weaken the taxpayer's net capacity to obtain needed cash flow. On the other hand, if the taxpayer spends $1000 in cash to acquire the asset without incurring debt, it obviously had more than $100 in cash liquidity in the first place.

Thus, tax savings cash flow from such an investment is much closer by analogy to income received from a nonbusiness investment that is later applied to business use. Mere flow of funds from a nonbusiness asset into an apportioning trade or business does not convert the asset into a business asset (Container Corp. of America v. Franchise Tax Board (1983) 463 U.S. 159; Fairmont, supra.)

Taxpayers also may assert that both the cash flow from the tax-motivated investment and the underlying principal of the investment was intended for future business use. In that case, the auditor should develop information to determine that both the cash flow from the tax motivated investment and recovery of the value of the principal amount of the investment were used in furtherance of the apportioning trade or business. To constitute a business asset, the asset must constitute an integral part of the taxpayer's apportioning trade or business (R&TC Section 25120(a), *Hoechst Celanese v. Franchise Tax Board* (2001) 25 Cal. 4th 508) and must serve an operational function rather than an investment function (*Allied-Signal v. Director, Div. of Taxation* (1992) 504 U.S. 768.

Out-of-state cases: Some taxpayers have cited one or more of the following out of state appellate court decisions in attempting to secure business income treatment of tax benefit generating investments:

Case #1: *National Service Industries, Inc. v. North Carolina*, (1990) 98 N.C. App. 504. Taxpayer entered into "safe harbor leases" (as defined in Internal Revenue Code section 168(f)(8)) and treated the attendant losses as business income. The North Carolina Court of Appeals agreed with taxpayer, placing significance on the fact that the investment generated cash flow for business operations, and giving weight to the fact that the investments represented a large portion of the taxpayer's net worth.

Case #2: *Eastman Kodak v. South Carolina*, (1992) 308 S.C. 415. Taxpayer entered into "safe harbor lease" and treated the attendant losses as business income. The losses resulted in tax savings. The South Carolina Supreme Court ruled in taxpayer's favor, holding that the magnitude

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and frequency of the various lease transactions indicated that they were related to the apportioning business, and giving weight to the fact that the funds used to acquire the leases came from the corporate treasury and that no separate staff supervised the investments.

Case #3: *Kewanee Industries, Inc. v. New Mexico*, (1993) 114 N.M. 784. Taxpayer leased equipment to an affiliated party. Due to the depreciation expense deduction, the transaction generated net losses that resulted in tax savings. Ultimately, the New Mexico Supreme Court found the leases to be part of the unitary business because they generated substantial capital for the unitary business enterprise. Furthermore, the court found it significant that the leases were ongoing and recurring transactions.

The three cases discussed above are not controlling for California purposes, for three reasons. First, they are out-of-state cases, and thus are not binding authority. Second, two of the three cases (*National Service Industries* and *Eastman Kodak*) deal with safe harbor leases. Safe harbor leases are investment vehicles that are not recognized under California law, and most safe harbor lease transactions permitted essentially a "sale" of tax benefits, without significant risk or economic reality. Finally, the cases are conceptually flawed, because they are based in part on the magnitude and/or the frequency of the transactions in question. These considerations are not the proper focus of inquiry under the transactional or functional tests of UDITPA, nor would an analysis based on them pass constitutional muster under *Allied Signal*. (*Allied-Signal Inc. v. New Jersey* (1992) 119 L.Ed.2d 533, 550.) The fact that acquisitions occur with some frequency or are large in size does not by itself establish that the assets are acquired in the regular course of the taxpayer's apportioning trade or business, or are integral parts of the taxpayer's apportioning trade or business within the meaning of R&TC Section 25120(a).

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4015 CONVERSION FROM BUSINESS TO NONBUSINESS INCOME

Items of income may, over time or because of changed circumstances, change their character between business and nonbusiness. The types of income that are most likely to change character are rental income and gains and losses from sales of assets. CCR §25120(c)(1) indicates that rental income from real and tangible personal property is business income when the property is includable in the property factor. CCR §25120(c)(2) provides that gain or loss from sales of real or tangible or intangible personal property will be nonbusiness if the property was used for the production of nonbusiness income or otherwise was removed from the property factor before its sale. The reference to the property factor in both of these rules has been interpreted by the SBE to imply that the rules for exclusion of property from the property factor can serve as a guide for determining when income related to that property is nonbusiness.

CCR §25129(b) provides that property is includable in the property factor if it is actually used or is available for or capable of being used during the taxable year in the regular course of the trade or business. Once property is used in the trade or business, it remains in the property factor until its permanent withdrawal is established by an identifiable event. Property that is temporarily idle is still available for use, as is property that is being held for sale. If idle property held for sale has not been sold after an extended period of time (the regulations suggest five years), then it will be removed from the property factor. (See MATM 7140 for further discussion of these concepts.)

CCR §25120(c)(1) contains the following examples of when property converts from business to nonbusiness use:

Example
The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example
The taxpayer operates a multistate chain of grocery stores. It owned an office building that it occupied as its corporate headquarters. Because of inadequate space, the taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, the taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

The following cases also help to illustrate the criteria that is relevant for determining whether business property has been converted to nonbusiness use:

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In the *Appeal of Ethyl Corporation*, Cal. St. Bd. of Equal., March 18, 1975, the taxpayer sold a plant that had been idle and partially dismantled for a period of time. The SBE first addressed the issue of whether the plant was properly includable in the property factor prior to its sale. Although it would only have been economically feasible to resume operations at the plant under certain unusual conditions, the fact remained that the plant was available for limited use in the unitary business, and was capable of such use. Therefore, the SBE held that it was includable in the property factor.

In addressing the issue of whether the gain from the sale of the plant was business or nonbusiness income, the SBE referred to its analysis of the property factor issue and concluded that since the plant had not been permanently withdrawn from unitary use, the gain was unitary business income.

Although this was a pre-UDITPA case, the same conclusions would be applicable under current law.

In the *Appeal of Thor Power Tool Company*, Cal. St. Bd. of Equal., April 8, 1980, the taxpayer closed one of its manufacturing plants and then held the property for sale. Since the building was deteriorated, the taxpayer demolished it to facilitate the sale of the land. The land was sold in the following year at a gain. The taxpayer argued that the gain should be treated as business income, but the FTB determined that the property had been converted to nonbusiness use when the plant was demolished.

The SBE agreed with the taxpayer, stating that the land and building had been consistently used in the taxpayer's trade or business from the time of acquisition, and although the building had been demolished, the land could still have been put to use in the unitary business. The SBE pointed out that they did not consider the examples in the regulations of identifiable events sufficient to cause property to be permanently withdrawn from the property factor to be all-inclusive. Nevertheless, they did not conclude that an identifiable event of the type contemplated by the regulations had occurred with respect to the land prior to its sale.

The *Appeal of Nicholas Turkey Breeding Farms, Inc*., Cal. St. Bd. of Equal., May 7, 1987, involved whether income received from the rental and sale of former turkey farms was nonbusiness. The taxpayer was engaged in the turkey breeding business in California and South Carolina that involved the sale of eggs and the "growing out" of surplus stock for meat. Its four South Carolina farms had been operated as part of the business until operations were terminated due to ineradicable diseases that were affecting the production. The taxpayer moved the salvageable portions of those operations to California and leased the four farms to third parties, who used them to raise turkeys for meat. Each lease gave the lessee an option to purchase the property, and each option was eventually exercised. The taxpayer treated the rental income and the gains from the sale of the farms as nonbusiness on the theory that the leases had converted the farms into nonbusiness assets.

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The SBE agreed with this treatment, holding that the farms began producing nonbusiness income when they were leased out to other parties, and that they should have been withdrawn from the property factor at that time. The disease had made the farms unusable for producing eggs, the taxpayer's principal product. Although meat production was still possible, the SBE stated that the property must be usable by the *taxpayer* in its own trade or business. When the farms were leased to third parties, they were no longer available for use in the taxpayer's turkey breeding business, and their permanent withdrawal from the business was established.

In *Appeal of Masonite Corporation*, Cal. St. Bd. of Equal., March 3, 1987; Opinion and Order Denying Petition for Rehearing, 11/15/88, the issue was whether income received by the taxpayer from production of oil on its timberlands constituted business income. The taxpayer was engaged in the unitary business of manufacturing and selling building materials, primarily hardboard. It owned large tracts of timberland for the purpose of having a secure source of raw wood materials for its business. Oil was discovered on some of those timberlands, and the taxpayer derived royalty income from its producing mineral rights. The taxpayer treated the royalty income as nonbusiness, arguing that it was unrelated to its unitary hardboard business.

The SBE agreed with the nonbusiness treatment, pointing out that although the oil royalty income had its source in timberlands originally purchased for future use in the unitary business, the crucial factor was that the income was generated through operations conducted entirely independently of the unitary business. Another factor supporting the SBE's conclusion was the fact that each oil well rendered approximately three acres of surrounding land unsuitable for timber production. Those portions of land ceased to be unitary assets when they were converted to the nonbusiness production of oil, and should have been removed from the property factor at that time.

The SBE also rejected the FTB's argument that the royalties were incidental to the unitary business and should therefore be treated as business income. Since the income was classifiable as nonbusiness income under the statutory tests, and since there was no problem with segregating the oil royalties and factors from the income and factors of the unitary business, the SBE concluded that the royalties could only be classified as nonbusiness income.

The *Appeal of Trus-Joist Corporation*, Cal. St. Bd. of Equal., August 1, 1984 also deals with the issue of business property which had been converted to nonbusiness use. In that case, the nonbusiness use consisted of a series of sub-leases.

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4020 DIVIDEND INCOME

R&TC Section 25126 provides that nonbusiness dividend income is allocated to the state of the taxpayer's commercial domicile (see MATM 1500 for the definition of commercial domicile).

The classification of dividend income as business or nonbusiness is discussed in CCR §25120(c)(4). Applying the transactional and functional tests (MATM 4010) to dividend income, dividends will be business income when (1) the stock was acquired in the regular course of the taxpayer's trade or business operations, or (2) the purpose for acquiring and holding the stock is integrally related to the trade or business operations (see *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal. 4th 508, cert. den. November 26, 2001; *Allied-Signal, Inc*. (1992) 504 U.S. 768).

Under these guidelines, dividends will clearly be considered business income when the stock from which those dividends are derived is held in the ordinary course of business, such as by a stockbroker. Dividends may also be business income if they are derived from stock held as current assets or excess working capital (for an analysis of this point in the context of interest, see MATM 4025). Additionally, dividends have been considered to be business income when the stock is held for a purpose that furthers the unitary business operations, such as when stock of a supplier is held to ensure a steady source of raw materials (*Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., March 2, 1983). Another example is where stock is held to further a technical service agreement that plays an operational function in the taxpayer's trade or business. Nonbusiness treatment of dividends is generally warranted only when the stock is held as an investment unrelated to the unitary trade or business activities. CCR §25120(c)(4) contains several examples illustrating when dividends may be considered business or nonbusiness income.

CAUTION: CCR §25120(c)(4) was amended in 1987 to reflect the current dividend treatment. Prior to that date, the regulation had essentially limited the business treatment of dividends to dealers in stocks and securities based upon pre-UDITPA case law. That historic classification was based upon the premise that the source of the dividend income is the shares of stock and the situs of such stock is traditionally the commercial domicile of the investing corporation (*Southern Pacific Co. v. McColgan* (1945) 68 Cal. App. 2d 48). In *Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., March 2, 1983, the SBE ruled that the transactional and functional tests implicit in R&TC §25120 were applicable to the business/nonbusiness classification of dividends, and that the (former) FTB regulations were invalid because they were contrary to those statutory tests. ***As a result of this decision, auditors should not rely on pre-UDITPA case law regarding the inclusion of dividends in business income, or on the former FTB CCR §25120(c)(4) prior to the 1987 amendment.***

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The following decisions illustrate the analysis used to determine whether dividends are business or nonbusiness income. Because this issue is very similar to the issue of whether gain or loss from the sale of stock is business income, the cases discussed in MATM 4030 may also be applicable.

In *Appeal of Standard Oil Company of California*, Cal. St. Bd. of Equal., March 2, 1983, the SBE held that dividends received by the taxpayer and its subsidiaries from affiliated joint venture corporations were business income. The taxpayer was an integrated oil company engaged in all aspects of the petroleum business throughout the world. It owned 30 percent of the stock of Aramco, which held and operated major oil producing fields in Saudi Arabia; and 50 percent of the stock of CPI, which held and operated major oil producing fields in Indonesia. The taxpayer's equity interests in Aramco and CPI entitled it to a share of the production from those ventures. For the year at issue, 52 percent of the taxpayer's worldwide supply of crude oil and natural gas came from its Aramco and CPI entitlements.

The taxpayer received dividends from Aramco and CPI, which it treated as business income. The SBE upheld this treatment, concluding that the dividends met the functional test. The purpose for creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to insure an available supply of crude oil and natural gas. This was an essential element in the taxpayer's worldwide petroleum operations. The dividends were therefore found to be business income.

In *Appeal of Twentieth Century-Fox Film Corporation*, Cal. St. Bd. of Equal., March 2, 1989, the SBE interpreted and applied FTB's current CCR §25120(c)(4) and concluded that dividends received by the taxpayer were nonbusiness income. The taxpayer, a major producer and distributor of motion pictures and television programs, acquired a regional soft drink bottler. The taxpayer had originally filed a combined report which included the soft drink bottler, and which reflected the elimination of a dividend received from the soft drink bottler pursuant to R&TC §25106. As a result of a determination by the SBE that the soft drink bottler was not unitary with the taxpayer, the corporations were decombined, and the dividend was no longer eliminated. The taxpayer's alternative argument was that the dividend should be treated as business income based upon its interpretation of the functional test. The taxpayer advocated the position that the functional test was met so long as it became involved in the activities of the dividend-paying subsidiaries in ways that went significantly beyond what an ordinary investor would do.

The SBE rejected the taxpayer's interpretation of the functional test as far too broad. The SBE went on to state that the proper test was whether there is an integral relationship between the stockholding and the taxpayer's trade or business. In this case, the SBE found no evidence that the soft drink bottler was acquired and managed as anything more than an investment, and specifically noted that the mere flow of funds between the entities was not sufficient to make the stock integrally related to the taxpayer's trade or business. The dividends were determined to be nonbusiness.

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In *F.W. Woolworth Co. v. New Mexico* (1982) 458 U.S. 354, the U.S. Supreme Court stated that the mere potential to operate a company as part of a unitary business will not necessarily result in the business characterization of the dividends if the company is in fact operated as an unrelated business enterprise. In *Allied Signal v. Director, Division of Taxation* (1992) U.S. [112 S. Ct. 2251], however, the U.S. Supreme Court clarified that the payee and payor of a dividend need not be engaged in the same unitary business as a prerequisite to apportionment of the dividend income in all cases, so long as the holding of the stock served an operational rather than an investment function. Restating its previous position, the Court stated that in order to exclude certain income from the apportionment formula, the taxpayer must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state (*Exxon Corp. v. Wisconsin Dept. of Revenue* (1980) 447 U.S. 207; *Mobil Oil Corp. v. Commissioner of Taxes* (1980) 445 U.S. 425).

Identifying nonbusiness dividend issues:
When analyzing the Federal Form 1120 Schedule C to determine the appropriate California dividend deductions (see MATM 6030 - MATM 6036), the auditor should consider the nature or character of the dividends and the purpose of the stockholdings in order to determine whether a possible nonbusiness issue exists.

In those situations where business income characterization is based on the business purpose of the stockholding, the business purpose will need to be established. All facts supporting the business relationship between the payee and payor must be developed at audit. Many of the techniques discussed in MATM 3500 - MATM 3595 with respect to developing facts related to unitary relationships may be applicable for developing this issue as well.

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4025 INTEREST INCOME

R&TC Section 25126 provides that nonbusiness interest income is allocated to the state of the taxpayer's commercial domicile (see MATM 1500 for the definition of commercial domicile).

The classification of interest income as business or nonbusiness is discussed in CCR §25120(c)(3). The regulation states that interest income will be business income where the intangible, which generated the interest, was received or was created in the regular course of the taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangible is related to or incidental to the trade or business operations.

One of the keys to determining the proper classification of interest income is understanding that the controlling factor is *the purpose for which the interest-bearing fund is established or the use to which the fund or account is put*. If the fund is established for an identifiable business purpose, the source of the funds deposited into the interest-bearing account is irrelevant, as is the use to which the interest income is ultimately put.

Notes and accounts receivables from customers arise out of the regular trade or business operations, therefore interest income generated by those notes and receivables are business income. Many taxpayers will deposit funds into special accounts to cover items such as workers' compensation claims, self-insurance or machinery replacement. As long as the purpose for these funds is related to the trade or business activity, any interest or dividend income generated will be business income. Likewise, interest income earned from items such as federal tax refunds and court judgments arising from the business operations will be business income.

CCR §25120(c)(3) contains examples of the application of these concepts. The following decisions also illustrate how the SBE has distinguished between business and nonbusiness interest income.

In the *Appeal of Cullinet Software, Inc*., Cal. St. Bd. of Equal., May 4, 1995, the taxpayer was in the business of designing, developing, and marketing computer programs. The taxpayer made stock offerings that netted $15 million and $29 million, respectively. The purpose of the offerings was to "provide additional capital for the acquisition of companies and products in the systems and applications software markets or in markets complimentary [sic] to the Company's business." A short time after the offerings, substantially all the funds were contributed to separate subsidiaries. The offering prospectuses provided that, until the proceeds were utilized for their intended purpose, they would be invested in United States Government obligations, certificates of deposit, short-term commercial paper, and other liquid investments. Apparently, this is how the funds were invested for the years in question. Intercompany transactions involving one of the subsidiary's funds suggest that the funds were used as working capital during the appeal period.

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The taxpayer argued that the income from the funds must be classified as nonbusiness income because until the subsidiaries decided how to invest the funds, there was not a certainty that the funds would be used in the unitary business. The SBE disagreed, stating that "idle funds invested in liquid financial instruments are part of a unitary business's working capital pool, and thus generate business income, unless management segregates or earmarks the funds in such a way as to clearly establish that they were not being held readily available for use in the taxpayer's regular trade or business operations." In this case, there was no such segregation or earmarking, and it was clear that the proceeds from the stock offerings were, in fact, at all times held readily available for any use in the unitary business which might have arisen during the appeal years. The income earned on those investments, therefore, constituted business income.

When read on its facts, *Cullinet* is properly considered a burden of proof case. The Board specifically found that the taxpayer had earmarked the funds at issue to acquire companies and products similar or complementary to the taxpayer's unitary business. The Board found no evidence that the taxpayer acquired any companies or products with those funds, or that the taxpayer even investigated any such new purchases. Instead, the Board pointed out that (1) "intercompany transactions "suggested the funds contributed to one subsidiary were used as working capital, and (2) "no proof" was presented that the funds contributed to the other subsidiary were *not* used as working capital (in fact, the Board noted that "it is admitted that [the funds] were available for use in appellant's regular business operations, if and when needed"). The Board further stated that it had "great difficulty perceiving how a taxpayer could satisfy this burden of proof when it admits, as appellant does here, that a major reason for having the funds was to meet the future capital needs of its business."

As explained in Legal Ruling 98-5, some have interpreted the language used by the Board in *Cullinet* as creating an "available for use" test of business income. Any implication in *Cullinet* that a liquid asset produces business income merely because it has the potential to be used in the trade or business, however, is not consistent with the language of the statute or CCR §25120(c)(3) and (4), which for business treatment require that (a) the intangible with respect to which the interest or dividends was receive must have arisen out of or have been created in the regular course of the taxpayer's trade or business operations, or (b) must have had a purpose for acquiring and holding the intangible that is related to or incidental to the trade or business operations. Contrasting CCR §25120, subdivisions (c)(3) Example (A) (interest income from accounts receivable), Example (C) (interest from special accounts for insurance or machinery replacement, and (c)(4) Example (F) (portfolio of stock and interest-bearing securities unrelated to the unitary business) clearly demonstrates that the regulation contemplates the generation of business or nonbusiness income from liquid investments. Moreover, the broad proposition of an "available for business use" test in and of itself raises concerns under the "potentiality doctrine" of *F.W. Woolworth v. Taxation & Revenue Department* (1982) 458 U.S. 354, 362. Thus, there is no support in the statute, regulations, or case law for the proposition that funds, in merely being available for business use, should always be characterized as business income: Given the fungibility of money, funds available for business use are likewise available for nonbusiness use. Rather, the facts of a particular case ultimately control

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resolution of the question of how income should be properly characterized under either the functional or transactional tests for business income. Accordingly, auditors should analyze whether the funds are needed for the taxpayer's current business cycle needs or have been identified for future business needs. To the extent that funds can be identified as in excess of any business need or contingency, the functional and transactional tests of business income have not been satisfied. Thus, the income from such funds clearly is not business income.

Although the fact that a taxpayer holds funds in liquid investments available for use in the unitary business is an indication supporting business income treatment, the mere fact that the funds are available for use, in and of itself, is not a valid separate indication of business income supported by statute or regulation. For example, an auditor would be correct in classifying income as business income when the only known fact in a particular case is that the funds at issue were held in liquid investments. The burden of proof then would be on the taxpayer to provide additional information to substantiate nonbusiness treatment.

See Legal Ruling 98-5 for detailed discussion of this topic.

CCR §25120(a) provides, in part, that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Under California law, a presumption stands as proof of the presumed fact only until such time as sufficient contrary evidence is introduced to rebut the presumption, at which time the presumption "disappears." In other words, the regulatory presumption does not end the inquiry, but serves to determine which party has the burden of proof to introduce evidence in support of its position. Once this has been done, the burden of proof shifts again. Once all evidence has been gathered, the State Board of Equalization or the courts must weigh the totality of the evidence and come to a conclusion. See Evid. Code § 604, subd. (a), or *Appeal of Sierra Production Services*, 90-SBE-010, Sept. 12, 1990, for additional discussion of the presumption.

In the *Appeal of Beck Industries*, Inc., Cal. St. Bd. of Equal., November 17, 1982, the issue was whether interest income from certificates of deposit (CDs) had been properly treated by the taxpayer as nonbusiness income. The taxpayer was primarily engaged in the manufacture and retail sale of shoes, apparel and furniture, and the operation of discount department stores. Pursuant to bankruptcy proceedings, the taxpayer had received substantial sums of cash from the sale of subsidiary stock and from the sale of discontinued business interests. The Bankruptcy Court had directed that the funds be segregated pending a determination by the court regarding the feasibility of reorganizing the taxpayer. The segregated funds were invested in CDs, the interest income from which was treated as nonbusiness by the taxpayer.

The FTB auditor reclassified the interest as business income. This position was based on the fact that the funds were segregated and invested at the direction of the Bankruptcy Court, and the purpose of the bankruptcy proceedings was to enable the corporation to continue its operations

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through rehabilitation of its affairs under the scrutiny and direction of the court. The SBE agreed with this basic premise, but noted that the conclusion of business income did not necessarily follow.

The SBE ruled that the FTB's position was erroneous in that it focused upon the relationship of the CDs with the taxpayer's corporate existence. The proper criteria for determining the business or nonbusiness character of the income was held to be the relationship between the CDs and the taxpayer's particular trade or business activity. Because the purpose for acquiring and holding the CDs had no relationship to the manufacturing and retail business, the interest there from was held to be nonbusiness income.

The *Appeal of American Medical Buildings*, *Inc*., Cal. St. Bd. of Equal., June 10, 1986 involved the classification of interest income from investments in marketable securities by a taxpayer engaged in the design, construction, and development of medical buildings. The taxpayer had raised $3.3 million through sale of its common stock: $2.2 million of these proceeds were invested in short-term investments pending a decision as to how the funds should be used. The following year, the taxpayer made a $10 million public bond offering, the stated purpose of which was to fund a wholly owned finance subsidiary to make loans to construct the medical buildings developed by the taxpayer. Over $8 million of these proceeds were distributed to the subsidiary. During the taxable years at issue, both the parent and subsidiary had invested their proceeds in marketable securities.

The taxpayer had treated the interest income from its investments in marketable securities as nonbusiness on the grounds that the sale of the stock and the issuance of the bonds was unrelated to the development of medical buildings. The SBE rejected this argument, stating that the relevant inquiry was whether the transactional or functional tests had been met. The finance subsidiary had been formed to benefit the unitary business during a time of rising interest rates by supplementing or replacing the traditional funding of the construction projects. Therefore, the SBE found that the acquisition of the capital was very much related to the unitary construction business. Additionally, the funds were managed in a way that benefited the unitary business because they were invested in short-term securities, which made them easily accessible for distribution as loans if needed. The readily available funds could also have given the sales staff leverage over a balking customer by allowing them to offer less expensive financing for new projects. Because the purpose for acquiring and holding the intangibles was related to the trade or business, the SBE concluded that the interest was business income.

In the *Appeal of Inco Express, Inc*., Cal. St. Bd. of Equal., March 3, 1987, the taxpayer had been retaining its earnings so that it would not need to borrow money at high interest rates, and also because it intended to eventually purchase land for expansion of the business. The cash was invested in short-term certificates of deposit when it was not being used in the business. During the taxable year at issue, the taxpayer purchased land using the cash that it had accumulated, and the land was treated as nonbusiness because it was not yet ready to be used in the unitary trade or business. The taxpayer also treated the interest income earned from its short-term investments as

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nonbusiness on the grounds that it had been earmarked for the purchase of a nonbusiness asset, and was in fact used for that reason.

The SBE rejected the taxpayer's argument, stating that the relevant inquiry was not what was purchased with the income, but whether the intangible that created the income was related to the taxpayer's unitary business. Short-term investments made to maximize the income of what would otherwise be idle funds are prudent and customary corporate money management. The SBE found that this taxpayer's investments arose in the regular course of its business, and were acquired, managed, and disposed of as integral parts of the regular business operations. Therefore, the interest generated from those investments was ruled to be business income.

In the *Appeal of R.H. Macy & Co., Inc*., Cal. St. Bd. of Equal., July 26, 1988, the taxpayer earned substantial amounts of interest income from a variety of short-term securities. The amount of money invested varied throughout the year depending upon the seasonal cash needs of the taxpayer's department store business. When cash needs increased, the taxpayer would sell sufficient securities to provide the needed cash. The taxpayer treated the interest from those investments as nonbusiness on the basis that the cash reserves were due to management's investment philosophy rather than due to the needs of the business because it easily could have borrowed the money to meet seasonal cash flow needs. The SBE interpreted this argument to imply that, absent an absolute business necessity, funds invested outside the taxpayer's business pending their use in the business do not produce business income. The SBE rejected this argument, stating that both the transactional and functional tests had been met, and there is no basis for a different result based on whether the investments are made because of business necessity or investment philosophy. The interest was found to be business income.

The *Appeal of Armour Oil Company*, Cal. St. Bd. of Equal., June 10, 1986, also deals with nonbusiness treatment of interest income in a case in which the taxpayer failed to prove a business connection with the payor of the interest.

Working capital vs. nonbusiness investment:
Investment of temporarily idle cash in marketable securities or other liquid investments will result in business interest income when the purpose of the investments is to maximize income pending the use of the cash in the unitary business (see *Appeals of American Medical Buildings, Inco Express, and R.H. Macy & Co.*, above). Occasionally, taxpayers will claim nonbusiness treatment for interest or dividend income arising from investments of surplus cash that arguably exceed their expected business cash requirements. As stated in CCR §25120(a), income is business income unless clearly classifiable as nonbusiness income. Therefore, taxpayers should be asked to substantiate the nonbusiness portion of their investments. An analysis of the working capital requirements of the business will usually need to be performed to evaluate how much of the interest-producing intangibles are reasonably necessary to meet business needs in the near future.

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The "Bardahl" formula originally developed in *Bardahl Mfg. Corp*. (24 TCM 1030) is one method for computing working capital requirements that also takes into account any anticipated extraordinary operating expenses. An example of this formula can be found in Federal CCH Explanation ¶23074.0154, and a set of standard audit schedules that perform this calculation is available on PASS. When applying this formula, auditors need to be careful not to overlook business reasons for accumulating cash in excess of the normal working capital needs for the operating cycle. For example, a computer manufacturer may accumulate earnings over several years to have the cash necessary when the time comes to launch a new generation of computers. Taxpayers may also accumulate funds to pay anticipated court awards, for business expansion, and for various other reasons.

Once the scoping process is completed and a commitment has been made to audit the issue, numerous areas can be explored to develop the facts of a particular case.

HOW DID TAXPAYER FILE

The fact gathering process should include an explanation from the taxpayer regarding why the return was filed in the manner reported. In some cases, this explanation could provide significant insight into the taxpayer's reasoning for treating the income in the manner reported and might dictate a different approach to the fact gathering process than originally planned. For example, an admission by the taxpayer that the funds are for business needs but were reported as nonbusiness because State X required that they be reported in this manner could eliminate a substantial amount of audit work, simply because such an admission per se is strong evidence of the correct characterization of the funds under examination.

REASONABLE NEEDS OF THE BUSINESS: EARMARKING OF FUNDS

To classify income as business income, the capital requirements of funds invested in liquid assets should be for the reasonable needs of the business, taking into account both current and future business needs.

In addition, a taxpayer's substantiated specific earmarking of funds for a specific purpose, in most cases, will be controlling in determining business or nonbusiness income. An absence of earmarking of funds, however, is not the sole criteria for determination.

Suggested auditor approach:

1. Ask the taxpayer to substantiate earmarking of funds; however, factual gathering should not be limited solely to this item.
2. Obtain cash forecast projections from the treasury department.

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3. Interview appropriate people handling cash forecasts.
4. Conduct a financial statement analysis using the Bardahl formula.
5. Review cash needs for dividend purposes. Historical payment of dividends might be used to determine potential for current dividend needs.
6. Review corporate minutes, including the Board of Director's minutes, committee minutes, and any other director committee minutes dealing with finance and budgeting.
7. Review long- and short-term business plans.
8. Analyze capital structure to determine how the business is funding its operations.
9. Review annual reports and SEC 10-Ks, including footnotes and management discussion of operations, which may disclose restricted retained earnings and contingent liabilities.
10. Review loan documents that may provide restrictions or covenants, such as a requirement that the working capital ratio never go below two to one.
11. Review all SEC filings.
12. Review prospectuses for any public offering or debt.
13. Review news articles that may identify leads on future expansion, research and development costs, marketing cost, liabilities, etc.

Once this information has been gathered and evaluated, the Bardahl schedules may be used to determine whether excess working capital exists. The result of the Bardahl formula should not be thought of as the "correct" answer, however. The Bardahl formula may not work for all industries or taxpayers. Either the auditor or the taxpayer may use more sophisticated financial analysis to prove excess working capital. The key issue is one of substantiation. For example, assume the taxpayer alleges that it properly classified income as nonbusiness income because the fund generating the income was excess working capital not needed in the unitary business. The auditor computes the Bardahl formula and determines that the taxpayer does not have excess working capital. The auditor can provide the Bardahl computation to the taxpayer and request the taxpayer to provide some other evidence of the amount, if any, of excess working capital. The auditor must evaluate any information provided by the taxpayer in making the final audit recommendation.

Another case that some taxpayers may try to cite as support for the nonbusiness treatment of investment income is the Ohio Supreme Court decision in *American Home Products Corp. v. Limbach*, 49 Ohio St. 3d 158 [551 N.E.2d 201]. The taxpayer in that case devised a formula that calculated the amount of the investment funds in excess of funds actually spent for operations, and treated that excess as "non-unitary" income. The Ohio case does not have precedential value for California. Furthermore, auditors should not use the rationale from the *American Home Products* (AHP) case to support a determination. The Ohio court relied on the U.S. Supreme Court decision in *ASARCO v. Idaho* (1982) 458 U.S. 307, to hold that AHP's corporate independence from the payers of the investment income broke nexus with Ohio for the investment income. Nexus was reestablished for funds that AHP used to foster its interstate business, but AHP proved a lack of need for the excess funds. The department's position is that *ASARCO* is materially distinguishable because the investment held by ASARCO was a 51.5 percent interest in a nonunitary subsidiary rather than a

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liquid investment. Also, the constitutional constraints on a state's right to tax income as outlined in ASARCO have been clarified to some extent by the U.S. Supreme Court in *Allied Signal v. Director* (1992 U.S. [112 S.Ct. 251]). In *Allied Signal*, the Court held that income can be included in the apportionment base if the capital transaction served an operational rather than investment function. Finally, the formula used in the AHP decision does not realistically represent business needs. For example, the AHP formula does not take into account inventory or accounts receivable turnover, contingencies such as a downturn in the economy, plant expansion or future R&D, or the fact that lenders look at working capital as the ability of the borrower to make timely loan repayments.

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4030 GAIN OR LOSS FROM SALE OF STOCK

Pursuant to R&TC §25125, nonbusiness capital gains and losses from sales of stock and other intangible property are allocated to the state in which the taxpayer is commercially domiciled. (See MATM 1500 for the definition of commercial domicile).

The issue of whether gain or loss from the sale of stock is business or nonbusiness income is identical to the issue of whether dividends from such stock are business or nonbusiness income. For both dividend and stock gain income, the determination of business or nonbusiness treatment will be based upon whether the stock was acquired in the regular course of the taxpayer's trade or business operations (the transactional test), or whether the purpose for acquiring and holding the stock is integrally related to the trade or business operations (the functional test). The analysis under MATM 4020 will therefore be applicable to this issue.

The *Appeal of General Dynamics Corporation* (Cal. St. Bd. of Equal., June 3, 1975), summarized in MATM 4010, provides an example of when gain from the sale of stock was held to be business income under the transactional test. The following cases illustrate application of the functional test to gain or loss from stock sales.

In *Times-Mirror Co. v. Franchise Tax Board*, (1980) 102 Cal.App.3d 872, the taxpayer sold the stock of a unitary subsidiary, and treated the gain on the sale of the stock as business income. The FTB determined that the gain was nonbusiness based upon pre-UDITPA standards and the regulations (now repealed) under R&TC §25120. The Court rejected this argument, concluding that under the tests imposed by the statute, gain from the sale of stock of a unitary subsidiary was business income as a matter of law.

In *Appeal of Occidental Petroleum Corporation*, Cal. St. Bd. of Equal., June 21, 1983, the taxpayer sold stock in five different corporations, each of which was in some way related to the taxpayer's effort to expand and consolidate its basic unitary business involving natural resources and energy sources. The taxpayer acquired 20% of the stock of KCL in an unsuccessful effort to acquire the company and combine KCL's petroleum operations into its own. A relatively small amount of stock in Island Creek Coal Co. was acquired for the purpose of impressing Island Creek's management with the sincerity of the taxpayer's interest in acquiring the company. The stock was sold in order to complete a merger of Island Creek and the taxpayer as a tax-free reorganization. Cofesa, Waiawa Realty Co., and Oxytrol were all unitary subsidiaries, the stocks of which were sold for various reasons. The taxpayer treated the gains and losses from each of these stock sales as business income. The SBE confirmed that classification of all types of income from intangibles under the functional test must be made on the basis of the relationship between the intangibles and the unitary business operations. With respect to the sales of Cofesa, Waiawa, and Oxytrol stock, the SBE found that the stock had been acquired and managed in furtherance of the unitary business. Furthermore,

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at the time that the decisions to sell the stock were made, the assets and activities represented by the stock were fully integrated and functioning parts of the existing unitary business. The gain from the sale of the Cofesa, Waiawa and Oxytrol stock was business income. Although the taxpayer had intended to integrate KCL and Island Creek into its business operations, no such integration had taken place by the dates of the stock sales. The SBE held that mere potential to become an integral part of the unitary business was insufficient to support a finding that the gains and losses from the stock sales were business income, therefore those gains were nonbusiness. It is also noteworthy that the SBE commented upon the dictum in *Times-Mirror*, stating in a footnote that they did not agree that any particular significance should be attached to the taxpayer's eventual use of the proceeds from the stock sales. The SBE explained that the moment of judgement will generally be when the decision to sell is made. If the stock is an integral part of the taxpayer's unitary business at that moment, the gain or loss will be business income.

The *Appeal of Sundstrand Corporation*, Cal. St. Bd. of Equal., June 10, 1986, also involved a situation where the intended integration of an acquired subsidiary into the unitary business never materialized. Neither the functional nor the transactional tests were determined to have been met, and the subsequent sale of stock was held to be nonbusiness.

In 2001, the California Supreme Court in *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal. 4th 508 supported the department's view that liquidation gains can constitute business income under the functional test. Although Hoechst Celanese itself did not involve the liquidation of a subsidiary, the court interpreted the functional test by quoting and relying on a case that did involve such a liquidation. The term " integral" used in Hoechst Celanese came from the decision of *Holly Sugar Corp. V. Johnson* (1941) 18 Cal.2d 218. The court in Holly Sugar held that losses suffered by a taxpayer from the forced liquidation of stock were apportionable because "the stockholding was an integral part of the taxpayer's unitary sugar business". Accordingly, there should not be an analytical distinction between a liquidation sale of a single asset and a liquidation sale of a collection of assets such as a division or subsidiary stock. A corporation that decides to liquidate a portion of its business, such as a corporate division, by sale for cash or other value has made the same determination that such portion of the business is no longer "essential" to its operations. Thus, *Celanese* supports the proposition that liquidation gain or loss should be treated no differently than any gain or loss of any business asset under the functional test. See MATM 4035 for a discussion of additional cases in the context of the cessation of a business.

Material sales of stock may often be identified by a review of the federal Schedule D (capital gains schedule). When analyzing the treatment of stock sales, the auditor should be sure to consider whether federal/state basis differences have been properly taken into account in the computation of the gain or loss (MATM 6095).

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4035 GAIN OR LOSS FROM SALE OF ASSETS OTHER THAN STOCK

Pursuant to R&TC §25125, nonbusiness capital gains and losses are allocated as follows:

- Gains and losses from sales of real property are allocable to the state in which the property is located.
- Gains and losses from sales of tangible personal property are allocated (1) to the state in which the property had a situs, or if the taxpayer is not taxable in that state, (2) the taxpayer's commercial domicile. (See MATM 1500 for the definition of commercial domicile.)
- Gains and losses from sales of intangible property (other than partnership interests -- see MATM 4040) are allocated to the state of the taxpayer's commercial domicile.

CCR §25120(c)(2) provides that gain or loss from sales of property constitute business income if the property was used in the unitary trade or business while owned by the taxpayer. Gain or loss will be nonbusiness if the property was used for the production of nonbusiness income or was otherwise removed from the property factor before its disposition. Unless an identifiable event has taken place to establish the permanent withdrawal of property from the unitary business however, the fact that it is temporarily idle or held for sale will not be sufficient to cause the gain to be nonbusiness (see MATM 4015). The regulation includes some examples of when gains or losses on sales of assets are treated as business or nonbusiness income. The *Appeal of W.J. Voit Rubber*, Cal. St. Bd. of Equal., May 12, 1964, is a widely-cited decision that also addresses this issue.

In recent years, some taxpayers have argued, and some states have agreed, that any sale of assets that represents a cessation of the taxpayer's trade or business, in whole or in part, should not be subject to the functional test. Proponents of this "cessation-of-business" concept advocate that, instead, a "totality of the circumstances" test be applied to characterize the gains from any such sales. (*Lenox, Inc. v. Tolson* (2001) 353 N.C. 659; *Texaco-Cities Service Pipeline Co. v. McGaw* (1998) 182 Ill.2d 262 [695 N.E.2d 481]; *Laurel Pipe Line Co. v. Commonwealth* (1994) 537 Pa. 205 [642 A.2d 472]; *Welded Tube Co. v. Commonwealth* (Pa. Commw. Ct. 1986) 101 Pa.Commw. 32 [515 A.2d 988]; *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue* (1975) 88 N.M. 521 [543 P.2d 489].) However, when one examines the roots and development of the "cessation-of-business" concept, and its "totality of the circumstances" test, it becomes clear that they are really based on the transactional test, not the functional test. As a result, they are an improper replacement for the functional test in states that recognize the validity of that test, which include California. Moreover, in *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal.4th 508, cert. den. November 26, 2001, the California Supreme Court relied heavily on Holly Sugar Corp. v. Johnson (1941) 18 Cal.2d 218 (a pre-UDITPA case in which the California Supreme Court held that the sale of a unitary subsidiary generated business income), to explain that any gain on the sale of a business asset constitutes business income. As a result, the "cessation-of-business" concept and the *Lenox* case have no validity in California.

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Material sales or other dispositions of assets may often be identified by a review of the federal Schedule D (capital gains schedule). Auditors should ensure that any gains or losses from the disposition of property are given business or nonbusiness treatment consistent with the treatment of any income (such as rents or royalties) generated by the property prior to its disposition. When business/nonbusiness determinations are an issue, the gains or losses involved are generally material. The auditor should therefore be careful to examine all aspects of the transaction, including a verification that the gain or loss has been computed correctly and that federal/state basis differences have been considered (MATM 6040).

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4040 PARTNERSHIP INTERESTS

Classification of Distributive Share of Partnership Income as Nonbusiness

As discussed in MATM 5300, CCR §25137-1 provides that the determination of whether partnership income is business or nonbusiness is initially made at the partnership level. No distinction is made between general and limited partnerships. If an item of income is nonbusiness to the partnership, then the corporate partner's distributive share of that income is also treated as nonbusiness, but is treated as if earned directly by the corporate partner. CCR §25137-1(b) states, "the taxpayer's distributive share of such nonbusiness income shall be reported in the same manner as other nonbusiness income derived from other activities of the taxpayer." Each item of partnership nonbusiness income is therefore allocated in accordance with the rules set forth in R&TC §25123 - R&TC §25127. Thus, nonbusiness items such as interest or dividends are allocated to the commercial domicile of the corporate partner rather than the commercial domicile of the partnership.

Gain or Loss from Sale of Partnership Interest

R&TC Section 25125(d) provides that nonbusiness gain or loss from the sale of a partnership interest shall be allocated to California in the ratio that the original cost of tangible partnership property in this state bears to the original cost of tangible partnership property everywhere. The tangible partnership property is determined as of the time of the sale of the partnership interest. An exception to this rule will apply when more than 50% of the value of the partnership's assets consists of intangibles. In such cases, nonbusiness gain or loss from the sale of the partnership interest shall be allocated to California in accordance with the partnership's sales factor for its first full tax period immediately preceding the tax period during which the partnership interest was sold.

Note: The current rules for allocation of gain or loss from sales of partnership interests are effective for taxable years beginning on or after January 1, 1989. For years prior to the addition of this statutory rule, the SBE has held that the sale of a partnership interest is a sale of intangible property allocable to the commercial domicile of the taxpayer (*Appeal of Holiday Inns, Inc*., Cal. St. Bd. of Equal., April 9, 1986; also FTB Legal Ruling 426).

The determination of whether gain or loss from the sale of a partnership interest is business or nonbusiness is subject to the transactional and functional tests as illustrated by the following SBE decision:

In *Appeal of Centennial Equities Corporation*, Cal. St. Bd. of Equal., June 27, 1984, the taxpayer and its unitary subsidiaries were engaged in the business of real estate development, and owned interests in 39 partnerships which were also involved in real estate development and which were part of the

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taxpayer's unitary business. During the appeal year, the taxpayer sold partnership interests and reported the gain as nonbusiness income allocable to its New York domicile (under pre-1989 law). The taxpayer argued that the nonbusiness treatment was appropriate because it did not continuously acquire and dispose of partnership interests in the regular course of its business.

The SBE applied the functional test, pointing out that income realized from assets which are an integral part of the unitary business are business income even though the income may arise from an extraordinary disposition of the property. The SBE further noted that gain realized from the disposition of an asset, which "contributed materially to the production of business income" constitutes business income. Based upon this analysis, the gains from the sale of the partnership interests were concluded to be business income.

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4045 RENTS AND ROYALTIES FROM REAL AND TANGIBLE PERSONAL PROPERTY

R&TC Section 25124 provides for the allocation of rents and royalties from real and tangible personal property as follows:

1. Net rents and royalties from real property are allocated to the state in which the property is located.
2. Net rents and royalties from tangible personal property are allocated to the state in which the property is utilized. If the taxpayer is not taxable in that state (MATM 1100), then the rents and royalties are allocated to the state of the taxpayer's commercial domicile (MATM 1500).
3. If the property from which the rents and royalties were generated was used in more than one state, the portion allocable to California shall be determined based upon the ratio that the number of days that the property was physically located in this state bears to the total number of days the property was rented everywhere during the taxable year. If the taxpayer does not know this information, then the income will be allocable to the state in which the rental or royalty payor obtained possession.

CCR §25120(c)(1) provides that rental income from real and tangible personal property is business income if the property is used in the taxpayer's trade or business or is incidental to the business and therefore includable in the property factor. In *Appeal of Masonite Corporation* however, the SBE held that if rent and royalty income is properly classifiable as nonbusiness under either the functional or transactional test, and if the income and expenses attributable to the income can be segregated, then the fact that the income arose from an incidental activity will not transform it to business income (a summary of this decision is at MATM 4015).

Clearly, if a taxpayer is engaged in a rental business (such as car rentals), then the rents will be business income under the transactional test. An example of rents considered to be business income under the functional test would occur if a taxpayer rents temporarily idle equipment out on a short-term basis. On the other hand, if a taxpayer purchases a rental property such as a shopping mall or an office building as an investment, and neither the property nor the rental activity is related to the taxpayer's trade or business operations, then the rental income will be nonbusiness.

The determination of business or nonbusiness classification is not always so clear-cut. CCR §25120(c)(1) contains an example wherein a taxpayer owns a 20-story building and uses the first two floors in its trade or business. The remaining 18 floors are leased to others. The example states that the rental of the 18 floors is not incidental, but rather is separate from the operation of the taxpayer's trade or business. Therefore, the rental income is nonbusiness. The Regulations contain a different example wherein the taxpayer uses three floors of a five story building in its trade or business, and leases the remaining two floors. That example states that the rental of the two floors is incidental to the trade or business, and that the rents are business income. In light of the *Masonite Corporation*

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decision, auditors should not attempt to apply these examples as bright-line tests, but should consider the unique facts and circumstances of each case. For example, if the two leased floors in the above example would not be considered to be "available for or capable of being used" in the taxpayer's trade or business for purposes of being included in the property factor, and if the transactional and functions tests are clearly not met, then a situation that appears similar to the Regulation example on the surface might actually warrant nonbusiness treatment.

Another example in CCR §25120(c)(1) indicates that if property that has been used in the trade or business is temporarily rented out while it is held for sale, the rents will be business income. This issue is discussed in MATM 4015.

Annual reports might mention material leases or royalty arrangements that may alert an auditor to a potential nonbusiness issue. If a review of lines 6 (Gross Rents), 7 (Gross Royalties), and 10 (Other Income) of the Federal 1120 reveals amounts that appear especially high or otherwise unusual for the taxpayer's trade or business, then further inquiries into the source of the income may identify whether a nonbusiness issue exists.

Taxpayers with rental income will generally have expenses associated with that income. For example, a taxpayer renting out an office building will normally incur expenses such as depreciation and maintenance with respect to that office building. If the rental income is treated as nonbusiness, then the auditor should ensure that the expenses related to the income are also treated as nonbusiness and allocated along with the rental income.

If rent or royalty income is treated as nonbusiness, the auditor should verify that the property generating that income has not been included in the property factor.

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4050 ROYALTIES FROM INTANGIBLE PROPERTY

R&TC Section 25127 provides that nonbusiness patent and copyright royalties will generally be allocated to the state in which the patent or copyright is used. If the taxpayer is not taxable in the state in which the patent or copyright is used, the royalties will be allocated to the state of the taxpayer's commercial domicile. (See MATM 1500 for a definition of commercial domicile.)

The statute further explains that patents will be considered to be used in a state if they are employed in production, fabrication, manufacturing, or other processing in the state; or if the patented product is produced in the state. Copyrights are used in a state if the printing or other publication originates in the state. If patents or copyrights are used in more than one state, then the royalties should be allocated among those states. In cases where the basis of the receipts from patents or copyrights do not permit a reasonable allocation among the states in which the intangible is used, or if the taxpayer's accounting procedures do not identify the states of use, then the royalties should be allocated to the taxpayer's commercial domicile.

CCR §25120(c)(5) explains that patent and copyright royalties are business income where the patent or copyright arises out of or was created in the regular course of the taxpayer's trade or business, or where the purpose for acquiring and holding the patent or copyright is related to or incidental to the trade or business operations. The following examples are contained in the Regulation:

Example (A)
The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Note: (Long-established SBE decisions have held that royalties received on patents developed in the regular course of the taxpayer's trade or business are business income even if the taxpayer is not in the business of licensing patents, and even if the taxpayer never actually manufactured the patented product itself: *Appeal of International Business Machines Corporation*, Cal. St. Bd. of Equal., October 7, 1954; *Appeal of Velsicol Chemical Corporation*, Cal. St. Bd. of Equal., October 5, 1965.)

Example (B)
The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including copyrights. The taxpayer thereafter uses these acquired copyrights in its business. The royalties received on these copyrights are business income.

Example (C)

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Same as Example (B), except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

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4052 TRADE OR BUSINESS OF INVESTING

California Code of Regulations 25120(b) identifies the possibility of a taxpayer having more than one trade or business. However, the term "trade or business" has not been defined for purposes of California Corporation Tax Law. As a result, a taxpayer might assert that: (1) it is in the trade or business of investing (i.e. a taxpayer investing for itself, not a taxpayer that is in the brokerage business) and therefore, its investment activities (which are otherwise unrelated to each other) generate business income under the transactional test; or (2) it has a trade or business of investing that should be combined with another trade or business under CCR §25120(b)(3) (strong central management, see MATM 3570). In effect, either scenario could represent an attempt to convert nonbusiness income into business income by assertion that various investments comprise a trade or business, and use of strong central management as the link between those investments to form a unitary enterprise.

Although it may be theoretically possible to be in a trade or business of investing in California, in practice, such a trade or business would only arise in limited circumstances that must be determined on a case-by-case basis using a facts and circumstances test. The analysis should concentrate on whether the activities at issue generate apportionable business income and not whether there is a trade or business of investing. Even if there is a trade or business of investing, the investments themselves would constitute nonbusiness income if they do not materially contribute to the taxpayer's regular trade or business. Thus, more significant resources should be devoted to the alternative business/nonbusiness income argument, see MATM 4000, than the unitary argument.

Appeal of Holloway Investment Co., Cal. St. Bd. of Equal., August 17, 1983, involved an entity with no apportioning trade or business and only a series of investments. In *Holloway*, the Board was faced with determining whether gains resulting from sales of these investments, certain real property parcels, were properly characterized as business income subject to formula apportionment. The taxpayer had been in the candy business, but had sold its manufacturing facilities and limited its activities thereafter to holding and managing investments. The taxpayer argued that it was not engaged in a unitary business, and that the gains realized from the sale of a parking lot and from the liquidation of a limited partnership interest in a shopping center should properly be characterized as generating nonbusiness income allocable to their Illinois situs. The Board rejected the department's position that the taxpayer was engaged in a unitary trade or business of investing in securities, real property, and real property partnerships, and that the gains at issue in the case constituted business income subject to formula apportionment. The Board stated that before addressing the business or nonbusiness issue, it must first be determined that appellant's activities constituted a single unitary business under either the three unities test or the contribution or dependency test. If a unitary business does not exist, there can be no "business income." Because of the lack of any significant common relationship between any of appellant's various investments, the Board concluded that appellant's various investment activities did not constitute a single unitary investment business.

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Below is a list of factors that may be considered when developing a case where it is necessary to determine if the taxpayer is engaged in a trade or business of investing. The list is not intended to be all-inclusive, nor are the factors listed in any particular order:

1. **Length of holding period and source of profits** – This might provide some objective evidence of a taxpayer's intent to conduct activities with an investment purpose versus an operational purpose (e.g., capture of short-term market swings or dividends, in contrast to capital appreciation or interest).
2. **Regular and continuous activity** – Sporadic or infrequent activity is clearly insufficient to constitute a trade or business. However, mere frequency and continuity of an activity are not necessarily sufficient to conclude that the activity constitutes a trade or business.
3. **Actively engaged** – The activity cannot be passive, and requires something more on the part of the taxpayer than merely a decision of whether or not to invest.
4. **Intent** – Intent is a key question in determining the profit motive or type of profit sought (i.e., dividends or appreciation, short- or long-term, etc.) Further, the activity cannot be intended to maintain assets or otherwise be devoted solely to long-term appreciation.
5. **Holding oneself out to third parties as providing goods or services** – This is an important factor, the absence of which might point against there being a trade or business. Name recognition, while not a factor itself, can be relevant because it is important to a taxpayer selling or providing goods and services to third parties, rather than only for itself.
6. **Use of personal skill and judgment** – A distinction should be drawn between investors who are merely sophisticated, or who retain sophisticated investment professionals, and those who are conducting a true trade or business.
7. **Stand-alone activity** – The activity cannot be solely a support for other business activities. Thus, for example, a corporation's treasury department cannot be converted into a separate trade or business. Potential areas of inquiry might include: (1) whether there is evidence of in-house expertise or whether decisions were contracted to unrelated third parties; (2) whether the investment capital was used to fund the taxpayer's business operations during the year; (3) whether the investment vehicles are outside the taxpayer's primary business expertise; (4) whether there is risk such that the loss of capital is possible; and (5) whether there is investment volatility that might render an investment illiquid on a short-term basis.
8. **Full-time activity** – An assertion that a particular investment activity constitutes a separate trade or business might carry more weight if the taxpayer engaged in the activity full-time, and if it was the taxpayer's principal livelihood or source of income.
9. **Business formalities followed** – The absence of the usual steps in establishing and continuing a trade or business, such as a business plan and conducting research on the particulars of the market and potential investments, would suggest that the taxpayer is not engaged in a trade or business. However, the mere presence of these business formalities, without more, would be insufficient to establish the existence of a trade or business.

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10. **Self-supporting activity** – Once initially capitalized, the activity must be self-sustaining and intended to generate income for use in continuing the activity or enlarging it for distribution of profits.
11. **Operational/participatory control** – In attempting to draw distinctions between use of skill and knowledge to manipulate outcomes and merely being a passive investor, it is important to examine whether the taxpayer had any operational or participatory control in the underlying investments.
12. **Intangible flows of value between investments** – Evidence of intangible flows between the various investment activities, such that the success or failure of some investments affected other investments, might tend to support the conclusion that the taxpayer was engaged in a trade or business.
13. **Market risk** – If the investments were subject to market risk, such risk might be evidence pointing toward a trade or business. Although market risk alone is not sufficient to support the conclusion that the activity properly comprises a trade or business, it might help distinguish between passive investments for which the taxpayer would have a relatively known rate of return over a period of years (e.g., sale-leaseback transactions) from an investment subject to market fluctuations that the taxpayer could take advantage of to earn profits.

The determination of whether the taxpayer is in the trade or business of investing must be based upon the facts and circumstances of each particular case. Thus, the auditor should develop as many facts as possible and the determination should be made based upon the consideration of all of those facts and circumstances.

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4053 WORKING INTERESTS IN OIL AND GAS OPERATIONS

Although items of income or loss (i.e., capital gains or losses, royalties, etc.) from working interests in oil and gas drilling operations are ultimately sourced under the rules found in R&TC §25124 - R&TC §25127, there are some unique features of working interests that should be considered.

CCR §25120(a) provides that ". . . the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." If a taxpayer's involvement in working interests is sufficient to constitute a trade or business, then the analysis should be whether that trade or business is unitary with the taxpayer's other trade(s) or business(es). Otherwise, a nonbusiness analysis will apply. The following steps may be taken in conducting the analysis:

1. Identify the existence of the taxpayer's principal trade or business.
2. Identify other activities outside of the main trade or business that are subject to question (i.e., the holding of working interests).
3. Apply the functional and transactional tests (MATM 4010) to the items of income or loss identified in step #2 to determine whether the items arose from transactions and activities occurring in the taxpayer's main trade or business.
4. If the income or loss from the working interests does not satisfy the transactional or functional tests in step 3, then determine whether the activity is conducted in a trade or business-like manner sufficient to constitute a "trade or business." Passive holding of income producing assets is unlikely to constitute a trade or busineess.
5. If the activity does not meet the standard for a trade or business-like activity, then the income or loss should be allocated under the nonbusiness rules.
6. However, if the activity is conducted in a trade or business-like manner, analyze whether it is either (a) a separate trade or business, or (b) unitary with the main trade or business. If the basis for combination is strong central management and centralized departments, see MATM 3075 dealing with those topics.
7. If the working interest activity is determined to be unitary in step #6, combine. If not unitary, separately apportion the income or loss.

The determination whether income or loss from a working interest is nonbusiness or non-unitary must be based upon the facts and circumstances of each particular case. Therefore, auditors should be careful not to jump to conclusions regarding the characterization of the income or loss based upon labels or upon perceptions about how investments in working interests are generally managed. Instead, auditors need to develop the facts concerning the relationship between the working interest and the taxpayer's other trade(s) or business(es). For example, if the taxpayer claims that the primary purpose of the working interests in oil and gas drilling operations is to serve as a hedge against fuel shortages, the taxpayer should be asked to provide documentation to establish that such

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a plan would actually be feasible. If the taxpayer claims that strong central management exists, documentation to support this contention needs to be examined.

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4055 INCOME NOT SPECIFICALLY ADDRESSED IN THE STATUTE

R&TC Section 25123 provides for the allocation of nonbusiness income. That section lists various types of income (rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent or copyright royalties) and states that such items, to the extent that they are nonbusiness, shall be allocated as provided in R&TC §25224 - R&TC §25127. Certain types of income are not listed in that section. The position can be taken that such income should be allocated to California if it arises from tangible or intangible property located or having a situs in this State, or from activities carried on in this State (R&TC §23040).

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4060 EXPENSES ATTRIBUTABLE TO NONBUSINESS INCOME

To the extent that expenses have been incurred for the production of nonbusiness income, those expenses will not be allowed as a deduction from business income. For example, assume a taxpayer invests in an apartment building from which it derives nonbusiness rental income. The depreciation, maintenance, management fees, and any other expenses attributable to that property will not be allowed as a deduction from the taxpayer's business income. Instead, the expenses will be netted with the gross rents received from the property, and the net income or loss from the activity will be treated as nonbusiness.

In some cases, an expense may be applicable to more than one nonbusiness activity, or to both, a business and a nonbusiness activity. In such cases, CCR §25120(d) provides that the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner that fairly distributes the deduction. The allocation method may vary depending upon the type of expense. For example, a ratio of time spent on the various activities may be an appropriate method for allocating employee compensation expenses. Square footage of floor space may be a better basis to use for the allocation of building expenses. In general, any method of proration which is reasonable under the circumstances and which bears a rationale relationship to how the expenses are incurred will be allowable so long as the same method is used consistently from year to year.

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4065 Interest Offset and Business or Nonbusiness Character of Interest Expense

The interest offset is contained in R&TC §24344(b). Its purpose is to match income and expense to nonbusiness interest and dividends and interest expense. In general, R&TC §24344(b) is an expense ordering rule that requires that interest expense be applied as a deduction (i.e., offset) first dollar-for-dollar against business interest income, and then, if interest expense exceeds business interest income, interest expense is applied dollar-for-dollar against nonbusiness interest and dividends. If interest expense exceeds business interest income and nonbusiness interest and dividends, interest expense is generally allowed as a deduction under R&TC §24344. That section provides no further guidance as to business or nonbusiness treatment of such excess interest expense. However, CCR §25120(d), provides general rules for assignment of expense (including interest income) against business or nonbusiness income. Thus, to the extent that the provisions of R&TC §24344 do not provide a rule for assignment of interest expense, CCR §25120(d) will apply, except as provided below.

The U.S. Supreme Court in *Hunt-Wesson, Inc. v. FTB*, 120 S. Ct. 1022 (2000), found that the interest offset was unconstitutional. The basis of the court's finding was that the methodology of the interest offset resulted in the taxation of extra-territorial values.

The Franchise Tax Board issued FTB Notice 2000-9 to explain the department's policy concerning the application of the Supreme Court's decision in *Hunt-Wesson*. The Franchise Tax Board determined that:

1. The U.S. Supreme Court did not consider the first clause of the interest offset. The first clause provides for the netting of interest expense and business interest income. The Franchise Tax Board will continue to apply that portion of R&TC §24344(b) to all taxpayers.
2. The Court did not address the application of R&TC §24344(b) to California domiciled entities, The Franchise Tax Board will continue to apply R&TC §24344(b) to such entities.
3. The US Supreme Court held that R&TC §24344(b) was unconstitutional to the extent that it would assign interest expense to nonbusiness interest and dividends allocable to another state. Accordingly, such interest expense is to be treated as business interest expense.

The notice goes on to explain that CCR §25120(d) will be used to assign any remaining interest expense to nonbusiness income. An exception is made for income from such assets that have the potential to give rise to dividend and interest income. In other words, CCR §25120(d) cannot be used to assign interest expense to the value of or capital gain from debt or equity securities.

The following examples explain the application of FTB Notice 2000-9:

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1. X Corporation operates retail department stores. X Corporation also provides credit for their customers through the use of the stores credit card system. X Corporation has business interest income of $100 million from the credit card operations and total interest expense of $80 million. The first step for all taxpayers regardless of domicile is to net business interest income and interest expense. In this example business interest income exceeds interest expense resulting in no nonbusiness interest expense.
2. Y Corporation is a manufacturer commercially domiciled in California. Y Corporation has $50 million interest expense, $10 million business interest income and $45 million of nonbusiness dividends and interest income. The first step is to net the interest expense of $50 million with business interest income of $10 million resulting in excess interest expense of $40 million. The second step is to match the excess interest expense of $40 million with nonbusiness interest and dividend income of $45 million. Since the nonbusiness interest and dividend income exceeds the remaining interest, all of the $40 million interest expense, not directly assigned to business interest income, is classified as a nonbusiness expense.
3. Same facts as 2 except Y Corporation is domiciled outside California. All of the interest expense would be classified as business interest expense.
4. The following two examples are based on an example in FTB Notice 2000-9:
   a. Assume that a taxpayer's total interest expense was $400 including $200 that can be directly traced to holding nonbusiness stock and $50 that can be directly traced to a mortgage to acquire nonbusiness real property located in California. The taxpayer had business interest income of $100 and nonbusiness dividends of $100. If the taxpayer is domiciled in California, the first step is to net interest expense of $400 and business interest income of $100 resulting in excess interest expense of $300. Thus, the first $100 of interest expense is treated as business interest expense. The second step is to net the $300 excess interest expense with $100 nonbusiness dividend income for remaining interest expense of $200. The California domiciled entity treats the $100 interest expense in step 2 as a nonbusiness expense. Step 3 is to use CCR §25120(d) to assign interest expense to directly traceable business or nonbusiness income. In this example the taxpayer has $50 directly traceable to nonbusiness real property rental located in California, which is treated as a nonbusiness expense allocable to California. However, FTB Notice 2000-9 provides that you cannot use CCR §25120(d) to assign interest expense to assets that have the potential to generate nonbusiness interest and dividend

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income. Thus, you cannot assign interest expense to holding the nonbusiness stock even though $200 can be directly traced to that activity. The California domiciled entity would have business interest expense of $100 and nonbusiness interest expense of $150 ($100 from step 2 and $50 from step 3). The remaining interest expense of $150 would be treated as business or nonbusiness expense under the general provisions of CCR §25120(d), as described above.

b. Assume the same facts as example 4, except that the taxpayer is domiciled in another state. Step one (assignment to business interest income) would be the same as example 4. However, in step 2, interest expense in an amount equal to nonbusiness interest and dividends ($100) is treated as a business expense. As in example 4, directly traceable interest expense would be assigned to the California nonbusiness real property, but would not be assigned to the holding of nonbusiness stock. Thus, the non-California domiciled entity with these facts would have business interest expense of $200 and would have California nonbusiness interest expense of $50 from step 3. The remaining interest expense of $150 would be subject to the general provisions of CCR §25120(d).

On August 10, 2001 the California Legislative Counsel offered an opinion concerning the question of whether, in light of the US Supreme Court decision in Hunt-Wesson v. FTB, the Franchise Tax Board may continue to enforce any portion of R&TC section 24344(b). It was the opinion of the Legislative Counsel that the Franchise Tax Board may not continue to enforce any portion of R&TC section 24344(b). The role of the Legislative Counsel is to provide legal advice to the Legislature. The opinion of the Legislative Counsel is not controlling concerning the department's administration of the tax law. Staff will continue to follow FTB Notice 2000-9 unless otherwise provided by the members of Franchise Tax Board or R&TC §24344 is amended by legislation.

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4070 Contributions Adjustment

The purpose for the contributions adjustment is to allocate the charitable contribution deduction between business and nonbusiness income and to properly reflect the 5% (10% for taxable years beginning on or after 1/1/96) income limitation after apportionment and allocation. At one time, the Schedule R-6 also allocated a portion of the contributions deduction to deductible dividends, but that allocation is no longer a part of the contributions adjustment computation. If you are proposing to disallow contributions allocable to deductible dividends, you will need to make that adjustment first. The disallowed contributions will then reduce the amount of remaining contributions that you will input on line 1 of the Schedule R-6.

Pursuant to R&TC §24358, the deduction for charitable contributions is limited to 5% (10% for taxable years beginning on or after 1/1/96) of the taxpayer's net income (computed before special deductions including built-in gains, dividend deductions and NOL deductions). For taxable years beginning before 1/1/96, since the limitation is 10% for federal purposes, a state adjustment is usually made to adjust the federal contributions deduction to the 5% state limitation. Taxpayers will normally compute this limitation based upon net income before apportionment and allocation. If the taxpayer has nonbusiness activity allocated outside of California however, the income from that activity is not included in the California measure of tax. Since the nonbusiness income was included in the base for the 5% limitation, the department requires that a portion of the contributions deduction be allocated to that income.

Example
Corp Y paid contributions of $100 during the taxable year. Corp Y had business income of $800 (without regard to the contributions deduction) and nonbusiness income allocated outside of California of $200, for total net income (before apportionment and allocation) of $1000. Corp Y's apportionment percentage was 60%. The contributions deduction reported after state adjustments would be limited to $50 ($1,000 X 5%). After running through Schedule R, the contributions effectively allowed against California income would be $30 ($50 X 60% apportionment percentage).

Since $200 of nonbusiness income is not taxable to California, the portion of the contribution deduction attributable to that income is not deductible against California income. The Schedule R-6 (contribution deduction worksheet) limits the contributions deduction to 5% of the income that is subject to California tax. The allowable deduction is limited to $24 (800 X 60% apportionment percentage X 5%). Since income before the contributions adjustment should reflect a $30 deduction, a $6 contributions adjustment is necessary.

The contributions adjustment is only necessary if the taxpayer has nonbusiness income. Sometimes, however, taxpayers will use the Schedule R-6 contributions adjustment computation to compute the overall difference in the federal/state limitations. Other taxpayers may not add back the dividend

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deduction before calculating the 5% limitation for purposes of the state adjustment In these types of situations, an amount may be characterized as a contributions adjustment even though there may be no nonbusiness income. If material, the auditor will need to analyze what has ultimately been deducted on the California return (federal deduction ± state adjustment ± contributions adjustment) in order to determine whether contributions have been reported correctly. See MATM 6050 for further discussion.

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5000 CALCULATION OF BUSINESS INCOME

Once the auditor has identified the various components or entities involved in the unitary business (MATM 3000 et al.) and segregated the income or loss from nonbusiness activities (MATM 4000 et al.), the next step is to verify the business income reported by the taxpayer. In some cases, such as when the income reported by the taxpayer cannot be traced to any verifiable source or when the auditor is combining or decombining entities, it may be necessary for the auditor to reconstruct business income.

This section of the manual will cover the various sources that may be used to verify business income and will provide guidance for performing a reconciliation of net income:

Next, starting at MATM 5190, the discussion will turn to adjustments and special computations that may be required for calculating the business income reportable to California.

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5100 SOURCES FOR INCOME VERIFICATION

There are several sources that may be used to verify business income. Each source has its strengths and weaknesses, and these will be discussed in the following sections. Usually, auditors will find it necessary to use more than one source in order to overcome the shortcomings that the various sources have when considered individually. Use of these sources in the income reconciliation is discussed in MATM 5130.

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5105 Consolidated Financial Statements (Annual Reports, Sec 10-Ks)

The financial statements presented in U.S. annual reports and SEC 10-Ks are prepared in accordance with GAAP and are required to be on a consolidated basis. The parent corporation and all majority-owned subsidiaries will generally be included. The annual report will not usually identify each of the entities included in the consolidation, but such a listing will usually be attached to the SEC 10-Ks.

If any material majority-owned affiliates have been excluded from the consolidation for any reason, this will be disclosed in the footnotes (usually Footnote #1). Although 100% of the operations of the affiliates will be presented in the consolidated statements, any income or investment attributable to minority interests will be deducted as separate line items. Any subsidiaries, joint ventures or other investments that have been accounted for under the equity method will also be identified. (Rather than consolidating each line item of the subsidiary with the corresponding items for the rest of the affiliated group, the equity method reports the net income or loss of the subsidiary as a lump sum amount. This lump sum is reported as a separate line item on the income statement. Since 1988, the equity method is not allowed for subsidiaries owned more than 50%.) These consolidation requirements are found in FASB 94, effective for fiscal years ending on or after December 16, 1988.

Since the financial statements of foreign-owned groups may not be prepared in accordance with GAAP, the auditor will have to ascertain which entities have been included. Sometimes, a foreign parent will have separate financial statements prepared to reflect only the domestic affiliates. If so, the auditor should also request the financial statements for the group as a whole (it may be necessary to request a translated version).

Strengths:
Audited financial statements accompanied by an unqualified opinion from the outside CPA are generally the most reliable source for verifying the income base. The data included in these financial statements has been audited and has been determined to fairly represent the financial status of the business. Since consolidated financial statements will either include all majority-owned affiliates or will disclose any affiliates that have not been included, the auditor can be assured that no unitary affiliates are being left out. Another benefit of using audited financial statements when auditing a worldwide group is that intercompany eliminations will already have been made.

Weaknesses:
The weakness of using financial statements as a verification source is that they represent book income rather than taxable income. Therefore, an analysis of the Schedule M-1 will also be necessary if financial statements are used to reconcile income. If foreign entities are included in the unitary group, further analysis will also need to be done to determine whether any significant book/tax

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differences exist with respect to those entities. Adjustments based upon book income should not be made without first giving the taxpayer the opportunity to make book/tax adjustments.

Since the financial statements themselves do not usually disclose income on an entity basis, the auditor will have to consult additional verification sources if the members of the combined report differ from the entities included in the consolidated financial statements.

Reviewed: January 2004

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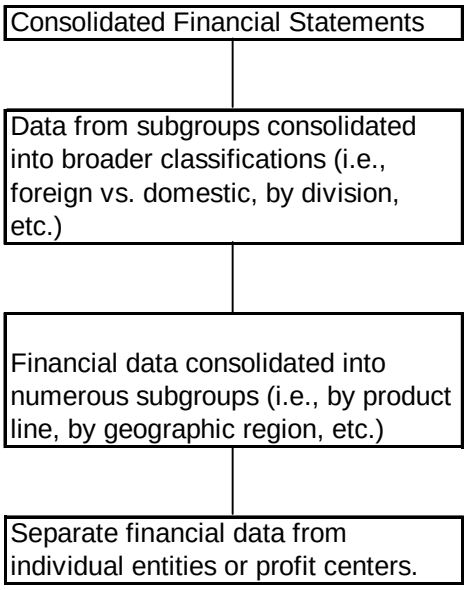
5110 Consolidating Workpapers To The Financial Statements

The consolidating workpapers used to compile the financial statements show how the separate income items from each of the affiliates have been consolidated into a single statement. These workpapers are where the intercompany eliminations and other consolidating adjustments have been made for book purposes. For large groups, several levels of consolidation may have been made. For example:



The workpapers for the highest level of consolidation should tie to the data reported on the financial statements (these are often termed the "top" consolidating workpapers). The auditor should verify that the figures do in fact agree to the financial statements. (The annual reports are prepared from the consolidating workpapers, so the figures should agree. Since revisions to the workpapers are often made as the workpapers pass through the review process however, the verification should be done to ensure that the taxpayer has provided the final version.) The detail shown on the top level consolidating workpapers is often sufficient to enable the auditor to reconcile income (see MATM 5130). If not, then the auditor should request the workpapers for the lower levels of consolidation.

The consolidating workpapers will contain "off book" entries that will not be posted to the individual books of account (consolidation adjustments and reserves for restructuring are examples of some types of adjustments that are not posted to the books of the separate entities). A review of these journal entries will help the auditor to understand what is being included in the financial statements, and may identify potential audit issues.

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Strengths:
If the figures on the consolidating workpapers tie to the audited financial statements, then the workpapers share the reliability of those financial statements. These workpapers contain the detail that will enable the auditor to adjust annual report net income for entities that are not included in the combined report.

Weaknesses:
As with the financial statements, book/tax differences will need to be taken into account when the consolidating workpapers are used as a starting point. Also, many taxpayers are reluctant to provide the consolidating workpapers to the financial statements. If the information from those workpapers is necessary in order to properly verify the income base and adequate information can not be obtained from other sources, then the auditor should be prepared to issue a formal demand for the workpapers (see MAPM 8040 for policy concerning a taxpayer's failure to furnish information).

Reviewed: December 2002

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5115 Consolidated Federal Form 1120

Every U.S. Corporation, which is not expressly exempt from tax, must file an annual income tax return for federal purposes, regardless of whether there is positive income or a tax due. The return form for most corporations is the Federal Form 1120. Other corporate returns are Federal Form 1120F for domestic operations of foreign companies, Federal Form 1120- FSC for Foreign Sales Corporations, and Federal Form 1120-DISC for Domestic International Sales Corporations. Federal Form 1120X, Amended U.S. Corporation Income Tax Return, is used to amend the original Form 1120.

If certain conditions are met, domestic members of an affiliated group of companies may elect to file a consolidated Federal Form 1120. The federal consolidated return includes a parent corporation and all affiliates owned (directly or indirectly) at least 80% by that parent. As a result, only parent/subsidiary groups may file on a federal consolidated basis. Brother/sister groups owned by an individual or by a foreign corporation will not be eligible. See IRS Publication 542, *Tax Information on Corporations* for a more in-depth discussion of Form 1120 filing requirements.

Since the California combined report includes foreign corporations and brother/sister groups, and only requires common ownership of more than 50%, the California combined report may include entities that are not included in the federal consolidated return. Also, since federal consolidation is based on ownership rather than unity, non-unitary affiliates may be included in the federal consolidated return but will not be included in the California combined report.

The consolidated Federal Form 1120 is often the starting point used by both taxpayers and auditors for determining combined business income for California tax purposes. If the Federal 1120 has been subject to a comprehensive federal audit, then the Federal 1120 net income can be used to verify domestic net income before state adjustments. This reflects the department's policy of conserving audit resources whenever possible by not duplicating work performed by the IRS.

On the other hand, if the federal 1120 has not been audited, then the auditor should review the income statement for material issues and unusual transactions. This does not mean that auditors are required to perform detailed income and expense audits on all taxpayers that have not undergone a federal audit, but it does mean that auditors can not assume that no issues exist with respect to income and expenses just because the items were reported the same way for federal and state purposes. In addition, if an income reconciliation is prepared from an unaudited federal return, the results should be double-checked against a reconciliation of income from another source (such as audited financial statements). If a material difference is detected, than additional audit work will be necessary. See MATM 5130 for additional detail regarding income reconciliation procedures.

Note: If the IRS scopes a return and performs preliminary audit procedures before determining that the return will be accepted as filed, the federal return is considered to be unaudited. Since the return

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has not been subjected to a complete IRS examination, auditors should look upon the income and expense items reported on the federal return as having no greater reliability than state-only items reported on an unaudited California return.

Strengths:
The benefit of reconciling net income to an audited federal return is that the IRS will already have audited the income base and the book/tax adjustments. Although the auditor should still perform a quick review of the components of net income and the Schedule M-1 adjustments to look for items which result in federal/state differences, this review will be substantially less detailed than the review that would be required if no federal audit had been performed.

Weaknesses:
Since the federal consolidated return does not include brother/sister groups or foreign corporations, it is not as useful as the consolidated financial statements for identifying unitary affiliates that may have been left off the combined report. In addition, although other sources may be used to verify the income of non-consolidated corporations (once they have been identified), intercompany eliminations will not have been taken into account.

Reviewed: December 2002

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5120 Verification Sources For Foreign Corporations

If the Federal Form 1120 is used to verify domestic income, another source will be needed to verify foreign income. Often, separate financial statements will have been prepared for each foreign entity or group of entities. Since these financial statements may not be prepared in accordance with GAAP, substantial adjustments may be required to adjust the foreign income to a California tax basis. Separate financial statements will not reflect intercompany transactions between the unitary affiliates. The workpapers to the consolidated financial statements will generally identify the income of foreign affiliates and may be used as a source for verifying foreign income. Although book/tax adjustments will still have to be considered, the consolidating workpapers will be more helpful for identifying intercompany transactions involving the foreign entities. If the financial statements have not been printed in English, the auditor should ask the taxpayer to translate the statements.

Note: For taxable years beginning on or after January 1, 1990, California conformed to IRC §6038A, including the record maintenance requirements for foreign-owned corporations and the provision that such records requested by the IRS/FTB must be translated into English. For more information, see R&TC §19141.5; Treas. Reg. §1.6038A-3; and Chapter 20A, Water's-Edge Manual.

Publicly held foreign corporations often trade their securities or American Depository Receipts in the United States. (ADRs are negotiable instruments that represent securities on deposit with a custodian.) Such corporations are required to register with the Securities and Exchange Commission (SEC), and annually file SEC Form 20-F. This report is similar to the Form 10-K used by domestic entities. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP or must disclose the variations from GAAP and contain a schedule, which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used.

For federal purposes, domestic parents are required to file Form 5471 for each foreign subsidiary. This form contains an income statement that may be useful. The Form 5471 is only an *information* return, however, and is not generally audited by the IRS. Taxpayers are, therefore, not always as diligent in preparing the Form 5471 as they might otherwise be. Consequently, auditors should be wary about relying upon information presented on the Form 5471. Although the instructions for the Form 5471 require that the income statement and balance sheet be presented in accordance with GAAP, book/tax adjustments will not have been made.

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5130 INCOME RECONCILIATION

A reconciliation of the income reported in the California tax return to some verifiable source should always be done. The purpose of the reconciliation is to validate the income computation and to verify that all unitary members of the group have been accounted for in the income computation. The reconciliation may also identify book/tax adjustments that have bypassed the Schedule M-1. An analysis of the Schedule M-1 adjustments will only be meaningful once the auditor has established that the starting point is valid. Whenever possible, the audited consolidated financial statements should be used for this reconciliation.

Note: When a reconciliation is based on the financial statements, it is reconciling Schedule M-1 book income; *not* taxable income. This type of reconciliation must be followed by an analysis of the Schedule M-1 adjustments in order to verify the tax base. See MATM 5140 for a discussion of the Schedule M-1 analysis.

As discussed in MATM 5115, reconciliations to Federal Consolidated 1120s can also be beneficial, so it is a good idea to reconcile California income to both the financial statements and to Federal Form 1120 income.

Before actually beginning the reconciliation, the auditor needs to have an understanding of how the taxpayer determined their income for California purposes. For example, did the taxpayer use the consolidated Federal Form 1120 for domestic income and the Forms 5471 for foreign income, or were the consolidated financial statements used as the base? These questions can be asked during the initial meeting with the tax department personnel. Once this information is obtained, the auditor will have a better idea of what adjustments will be required to calculate the income reconciliation, and will be aware of areas where potential problems may exist (for example, use of the Federal Forms 1120 and 5471 may not properly reflect intercompany transactions between domestic and foreign entities). It may be helpful to review income reconciliations from prior audit cycles to see how the income was determined and whether the prior auditors identified any problems. After this groundwork has been set, the auditor may begin the reconciliation.

The steps for performing an income reconciliation based upon audited consolidated financial statements are:

Step 1: Identify the basis for consolidation.
Step 2: Compare the net income.
Step 3: Analyze the differences between the income reported on the financial statements and on the tax

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returns.

Step 1: Identify the basis for consolidation

The first step in reconciling net income to the consolidated financial statements is to identify which affiliates are included in the consolidation. If the financial statements include affiliates that are not in the combined report, the consolidating workpapers will be necessary to derive the items attributable to those affiliates that will need to be backed out. (This may also trigger a question as to whether those affiliates may in fact be unitary.) If the combined report includes entities that are not in the financial statements, alternative sources, such as the entity's separate financial statements, will need to be consulted to verify the income of those entities.

Step 2: Compare the net income

In its simplest form, the income reconciliation consists of a comparison between net income from the consolidated financial statements and Line 1 of the Form 100 Schedule M-1. In reality, however, the calculations are usually more complex. Since most taxpayers use the Schedule M-1 from the Federal Form 1120, foreign entities will not be included. Differences will also occur if the financial statements include any entities that are not in the combined report (or the federal return, if a federal M-1 is used).

One method for taking these differences into account is as follows:

	Consolidated Financial Statement Net Income (after tax)
+	Combined entities not included in the financial statements (after tax)
-	Entities included in the financial statements, but not the combined report (after tax)
-	Amount from Schedule M-1, line 1 (this should be an after tax amount)
+	Schedule M-1, line 1 amounts pertaining to entities not in the combined report
-	<u>After tax book income for combined entities not included in the Schedule M-1</u>
=	<u>DIFFERENCE</u>

The auditor will need to be flexible in applying this method based upon the available information. For example, if the auditor only has pre-tax income for foreign entities, which are not included in the consolidated Schedule M-1, then the rest of the computation should be revised to also reflect pre-tax income:

Consolidated Financial Statement Net Income Before

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	Income Taxes
+	Combined entities not included in the financial statements (before taxes)
-	Entities included in the financial statements, but not the combined report (before taxes)
-	Amount from Schedule M-1, line 1
-	Amount from Schedule M-1, line 2
+	Sch M-1, line 1 and 2 amounts pertaining to entities not in the combined report
-	Pre-tax book income for combined entities not included in the Schedule M-1
=	DIFFERENCE

If pre-tax income is used in the reconciliation, an analysis of the provision for income taxes may need to be done. Since state or foreign income taxes may have been deducted from the amount on Schedule M-1 line 1, an adjustment may be required to add back those taxes in order to place M-1 income and financial statement income on a comparable basis.

Step 3: Analyze the Differences between the income reported on the financial statements and on the tax returns

Significant differences resulting from the above reconciliation will usually fall into one of three categories: (1) intercompany transactions; (2) off-book adjustments; and (3) "ghost" or hidden M-1 adjustments. To understand these adjustments, it is helpful to keep in mind the format that the consolidating workpapers commonly use:

Parent	Subsidiaries	Eliminations	Adjustments	Consolidated Total

The first two columns represent the amounts from the separate books of the entities (or from partially consolidated subgroups from the lower levels of the consolidating workpapers -- see MATM 5110). The "eliminations" column represents the elimination of intercompany transactions. The "adjustments" column represents adjustments other than intercompany eliminations that are made only for consolidation or financial statement presentation purposes, and are not posted to the separate books of account. An example of an item that may be found in this column would be an adjustment to back out a minority interest in a consolidated subsidiary. The "consolidated totals" are the amounts that are carried to the actual consolidated financial statements.

Intercompany transactions:
Intercompany eliminations between the domestic entities and the foreign entities (or any other entities that were not consolidated in the federal return) will not have been made for federal tax purposes.

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The Form 1120 Schedule C should be reviewed to determine whether any intercompany dividends between those entities need to be eliminated. The Federal Forms 5471 and 5472 should identify intercompany transactions between domestic and foreign corporations. The Schedule M-1 adjustments may also reveal eliminating adjustments that had been made for financial statement purposes but not for federal purposes.

Similarly, if financial statement income is adjusted to exclude affiliates who are not in the combined report, then adjustments may also be necessary to restore the eliminated intercompany profit and loss attributable to those entities. The auditor should be able to derive these amounts from the consolidating workpapers to the financial statements.

Off-book adjustments
Instead of starting with consolidated net income when not all of the affiliated entities are included in the consolidated Federal Form 1120, the taxpayer may have aggregated the separate book income amounts in order to derive line 1 of the Schedule M-1. Since consolidating adjustments are not posted to the separate books of the individual entities, this method may not pick up the consolidating adjustments for purposes of the Schedule M-1 book income. For example, assume that a consolidating adjustment was made to establish a reserve for restructuring of $100 million. This provision was not posted to the separate books of any individual entity. If the taxpayer calculated the Schedule M-1 book income by aggregating the separate net income amounts for each corporation included in the federal return, the $100 million deduction would not be reflected in the M-1 book income.

By examining the workpapers used to prepare the Schedule M-1 or by asking the taxpayer how the net income was compiled, the auditor should be able to determine quickly whether this type of situation exists.

"Ghost" or Hidden M-1 Adjustments
Ghost M-1 adjustments are book/tax differences that are buried in the Schedule M-1, line 1 amount and do not appear as a separate M-1 item. For example, assume a corporation capitalizes its leases for book purposes, but treats them as operating leases for tax purposes. Rather than making an M-1 adjustment to convert book lease income to tax lease income, the taxpayer may restate its book income as *if* they had used operating lease accounting for book purposes. The workpapers used to prepare the Schedule M-1 should identify whether these types of restatements have occurred.

If the auditor is not able to easily reconcile net income to the consolidated financial statements, the taxpayer should be asked to provide a reconciliation. In a complex income reconciliation, it may not be possible to completely reconcile the amounts. As long as the differences are relatively minor and the auditor can be reasonably assured that the starting point for the Schedule M-1 is valid and includes all unitary members, then no adjustments are necessary. On the other hand, if the taxpayer

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is unable to adequately explain material differences, the auditor should consider proposing an audit adjustment for the unreconciled amount, or reconstructing net income using the consolidated financial statements as a verifiable starting point.

Reconciliation of Income from an Audited Federal Return
Occasionally it will not be possible to reconcile net income based upon consolidated financial statements. This may occur with smaller, privately held taxpayers who are not required to prepare annual reports or file SEC reports. It may also occur in foreign parent cases where the foreign financial statements are not prepared on a consolidated basis, or where the accounting methods are so far removed from GAAP as to be of little use for our purposes. In such cases, the auditor may reconcile domestic net income before state adjustments to federal taxable income. Foreign income will have to be reconciled using the most reliable source available (see MATM 5120 for suggestions).

When using this method, the auditor should be careful to consider whether any intercompany transactions took place between the domestic and foreign entities, and whether any book/tax adjustments are applicable to the foreign entities (MATM 5140). Since this method may not identify unitary entities, which have not been included in the federal return or combined report, the auditor should be sure to utilize other methods to test for this issue (such as consulting a corporate directory such as Moody's Investors Service).

Since the IRS will already have audited domestic M-1 adjustments, the auditor will not have to conduct an extensive M-1 analysis other than to review for federal/state differences. See MATM 5140.

If the federal return has not been audited, then the auditor will have to verify the reasonableness of the net income computation based upon the records that are available (separate profit and loss statements, trial balances, general ledger summaries, etc.). In addition, the auditor should review the income statement for material issues and unusual transactions.

Reviewed: December 2002

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5140 SCHEDULE M-1 ANALYSIS

Once book income from line 1 of the Schedule M-1 has been reconciled to the consolidated financial statements, an analysis of the Schedule M-1 adjustments should be performed to verify the net income for tax purposes (before state adjustments). If the IRS has already audited the federal return, this analysis can be limited to a general review in order to gain an understanding of what is included in the tax base, to identify items, which may be treated differently for state and federal purposes, and to explore unfamiliar items to determine whether any California implications exist. The taxpayer's workpapers used to prepare the Schedule M-1 will be useful in conducting this review. The taxpayer can be asked to explain any unusual or unfamiliar items. Some additional tips for performing the Schedule M-1 analysis are discussed at MATM 2550.

In some cases, the audit adjustments will disregard the taxpayer's income computations and reconstruct net income from scratch using the consolidated financial statements as a starting point. This sometimes occurs when the auditor cannot reconcile the taxpayer's net income figures or is proposing significant adjustments to the taxpayer's method of filing. If the financial statements were prepared in accordance with U.S. generally accepted accounting principles (GAAP), then it may be reasonable for the auditor to convert book income of the domestic companies to a tax basis by using the following formula:

	Worldwide pre-tax book income prepared under GAAP
+	Lines 4 and 5 of Schedule M-1
-	Lines 7 and 8 of the Schedule M-1
=	Worldwide income with domestic corps on federal tax basis

On the other hand, if the consolidated financial statements are prepared under the accounting practices of a foreign country, and the book income per the Schedule M-1 is based on the domestic corporations' profit and loss statement prepared in accordance with GAAP, then the M-1 adjustments may not be applicable to the underlying income used in the above formula. A more accurate approach under these circumstances may be as follows:

	Worldwide pre-tax book income from foreign financial statements
-	book income attributable to domestic corps (from consolidating workpapers or trial balances used to prepare the foreign financial statements)
+	Federal income (from line 28 of the consolidated federal return)

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= Worldwide income with domestic corps on federal tax basis

Before applying either of the above methods, the auditor should verify that the Sch. M-1 adjustments are applicable for California. In particular, the auditor should look for M-1 adjustments related to foreign-domestic transactions (such as gain from sales to foreign affiliates which is eliminated for book purposes but included in federal income because the foreign entities are not in the federal Form 1120). Auditors should also be alert for "ghost" or hidden book/tax adjustments that have already been incorporated into line 1 of the Sch. M-1 (see MATM 5130).

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5145 ADJUSTMENTS TO CONFORM FOREIGN BOOK INCOME TO STATE METHODS

If the combined report contains foreign entities, the taxpayer may not have adjusted the foreign book income to reflect U.S. or California tax accounting. CCR §25106.5-10 and MATM 5320 describe how the taxpayer should compute income from foreign operations. Once the auditor has determined the starting point used by the taxpayer to compute foreign income, they should review the income statement to determine whether adjustments would be appropriate. Some of the more common book/tax adjustments associated with foreign financial statements are listed in Exhibit J. In addition to looking for book/tax adjustments that are unique to a particular country's accounting practices, auditors should not forget to look for the same types of book/tax adjustments that might exist for domestic companies. It will usually be necessary to work with the taxpayer to determine the proper book/tax adjustment.

For example, foreign income statements will often deduct additions to various special-purpose reserves. Although these deductions are not applicable for California purposes, the taxpayer should be allowed to deduct the expenses when and if they are actually incurred. Rather than simply disallowing the deduction, the auditor should ask the taxpayer to provide the amount of the allowable deduction under California law. If this information is not readily available, reasonable approximations may be necessary (see below).

As another example, large losses may be taken for write-downs in the value of assets. Since these losses are unrealized, they are not deductible for California purposes. When the assets are eventually disposed of (or depreciated) however, California will have a higher basis in the assets, thereby reducing California income in that period. When proposing to disallow devaluation losses, the auditor should determine whether any offsetting adjustments resulting from the disposition or depreciation of the assets are applicable.

When combining foreign entities for the first time, the auditor should ask the taxpayer to provide any book/tax adjustments that they wish to make with respect to those entities. For example, the taxpayer may be entitled to use LIFO inventory methods (MATM 6075) or accelerated depreciation methods (MATM 6020) for its foreign entities.

In many cases, it will be difficult for the taxpayer to obtain the information needed to completely conform their foreign income to the methods acceptable for California tax purposes. CCR §25106.5-10(e)(1) provides:

"In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records

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maintained in the regular course of business, the Franchise Tax Board may accept reasonable approximations."

One of the key elements in the U.S. Supreme Court's analysis in B*arclays Bank Plc. v. Franchise Tax Board* (114 S.Ct. 2268 (1994)) was the fact that the department had recognized the difficulties which foreign parent businesses face in attempting to file a worldwide combined report. The Court confirmed that the department must consider whether the cost and effort of producing information justifies the submission of reasonable approximations. The types of approximations that will be necessary will vary taxpayer by taxpayer, as will the types of records that are available. Materiality is obviously a primary consideration. Other criteria that may be considered could include the size of the item relative to the corporation's total assets or income, the consistency with which the practice has been applied, and whether it is a recurring or nonrecurring item. Based upon their knowledge of the taxpayer, and their experience with auditing similarly situated taxpayers, auditors will have to make judgements as to what is reasonable and what is not.

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5190 CAPTIVE INSURANCE SUBSIDIARIES

Corporations often form captive insurance subsidiaries to provide for their insurance needs. The traditional captive insurance situation, in which the insurance subsidiary insures only its parent and/or members of the affiliated group, is really a form of "self-insurance" because the parent ultimately retains all of the risk. For example, assume a captive insurance company has an investment account of $1.1 million, insurance liabilities of $1 million, and capital of $100,000. The captive insurance company has an insurance claim of $1,050,000. The claim reduces dollar for dollar the value of the parent's investment in the subsidiary. Taxpayers who place funds into a reserve for losses do not get a deduction until the losses are actually incurred. By the same token, taxpayers who structure the same result by paying premiums to a wholly owned subsidiary should not get a deduction. California follows Rev. Rul. 77-316, 1977-2 CB 53, which provides that premiums paid to a captive insurance subsidiary are not deductible to the extent that there are no reinsurance agreements with unrelated insurers.

Legal Ruling 385 concludes that an insurance company cannot be included in a combined report. The Department of Insurance applies the gross premiums tax equally to all admitted insurers without distinguishing between captive and noncaptive insurers. The Franchise Tax Board will consider a captive insurance company to be an insurance company for purposes of Legal Ruling 385. Thus, the captive will not be included in the combined report to be consistent with the practices of the Department of Insurance.

Legal Ruling 385 also states that an out-of-state insurance company not subject to the gross premiums tax is treated in the same manner as an in-state insurance company that is subject to the gross premiums tax.

Although combination of a captive insurance company is no longer the department's policy, the issue of what the proper deduction is for insurance expense is still present.

INSURANCE EXPENSE DEDUCTION

Taxpayers are allowed a deduction for amounts paid for insurance as an ordinary and necessary business expense. When insurance insures only the parent of a captive insurance company, the circumstance of “self-insurance” exists because the parent is the party that ultimately retains the risk. Each dollar of loss incurred at the insurance subsidiary level concomitantly reduces the parent’s investment in the insurance subsidiary.

Determining whether a true insurance relationship exists:
In the past, premiums paid to any wholly owned insurance subsidiary were disallowed, irrespective of whether the subsidiary regularly insured unrelated parties (Rev. Rul. 88-72, 1988-2 CB 31). A series

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of court cases in 1992 changed this practice (AMERCO v. Comm'r, 96 TC 18, 979 F.2d 162 (9th Cir. 1992); *The Harper Group v. Comm'r*, 96 TC 45, 979 F.2d 1341 (9th Cir. 1992); *Sears Roebuck & Co. v. Comm'r*, 96 TC 61, 972 F.2d 858 (7th Cir. 1992)). The courts established a three-prong test for determining whether a true insurance relationship existed:

The arrangement must involve the existence of an insurance risk.

There must be both risk shifting and risk distribution. Risk shifting may be found to occur if the subsidiary has an existence separate and apart from its parent, is financially able to satisfy the claims, and in fact pays claims. A co-insurance arrangement whereby the insured affiliate shares in a portion of the loss will result in no shifting of risk with respect to that portion of the insurance arrangement.

Risk distribution occurs when the insurance company pools the affiliates' premiums with premiums from a significant number of unrelated insureds. The courts have not defined the level of unrelated risk that is required to constitute sufficient risk distribution. In Gulf *Oil Corp*. (3d. Cir. 1990) 914 F.2d 396, the court held 2 percent unrelated insurance to be de minimis, and found the insurance subsidiary to be a captive. In *The Harper Group* on the other hand, unrelated insurance constituting 30 percent of the pool was found to be enough to meet this prong of the test.

The arrangement must be for insurance in its commonly accepted form. This prong will be met if the subsidiary is organized and operated as an insurance company, is adequately capitalized, is regulated as an insurance company, and uses valid, binding insurance policies that result from arm's-length transactions.

Parent/subsidiary relationships vs. Brother/sister relationships:
In *Humana Inc. v. Commissioner* (6th Cir. 1989) 881 F.2d 247, the Sixth Circuit distinguished between premiums paid by the parent corporation and by the insurance subsidiary's brother/sister corporations. In that case, there were no unrelated insureds, and the court did not find a true insurance relationship to exist between the parent and its wholly owned insurance subsidiary. On the other hand, because the brother/sister subsidiaries had no direct control or investment in the insurance subsidiary, the court held that risk shifting and risk distribution occurred with respect to those subsidiaries. Deductions were allowed for the premiums paid by the brother/sister subsidiaries. The department will follow the *Humana* decision.

Audit techniques:
The search for related corporations that are normally performed to reveal unitary issues may reveal insurance subsidiaries. The existence of insurance subsidiaries may also be identified in the annual reports, SEC 10-Ks, or the Form 1120.

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To determine whether premiums paid to an insurance subsidiary are deductible, the auditor must first determine the nature of the arrangement. Often, a primary insurer (the company that issued the policy for the insured) will transfer a portion of its premiums to another insurance company (the reinsurer) in return for the reinsurer assuming a portion of the insurance risk. (This is termed "reinsurance," and the primary insurer is considered to have "ceded" its risk.) To the extent that an insurance subsidiary reinsures its risk with an unrelated party, the risk has shifted outside the affiliated group, and the premiums will be deductible. Conversely, premiums paid directly to an unrelated company may not be deductible if the risk is reinsured by the captive insurance subsidiary.

To the extent that the insurance risk remains with related entities, the auditor must consider the three-prong test to determine whether a true insurance relationship exists. Most domestically organized insurance companies will be subject to regulation by the insurance departments of the states in which they operate. Reports filed with the state insurance departments will be good sources of information regarding the insurance company's operations. For insurance companies organized in offshore locations such as Bermuda, auditors should determine what types of reports are filed. Because insurance companies use specialized accounting procedures, it may be helpful for auditors to consult publications on the insurance industry (industry audit guides issued by the AICPA, for example) to understand how transactions are reported.

Careful scoping of the tax return is needed to determine if the potential premium adjustment is worth auditing. Inclusion of the insurance company's investment income in the combined report is not an option because captive insurance companies are not combined. Auditing Subpart F income of insurance Controlled Foreign Corporations (CFC's) for partial combination in the Water's Edge combined report is not an issue because the insurance subsidiary cannot be combined.

The only potential issue is the disallowance of part of the parent's insurance expense as provided by R&TC §24343 (IRC §162). The first step is to identify whether an insurance relationship exists with a related party. The payment of insurance premiums may be to either a domestic or foreign entity. For domestic insurance companies, a review of the consolidated federal 1120 will identify whether an insurance subsidiary was consolidated. For foreign entities, a review of the federal Form 5471 may disclose the amount of potential adjustment.

For example, a review of the federal Form 5471 or attached financial statements may disclose:

Premiums from parent	4,000,000	
Premiums from affiliates	1,000,000	
Subtotal		5,000,000
Investment income		15,000,000
Reinsurance expense		(4,000,000)

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Accrued insurance expense	(2,000,000)
Net income	14,000,000

For scoping purposes, it should be assumed that the reinsurance expense relates proportionately to the insurance of the parent and the affiliates (in this case 80 percent of the reinsurance, or $3,200,000, relates to the parent's insurance). The tax effect of the potential insurance adjustment is $4,000,000 insurance paid by the parent, less the proportionate share of reinsurance of $3,200,000, for a potential adjustment of $800,000. $800,000 times the apportionment factor (assume 20 percent), times a 9.3-percent tax rate, would result in a potential tax change of $14,880.

Once the potential deficiency or overassessment is known, the auditor must determine if the potential tax change warrants the amount of resources necessary to propose an adjustment. To make the adjustment the auditor must read the relevant case law as cited above and check for current developments. The auditor needs to determine the facts by reviewing the insurance subsidiary's general ledger or financial statements to confirm the amount of insurance paid by the parent and its related reinsurance expense.

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5200 CORPORATIONS HAVING DIFFERENT ACCOUNTING PERIODS (FISCALIZATION)

The income of all corporations included in a combined report must be determined on the basis of the same accounting period. When members of the combined report have differing fiscal years for tax purposes, it becomes necessary to make certain adjustments so that the income and factors included in the combined report will be representative of the income and factors for the common accounting period. This process is known as "fiscalization."

Where there is a parent/subsidiary relationship, the common accounting period for the unitary group should generally be determined on the basis of the parent's taxable year.

Where there is no common parent corporation, the income of the related corporations should generally be determined on the basis of the taxable year of the corporation required to file a California return. If more than one member is required to file in California, the income should be determined on the basis of the taxable year of the California reporting corporation expected to have the largest amount of California income on a recurring basis.

The most accurate method of fiscalization requires the taxpayer to determine the income for the common accounting period based upon the actual books of account of each member of the group. The difficulty with this method is that many of the closing and consolidating entries that are necessary to properly determine the interim income will not be prepared by some taxpayers until the end of the fiscal year. Although most larger taxpayers will have a quarterly filing requirement with the SEC, this may not be helpful if the common accounting period does not correspond with one of the quarters of the fiscal year.

As long as the results do not materially misstate the income apportioned to California, taxpayers may choose to use a pro-rata method of fiscalizing their income. Under this method, the income attributable to the common accounting period is determined on the basis of the number of months in the fiscal periods, which fall within the common accounting period. For example, assume a parent corporation operates on a calendar year basis and a unitary subsidiary operates on a September 30 taxable year. To determine the subsidiary's income attributable to the 1992 calendar year, it is necessary to assign 9/12 of the subsidiary's unitary income from the 9/30/92 fiscal year, and 3/12 of the unitary income from the 9/30/93 fiscal year. In some cases, this procedure results in using the income of a corporation whose taxable year has not yet closed. When that situation occurs, it may be necessary for the taxpayer to estimate the income based on available information and amend the return at a later date.

After the combined unitary income is determined on the basis of a common taxable year, the next step is to apportion the combined income. The apportionment factors should be computed on the basis of the same common taxable year used to compute the unitary income. If an interim closing of

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the books was done to determine the income attributable to the common taxable year, then the actual figures from the books should also be used to determine the apportionment factors attributable to the common accounting period. Otherwise, the pro-rata method may be used by determining the factors in accordance with the number of months of the fiscal years that fall within the common accounting period.

Once the factors for the common accounting period have been determined, the California business income attributable to each of the taxpayers is calculated using the intrastate apportionment procedures described in MATM 7900 and MATM 7905. Each taxpayer's share of the unitary business income is then converted back to that taxpayer's normal accounting period.

Example: A parent corporation operating on a calendar year-end files a combined report with its unitary subsidiary for IYE 12/92. The subsidiary has a September 30 fiscal year-end. This example will illustrate the computations necessary to fiscalize the income and apportionment factors under the pro-rata method:

The subsidiary's income and factors for the fiscal periods falling within the 1992 calendar year are as follows:

	IYE 9/30/92	IYE 9/30/93		IYE 9/30/92	IYE 9/30/93
			Payroll:		
Income	40,000	48,000	Total	40,000	50,000
			California	12,000	25,000
Property:			**Sales:**		
Total	200,000	300,000	Total	3,000,000	4,000,000
California	60,000	120,000	California	900,000	2,400,000

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	PARENT	SUBSIDIARY			Total for 12 months ending 12/31/92
	IYE 12/31/1992	(a) IYE 9/30/92 (9/12ths)	(b) IYE 9/30/1993 (3/12ths)	Total for 12 months (a) + (b)	
Business Income	558,000	30,000	12,000	42,000	600,000
Total Property	525,000	150,000	75,000	225,000	750,000
CA Property	375,000	45,000	30,000	75,000	450,000
Property %	50%			10%	60%
Total Payroll	262,500	30,000	12,500	42,500	305,000
CA Payroll	152,500	9,000	6,250	15,250	167,750
Payroll %	50%			5%	55%
Total Sales	5,250,000	2,250,000	1,000,000	3,250,000	8,500,000
CA Sales	4,250,000	675,000	600,000	1,275,000	5,525,000
Sales %	50%			15%	65%
Average Apportionment %	50%			10%	60%
Business income apportioned to California	300,000			60,000	360,000

This calculation reflects the income for the calendar year ended 12/31/92. Since the subsidiary reports on a September 30 year-end, it is necessary to convert the subsidiary's California income back to a fiscal year basis. The following computation will accomplish this:

9/12ths of Subsidiary's income for 12 months ended 12/31/92:	45,000
3/12ths of Subsidiary's income for 12 months ended 12/31/91:[1]	10,000
Subsidiary's California business income for IYE 9/30/92:	55,000

[1]Note: The computation for this amount is not shown. It represents 3/12ths of the combined California income of S for the calendar year 1991 computed in the same manner as shown herein for 1992. The remaining 3/12ths of the calendar year 1992 income ($60,000 x 3/12 = 15,000) will be carried forward to compute the income for IYE 9/30/93.

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Note that the above example reflects a single-weighted sales factor. For taxable years beginning on or after January 1, 1993, the computation will usually have to be adjusted to reflect a double-weighted sales factor. Variations of these computations may also be made in certain cases if the circumstances warrant.

NOTE: Financial statements prepared under GAAP do not require that all consolidated affiliates have the same fiscal year so long as each of the fiscal year ends are within three months of the balance sheet date (FASB 94). When the affiliates included in the consolidated financial statements do not share a common fiscal year, this fact should be disclosed in the footnotes (usually footnote #1).

Foreign affiliates will often operate on different accounting periods than the U.S. affiliates. When numerous non-California reporting entities are reporting on a different fiscal year, the auditor must decide whether the time and effort necessary to fiscalize the entities is necessary. Both the materiality of the adjustments and the benefits from achieving consistency should be considered.

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5220 FSCS AND DISCS

FSCs:

Foreign Sales Corporations (FSC's) are corporations organized under the laws of certain eligible foreign countries or U.S. possessions in order to take advantage of favorable U.S. tax provisions for export sales. The use of a FSC permits a portion of a domestic exporter's income from export sales to be immunized from federal income tax. California has no similar provisions. Therefore, FSCs are treated the same as any other corporation for state purposes.

FSCs are not permitted to be included in a federal consolidated return; their income is reported on Federal Form 1120-FSC. To qualify as a FSC for federal purposes, a foreign corporation must maintain an office and a permanent set of books of account at a location outside the United States, and must meet certain other requirements specified in IRC §922. If a corporation meets these qualifications, a portion of its foreign trade income is treated as foreign source income not effectively connected with the conduct of a trade or business within the United States, and is therefore exempt from federal income taxation. The exempt portion consists of 16/23rds of the foreign trade income from transactions that are subject to the federal administrative pricing rules, and 32% of the foreign trade income derived from arms-length pricing subject to IRC §482 reallocation. Deductions attributable to foreign trade income must be allocated between exempt and non-exempt income.

Since a FSC's primary function is the export of goods for its domestic affiliate, it will almost always be unitary with that affiliate for California purposes. The FSC will not be included in the federal consolidated return, so some ways to identify the existence of a FSC are: (1) by checking the list of company affiliates in the SEC Form 10-K; (2) by scanning the dividends on Schedule C of the Federal Form 1120 for FSC dividends; (3) by reviewing the detail to "Other Deductions" (line 26, Form 1120) for commissions paid to a FSC; and (4) by checking the Form 1120 Schedule M-1 for items related to FSCs. The income reconciliation procedures discussed at MATM 5130 may also reveal the existence of a FSC.

The FSC income included in the combined report should be verified to ensure that no federally exempt foreign trade income has been excluded for California purposes. Although reconciliation of the FSC book income may be part of the normal income reconciliation described in MATM 5130, special attention must be given to the Schedule M-1 analysis to verify that the federal book/tax adjustments exempting foreign trade income have been reversed. These book/tax adjustments will usually appear on lines 5b and 7b of the Federal Form 1120-FSC Schedule M-1.

The method that gives the most accurate results in reconciliation of FSC income is the Schedules A-G 1120 FSC method, if properly executed. It is the most complicated method and the auditor must pay careful attention so not to double count items of income and expense. Both column (a) and (b)

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must be combined when preparing the calculation. If the auditor is reconciling FSC income to an audited Form 1120-FSC and Schedules A-G, the following method may be used:

Total Foreign Trading Gross Receipts (1120-FSC, Sch B, line 6a -- combine columns (a) and (b)):	xxxx
Less: Cost of goods sold (1120-FSC, Sch. B, line 7 -- combine columns (a) and (b)):	(xxxx)
Less: Expenses attributable to foreign trade income (1120-FSC, Sch. G, line 15 -- combine columns (a) and (b))	(xxxx)
Plus: Nonexempt foreign trade income not included above (1120-FSC, Sch. B, line 14 -- combine columns (a) and (b)):	xxxx
Plus: Nonforeign trade income (1120-FSC, Sch. B, line 17)	xxxx
Less: Excess income of small FSC already included in Sch. B, line 6a (1120-FSC, Sch. F, line 7)	(xxxx)
FSC Income for California purposes (before normal state adjustments such as depreciation, taxes measured by income, etc.):	**xxxx**

NOTE: The line numbers referenced in this computation were taken from the 1997 Form 1120-FSC. Since the line numbers and format of the form may change slightly from year to year, care must be taken to adapt this computation if necessary.

In addition to reconciling the FSC income, the auditor should also ensure that intercompany eliminations have been properly made (MATM 5260), and that any FSC dividends have been properly treated. (FSC dividends are treated in the same manner as dividends received from any other corporation, and are subject to deduction or elimination under R&TC §24402 and R&TC §25106. See MATM 6030, MATM 6032, MATM 6036). Adjustments to the apportionment factors may also be necessary (MATM 7550).

Further discussion of FSCs may be found in Chapter 2, Section 2.3, of the Water's-Edge Manual.

DISCs:
Domestic International Sales Corporations (DISC) are domestically incorporated export corporations that meet certain requirement set forth in IRC §992. In order to qualify as a DISC, at least 95% of its gross receipts must be "qualified export receipts" as defined in IRC §993(a). For federal purposes, DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales. For California purposes, DISCs are treated the same as any other corporation.

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Since 1984, most DISCs have been replaced by FSCs. Federal law still provides for DISCs to a limited extent however, so auditors will still run across these entities occasionally.

As with FSCs, DISCs are not included in the federal consolidated return. DISC income is reported for federal purposes on the Federal Form 1120-DISC. The 1120-DISC taxable income before net operating loss and special dividend deduction should be used as the base for DISC income reportable to California.

Often a DISC will report on a different fiscal year than the domestic affiliates to take advantage of special rules allowing the deferral of DISC income for federal purposes. Since the federal deferral rules are not applicable for state purposes, the income of a DISC reporting on a different accounting period should be fiscalized to the common accounting period of the unitary group as discussed in MATM 5200.

When a DISC corporation is included in a combined report, any DISC deemed dividends included in the federal taxable income of its parent should be eliminated. It may also be necessary to adjust the sales factor (MATM 7550) and eliminate income from intercompany sales of goods (MATM 5260).

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5240 INCOME ATTRIBUTABLE TO MINORITY INTERESTS

The auditor should verify that taxpayers filing a combined report are including 100% of the income of combined unitary corporations. When taxpayers own less than 100% of a subsidiary, they will occasionally exclude a portion of the subsidiary's income as being attributable to a minority stock interest. Although this treatment is correct for book purposes under GAAP, it is not acceptable for California tax purposes. The income reconciliation will usually identify this error (MATM 5130).

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5260 INTERCOMPANY TRANSACTIONS

The treatment of intercompany transactions affects the timing of gain or loss recognition, and in some cases may effect whether the gain or loss is taxable to California at all. Although the rules regarding intercompany transactions are complex, issues involving intercompany transactions can often be very material. The materiality may result either from the magnitude of individual transactions or because of a large volume of smaller transactions.

When transactions occur between members of a group, the individual members may experience a gain or a loss, but there will be no economic effect to the group as a whole. The combined report is based on the premise that the same apportionment result should be obtained whether the unitary business is conducted by a single corporation or by multiple corporations. Therefore, combined reporting theory supports the position that intercompany gain or loss incurred by individual members of a combined report is not recognized until the position of the group is altered. Although systems are in place under both GAAP and the federal consolidated return regulations to deal with intercompany transactions, the treatment for California purposes has only recently been well defined with the adoption of CCR §25106.5-1. Prior to discussing the newly adopted regulation, it is first necessary to understand the methods used for book and federal tax purposes. In addition, following the discussion of CCR §25106.5-1, which is effective for intercompany transactions occurring on or after 1/1/01, a discussion is included for intercompany transactions accurring prior to 1/1/01.

Book Treatment: Elimination/Basis Transfer

Under U.S. GAAP (and also under the generally accepted accounting principles of many foreign countries), all transactions between members of the consolidated financial statements are eliminated. When assets are sold intercompany, the buyer takes the related seller's basis in the asset. The buyer will recognize any appreciation in value that took place while the seller held the asset when the asset is sold to an unrelated party or through lower depreciation deductions.

> **Example 1:** Corporations S and B are included in the consolidated financial statements of an affiliated group. In 19x1, S sells machinery to B for $100. At the time of the sale, S's basis in the machinery had been $75. Although S has realized a $25 gain from the sale, the gain is eliminated and B will have a $75 basis in the machinery. By taking S's lower basis in the asset, B's depreciation deductions will be reduced. This effectively spreads the $25 gain over the remaining life of the asset.
>
> Assume instead that B was to immediately sell the machinery to an unrelated party for $100 before any depreciation was taken. Although

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B paid $100 for the asset, the $75 basis would result in a $25 gain to B.

For book purposes, the eliminating entries are made on the workpapers to the consolidated financial statements. These entries are *not* posted to the books of the individual corporations. This distinction is important because the adjustments necessary to convert book income and property balances to the amounts applicable for California tax purposes will vary depending upon whether the tax return is based on pre- or post-consolidation figures. For example, if the taxpayer computed its property factor using pre-consolidation book balances, adjustments may be necessary to back out step-ups in basis that resulted from the intercompany sales (see MATM 7121). If the property factor were based upon the consolidated figures from the annual report, these eliminations should already have been made.

Federal Tax Treatment:

TRANSACTIONS OCCURRING IN YEARS BEGINNING PRIOR TO JULY 12, 1995:

Under the federal regulations in effect prior to July 12, 1995, gains and losses from intercompany transactions were not truly eliminated, but merely deferred (Treas. Reg. 1.1502-13). The seller's gain was put into a deferred status (unless the taxpayer had elected not to defer -- see below), and would eventually be recognized when a "restoration" event occurred. A restoration event generally occurred at the point in time when the consolidated group realized the economic benefit of the seller's gain, such as when depreciation was deducted, when the asset was sold outside the group, or when either the buyer or seller left the consolidated group. In contrast to the elimination method wherein the seller's basis in the asset carried over to the related buyer, the buyer takes its own tax basis under the deferral method.

Example 2: Assume the same facts as in Example 1, but now consider the transaction from the point of view of the federal consolidated return. S's $25 gain is not reported at the time of the intercompany transaction, but B still gets a $100 basis in the machinery. As B depreciates the machinery, the consolidated group benefits by the incremental portion of the depreciation attributable to the step-up in basis from the intercompany sale. This is considered a partial restoration event. In each year in which depreciation is claimed, S will recognize a portion of its gain determined as follows:
Total Deferred Gain
X
B's Depreciation Deduction/ B's Depreciable Basis of the Asset

By the time that the machinery is fully depreciated, S will have

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recognized its entire deferred gain of $25.

Now assume as in the previous example that B sold the machinery to an unrelated party for $100. Since B had a $100 basis, it would not recognize any gain or loss. With respect to S however, the outside sale is a restoration event that would have triggered recognition of the $25 gain.

The federal deferral rules applied to intercompany sales of property and to intercompany expenditures where the amount of the expenditure was capitalized (examples of such capitalized expenditures would include architect's fees which were included in the basis of a self-constructed building, and prepaid rents). Deferral did *not* apply to transactions for which the seller/service provider recognized income in the same period as the buyer/service recipient deducted a corresponding expense. An example of such an item would be the corporation receiving the service deducts management fees that are generally reported by the entity providing the service in the same period as the fees. Since the income and expense are a wash in the consolidated return, there was no need for elimination or deferral for federal purposes.

As an alternative to deferral, taxpayers may request the IRS's consent to recognize income from intercompany transactions currently for federal purposes (Treas. Reg. §1.1502-13(c)(3)). This election could be made for intercompany transactions with respect to all property or any class or classes of property (for example, a taxpayer could elect not to defer income from intercompany sales of inventory, but could still defer gain from intercompany sales of other assets). Once the election was made, current recognition of intercompany income was an accounting method and had to be used for all consolidated return years.

TRANSACTIONS OCCURRING IN YEARS BEGINNING ON OR AFTER JULY 12, 1995:

The federal regulations governing the treatment of intercompany transactions were substantially revised as of July 12, 1995. Although the new rules are still basically a deferral system, the approach and terminology are very different. For most common types of intercompany transactions, the amount and timing of gain recognition will be the same under the new federal method as under the old method, but attributes such as character and source of the gain may differ.

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The new federal rules apply to any transaction between corporations that are members of the same consolidated group immediately after the transaction. The buyer in an intercompany transaction still takes its own cost basis (its purchase price) in the asset. The amount and location (location refers to which corporation recognizes the intercompany item) of intercompany items are determined on a separate entity basis. Unlike the old regulatory scheme where only the timing of intercompany items was determined on a single entity basis, the new rules also determine the character, source and other attributes of intercompany items as if the members of the consolidated return are divisions of a single entity.

> **Example**: Assume the selling member (S) is in the trade or business of selling land, and sells a parcel of land to the buying member (B). B holds the land as an investment. On a separate entity basis, B would receive capital gain treatment from a subsequent sale of the land to a third party. If S and B are treated as divisions of a single entity however, then S's activities may cause B's gain to be characterized as ordinary income.

California Adoption of CCR §25106.5-1 for transactions occurring on or after 1/1/01

The FTB recently adopted regulations to provide a methodology for taking into account intercompany transactions within a combined report. CCR §25106.5-1 applies to intercompany transactions occurring on or after January 1, 2001.

Prior to the enactment of this regulation, the policy of the FTB was to eliminate the intercompany gains and losses from the sale of inventory used in the unitary business operations (elimination/carryover basis method). This policy was incorporated in FTB Publication 1061 *Guideline For Corporations Filing a Combined Report*. Intercompany profits from the sale of inventory were eliminated from beginning and ending inventories to compute cost of goods sold and the property factor. This treatment is similar to the book elimination/basis transfer method. The gain or loss would be recognized when the buying member resells the asset outside the combined report. See the discussion near the end of this section for more details regarding California's treatment of intercompany transactions occurring prior to January 1, 2001.

CCR §25106.5-1 provides for a deferral method, which is substantially in conformity with federal Treas. Reg. §1.1502-13 (The current deferral method under Treas. Reg. §1.1502-13 was adopted July 12, 1995.) The basic approach of the federal regulation is to prevent intercompany transactions from affecting the overall taxable income of the consolidated group. The regulation replaces the mechanical rules of the former Treas. Reg. §1.1502-13 and Treas. Reg. §1.1502-14 with broad, general principles using numerous examples to illustrate the new system.

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Example (deferral method versus elimination method) – S and B are members of the same combined reporting group. S sold inventory with a basis of $70 to B for $100 in year 1. B sells the inventory to X, a nonmember, in year 3 for $110.

Under the elimination method, the intercompany gain of $30 ($100 less $70) is eliminated from income in year 1 and included in income in year 3. The total profit of $40 ($110 less $70) is included in the income of B. The $30 intercompany profit is eliminated from income in year 1 through adjustments to ending inventory (which effects CGS). Adjustments are made to beginning inventory in year 3 in order to include the $30 of intercompany profit in income.

Under the deferral method the $30 of intercompany profit is deferred (not eliminated) until year 3. S reports the intercompany profit of $30 and B reports the corresponding profit of $10.

Under both methods, the total profit of $40 is included in income in year 3. Under the elimination method, B reports the total profit of $40 whereas under the deferral method B reports $10 and S reports $30.

If either S or B becomes nonmembers in year 2 (either sold or no longer unitary), then the acceleration rule applies under the deferral method and S recognizes the intercompany profit in year 2. There is no comparable rule under the elimination method.

Under the deferral method, the intercompany gain or loss is deferred (not eliminated) and taken into account under either the acceleration rule or matching rule. The buying member's basis in the property is its own cost basis (or purchase price) whereas under the elimination method, the buying member's basis reflects the selling member's cost basis (carryover basis). The amount, timing (when the intercompany item or corresponding item is taken into account), location (the entity that reports the intercompany or corresponding item. Typically the selling member reports the intercompany item whereas the buying member reports the corresponding item), and character (e.g., capital or ordinary) are determined under the matching and acceleration rules.

Treas. Reg. §1.502-13(a)(2) provides that the matching and acceleration rules encompass the single entity theory and separate entity theory. The single entity theory treats the buying member and

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selling member as divisions within a single entity. The timing and character are determined under the single entity theory whereas the amount and location are determined under the separate entity theory. The separate entity theory treats the buying and selling members as separate entities.

The matching rule and acceleration rules are explained below. There are many examples to illustrate the mechanics of the regulation. In the examples below, S is the seller of the property or service and B is the buyer of the property or service. Both S and B are members of the same combined reporting group.

MATCHING RULE

Timing – The federal intercompany regulations use the terms “corresponding item” and “recomputed corresponding item” to determine the timing of the intercompany item (Treas. Reg. §1.502-13(c)(2)(ii)). The corresponding item is the income, gain, deduction or loss recognized by the buying member from an intercompany transaction (Treas. Reg. §1.502-13(b)(3)). The recomputed corresponding item is typically the income, gain, deduction or loss that the buying member would take into account if the seller and buyer were divisions within a single entity (Treas. Reg. §1.502-13(b)(4)). The intercompany item is taken into account in the year there is a difference between the recomputed corresponding item and the corresponding item (Treas. Reg. §1.502-13(c)(2)).

> **Example** – S and B are members of the same combined reporting group. S holds land with a basis of $70 for use in its trade or business. S sells the land to B for $100 in year 1. B sells the land to X, a nonmember, in year 2 for $110. The intercompany gain is $30 ($100 - $70) and the corresponding gain is $10 ($110 - $100). The recomputed corresponding gain is $40 ($110 - $70) for year 2. Year 2 is the first year where there is a difference between the recomputed corresponding gain and the corresponding gain (In year 1, the corresponding gain is 0 and the recomputed corresponding gain is also 0); therefore, year 2 is when the intercompany gain of $30 will be taken into account by S. B will take into account the $10 corresponding gain in year 2.

Location – As provided in CCR §25106.5-1(b)(9) the location refers to the member that reports the intercompany item and corresponding item. In the above example, S reports the intercompany gain of $30. B reports the corresponding gain of $10. In general, the selling member reports intercompany items and the buying member reports corresponding items.

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Keep in mind that under the elimination method, B would have reported the total gain of $40. Under the deferral method, B reports only a $10 gain and S reports the remaining $30 gain. If the taxpayer incorrectly prepared the combined report under the elimination method, an adjustment should be made to correct the income of S and B. There are certain code sections that use the separate entities income to determine deduction limitations, such as IRC §163(j); therefore the correct income of each entity is needed.

Character – The federal intercompany regulations do not provide specific guidelines for determining the character of an income item. The regulations instead provide general rules that are subject to various exceptions. The general rule is that the single entity theory is used to determine the character of an income item (Treas. Reg. §1.1502-13(a)(2)). CCR § 25106.5-1(c) provides that the separate entity attributes of the selling member's intercompany item and buying member's corresponding item are re-determined to the extent necessary to produce the same effect on the total group combined report business income as if seller and buyer were divisions of a single corporation, and the intercompany transaction was a transaction between divisions. In the above example, the intercompany gain and corresponding gain would be characterized as a *capital gain*.

The holding period is the aggregate of the holding period of both the seller and buyer.

> **Inventory Example** – S manufactures and sells inventory to B in year 1. The cost to manufacture the inventory is $70 and the inventory was sold to B for $100. In year 2 B sells the inventory to X, a nonmember, for $110. S reports the intercompany gain of $30 ($100 - $70) in year 2, which is when the recomputed corresponding gain ($40) is different from the corresponding gain ($10). B will report the corresponding gain of $10 in year 2. Both the intercompany gain of $30 and the corresponding gain of $10 will be classified as ordinary income.
>
> For the affect on the apportionment factor, see a more detailed discussion later in this section.
>
> **Service income example** – S provides a service to B. B pays S $100 and S incurs $80 of expenses related to the service. The service was provided in year 1. The $100 of gross income and $80 of related expenses are both included in determining S's intercompany profit of $20. The $100 paid by B to S is the corresponding item and the recomputed corresponding item is the $80 of expenses incurred by S. Therefore the intercompany item ($20) is taken into account in year 1 since that is the year in which the recomputed corresponding item is different from the corresponding item. B deducts the $100 paid to S and S reports $100 of gross income and the $80 related expense.

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For the affect on the apportionment factor, see a more detailed discussion later in this section.

Depreciation example – S buys property on January 1st of year 1 for $100. The property has a 10-year useful life. S begins depreciating the property in year 1 using the S/L method. S sells the property to B for $130 on January 1st of year 3. B determines that the useful life of the property is 10 years from the date of B's acquisition. B uses the S/L method. The intercompany gain is $50 ($130 - $80) (The adjusted basis of $80 is determined by subtracting the two years of depreciation (10 + 10) from the cost of $100). In year 3 B deducts $13 of depreciation ($130/10 years = $13). Although the property was not sold to a nonmember, S would take into account $5 of its intercompany gain in year 3 because the corresponding item is $13 of depreciation and the recomputed corresponding item is $8 of depreciation expense. The recomputed corresponding item is determined by treating S and B as divisions within a single entity. If S & B were treated as divisions, then the depreciation would only be $8 (The $80 remaining basis at the time B purchased the property is divided by a 10-year useful life. The 10-year useful life was redetermined at the time the property was purchased by B).

If B had determined that the remaining useful life (at the time of purchase) was 8 years instead of 10, then the recomputed corresponding item would be $10 ($80 remaining basis/8 years) and the corresponding item would be $16.25 ($130/8). Therefore the intercompany item taken into account by S would be $6.25.

ACCELERATION RULE

Except as otherwise provided, CCR §25106.5-1(d) adopts the acceleration provisions of Treas. Reg. §1.1502-13(d). Acceleration occurs when intercompany items and corresponding items are taken into account (no longer deferred) because the parties to the transaction cannot be treated as divisions of a single corporation (CCR §25106.5-1(d)). Unlike the matching rule where both the intercompany item and corresponding item are taken into account, under the acceleration rule only the intercompany item is taken into account.

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The following are some circumstances, which will cause the acceleration rule to apply:

1. The seller and buyer are no longer in the same combined reporting group; or
2. The asset in an intercompany transaction is converted to nonbusiness use (CCR §25106.5-1(d)(1)(A)).

CCR §25106.5-1(d)(2) provides that if the circumstances, which would trigger the acceleration rule, are not known in time for the taxpayer to file an accurate return, it may be necessary to make an estimate and amend the return at a later date.

> **Example - Becoming a nonmember:** S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.
>
> S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0. (B has not disposed of the land.)
>
> In year 3, 60% of S's stock is sold to Y, a nonmember. As a result of the sale of S's stock, S becomes a nonmember of the unitary group. S and B can no longer be treated as divisions of a single corporation. Therefore, under the acceleration rule, S's intercompany gain of $30 is taken into account in Year 3 immediately before S becomes a nonmember. S's intercompany gain of $30 will be treated as current apportionable business income.
>
> For the affect on the apportionment factor, see a more detailed discussion later in this section.

In the above example S's stock was sold resulting in the recognition of the intercompany gain under the acceleration rule. If B's stock had been sold instead of S's stock, the acceleration rule would still apply and S's intercompany gain of $30 would be taken into account in Year 3.

> **Example - Conversion to nonbusiness use**: S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.

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S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0.

In year 3, B converts the land to a nonbusiness use. Once B converts the land to nonbusiness use, the effect of treating S and B as divisions of a single corporation cannot be achieved. The acceleration rule causes S to take its $30 gain into account immediately before the conversion to nonbusiness use takes place.

S's intercompany gain of $30 will be treated as current apportionable business income

For the affect on the apportionment factor, see a more detailed discussion later in this section.

B's conversion of the property to nonbusiness use would not affect the treatment on the federal return. Therefore, S's intercompany gain will continue to be deferred for federal purposes.

Example - Change in combined reporting group, S & B remain affiliated and unitary: S and B are members of a consolidated federal return. They are also included in a California combined report. S sells land to B for $100 in year 1. S's basis in the land is $70.

S has a $30 intercompany gain, which is not taken into account under the matching rule because there is no difference between B's corresponding gain of $0 and the recomputed corresponding gain of $0.

In year 3 both S and B are sold to Y, a nonmember, resulting in the exclusion of both S and B from the combined report. If S and B remain unitary after the sale, then the sale will not cause S's intercompany items to be taken into account under the acceleration rule. S's intercompany gain of $30 remains deferred until either the matching rule or acceleration rule causes the item to be taken into account.

For the affect on the apportionment factor, see a more detailed discussion later in this section.

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For federal purposes under Treas. Reg. §1.1502-13(d)(1), the sale of S and B together results in the acceleration rule applying, therefore the intercompany gain is taken into account. However, CCR §25106.5-1(j)(1)(B) provides that since the intercompany item is taken into account for federal purposes, the taxpayer may elect the same treatment for California purposes by taking the intercompany item into account on a timely filed original California return.

> **Example - Consolidated group enters state and a member is subsequently sold:** S and B are members of a unitary group which conducts all of their business activity in the U.S. Both are members of a federal consolidated group. In year 1 when no member of the group is a California taxpayer, S sells land to B for $100. S's $30 gain is treated as a deferred intercompany item in S and B's consolidated return.
>
> In year 2, a member of the consolidated group starts doing business in California. A combined report is filed including S and B. No event occurred which would have caused the intercompany item to be taken into account.
>
> In year 3, S is sold, and becomes a nonmember of the group.
>
> Once the stock of S is sold, the effect of treating the unitary operations of S and B as divisions of a single corporation cannot be achieved. Therefore, under the acceleration rule of subsection (d), S's $30 intercompany gain is taken into account in Year 3 immediately before S becomes a nonmember. S's intercompany gain will be treated as current apportionable business income in Year 3.
>
> For the affect on the apportionment factor, see a more detailed discussion later in this section.

Although the unitary group that included S and B was not doing business in California when the intercompany transaction took place, the intercompany gain is still deferred for both federal and California purposes. Therefore when either the matching or acceleration rule applies after the group becomes taxable in California, the intercompany gain will be taken into account for California purposes (CCR §25106.5-1(j)(2)).

STOCK AND DEBT TRANSACTIONS

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California intercompany regulations with respect to transactions involving stock and obligations of members are modeled after the federal regulations with modifications, as explained below.

Dividend distributions – Dividend distributions between members of the consolidated 1120 are eliminated under Treas. Reg. §1.1502-13(f) whereas the authority for eliminating intercompany dividends for California purposes is found under R&TC §25106. California does not conform to the federal regulation. Therefore none of the federal provisions referenced under CCR §25106.5-1 provide authority for eliminating intercompany dividends.

DISA – Distributions are dividends to the extent that they are paid out of earnings and profits. Once the earnings and profits have been depleted, the distributions will reduce the shareholder's basis in stock. Distributions in excess of both earnings and profits and shareholder's basis are treated as a capital gain distribution under IRC §301(c)(3). Under IRC §301(c)(3), this is income to the shareholder. For transactions occurring prior to January 1, 2001, the taxpayer was allowed to enter into a closing agreement with the FTB to defer the capital gain (FTB Notice 1997-2).

> **Example** – S owns all of T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution to S of $70. If S and T are included in the combined report, then S will treat the $70 distribution as follows. Since T has $10 of earnings and profits, $10 of the distribution will be treated as a dividend and eliminated under R&TC §25106. The distribution is then treated as a return of capital to the extent of S's basis in T stock. Therefore $20 of the distribution is a tax-free return of capital and S will reduce its basis in T stock to zero. To the extent the distribution exceeds both earnings and profits and shareholder basis, the distribution will be treated as a capital gain distribution under IRC §301(c)(3). The capital gain distribution is $40 ($70-$10-$20 = $40).

CCR §25106.5-1(f)(1)(B) provides that for transactions occurring on or after January 1, 2001, the capital gain distribution is put into a Deferred Intercompany Stock Account (DISA). Under CCR §25106.5-1(b)(8), the balance of each DISA account must be disclosed annually on the taxpayer's return. The income is then deferred until either the distributor or recipient is no longer included in the combined report as provided in CCR §25106.5-1(f)(1)(B). If there is a partial stock sale of the distributor and the distributor remains in the combined report after the stock sale, then the DISA will be taken into account to the extent of the stock sale.

> **Example** – S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution of $70 to S. If S and T are both included in the combined report, then S will have a $40 DISA which

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> will be deferred until either S or T are no longer included in the combined report. If S sells 30% of its T stock in the following year, then S will have to include $12 or 30% of the DISA in income in the year of sale. If 51% of the T stock were sold, then 100% of the DISA would have to be taken into account by S in the year of sale since S would no longer be included in the combined report..

For federal purposes, capital gain distributions create Excess Loss Accounts (ELA). The ELA creates a negative basis in the stock, which is restored to income when the stock of the distributor is sold. For federal purposes (Treas. Reg. §1.1502-32), the stock basis is adjusted every year by the earnings of the subsidiary and is decreased by the dividends paid out of those earnings. Since California does not conform to these adjustments (See Appeal of Rapid-America Corporation, Cal. St. Bd. of Equal., May 8, 1997), the California stock basis may be materially different from the federal basis.

CCR §25106.5-1(f)(1)(B)2 provides that if the distributor is liquidated into the distributee under IRC §332, then the DISA is taken into account over a 60-month period upon liquidation. However, the taxpayer can elect to take all of the income into account in the year of liquidation.

> **Example** – S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $10 of current unitary earnings and profits. T makes a distribution of $70 to S. If S and T are both included in the combined report, then S will have a $40 DISA which will be deferred until either S or T are no longer included in the combined report. If T is liquidated into S under IRC §332 in the following year, then S will have to include one fifth ($8) of the income in the year of liquidation and one fifth in each of the following four years. S can elect to include the full $40 of DISA in unitary business income in the year of liquidation.

If the taxpayer has entered into a closing agreement with the FTB to defer a capital gain distribution that occurred prior to January 1, 2001, then the deferred income will be included in the DISA of the distributee (to the extent it has not already been taken into account) for taxable years beginning on or after January 1, 2001. Thereafter, the balance of the DISA will be taken into account under the rules of the intercompany regulations (CCR § 25106.5-1(f)(1)(B) 4).

IRC §311(b) transactions – Prior to January 1, 2001, a corporation recognized gain but not loss when it made a nonliquidating distribution of appreciated property to its shareholder. The distribution was treated as a sale of property at the property's fair market value. If the distribution occurred between members of the same combined reporting group, the gain was eliminated and the shareholder's basis in the property reflected the distributor's basis (carryover basis).

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Example – S owns all of the T stock with a basis of $20 and T has no accumulated earnings and profits but does have $80 of current unitary earnings and profits. S and T are included in the same combined report. T distributes land (instead of cash) to S out of current earnings and profits. The land has a FMV of $70 and a basis of $10. The distribution is treated as a dividend to S of $70.

The dividend is eliminated under R&TC §25106. In addition there is an IRC §311(b) transaction since T distributed property with an appreciated value to S. The IRC §311(b) gain is $60 ($70 FMV less $10 basis). Prior to January 1, 2001, an IRC §311(b) gain would be eliminated since this is an intercompany transaction and the basis of the land in the hands of S would be $10.

Under CCR §25106.5-1(f) and Treas. Reg. §1.1502-13(f)(2)(iii), the $60 IRC §311(b) gain is deferred until either the land is sold to a nonmember, converted to a nonbusiness use, or S or T is no longer included in the combined report.

For example, if S is no longer unitary with the combined reporting group, then T takes the $60 deferred gain into account.

Intercompany loans – Unless otherwise provided, California conforms to Treas. Reg. §1.1502-13(g) relating to the obligations of members. Intercompany obligations are obligations between members of the same combined reporting group. Typically the creditor will report the interest income and the debtor will report the interest expense in the year it is reported for federal purposes. The interest income and interest expense will offset each other resulting in no net interest income or expense.

Example – S loans B $100 for 10 years. B agrees to pay S $10 of interest in each of the 10 years the debt is outstanding. If both S and B are members of the same combined reporting group, then S will report $10 of interest income each year and B will report $10 of interest expense. The net interest income and expense is zero.

APPORTIONMENT FACTOR

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In general, intercompany items should not be included in the apportionment factor. This is the same policy that existed prior to the adoption of the intercompany regulations as provided in CCR §25106.5-1. Below are the more common rules associated with the sales factor and property factor.

Sales factor – The gross receipts from an intercompany transaction should never be included in the sales factor. CCR §25106.5-1(a)(5)(A) 1 provides that sales attributable to intercompany items are not included in the sales factor in either the year that the intercompany transaction takes place or the year that the intercompany transaction is taken into account. However, the gross receipts from the corresponding item should be included in the sales factor by the buying member in the year of sale as provided in CCR §25106.5-1(a)(5)(A) 2.

> **Example** – S sells property used in its trade or business to B in year 1 for $100. The basis in the property is $80; therefore the intercompany gain of $20 is deferred until it is taken into account under the acceleration or matching rule. In year 2, B sells the property to X, a nonmember, for $110. Under the matching rule, both the intercompany gain of $20 and the corresponding gain of $10 is taken into account in year 2. B will include $110 of gross receipts in its sales factor for year 2. S will not include the $100 of intercompany receipts in the sales factor.

Assume instead that the stock of B is sold in year 2 and B is therefore excluded from the combined report. The acceleration rule applies resulting in the recognition of the intercompany gain of $20 by S in year 2. There is no corresponding gain. Since the intercompany gain must be recognized and included in business income in year 2, will the gross receipts of $100 be included in the sales factor? The answer is no, the intercompany receipts are never included in the sales factor.

Property factor – CCR §25106.5-1(a)(5)(B) 1 provides that on the date that property is transferred from the seller to the buyer, the property will be included in the property factor of the buying member at the seller's original cost (carryover basis). B's purchase price from S is not used for property factor purposes.

CCR §25106.5-1(a)(5)(B) 4 states that if the acceleration rules apply resulting in the recognition of the intercompany gain by S, then the basis of the property is stepped up to the buyer's purchase price. The increase in the property factor should reflect the amount of gain recognized by the seller.

> **Example** – S sells property used in its trade or business to B on January 1st of year 1 for $100. S's basis in the property is $80, therefore, the intercompany gain is $20. On January 1st of year 2, the stock of S is sold to a nonmember, and S is no longer included in the combined report. B

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> will include the property in its property factor for year 1 at $80 (S's costs basis). B will also include the property in its factor for year 2. The property will however be increased to $100 to reflect the gain recognition by S under the acceleration rule. If for some reason the gain recognition were only $15, then B would only increase the property factor to $95.

If S and B are sold together and continue to remain unitary, then the acceleration rule does not apply. Therefore B's property factor would continue to be reflected at the carryover basis (S's cost).

CCR §25106.5-1(a)(5)(B)2 provides that intercompany rent should also be excluded from the property factor.

SIMPLIFYING RULES

The purpose of CCR § 25106.5-1 is to reflect the taxable income of the taxpayer members as if the intercompany transactions within the group occurred between divisions of a single corporation.

However, Reg. 25106.5-1(e) applies the simplifying rules of Treas. Reg. §1.1502-13(e)(3) allowing an election to report transactions on a separate entity basis (currently recognized). A federal election is binding for state purposes unless the taxpayer makes a separate California election to prevent the federal election from applying as provided in CCR §25106.5-1(e)(2)(A).

> **Example** – S sells land to B for $100 in year 1. The basis is $70. For federal purposes, an election was made to recognize the $30 intercompany gain in year 1 even though neither the acceleration nor matching rules applied. The taxpayer will have to report the $30 gain in year 1 for California purposes unless a separate election is made on an original California return. The federal election automatically applies for California purposes, unless an election is made by the taxpayer on its original California return.

CCR §25106.5-1(e)(2)(B) provides that a separate election can be made for California purposes to report transactions on a separate entity basis when no federal election is required. For example, when there are foreign corporations included in the combined report, the taxpayer can elect to use the separate entity method and recognize any intercompany gains and losses that occur between foreign and domestic corporations. The election is made by recognizing those gains and losses on a timely filed original return (CCR §25106.5-1(e)(2)(C)). For federal purposes, no election is required since foreign corporations are not included in the consolidated 1120. The reason for making the election for California purposes is to avoid keeping two separate sets of books (One set of books would be kept for the deferral method for California and one under the separate entity method for federal purposes). If the consolidated 1120 is used as the basis for preparing the California

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combined report, then the separate entity method would apply to any transactions with related foreign corporations unless a state adjustment is made to use the deferral method. The election is made for the first year in which the election is to apply.

CCR §25106.5-1(e)(2)(B) provides that an election can be made for all items or for items from a class or classes of transactions. For example, intercompany sales to a controlled foreign corporation included in a water's-edge return may be considered a class of transactions for which a separate state election can be made. Furthermore, CCR §25106.5-1(e)(2)(C) provides that the election shall be treated as an accounting method and will apply to the class each year thereafter.

Any election made to treat intercompany transactions on a separate entity basis will not apply to losses and deductions deferred under IRC §267(f) as provided in CCR §25106.5-1(e)(2)(D). Such deductions or losses are deferred until the property is transferred outside of the controlled group. In addition, an election cannot be made with respect to transactions related to stock or obligations of members. CCR §25106.5-1(f) provides specific rules for stock of members and CCR §25106.5-1(g) provides specific rules for obligations of members. See the discussion on stock and debt transactions above for more details.

If the combined reporting group change results in the seller's intercompany item being taken into account for federal purposes (ownership drops below 80%), the seller may make an election to take those same items into account for California purposes, by including them on a timely filed original return.

AUDIT CONSIDERATIONS

In general either the consolidated 1120 or the worldwide annual report is used as the basis for preparing the California combined report. Different issues may exist depending on which method is used by the taxpayer.

If the consolidated 1120 is used as the basis for preparing the combined report, then issues will usually exist when the acceleration rule applies for California purposes and not for federal. The following are situations in which the intercompany item will have to be recognized for state purposes but not federal:

1. If the selling member is no longer unitary with the combined group but is still included in the consolidated 1120, then the intercompany item will be taken into account for California purposes under the acceleration rule whereas for federal purposes the intercompany item will continue to be deferred.
2. If the buying member is no longer unitary with the combined group but is still included in the consolidated 1120, then the intercompany item will be taken into account for California

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purposes under the acceleration rule whereas for federal purposes the intercompany item will continue to be deferred.

3. If the property is no longer used in the unitary business but is instead used for a nonbusiness purpose, then the intercompany item will be taken into account for California purposes but continue to be deferred for federal purposes.
4. If there are members of the consolidated 1120 that are not included in the combined report (i.e. nonunitary corporations), then the transactions between the nonunitary members will be recognized for California purposes but deferred for federal purposes.

In contrast the following are situations in which the intercompany item will be taken into account for federal purposes but not for California purposes:

1. The ownership percentage in the selling member drops below 80% but remains above 50%. If the selling member is still unitary with the combined reporting group, then the intercompany item will be recognized for federal purposes under the acceleration rule (since it is no longer included in the consolidated 1120) but not for California purposes.
2. The ownership percentage in the buying member drops below 80% but remains above 50%. If the buying member is still unitary with the combined reporting group, then the intercompany item will be recognized for federal purposes under the acceleration rule (since it is no longer included in the consolidated 1120) but not for California purposes.
3. If both the buying member and selling member are sold together and are no longer included in the combined reporting group (and consolidated group), then the intercompany item will be recognized for federal purposes under the acceleration rule but remain deferred for California purposes. This is one area where California did not conform to the federal regulation.
4. If there are corporations included in the combined report that are not included in the consolidated 1120 (i.e. foreign corporations) then any intercompany transactions with those corporations will be recognized for federal purposes but not for California purposes. The taxpayer can however elect to use the separate entity method by recognizing those items on a timely filed original California return.

Depreciation can also affect the timing of the intercompany item. Under the matching rule, the intercompany item is taken into account to the extent that depreciation claimed by the buying member (corresponding item) exceeds the depreciation that would have been claimed if the buying member and selling member were divisions within a single corporation (recomputed corresponding item). Therefore if there are significant differences between the federal and state depreciation methods, then there should be a state adjustment to the intercompany item recognized for federal purposes.

If the combined report was prepared using a worldwide annual report, then most likely the combined report will reflect the elimination method as opposed to the deferral method. Adjustments should be made by the taxpayer to reflect the deferral method. However, if the taxpayer has not made any adjustment, the auditor should address the following issues:

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1. If the buying member is no longer unitary with the combined reporting group, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.
2. If the selling member is no longer unitary with the combined reporting group, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member immediately before becoming a nonmember. Under the elimination method, the intercompany item will not be taken into account.
3. If the buying member is sold and is therefore no longer included in the combined report, the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.
4. If the selling member is sold and is therefore no longer included in the combined report, the acceleration rule applies requiring the intercompany item to be taken into account by the selling member immediately before becoming a nonmember. Under the elimination method, the intercompany item will not be taken into account.
5. If the property is no longer used in the unitary business and is therefore reclassified as nonbusiness property, then the acceleration rule applies requiring the intercompany item to be taken into account by the selling member. Under the elimination method, the intercompany item will not be taken into account.
6. Under the elimination method both the intercompany item and corresponding item are reported by the buying member, whereas under the deferral method the intercompany item is reported by the selling member and the corresponding item is reported by the buying member. If the net income of each member is needed to determine a deduction limitation for another section such as IRC §163(j), then an adjustment should be made to each member's net income to reflect the deferral method (and not the elimination method).

California Treatment for transactions occurring prior to 1/1/01

On November 28, 2001 the California State Board of Equalization addressed the intercompany profit in inventory issue in both the Appeal of Yamaha Motor Corporation USA and the Appeal of Pentel America, Ltd. The Board held that FTB Notice 1989-601 should apply in determining the amount of intercompany profit in inventory to recognize each year. The Board voted not to publish either decision, therefore there is no change in the current department policy concerning intercompany profits in inventory. The methodology explained below still applies (for taxable years prior to January 1, 2001).

INVENTORIES

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Intercompany profits should be eliminated from beginning and ending inventories to compute cost of goods sold and the property factor. This treatment is similar to the book elimination/basis transfer method. The gain or loss will generally be recognized when the buying member resells the asset outside the combined report.

Eliminated gains can not be brought back into income when either the buying or selling member leaves the combined report, so the buyer will continue to carry the inventory at the seller's carryover basis. When the inventory is later resold, the auditor should verify that the taxpayer used the carryover basis to calculate the gain. This can be a material issue when foreign corporations become excluded from a combined report as the result of a water's-edge election. A detailed discussion of the issue in the context of water's-edge taxpayers is in Chapter 17, Water's-Edge Manual.

The following Court and SBE decisions either support the use of an elimination method, or reflect FTB's long-standing practice of using elimination and basis transfer: *Chase Brass v. Franchise Tax Board* (II), (1970) 70 Cal.App 3d 457; *Appeal of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978; *Appeal of Jenkel-Davidson Optical Company*, Cal. St. Bd. of Equal., May 19, 1981; *Appeal of Dohrman Commercial*, Cal. St. Bd. of Equal., February 29, 1956; *Appeal of Texaco, Inc*., Cal. St. Bd. of Equal., January 11, 1978.

For a discussion of state adjustments and property factor adjustments related to intercompany profits in inventory, see MATM 6070 and MATM 7173 respectively.

FIXED ASSETS AND CAPITALIZED ITEMS

These rules apply to intercompany sales or exchanges of fixed assets, such as equipment or land; and to intercompany expenditures where the amount of the expenditure is capitalized. Gain or loss on intercompany transactions involving these items is deferred in a manner similar to the federal methodology (although if the taxpayer elects not to defer for federal purposes, the federal election will be allowed for California). Deferred intercompany gains or losses are restored based upon the same types of events that would trigger restoration for federal purposes (e.g., a sale of the asset to a nonmember of the combined report, depreciation of the asset, or either the selling or buying member leaving the combined report). In cases where the deferred gain is triggered as a result of the selling or buying member being excluded from the combined report because of a water's-edge election, FTB Notice 1989-601 will allow the restoration of deferred gain to be spread over five years (see Chapter 17, Water's-Edge Manual).

When deferred gain or loss is recognized or restored into income, it will generally be apportioned using the current apportionment factors for that restoration year. As long as records are provided to substantiate their computations however, taxpayers will also be allowed to use the historical apportionment percentage from the taxable year in which the intercompany transaction occurred. In some cases the auditor may require the use of this historical apportionment percentage, but the

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department will not impose historical apportionment factors on taxpayers unless both of the following conditions are met:

1. the historical apportionment percentage varies by more than 10% from the apportionment percentage for the year in which the gain is reported, and

2. use of the historical apportionment percentage results in at least $100,000 additional income apportioned to California.

(These criteria for the use of historical apportionment factors are consistent with the guidelines concerning restoration of deferred gains after a water's-edge election -- FTB Notice 1989-601.)

Although the methodology for treating intercompany transactions involving fixed assets and capitalized items is the same for federal and state purposes, differences may still result when the members of the consolidated return are different from the unitary group. For example, assume that Corporations A and B are both included in the federal consolidated return, but are not unitary. If A realizes a gain from an intercompany transaction with B, the gain will be deferred for federal purposes. Since B is not in the combined report, the gain will be currently taxable for California.

The by-company detail to the Federal Form 1120 income computation will usually include an eliminations column. An analysis of the entries in this column should reveal whether intercompany income attributable to entities not included in the combined report has been deferred (it may be necessary to request the workpapers used to prepare the federal consolidated return in order to obtain enough detail to perform this analysis). The annual report or SEC Form 10-K may also disclose material transactions between related parties.

In addition to ensuring that current year transactions have been reported correctly, auditors should look for prior year deferrals that may require restoration in the current year:

> **Example -** Assume that Corporations S and B are members of a combined report. In 1988, S sold an asset to B for an intercompany gain of $1 million. The gain was properly deferred. As a result of an audit of IYE 12/93, the FTB auditor determines that B is no longer unitary with the remainder of the group. The decombination is a triggering event that will require the restoration of the deferred gain for California. Since S and B are still included in the federal consolidated return, no restoration will be reported for federal purposes.

This issue may be difficult to identify. When an auditor notices that a material intercompany gain has been deferred during their audit cycle, a note of the transaction should be made in the audit narrative

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so that future auditors can be on the lookout for a restoration event. The workpapers used by the taxpayer to track their federal deferred income account may also be useful in identifying this issue.

INTANGIBLES
Gain or loss from intercompany sales of intangibles is eliminated from income and the seller's basis in the asset is carried over to the buying member.

APPORTIONMENT FACTORS

Receipts from intercompany sales and other intercompany revenues are not included in the sales factor. Authority for this position can be found in *Chase Brass & Copper Co. v. Franchise Tax Board*, (1977) 70 Cal.App. 3d 457. See MATM 7518 for further discussion of sales factor implications.

Although the deferral method requires the basis of property acquired in an intercompany sale to be stepped up to reflect the intercompany sales price, the asset must still be reflected in the property factor at the seller's original cost. If the gain on the intercompany transaction had been currently recognized, however, then the property factor value should reflect the intercompany sales price. See MATM 7121 for a discussion of this issue.

GAIN FROM DISTRIBUTIONS IN EXCESS OF BASIS

Distributions are dividends to the extent that they are paid out of earnings and profits. Once earnings and profits have been depleted, the distributions will reduce the shareholder's basis in the stock. After the stock basis has been reduced to zero, any excess distribution is treated as a capital gain to the shareholder (IRC §301(c)(3)). Elimination under R&TC §25106 only applies to the dividend portion of a distribution, not to the portion of a distribution that is in excess of stock basis (MATM 6032).

Because the general rule under IRC §301 provides for current recognition of gains from distributions in excess of basis, elimination or deferral of such gains will not generally be allowed for California even though both the payor and payee are members of a single combined report.

To the extent that distributions exceed federal stock basis, they should be identified as a capital gain for federal purposes. For federal consolidated return purposes, however, stock basis is adjusted every year by the earnings of the subsidiary and is decreased by dividends paid out of those earnings (Treas. Reg. § 1.1502-32). Since California does not conform to these adjustments (See *Appeal of Rapid-American Corporation*, Cal. St. Bd. Of Equal., May 8, 1997), the California stock basis may be materially different from the federal basis. State and federal E & P amounts may also be different. Consequently, material distributions in excess of basis may exist for California but not for federal purposes. The by-company detail to the Schedule M-2 should identify any distributions. If material

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distributions have been made, the auditor should consider analyzing the taxpayer's E & P and stock basis computations to determine whether the distribution has been reported correctly.

Although excess distributions may occur in a variety of situations, auditors should be especially careful to look for them after a leveraged buy-out (LBO). For example, after acquiring a target corporation, a parent may cause the target to liquidate its pension plan assets and distribute the cash up to the parent. The parent will use the cash to pay for the acquisition. If the cash distributed exceeds the target's E&P and the parent's stock basis, then the excess distribution will be a capital gain. (In this type of situation, even the dividend portion of the distribution will probably be paid from pre-acquisition E&P, so will not be eligible for R&TC §25106 intercompany dividend elimination.)

For additional discussion of intercompany transaction issues, see Chapter 17, Water's-Edge Manual. (The discussion in the Water's-Edge Manual is very in-depth, and much of it is applicable to worldwide filers as well as water's-edge taxpayers.)

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5280 OVERHEAD ALLOCATIONS, INTRA-GROUP CHARGES

Often, one corporation in an affiliated group will provide services to the other members of the group. A corresponding intercompany charge will generally be entered onto the books of the corporations receiving those services. This practice does not present a problem when all of the corporations are included in the combined report because the intercompany income and expense items will usually result in a wash (for example, the deduction for management fees charged to a subsidiary will be offset by the management fee income reported by the unitary parent). When one of the corporations is not a member of the combined report however, the deduction of overhead allocations and other similar items may present an audit issue.

Note: The discussion in this section focuses on allocating charges between corporations when one of those corporations is not included in the combined report. This is different from the issue of allocating the expenses of a single corporation between business and nonbusiness income, or between two or more nonunitary trade or business activities engaged in by that corporation. That issue is covered in MATM 4060.

Charges between related corporations are subject to the same criteria as any other deduction. They are deductible only if the taxpayer establishes that they are ordinary and necessary business expenses as defined by IRC §162 (See *Appeal of Jenkel-Davidson*, Cal. St. Bd. Of Equal., May 19, 1981). With respect to interest expense, IRC §163 operates to allow deductions only to entities incurring debt. Therefore, an intercompany interest charge is allowed only where there is an intercompany debt: interest expense incurred by one member of a group (on indebtedness to a third party) cannot be “assigned” somehow to other affiliates.

The consolidating workpapers to the financial statements may reveal whether material intercompany charges exist between non-unitary affiliates. By identifying intercompany accounts from the taxpayer's chart of accounts, the auditor may also be able to extract the intercompany charges from the general ledger summaries. Since the existence of such charges is often an indication of unity, the auditor should verify that the corporations are not in fact unitary before moving forward.

Once such charges have been identified, the auditor should question the taxpayer about their method for allocating the charges. If management agreements or written overhead allocation policies exist, copies should be requested. Whether an allocation method is reasonable will depend upon the type of expense being allocated. For example, it may be reasonable to allocate the costs of maintaining the parent's personnel department based upon the number of employees or the total compensation paid by each subsidiary. On the other hand, an allocation that was based upon sales or net income may not bear a reasonable relationship to the personnel services that were provided. If it appears that a problem may exist, the taxpayer should be asked to document the services or benefits that

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were actually rendered, and a reasonable deduction should only be allowed to the extent that a corresponding benefit has been established.

If the charges to the subsidiaries were not reasonable in relationship to the benefits received, or if no payments were made for services that were received, then the auditor might consider a reallocation under the authority of IRC §482 (R&TC §24725) to reflect an arm's length charge for such services. Such a reallocation may only be done if necessary to clearly reflect a taxpayer's income, and must be performed in accordance with the rules under Treas. Reg. §1.482-2(b). In general, the regulation requires that the allocations be consistent with the intended benefits of the services. The benefits must be direct enough that an unrelated party would have charged for the services, and they must not duplicate services that the subsidiary already provides for itself. Examples of these principles may be found in the regulation.

Note: IRC §482 (and R&TC §24725) may only be invoked by the Commissioner (or by FTB). Its use is therefore subject to the auditor's discretion. A taxpayer may not compel FTB to use IRC §482 simply because they have changed their mind about how to allocate overhead items to their subsidiaries. (For taxable years beginning after April 13, 1993, a limited exception to this rule will allow taxpayers to correct pricing problems by reporting the proper amount of income under IRC §482 on a timely filed return (Treas. Reg. §1.482-1T(a)(3), Treas. Reg. §1.482-1(a)(3), and Treas. Reg. §1.482-1(e)(2)).)

Interest Expense:
Under the provisions of Treas. Reg. §1.163-1, a deduction for interest expense is only allowed to the extent that it represents a charge arising under an interest-bearing obligation. An entity, which has not incurred a debt, would not be entitled to an interest deduction. Therefore, intercompany interest charges are only deductible where there is a corresponding intercompany debt. Interest expense incurred by one member of a group can not be assigned to other affiliates.

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5300 PARTNERSHIP INCOME

CCR §25137-1 provides the rules for apportionment and allocation of partnership income and describes how the corporate partners take partnership income into account.
In accordance with the standard partnership rules set forth in Subchapter K of the Internal Revenue Code, the net income of a corporate partner will reflect that partner's distributive share of partnership items. In order to determine how the partnership items are to be treated on the corporate partner's return however, it is first necessary to determine the business or nonbusiness character of those items. CCR §25137-1(a) provides that this determination is made at the *partnership* level. Partnership income arising from transactions and activity in the regular course of the partnership's trade or business will constitute business income to *the partnership*.

If the activities of the partnership are unitary with the activities of the corporate partner under established standards (disregarding the ownership requirement), then the partner's share of the partnership business income is included in the partner's business income. The partner's share of the property, payroll and sales of the partnership are also reflected in that partner's apportionment factors (see MATM 7195 (property), 7360 (payroll) and 7570 (sales)).

On the other hand, if the partnership has business income but the activities of the partnership and the partner are not unitary, then CCR §25137-1 provides that the corporate partner is considered to be engaged in two separate business activities. The partnership income would be apportioned separately using only the partnership factors (See MATM 5340 and examples illustrating this concept in CCR §25137-1(a)). This treatment applies whether the taxpayer is a general or limited partner.

The SBE has approved of CCR §25137-1 and determined that regulation should be applied to apportioning and allocating partnership income for years to which UDITPA is applicable (*Appeal of Saga Corporation*, Cal. St. Bd. of Equal., June 29, 1982). On occasion (even in years after the Board's decision in Saga), the SBE has characterized income from a non-unitary partnership as being allocable outside of the state under authority of R&TC §23040, e.g. *Appeal of Peel Construction*, Cal. St. Bd. of Equal., January 6, 1987 and *Appeal of W.R. Thomason*, Cal. St. Bd. of Equal. March 3, 1987. However, in *Appeal of Holiday Inns*, Cal. St. Bd. of Equal., April 9, 1986 the Board held that R&TC Section 23040 has no application to the extent that UDITPA applies.

In *Peel Construction* and *W.R. Thomason*, whether the partnership distributive income was characterized as allocable under R&TC Section 23040 or as business income from a separate trade or business conducted entirely outside of the state under CCR §25137-1 would have had no effect on income apportioned or allocated to California. In either case, the income would be wholly assigned to an out-of-state location. However, the R&TC Section 23040 analysis of these cases should not be applied, and CCR §25137-1 should be applied instead. It is particularly important to do so if the nonunitary partnership is conducting its trade or business within and without California. In that case,

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the income of the partnership would be subject to apportionment as a separate apportionable trade or business, not as an allocable activity. The taxpayer's distributive share of that income (apportioned at the partnership level) would be aggregated with any California source apportioned business income or nonbusiness income in determining the taxpayer's income subject to tax.

CCR §25137-1 does not distinguish between general and limited partnerships. However, under partnership law (See Cal. Corp. Code §15632) a limited partner, in order to retain its capacity as a limited partner, ordinarily cannot exercise a management role with respect to a limited partnership. Therefore, unless the general partner of a limited partnership is a member of the limited partner's commonly controlled group, unity between the limited partnership and its limited partners based upon strong central management grounds is highly unlikely. If the limited partnership shares significant operational ties with the limited partner however, CCR §25137-1 does not preclude combination of the partner's share of distributive income from the partnership with the partner's trade or business. If the limited partnership and partner are not unitary, the income from the partnership is considered income from a separate trade or business of the partner and separately apportioned. (See *Appeal of Gasco, Inc*., Cal. St. Bd. of Equal., June 1, 1988, where the SBE held that limited partnership interests in oil and gas drilling operations were not unitary with the taxpayer.)

The allocation of income or loss, which is determined at the partnership level to be nonbusiness, is discussed at MATM 4040.

Normally, a corporate partner's net income and apportionment factors will include their share of partnership items for any partnership year ending within or with the partner's taxable year (CCR §25137-1(a) and CCR §25137-1(f)). If necessary in order to avoid distortion however, CCR §25137-1(f)(5) states that partnership income and factors may be fiscalized on the basis of the corporate partner's taxable year. As with most other situations involving distortion, the burden of proving that distortion exists will be on the party seeking the benefit of the fiscalization provision. In cases where distortion can be established, the computations necessary to fiscalize the partnership items will be similar to those covered in MATM 5200.

The detail to the Form 1120, line 10 "Other Income" will often identify partnership income or loss. Material partnership interests may also be disclosed in the annual reports, SEC Form 10-Ks, or in the notes to the financial statements. Auditors should be aware that joint ventures can be operated either in partnership form or corporate form. If operated in partnership form, the unity of ownership test is not applicable, and the partnership rules discussed in this section apply. If operated in corporate form, the joint venture is treated the same as any other corporation, and is combinable only if the unity of ownership test is met.

For additional criteria to consider when the partnership takes the form of a working interest in oil and gas drilling operations see MATM 4053.

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5310 RAR ADJUSTMENTS

If a federal audit has been performed, it may be necessary to modify net income to reflect the federal adjustments. Procedures for handling RARs and guidelines regarding the weight to be given to federal audit adjustments are covered in MAPM 12000.

Before picking up the federal adjustments, the auditor should consider whether the adjustments are applicable under state law. Obviously, it is important to verify that the federal RAR does not include adjustments attributable to corporations that are not included in the combined report. Adjustments to items such as state income tax expense or federal NOL deductions will not be applicable for California. Adjustments to dividend income may or may not be applicable to California depending upon whether the dividend is subject to intercompany elimination for state purposes. Although federal changes to subpart F income will not affect worldwide filers, those changes may lead to revisions in the percentage of a controlled foreign corporation's income and factors that are includable in a water's-edge return. It is a good idea to analyze the RAR adjustments in conjunction with the taxpayer's state adjustments to ensure that the state adjustments are consistent with revised federal income.

It may be necessary to review the detail of material RAR adjustments to determine whether those adjustments are applicable for California. For example, because California does not generally conform to federal depreciation methods, federal changes to the taxpayer's depreciation computations may not apply for state purposes. On the other hand, a review of the detail underlying a federal depreciation adjustment may reveal that the depreciation was revised because of an adjustment to the cost basis of the asset. If the reasons for revising the cost basis are applicable to California, than the state depreciation deduction should be revised accordingly.

RARs may include IRC §482 transfer pricing adjustments to reallocate income or deductions between members of a commonly controlled group. This type of adjustment might be necessary based on the application of the arm's-length standard if prices charged in transactions between related parties do not reflect arm's-length prices. For worldwide filers, the corporations at both ends of the intercompany transactions will usually be in the combined report, so the federal IRC §482 adjustments will generally have a wash effect for state purposes and the combined net income will remain the same. The IRC §482 adjustments will, however, have an effect on the earnings and profits of each party to the transaction. Collateral adjustments may also be identified on the RAR as correlative or conforming adjustments. As an example of a collateral adjustment, assume that the IRS determines that a U.S. subsidiary paid inflated prices for inventory and equipment purchased from its foreign parent. The RAR might increase the U.S. subsidiary's taxable income, recharacterize a portion of the payments as a dividend, and reduce the basis of the equipment. The basis reduction would lead to a correlative adjustment to reduce the allowable depreciation adjustment.

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When federal IRC §482 adjustments are made involving a taxpayer that is a California water's-edge filer, while the IRC §482 adjustment does effect both sides of the related-party transaction, only one of the entities might be in the water's-edge group if the foreign entity is excluded from the water's-edge combined report due to the water's-edge election. However, in some situations the foreign entity might be partially or fully included in the water's-edge group. When dealing with a water's-edge filer, all collateral adjustments should still be taken into account as well as the effect on earnings and profits for both sides of the related-party transaction, even if one of the entities is excluded from the water's-edge combined report.

More detail regarding IRC §482 adjustments and collateral adjustments can be found in Chapter 18, Water's-Edge Manual. The effects of IRC §482 and related collateral adjustments on earnings and profits are discussed in Chapter 11, Water's-Edge Manual.

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5320 TRANSLATION OF FOREIGN CURRENCY

When operations are conducted in foreign countries, it is usually necessary to translate income into U.S. dollars. The method used to perform the translations is set forth in CCR §25106.5-10 (formerly CCR §25137-6 and CCR §25106.5-3). In general, the procedures are as follows:

Each foreign branch or corporation should prepare its profit and loss statements in the currency in which it maintains its books of account (usually the local currency). (CCR §25106.5-10(b)(1)(A).)

The above profit and loss statements must be adjusted to conform to U.S. GAAP and to California tax accounting standards. (See MATM 5140)

The profit & loss statements for each branch should then be translated into the currency in which the parent company maintains its books. For domestic parents, the profit and loss statements would be translated into U.S. dollars. For foreign parents, each subsidiary (including the U.S. subsidiaries) would translate their profit and loss statements to the currency of the foreign parent. (CCR §25106.5-10(b)(1)(D).)

The property, payroll and sales factors should be calculated in the currency of the parent corporation. The resulting apportionment percentage will also reflect the parent corporation's currency. (Regulations 25106.5-10(c)(1)(E) and (2)(C).)

Note: CCR §25106.5-10 provides that in lieu of steps #1-#3, the FTB may allow a corporation to determine its income on the basis of the consolidated profit and loss statement prepared for SEC or shareholder reporting purposes. Adjustments may be required to conform the consolidated profit and loss statement to GAAP and California accounting standards, and to eliminate unrealized translation gains/losses.

If the parent corporation's currency is other than U.S. dollars, California income should be translated back to U.S. dollars after allocation and apportionment. (CCR §25106.5-10(b)(2)(E).)

Exhibit H contains an example of audit schedules that cover these steps. In addition, the PASS schedules do provide for these computations.

Exchange Rates: The necessary translations should be made at the following exchange rates (CCR §25106.5-10(b)(4); (c):

Depreciation: Depreciation, depletion or amortization shall be translated using the historical rate for the period in which the cost of the asset was incurred.

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Dividends: Dividends or income otherwise repatriated during the year are translated at the exchange rate at the date of repatriation.

All other income and expense items are translated at either the end-of-year exchange rate or at the simple average exchange rate for the period.

Property factor: Fixed assets are translated at the exchange rate as of the date of acquisition. After the annual rental rate of rented property is capitalized by eight, it is translated using the simple average rate for the period.

Payroll and Sales factors: Payroll and sales are translated using the simple average exchange rate for the period. An exception will occur if the closing rate for any month ending within the period varies by more than 10% from the closing rate for any preceding month within the period. In such a case, the appropriate exchange rate would be either a simple average of month-end rates, or a weighted average that takes into account the volume of transactions for the months within the period.

The regulation states that the exchange rates may be derived from any source that reflects actual transactions of representative amounts conducted in a free market. If the taxpayer is unable to demonstrate that their source meets this criteria, the rates should be determined by reference to the free market rate as published in the pertinent monthly issues of International Financial Statistics (CCR §25106.5-10(d)(1)). This publication is available in larger libraries and in several FTB offices.

Translation Under GAAP:
For U.S. financial accounting purposes, FASB 52 covers translation of foreign currency. As a general rule, FASB 52 utilizes the weighted average exchange rate for the period for translating all revenue and expense items, and the current rate at the balance sheet date for translating assets and liabilities. Exceptions to this general rule apply (1) for remeasurement of local branch operations into the "functional currency" of the foreign entity; and (2) for entities operating in hyperinflationary economies. (For these limited exceptions, assets, liabilities, depreciation and other asset-related items are translated at historical rates.)

When using GAAP financial statement income as a base for determining net income for California, auditors should be aware of the following differences between GAAP and California tax translations:

The financial statements translate depreciation at current exchange rates, while CCR §25106.5-10(b)(4)(A) requires translation at the historical rates for the period in which the asset was acquired. In determining the tax potential associated with this issue, auditors should consider the materiality of the foreign depreciation expense, and whether the exchange rates have fluctuated significantly over the period in which the assets were owned. The practicality of obtaining the information necessary to calculate the adjustment should also be taken into account.

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Balance sheets prepared in accordance with GAAP will generally present property at current exchange rates rather than at the historical rates required under CCR §25106.5-10(c)(1)(A) for property factor purposes. Depending upon the significance of the foreign assets in the factor and the stability of the exchange rates over the life of the assets, using book translations in the factor may affect the apportionment factor. Again, auditors should weigh the materiality of the adjustment against the practicality of obtaining the necessary information before pursuing this issue.

The remeasurement of hyperinflationary currencies and branch income under GAAP may result in the inclusion of unrealized translation gains and losses in net income. Foreign currency transactions that are not settled as of the balance sheet date may also result in unrealized gains or losses under GAAP. This issue is discussed below in MATM 5325.

The translation rules are very complex, and there are exceptions to the general rules stated above. If the auditor is faced with a material translation issue, it may be helpful to research FASB 52 and related accounting pronouncements on the subject. For foreign financial statements, the accounting practices of the foreign country should be researched.

Note: Prior to 1982, FASB 8 determined currency translation under GAAP. The rules under FASB 8 allowed both realized and unrealized translation items to be included in income. See FTB Bank & Financial Handbook Section 0440 for a summary of the FASB 8 provisions.

Federal Treatment:

The federal rules for translation of foreign currency transactions are found in IRC §985 - IRC §989. The methodology is substantially the same as FASB 52, although special federal rules apply with respect to translating operations in hyperinflationary economies. The issues discussed above with respect to GAAP/California differences will therefore also be applicable when the income of foreign entities in the combined report is based upon the Federal Forms 5471 *Information Return of U.S. Persons With Respect to Certain Foreign Corporations.*

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5325 Realized & Unrealized Currency Gains & Losses

Only realized currency gains and losses are recognized for tax purposes. Unrealized gains and losses from currency translation and balance sheet restatements are not taken into account. (CCR §25106.5-10(a)(2).)

Realized currency gain and losses result from completed transactions. They occur when the exchange rate changes between (1) the time a purchase or sale in a different currency is consummated and (2) the time of actual payment or receipt. *Unrealized* gains or losses, on the other hand, result from translations of assets and liabilities. The difference between realized and unrealized gains and losses is illustrated in the following example:

Example
USA Corporation is a calendar year taxpayer. On November 1, 1993, USA Corp purchases a machine from a German supplier under the following terms:

Purchase Price:	DM 171,100
Delivery:	The machine is received and placed in service on November 1, 1993.
Payment Date:	Payment is due in the German supplier's functional currency (DM) on May 1, 1994.

On November 1, 1993 (the date that title to the machine passed to USA Corp), the exchange rate was DM 1.711 = US $1. At this exchange rate, the cost of the machine to USA Corp was US $100,000 (DM 171,100 / 1.711). The following journal entry would be made on USA Corp's books to record the transaction:

Machinery		100,000	
	Accounts Payable		100,000

As of USA Corp's year-end on December 31, 1993, the exchange rate had fluctuated to 1.7263. If USA Corp were to pay their liability to the supplier on that date, their cost would be US $99,114 (DM 171,100 / 1.7263). The difference between USA Corp's recorded cost of $100,000 and the $99,114 is $886. If USA Corp were to restate its liability to reflect the current translation, an unrealized gain of $886 would result. Since the transaction has not been completed however, the unrealized gain is not relevant for tax purposes.

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On May 1, 1994, the exchange rate was 1.6412. USA Corp paid US $104,253 to satisfy its liability to the supplier (DM 171,000 1.6412). The $4,253 excess of the amount paid over the $100,000 cost basis of the machinery is a realized currency transaction loss, and may be deducted for tax purposes. Deduction of this loss will not affect the $100,000 cost basis used for depreciation and property factor purposes.

For GAAP purposes, a transaction that requires settlement in a currency other than the entity's functional currency is termed a "foreign currency transaction." The transaction in the above example is a foreign currency transaction. Financial statements prepared under GAAP will recognize exchange gains or losses on foreign currency transactions outstanding as of the balance date, even though the gain or loss is not yet realized.

Example: Assume the same facts as in the above example. For financial statement purposes, the $886 gain would be recognized in 1993. In 1994, USA Corp would recognize a $5,139 loss ($104,253 - $99,114). Schedule M-1 adjustments would be required in 1993 and 1994 to reflect the book/tax timing differences.

Under the general rule, GAAP does not include unrealized gains and losses from balance sheet translations in income, but reports these as a separate component of stockholder's equity. With respect to operations in countries with hyperinflationary economies however, both GAAP and federal translation methods include unrealized translation gains and losses in income. Economies are considered to be hyperinflationary when there is more than 100% inflation over a three-year period. Countries in Central and South America, Africa, and Eastern Europe will frequently fall into this classification. Under GAAP, unrealized gains and losses resulting from the remeasurement of local branch operations into the functional currency of the foreign entity may also be included in net income.

The notes to the financial statements will usually identify any material unrealized translation gains and losses. A review of the tax returns may also disclose translation or currency gains and losses. Commonly, they will be reported as "other income" or "other deductions," however they may be included in virtually any income or expense category. Unless the gains and losses are identified as unrealized, an analysis of the translation adjustments will usually be necessary in order to determine whether the amounts are properly includable in income.

It is common for realized and unrealized gains and losses to be netted together on the tax return. The workpapers supporting the financial statements should show how the exchange gain or loss was determined on a country by country basis. By analyzing this information, auditors can determine whether unrealized gains or losses were recognized. When determining the materiality of an adjustment however, auditors should consider the fact that the difference between realized and unrealized exchange gains or loss is often just timing. If an unrealized exchange loss is disallowed in

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one year, an adjustment may be necessary to allow the loss in a subsequent year when the loss becomes recognized.

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5340 TWO OR MORE BUSINESS ACTIVITIES

The Regulations recognize that a taxpayer may be engaged in more than one business activity (CCR §25120(b)). This may occur when one corporation has two operating divisions that are so distinctly separate that no contribution or dependency exists between the divisions. If the divisions are determined under established standards to be non-unitary, then separate combined report computations must be made to compute the business income and apportionment factors for each.

The first step is to identify the income and factors for each business activity. Since taxpayers, whom operate on a divisional basis, will generally keep separate accounts for each division, income and expenses that are directly attributable to a division will usually be easy to identify. Corporate overhead expenses, such as executive salaries, utilities, rent and similar items which cannot be directly attributed to any single division should be allocated to the separate divisions in a manner which fairly distributes the deduction among the classes of income (CCR §25120(d)). Not all such expenses must be allocated by the same method. Gross receipts may be an appropriate basis for allocating expenses such as executive salaries. Square footage of floor space might be a better basis to use for the allocation of building expenses. In general, any method of proration, which is reasonable under the circumstances, will be allowable.

Note: The overhead allocation described herein is different from the overhead issues discussed in MATM 5280. That section dealt with overhead charges between entities, while this discussion deals with overhead incurred *within a single entity*.)

After the business income of each separate trade or business is determined, the apportionment factors applicable to that trade or business are computed. A separate apportionment computation is performed for each trade or business to derive the amount of income attributable to this state. The apportioned California income for each trade or business is netted together and adjusted by any nonbusiness income or loss to arrive at the final measure of tax for California.

Example: Corporation W has two operating divisions which are engaged in unrelated business activities. The divisions are determined to be non-unitary. Corporation W's income apportioned and allocated to this state is computed as follows:

	Division A	**Division B**
Business income attributable to each division:	1,000,000	-500,000
Apportionment Factor	X 50%	X 30%
Business income (loss) apportioned to California:	500,000	-150,000

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Net Divisions A and B	350,000
Add nonbusiness income	75,000
Corporation W's net income for California:	425,000

Multiple business activities conducted by more than one corporation:
When more than one corporation is involved, the computation of California income from two or more separate trades or businesses becomes a little more complex. The basic computation, however, is made in the same manner as illustrated above. For example, assume Parent Corporation has two divisions: one is engaged in manufacturing paint, and one operates a chain of retail appliance stores. The divisions are not unitary with each other. Subsidiary Corporation manufactures appliances, and is unitary with Parent Corporation's appliance division, but not with the paint division. The steps for computing California net income are as follows:

Business income and factors attributable to Parent Corporation's two divisions are segregated and computed. Subsidiary Corporation's business income and factors are computed.

Business income attributable to Parent's paint division is apportioned based upon the paint division's separate apportionment factors.

Subsidiary Corporations business income is combined with the business income of Parent's appliance division, and the combined total is apportioned based upon the combined factors for the appliance trade or business. Intrastate apportionment is applied to determine the portion of the California income attributable to Subsidiary and to Parent.

Subsidiary Corporation will report its intrastate apportioned share of income from the appliance business (adjusted by any nonbusiness income or loss).

Parent Corporation will net its intrastate apportioned share of income from the appliance business with the apportioned income from the paint division, and apply any nonbusiness income or loss. The net result will be Parent's net income apportioned and allocated to California.

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6000 STATE ADJUSTMENTS

Once federal net income has been determined, state adjustments are made to revise federal income to the amount allowable under California law. The most common state adjustments are discussed in this section. Because of differences in the way that taxpayers compute "net income *before* state adjustments" however, state adjustments may include virtually any kind of adjustment that the tax return preparer considers appropriate in order to arrive at the bottom line California income. For example, net income before state adjustments will often reflect "pro-forma" Form 1120s that include unitary members that were not included in the consolidated return filed for federal purposes (such as subsidiaries owned less than 80%). In other cases, net income before state adjustments will include only the income from entities that were actually included in the consolidated return as filed. The taxpayer will then make a state adjustment to include the income from unitary foreign subsidiaries and less-than-80%-owned subsidiaries. Both methods of reporting the subsidiaries' income will result in the correct bottom line, but the differences in the way that the income is reported makes it impossible to develop a definitive checklist of state adjustments. Auditors will need to carefully analyze the state adjustments in conjunction with their analysis of the income base in order to fully understand what is being reported to California.

Not only should the auditor thoroughly review all material state adjustments, but the auditor should also look out for state adjustments that the taxpayer failed to report. In order to identify potential adjustments, the auditor will need to be familiar with the areas of the law in which federal/state differences exist.

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6005 AMORTIZATION OF INTANGIBLES

For federal purposes, IRC §197 entitles taxpayers to amortize certain intangible property over a 15-year period. Intangibles, which are eligible for this treatment, are defined in the statute, and include such property as goodwill, going-concern value, patents, licenses, and covenants not to compete. Although this provision generally applies to property acquired after August 10, 1993, taxpayers may elect to have the provisions apply to property acquired after July 25, 1991 (Temporary Treas. Reg. 1.197-1T; Sections 13261(a) and (g) of the Revenue Reconciliation Act of 1993 (P.L. 103-66)). If eligible assets were acquired in years that have already been filed, then federal amended returns will be necessary in order reflect IRC §197 treatment from the date of the asset acquisition.

California has adopted IRC §197 for taxable years beginning on or after January 1, 1994 (R&TC §24355.5). Although California also applies these rules to property acquired after August 10, 1993 (and to property acquired between July 25, 1991 and August 10, 1993 if such treatment was elected for federal purposes), IRC §197 treatment will not be allowed for any taxable year beginning before 1/1/94. Therefore, taxpayers will be under the old rules for years prior to 1994, and will switch to IRC §197 treatment beginning in 1994 (R&TC §24355.5(c)). (Under the pre-§197 rules, intangibles were only amortized if a limited useful life could be demonstrated with reasonable accuracy. No amortization or depreciation deduction was allowed with respect to goodwill (Treas. Reg. 1.167(a)-3).)

Example
A calendar year taxpayer acquires goodwill of $10 million on January 1, 1993, and makes the retroactive election to amortize it over 15 years. For federal purposes, the goodwill will be amortized at a rate of $666,667 per year for 15 years, beginning in 1993 ($10 million / 15).

For California purposes, no amortization is allowed for 1993. At January 1, 1994, the goodwill still has a basis of $10 million, and has 14 years remaining out of the 15-year life. Therefore, beginning in 1994, the taxpayer will deduct $714,286 per year for 14 years ($10 million / 14).

In 1993, the taxpayer will have a positive state adjustment of $666,667. For each year from 1994 through 2008, the taxpayer will have a negative state adjustment of $47,619.

The federal/state differences are only timing differences. As with any other issue that only involves the timing of a deduction, auditors should use judgement in deciding whether to make adjustments.

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6010 ADR DEPRECIATION

Congress adopted the ADR class life system to provide for a safe-harbor useful life. The ADR system assigns a class life (mid-range life) for each class of assets. Each class of assets (other than land improvements and buildings) is also given an asset depreciation range of 20% above or below the class life. Although for federal purposes a taxpayer could elect to use the lower or higher range life for depreciation purposes, California conforms only to the mid-range class life. (Rev.Proc. 83-35; CCR §24349(l).)

If a taxpayer uses the 20% lower range life for federal purposes, then a state adjustment is required to adjust depreciation to the amount allowable for California purposes. Reasonable adjustments made by the taxpayer should be accepted. If no adjustment has been made, and the amount of the adjustment would be material, then the auditor should request the taxpayer to recompute depreciation using mid-range class lives. The taxpayer should also be allowed to recompute additional depreciation for California if the 20% higher range life has been used.

If the taxpayer has used the 20% lower range, and will not recompute depreciation for California purposes, an adjustment to a mid-range life can be approximated by:

Disallowing 20% of the depreciation taken by class life in each year; and
Amortizing the 20% disallowance for each year over a period that is one-year less than the mid-range class life. The amortization should begin the year after the 20% disallowance.

Following is an example of this computation:

Asset Class	**Description**	**--- Depreciation Reported ---**		
		1st Year	**2nd Year**	**3rd Year**
0.11	Office Furniture	40,000	50,000	60,000
10.0	Mining Equipment	320,000	400,000	480,000
33.4	Assets used in the manufacture of steel	140,000	175,000	210,000

The asset depreciation range of classes 0.11 and 10.0 is 8, 10 and 12 years. The asset depreciation range of class 33.4 is 12, 15 and 18 years. The taxpayer has used the lower range lives.

The first step is to combine the depreciation of asset classes within the same range. Then, 20% of the depreciation is disallowed in each year, and amortized over subsequent years.

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Asset Class	**--- Depreciation Reported ---**		
	1st Year	**2nd Year**	**3rd Year**
0.11	40,000	50,000	60,000
10.0	320,000	400,000	480,000
Total depreciation in asset range	360,000	450,000	540,000
	X 20%	X 20%	X 20%
Amount disallowed	72,000	90,000	108,000
Amortize over 9 yrs (mid-range - 1):			
72,000 / 9		(8,000)	(8,000)
90,000 / 9			(9,000)
Net adjustment to 10 year mid-range	72,000	82,000	91,000

Asset Class	**----- Depreciation Reported ---**		
	1st Year	**2nd Year**	**3rd Year**
33.4	140,000	175,000	210,000
	X 20%	X 20%	X 20%
Amount disallowed	28,000	35,000	42,000
Amortize over 14 yrs (mid-range-1):			
28,000 / 14		(2,000)	(2,000)
35,000 / 14			(2,500)
Net adjustment to 15 year mid-range	28,000	33,000	37,500
Total Adjustment (10 yr + 15 yr)	100,000	115,000	128,500

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6015 ACRS OR MACRS DEPRECIATION

California has not adopted the federal depreciation methods known as Accelerated Cost Recovery System (ACRS) or Modified Accelerated Cost Recovery System (MACRS). If those systems are used for federal purposes, state adjustments are required to adjust depreciation to the amount allowable under California law.

For federal purposes, ACRS must be used to compute depreciation for most tangible depreciable property placed in service after 1980 and before 1987. Under ACRS, the cost of property is recovered over 3, 5, 10, 15, 18 or 19 years, depending on the type of property and the year it was placed in service. The amount of the depreciation deduction is determined through use of tables found in Proposed Treas. Reg. §1.168-2.

Federal law requires the use of MACRS for most tangible depreciable property placed in service after December 31, 1986. MACRS extended the ACRS useful lives to 3, 5, 7, 10, 15, 20, 27.5 and 31.5 years. The amount of depreciation is determined using the applicable depreciation method, the applicable period and the applicable convention. Tables computing the deduction may be found in Rev. Proc. 87-57.

The specific rules for both ACRS and MACRS are complex, and should be researched if additional information is necessary.

R&TC §24349(b)(4) provides that, for California purposes, taxpayers may use any consistent method of depreciation as long the method does not result in more depreciation during the first 2/3 of the useful life than would result through use of the double declining balance method. Under this test, ACRS or MACRS would be an allowable method for California for 3-year ACRS/MACRS property, which also has a 3-year mid-range ADR life. Most other classes of ACRS/MACRS property would not meet this test.

If the taxpayer has not made a state adjustment to place ACRS or MACRS on an acceptable state depreciation method, the auditor should request the taxpayer to recompute California depreciation. In determining whether the taxpayer's recomputation is reasonable, the auditor should be aware that use of the safe-harbor ADR mid-range lives may only be elected on a timely filed return for the year that the assets are placed in service (CCR §24349(l)(1)(C)). If no election was made, then the useful life is dependent upon the facts and circumstances. Facts to take into account may include the useful life of assets for financial reporting purposes, and the taxpayer's asset replacement and disposition history.

Since depreciation allowable under generally accepted accounting principles is usually allowable for California as well, the auditor may adjust federal ACRS or MACRS depreciation to reflect book

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depreciation if the taxpayer does not recompute depreciation under an allowable California method. (But there may be situations where book depreciation would not be acceptable. For example, if a corporation is acquired when the fair market value of its assets exceeds the book value, the acquiring corporation may step-up the asset values for book purposes, and accrue additional depreciation on the stepped-up amounts. This additional depreciation would not be deductible for California. See MATM 7110 for more information regarding this issue.) The adjustment to substitute book depreciation for federal depreciation may be made by reversing the taxpayer's M-1 adjustments related to depreciation. Alternatively, the auditor may review the taxpayer's AMT depreciation calculations to determine whether depreciation computed under the AMT methods can be accepted as a reasonable California depreciation deduction. (See MATM 8520 for a summary of the AMT depreciation methods.)

Corporate Partners and S Corporations:

A corporate partner's distributive share of partnership depreciation may reflect MACRS. Revenue and Taxation Code §17858, added by Sec. 55.5 of A.B. 802 (Stats. 1989, Ch. 1352), provides:

For purposes of this part and Part II (commencing with R&TC §23001) any election relating to the computation of depreciation shall be made by the partnership and each partner shall take into account his or her distributive share of the amount computed in accordance with that election.

Section 165 of that same bill provides that §55.5 of the act is declaratory of existing law and shall apply to taxable years beginning on or after January 1, 1987.

Therefore, for partnership taxable years beginning on or after January 1, 1987, a corporate partner is not required (or allowed) to recompute its distributive share of partnership income where the partnership properly elected the MACRS method of depreciation.

Pursuant to R&TC §23802(f)(1), S Corporations must compute depreciation in accordance with the rules set forth in the California Personal Income Tax Law. These rules include use of the MACRS method.

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6020 DEPRECIATION – FOREIGN CORPORATIONS

Depreciation laws in foreign countries may vary considerably from those of California. In addition to allowing different methods of depreciation, some countries may allow depreciation to be computed on a basis other than historical cost (i.e.,. market value). Depreciation deductions of foreign operations in a combined report should therefore be reviewed for reasonableness. Regulation 25106.5-10 provides that the profit and loss statements of foreign branches and corporations shall be adjusted to conform to California tax accounting standards, and this includes California law with respect to depreciation. In accordance with CCR §25106.5-10(b)(3)(C), however, no such adjustments shall be required unless they are material in nature.

U.S. parents are required to report depreciation of foreign branches and affiliates on a U.S. accounting basis for purposes of financial statements prepared in accordance with generally accepted accounting principles, and also for purposes of Federal Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations). In the case of foreign parents, the notes to the foreign financial statements may disclose information regarding the method of depreciation used.

The assets of foreign corporations in a combined group may be depreciated using any method of depreciation otherwise acceptable for California, including accelerated depreciation. In accordance with the normal rules for depreciation, accelerated depreciation methods will generally only be allowed when such methods are used for California purposes from the date that the depreciable asset is acquired. When an existing foreign corporation becomes a member of the combined group however, its depreciation has not generally been computed for California purposes in the past. Therefore, the new member may opt to use accelerated methods for existing assets as well as for newly acquired assets. The amount of accelerated depreciation on existing assets must be computed *as if* the accelerated method had been used from the time that the assets were acquired. Alternatively, if the taxpayer does not want to recompute prior years, and therefore elects to apply accelerated methods only to current year additions, they may do so. When combining a foreign corporation for the first time, the auditor should offer the taxpayer (in writing) an opportunity to elect an acceptable California accelerated depreciation method.

Occasionally, taxpayers will try to convert their foreign depreciation to an allowable California method through use of estimates or ratios (such as the ratio of foreign assets to domestic assets). Such adjustments should not be allowed unless the auditor determines them to be reasonable approximations of the actual depreciation allowances (see *Appeal of PPG Industries, Inc*., Cal. St. Bd. of Equal., August 31, 1995).

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6025 DEPRECIATION RECAPTURE

California conformed to the federal depreciation recapture provisions for taxable years beginning on or after January 1, 1987 (R&TC §24903; R&TC §24990 for taxable years beginning on or after January 1, 1988). Prior to 1987, California had not adopted depreciation recapture rules. In many cases, characterization of income as ordinary recapture income rather than as capital gain will not have a tax effect. In certain situations however, this can be a material issue. The situations that have been identified are as follows:

Limitation on capital losses. For taxable years beginning on or after January 1, 1990, taxpayers may only deduct capital losses to the extent that they have capital gains (MATM 6040). Gain from the sale of a capital asset that has been characterized, as ordinary depreciation recapture income will not free up capital losses.

Liquidations falling under the transitional relief rules: Pursuant to P.L. 99-514, §633(c)(1), liquidations and stock acquisitions qualifying under IRC §336 - IRC §338 were generally nontaxable if they were subject to a binding contract entered into on or prior to August 1, 1986, and if the liquidation or acquisition was completed by January 1, 1988. In addition, P.L. 99-514, §633(d) extended the transitional relief to January 1, 1989 for certain small corporations. Pursuant to IRC § 1245(a)(1) and IRC §1250(a)(1) (to which California conforms), the recapture provisions override these nonrecognition provisions. Therefore, recapture income is recognized with respect to transactions in taxable years beginning on or after January 1, 1987, which would otherwise be nontaxable under the transitional rules.

Although the recapture income is reported for both state and federal purposes, the auditor should be alert to the fact that the amount of recapture income will seldom be the same due to state and federal depreciation differences. Since federal depreciation methods are generally more accelerated than state methods, the recapture amount will usually be higher for federal purposes. For cases in which depreciation recapture will produce a tax effect, the taxpayer's workpapers computing the recapture adjustment should be requested to verify that their calculation is correct for state purposes.

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6030 DEDUCTIBLE DIVIDENDS (R&TC §24402)

Prior to 1990, dividends received from corporations subject to the Franchise Tax or Corporation Income Tax were deductible to the extent paid from earnings previously taxed under the Bank and Corporation Tax Law. The intent of this provision is to avoid double taxation of corporation income.

For taxable years beginning on or after 1990, R&TC §24402 was revised to allow a deduction for only the following portion of dividends paid from previously taxed earnings:

100% if received from a more than 50% owned corporation;

80% if received from a corporation owned at least 20%, but not more than 50%;

70% if received from a corporation owned less than 20%.

The deductible percentages used by the taxpayer should be compared to those shown on the deductible dividends website available on-line. If information for a particular dividend payor is not in the book, you may call the Deductible Dividend Desk in Sacramento for the deductible percentage ((916) 845-4138* *

Caution: The deductible percentages shown on the website represent 100% of the portion of the dividends paid from previously taxed income. For taxable years beginning on or after 1990, don't forget to make an additional adjustment of 70% or 80% if the payor corporation is not more than 50% owned. Following is an example of the computations:

Example
The taxpayer received a dividend of $100,000 in 1991 from Corp Y. The taxpayer's ownership percentage in Corp Y was 5%.

Total dividend received	100,000
X deductible percentage from on-line resources	3.50%
Portion of dividend declared from previously taxed income:	3,500
X 70% adjustment	70%
Deduction allowed under R&TC §24402	2,450

NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

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6032 INTERCOMPANY DIVIDENDS (R&TC §25106)

R&TC Section 25106 provides that intercompany dividends paid out of earnings from the combined unitary business are eliminated from the income of the recipient corporation. This section deals with the computations of the R&TC §25106 elimination. For a discussion of issues related to deemed intercompany dividends (IRC §1248 dividends) arising from the sale of a subsidiary, see MATM 6036.

When reviewing intercompany dividend eliminations, the auditor should verify that the distributions were paid from unitary business earnings. To the extent that the distributions exceed the earnings and profits of the payor, or to the extent that they are paid from pre-affiliation or nonbusiness earnings, such distributions are not eliminated under R&TC §25106 (See *Willamette Industries, Inc. v Franchise Tax Board*, 34 Cal.App.4th 1396A). The auditor must also keep in mind that adjustments to the taxpayer's method of filing may effect the dividends eligible for elimination. For example, if a subsidiary is determined to be non-unitary and is decombined at audit, dividends received from that subsidiary may not be eliminated under R&TC §25106 (although a R&TC §24402 deduction may be appropriate - see MATM 6030).

A distribution by a corporation to its shareholders is a dividend to the extent that it is paid out of current earnings and profits, then from accumulated earnings and profits in the reverse order of accumulation. (For years prior to 1991, R&TC §24495 defined the term "dividend." Effective for taxable years beginning on or after January 1, 1991, R&TC §24451 conformed to the IRC §316 definition.) Earnings and profits can vary tremendously from net income for state purposes, particularly since earnings and profits are decreased by federal and state income taxes. Therefore, even though a dividend may not exceed the net income of the payor corporation, it may exceed the earnings and profits. It is also important to note that earnings and profits are calculated on a separate company basis. Therefore, although a subsidiary that incurs losses on a separate basis may be apportioned a large share of the combined business income of the unitary group, its earnings and profits will still reflect losses. (See *Appeal of Young's Market Company*, Cal. St. Bd. of Equal., November 19, 1986.) A detailed discussion of how to compute earnings and profits is in Chapter 11, Water's-Edge Manual.

Example
(Distribution exceeding earnings & profits)
Corporation P and unitary subsidiary S filed a combined report for the year in which S was formed. S's net income computed on a separate basis was $10,000; its apportioned share of the unitary business income was $50,000. S paid income taxes of $4,000. S distributed $9,000 to its parent during the taxable year. Although S's net income exceeded the amount of the distribution, S's earnings and profits were only $6,000 ($10,000 income - $4,000 taxes). Therefore, only $6,000 of the distribution is considered a dividend subject to elimination under R&TC §25106. The remaining $3,000 will first be applied to reduce the parent's basis in the stock of S; and once the basis is

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reduced to zero, any remaining amount will be treated as gain from the sale or exchange of property (such gain is not subject to R&TC §25106 elimination). See MATM 5260 for more detail concerning treatment of intercompany distributions in excess of earnings and profits and stock basis.

Once the auditor has determined that the distribution is indeed a dividend, the auditor must take this concept one step further and determine whether the dividends were "paid out of the income of the unitary business."

IMPORTANT: Since dividends are paid out of earnings and profits and not out of income, this statutory wording should be interpreted to mean that the dividends must be paid out of the earnings and profits that correlate with the unitary business income (*Rosemary Properties, Inc. v. McColgan*, 29 Cal2d 677). To the extent that the dividends are paid from earnings attributable to nonbusiness or pre-affiliation income, they may not be eliminated under R&TC §25106.

Example
(Dividend paid out of nonbusiness income)
Corporation P owned 100% of the stock of unitary Subsidiary S. In the current year, S had net earnings and profits of $80,000 comprised of business earnings of $20,000 and earnings attributable to a nonbusiness activity of $60,000. At year-end, S paid a dividend of $10,000 to P.

Since 25% of S's current year earnings was attributable to business activities ($20,000/$80,000), Corporation P would be able to eliminate $2,500 (25% of the dividend) under R&TC §25106. The remaining $7,500 of the dividend is business income to P because the S stock was a unitary business asset of P at the time that the dividend was paid (see MATM 4020), but it would not be subject to R&TC §25106 elimination. The $7,500 income may, however, be subject to a R&TC §24402 deduction.

If the dividend had been paid out of earnings and profits accumulated in prior years, he same process would be applied to determine the portion of the earnings attributable to business activities in each prior year (starting with the most recent year and working backwards).

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6034 DIVIDENDS FROM INSURANCE COMPANIES (R&TC §24410)

On December 21, 2000, the Court of Appeal in *Ceridian v. FTB*, (2001) 85 CalApp4th 875 (as modified, 86 CalApp.4th 383) held that the R&TC section 24410 insurance dividend deduction is unconstitutional. R&TC Section 24410 provides for the deduction of part of the dividends paid by an 80% owned insurance subsidiary that was subject to the California gross premiums tax to a parent corporation commercially domiciled in California. The Court found that R&TC Section 24410(a) violates the US Constitution commerce clause by limiting the deduction to entities commercially domiciled in California. The Court also found that R&TC Section 24410(b), the formula to compute the amount of the deduction, violated the commerce clause because it limited the deduction for entities earning income outside the state.

A statute that is declared unconstitutional is void and ceases to operate, see *Kopp v. Fair Political Practices Commission* (1995) 11 Cal4th 607, citing with approval, *Jawish v. Molet* (1952) 86 A.2d.96. R&TC section 19393 provides that if a deduction, credit, or exclusion is determined to be invalid or discriminatory under the constitution, the tax for taxpayers who received the benefit of the deduction is to be recomputed by disallowing the deduction. However, the court in *Ceridian* held that section 19393 only applies if all taxpayers who took the deduction for a particular tax year can be treated similarly.

The court considered three potential remedies: making assessments against taxpayers that benefited from the deduction, allowing refunds to taxpayers disadvantaged by the deduction, or a combination of the two. The court held that the only remedy available in this case was to give Ceridian Corporation a refund because the years in issue were so old that the SOL had expired for assessing and collecting additional tax from Ceridian's competitors who had benefited from the deduction.

For tax years' ending before December 1, 1997, the statute of limitations for issuing assessments has already expired for some taxpayers, therefore, it is not possible to treat all taxpayers comparably by disallowing the R&TC Section 24410 deductions. Therefore, in accordance with the holding in *Ceridian*, taxpayers will be allowed to take a 100% dividend deduction for dividends received from an 80% owned insurance subsidiary regardless of the commercial domicile of the parent or where the insurance company is operating. Refunds will be allowed if claims are, or have been, filed within the statute of limitations.

For tax years ending on or after December 1, 1997, the statute of limitations for issuing assessments is open for all taxpayers, therefore, R&TC section 19393 is applicable and the R&TC section 24410 dividend deduction should be disallowed for all taxpayers.

Department Policy

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1. For tax years ending on or after December 1, 1997, the department will disallow all R&TC section 24410 deductions. To the extent that a taxpayer added back to earned income expenses related to the 24410 deductions because the insurance company dividends were not in the measure of tax as provided by R&TC section 24425, that state adjustment should be reversed.

2. For tax years ending prior to December 1, 1997, all dividends received from an 80 percent owned insurance subsidiary are deductible. We will apply R&TC section 24425 (if material) to deny expenses to earned income not in the measure of tax.

The following explanations may be used in the AIP and/or in the NPA to explain the adjustment:

- The Revenue and Taxation Code section 24410 deduction is disallowed in accordance with the Court of Appeal decision in *Ceridian Corporation v. Franchise Tax Board* (2001) 85 Cal.App.4th 875 (as modified, 86 Cal.App.4th 383). The Court of Appeal held that the R&TC section 24410 deduction, which allowed a deduction for dividends received from certain insurance companies, discriminated against interstate commerce in violation of the United States Constitution. The Court of Appeal also held that R&TC section 24410 could not be reformed.

- A statute that is declared to be unconstitutional is invalid and unenforceable. (See *Kopp v. Fair Political Practices Commission* (1995) 11 Cal.4th 607 citing, with approval, *Jawish v. Molet* (1952) 86 A.2d 96.) Because R&TC section 24410 is invalid and unenforceable, the deduction is not available. R&TC section 19393 provides that the proper remedy in such circumstances is to disallow the deduction to those taxpayers that benefited from the deduction.

Another paragraph should be added if we are reversing the original return R&TC section 24425 adjustment. If we are unable to determine whether or not a R&TC section 24425 deduction was made on the original return, we should include the following paragraph in the AIPS and/or NPA:

- R&TC section 24425 disallows expenses attributable to income not included in the measure of tax. We have attempted to identify any R&TC section 24425 adjustment related to the R&TC section 24410 dividend deduction on your original return. If you have previously made an adjustment under R&TC section 24425 and we failed to identify and reverse the adjustment, you should protest this notice or file an amended return, and identify where the adjustment was shown on the original return and the amount of the adjustment.

FTB staff may be asked the following questions concerning Ceridian:

1. What is the impact of the Court of Appeal decision in Ceridian?
   Answer: R&TC section 24410 is invalid and unenforceable for all years.

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Taxpayers that are similarly situated to *Ceridian* are members of the class of taxpayers disadvantaged by the deduction and are entitled to the same relief that was granted to *Ceridian*.

2. What taxpayers are eligible for relief consistent with the Court of Appeal decision in *Ceridian*?
   Answer: Taxpayers that received dividends from 80% or more owned insurance subsidiaries in years where the statute of limitations for making new assessments has run, but who were denied the deduction under the unconstitutional limitations of R&TC section 24410.

3. Why are dividends received from insurance subsidiaries owned less than 80% not deductible?
   Answer: A deduction was never allowed for such dividends under R&TC section 24410, so taxpayers that were denied the deduction on that basis are not within the remedial class of taxpayers under *Ceridian*. No taxpayer was benefited or harmed by this statutory limitation.

4. Why is there an abrupt change from full dividend deduction for taxable years ending prior to December 1, 1997 to no dividend deduction for years ending December 1, 1997 and later?
   Answer: The determination of the appropriate remedy for an unconstitutional provision requires treating similarly situated taxpayers the same. R&TC Section 19393 provides that when a statute is declared unconstitutional, the way to accomplish this is to deny the deduction to those who benefited from the deduction. However, as the *Ceridian* court held, this remedy couldn't be applied to taxpayers for taxable years beyond the four-year statute of limitations, because other similarly situated taxpayers have already taken the R&TC section 24410 deduction and the time to issue Notices of Proposed Assessment denying them the deduction has passed. Therefore, the only way to place all similarly situated taxpayers in the same position is to allow a 100% deduction for dividends received from 80% owned insurance companies during these years.

See also MATM 3085 and MATM 5190 for additional issues concerning insurance companies.

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6036 DIVIDEND GROSS-UPS, SUBPART F INCOME, AND IRC §1248 DIVIDENDS

The Federal 1120 returns contain adjustments to dividend income reported on Schedule C that may not be applicable for state purposes. Some adjustments are:

Dividend Gross-Ups - For federal purposes, dividends received from foreign affiliates are "grossed up" to include income taxes paid on the dividends to foreign countries. The taxpayer is then allowed to take a foreign tax credit for the grossed-up amount. California has no such provision and this income should be eliminated. A review of Schedule C of the Federal Form 1120, or Form 1118 (foreign tax credit form) may identify any dividend gross-ups.

Subpart F Income - For federal purposes, dividend income may include Subpart F income. In general, certain types of income earned by controlled foreign corporations (as defined in IRC §957) are taxed to the U.S. shareholder as a deemed dividend under Subpart F of the Internal Revenue Code (IRC §951 - IRC §964). To the extent that actual distributions are made out of earnings that have been previously taxed to the shareholder under Subpart F, the distributions are excluded from the recipient's income.

Example
A CFC has subpart F income of $8 in Year 1. The $8 is treated for federal purposes as deemed dividend income to the U.S. shareholder in Year 1. In Year 2, the CFC pays an actual dividend of $10. For federal purposes, dividends are considered to be distributed first from previously taxed income (in contrast to the normal LIFO ordering rule for dividends). Therefore, $8 of the $10 dividend is considered paid from the previously taxed income, and $2 is paid from non-subpart F earnings. Only $2 of the distribution will be shown as a taxable dividend on the federal return for Year 2.

Since California does not conform to the Subpart F provisions, the income is not taxed for State purposes until it is actually repatriated to the U.S. shareholder. Therefore, state adjustments will be necessary (1) to eliminate the subpart F deemed dividend income, and (2) to include the actual dividend distributions in income when paid.

Example
Assume the same facts as in Example 1. For California purposes, the taxpayer should have made a state adjustment in Year 1 to reverse the $8 federal subpart F deemed dividend income. In Year 2, another state adjustment will be necessary to increase dividend income reported for federal purposes by $8. If the CFC is a member of the combined report, then the $10 dividend may be subject to elimination under R&TC §25106. If the dividend was not paid out of unitary earnings and profits, then the dividend would be taxable for California purposes.

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The presence of Subpart F income is usually shown on the federal Schedule C or Form 5471. In the year that the actual distributions are made however, the Schedule C will only identify the portion of the dividend that is taxable for federal purposes. There should be a Schedule M-1 adjustment for the difference between the actual distribution and the federal taxable amount, but occasionally there will be no M-1 adjustment, or the adjustment will be buried within another M-1 item. Consequently, the federal return is not a reliable source for verifying the amount of the actual distribution. If properly prepared, Schedule 5 of the Form 5471 should detail actual distributions and whether they are considered to be from previously taxed subpart F income. The best way to determine the actual amount of the dividends received is usually through the taxpayer's pre-consolidation books of account. Chapter 9, Water's-Edge Manual and Chapter 11, Water's-Edge Manual describes this issue in more detail, and provides examples of how to determine the amount of the actual distributions.

1248 Dividends
When a U.S. shareholder sells stock in a controlled foreign corporation in which they meet certain ownership requirements, the gain recognized on the sale may be considered a deemed dividend for federal purposes (subject to certain earnings & profits limitations). Pursuant to R&TC §24903 and R&TC §24990, California conformed to this provision during a window period beginning with taxable years beginning on or after January 1, 1987. Our conformity was terminated by R&TC §24990.7 for transactions occurring after August 20, 1990, in taxable years beginning on or after January 1, 1990. Therefore, for sales of stock reported on the installment method, payments received during the window period would be subject to IRC §1248 treatment even though the actual sale took place prior to January 1, 1987.

During the window period, the deemed dividends may be subject to R&TC §25106 elimination if the foreign subsidiary was a member of the combined report (MATM 6032). Transactions occurring before and after the window period are treated as gains on the sale of stock for California purposes. Adjustments may be necessary to reflect the correct amount of gain based upon the California cost basis of the stock (see MATM 6095 for a discussion of these adjustments and other issues related to sales of subsidiaries).

If a member of the combined report has a recently acquired foreign subsidiary, and if the acquisition date was outside the window period, auditors should review the taxpayer's pre-consolidation books or ledger summaries to look for subsequent distributions made by the foreign corporation to its new owners. If the stock sale was treated as a deemed distribution for federal purposes, a portion of the foreign corporation's earnings and profits will be considered to be "previously taxed." Actual distributions made to the new owner in subsequent years will not be subject to federal tax to the extent that they are paid from the previously taxed earnings and profits (even though the E&P was previously taxed to the seller, not the buyer!) Consequently, foreign dividends identified on the new owner's federal Schedule C or Form 5471 may be understated or omitted altogether. The book/federal tax difference may be disclosed on the Schedule M-1, but is not always apparent. For

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California purposes, the earnings and profits are not considered to be previously taxed so the dividends may be taxable. Furthermore, since the E&P was incurred prior to acquisition by the new owners, it will not be subject to R&TC §25106 intercompany elimination (although a foreign dividend deduction may apply if the new owner has elected water's-edge).

A review of Schedule C of the Federal Form 1120 may identify whether any of these items are included in federal dividend income. The Schedules M-1 and Forms 5471 should also indicate the existence of dividend gross-ups and Subpart F income. The auditor will then need to determine whether appropriate state adjustments have been made.

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6040 CAPITAL LOSSES

Prior to 1990, California did not conform to the federal limitation on capital losses. For federal purposes, capital losses can only be deducted to the extent of capital gains. Any capital losses that are not deductible in the year of the loss may be carried back three years, and carried forward five years (IRC §1211 - IRC § 1212). In the year in which a capital loss was incurred, the taxpayer would therefore have a negative state adjustment for the amount of the loss that was not allowed for federal purposes. Positive state adjustments would be made in the years in which the taxpayer utilized the federal capital loss carrybacks and carryovers.

Effective for taxable years beginning on or after January 1, 1990, R&TC §24990 states that IRC §1201 - IRC §1296 are applicable law for determining capital gains and losses. Included in these sections are the provisions relating to the federal capital loss limitation. For California purposes however, unused capital losses may only be carried forward; no carrybacks are allowed. (R&TC §24990 - R&TC §24990.5).

Although California now conforms to the capital loss limitation, federal/state differences will still arise. Federal/state basis differences will affect both the amount of capital loss, and the amount of capital gain to which the capital loss deduction will be limited. (For example, assume a taxpayer has a $35,000 capital loss for both federal and state purposes. For federal purposes, the taxpayer has a $40,000 capital gain, and may therefore deduct the entire capital loss. Due to basis differences, the gain is only $30,000 for California. The loss will be limited to $30,000, and the taxpayer will have a $5,000 capital loss carryover for California.)

If material gain or loss transactions are reported on the Federal Schedule D or Form 4797, the federal and state computations should be reviewed to ensure that appropriate federal/state basis differences were taken into account. The amount of any capital loss carryover should also be reviewed to verify that it properly reflects the California amount.

Also, included in these law sections to which California now conforms are the federal procedures for netting gains and losses in order to determine the capital loss limitation. Capital losses are deductible only to the extent of capital gains, and any excess losses may be carried over and applied against capital gains in each of the five succeeding taxable years.

On July 13, 1999 CCR § 25106.5 went final. Regulation 25106.5-2 provides for the intrastate apportionment of business gains or losses from the sale or exchange of capital assets, IRC §1231 property and involuntary conversions prior to the netting provisions. Those gain/loss items are then netted at the entity level after intrastate apportionment with nonbusiness gains or losses. The regulation is retroactive.

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6050 CHARITABLE CONTRIBUTIONS

Contributions deductible for state and federal purposes may differ significantly. When reviewing the contributions deduction for state purposes, be aware of the following:

The federal limitation on the deduction for contributions is generally 10% of net income, although members of a consolidated return are limited to 5% of adjusted consolidated taxable income. The California limitation is 5% (10% for taxable years beginning on or after 1/1/96), and applies on a combined basis (R&TC §24358). In addition, California further adjusts the contribution deduction to take into account the effect of nonbusiness items on the income limitation (this is termed the "contributions adjustment" -- see MATM 4070). The contributions adjustment is calculated on Schedule R-6 of the Form 100. Rather than separately compute (1) the general 5% income limitation as a state adjustment, and (2) the contributions adjustment on Schedule R-6, taxpayers will often use the Schedule R-6 to reflect the overall adjustments. By analyzing the Schedule R-6 computation, as well as what has ultimately been deducted on the California return (federal deduction ± state adjustments ± contributions adjustment), auditors can determine whether the bottom line results are correct.

In addition to differences in federal and state net income, there are differences in the adjustments to income that are required for purposes of computing the limitation. For federal purposes, net income is adjusted for net operating loss deductions, and other special deductions not applicable to California. For California, adjustments are made to add back the R&TC §24402 dividends received deduction, deductions for built-in gains and passive investment income, and certain other deductions.

Federal law allows for a five-year carryover of excess contributions. For taxable years beginning prior to 1/1/96, California has no carryover. However, R&TC §24358(3)(b) was revised and now provides that IRC §170(d)(2), relating to carryovers of excess contributions, shall apply with respect to excess contributions made during taxable years beginning on or after 1/1/96.

California generally limits the contribution of appreciated property to the corporation's basis in the property (R&TC §24357.1). See MATM 6051 below for an exception with respect to qualified research contributions.

R&TC Section 24359 states that a charitable contribution means a contribution or gift to or for the use of a qualified recipient, created or organized in the United States or in any possession thereof. In computing combined unitary income, however, it is the Department's policy to allow contributions made by non-US corporations to non-US charitable organizations (provided that the foreign jurisdiction has not ruled that such beneficiary is not a qualified charitable organization). (Audit Program Report 86-4)

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R&TC Section 24425 provides for the disallowance of expenses incurred to earn income that is not included in the measure of tax. The most common type of income that is not included in the measure of tax is deductible dividend income. Because the dividend income is not being taxed, R&TC §24425 provides that the expenses incurred to earn the dividends should not be deducted. Expenses relating indirectly to this type of income may include charitable contributions, interest expense, officer's compensation, office rent and overhead, etc. If material, a portion of these expenses should be allocated to the deductible dividends. The methodology used to allocate the expenses will vary depending upon the facts and circumstances, so you will have to select an allocation method that is reasonable for the taxpayer's specific situation. For example, charitable contributions generally relate indirectly to all of a taxpayer's income. Therefore, it would be reasonable to allocate the contributions to deductible dividends based on the ratio of deductible dividends over the taxpayer's total receipts (the SBE and courts have supported this approach). However, if the taxpayer suggests a different allocation method, be sure to evaluate that method to determine whether it is reasonable. If the primary position the auditor is taking is that the dividends should not be deductible in the first place, the auditor is still required to develop whether material expenses attributable to that dividend income should be disallowed as an alternative position.

Certain other differences exist with respect to the rules for certain types of contributions. If a contribution is material, the auditor should verify whether California conforms to the specific rules pertaining to that contribution.

A review of the Schedule M-1 should reveal whether the federal contribution deduction includes carryover amounts or contributions of appreciated property.

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6051 QUALIFIED RESEARCH CONTRIBUTIONS

Many computer companies donate systems to colleges and avail themselves of R&TC §24357.8. If they meet all of the requirements, they are entitled to increase their deduction by 50% of the difference between fair market value and cost (limited to twice the basis of the property).

The principle requirements under this provision are as follows:

The contribution must be of tangible personal property as described in paragraph (1) of IRC 1221 -- generally property included in the inventory of the donor.

The contributed property must be scientific equipment or apparatus; and substantially all of the use by the donee must be for research or experimentation or for research training in physical, applied, or biological sciences, or for instructional purposes. (Use of the property for instructional purposes does not qualify for federal purposes.)

The property must be contributed within two years after construction. California does not have the federal requirement that the taxpayer must construct the property.

The donee must be an institution of higher education *in California*. Unlike federal, California does not include tax-exempt scientific organizations as eligible donees.

The donee must be the original user of the property.

The college or university cannot transfer the property for money, other property or services.

A written statement must be obtained from the donee representing that the use and disposition of the property will be in accordance with R&TC §24357.8.

The auditor should verify that deductions for qualified research contributions do not include contributions to non-California donees. If such contributions are noted, adjustments should be made to limit the deduction to the cost basis of the contributed property.

If the contribution to California institutions is material, the auditor should review the required donee statements for compliance with R&TC §24357.8. The taxpayer's method of establishing the fair market value of the property should also be reviewed for reasonableness.

Prior to 1992, any portion of the contribution deduction that exceeds the adjusted basis of the donated property is a tax preference item (see MATM 8530). Auditors should review the AMT computation to verify that this preference has been reported correctly.

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6054 CREDIT FOR CLINICAL TESTING EXPENSES

For years 1987 through 1992, California allowed a credit for the cost of clinical testing and development of drugs for rare diseases (R&TC §23609.5, MATM 9040). Pursuant to R&TC §24440, the taxpayer must reduce any deduction that would otherwise be allowable by the amount of the credit. Although federal law provides for a similar credit, differences between the federal and state computation of the credit will result in different limitations on the deduction of clinical testing expenses. When this credit is reported, state adjustments will be necessary to account for these differences.

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6055 DONATED AGRICULTURAL PRODUCTS CREDIT

For years 1989 through 1991, a credit is allowed for agricultural products that are donated to nonprofit organizations (R&TC §23608, MATM 9050). The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment will be required to add back the deduction.

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6056 FUEL TAX CREDIT

Under federal law, a taxpayer may apply for either a refundable tax credit (IRC §34) or a refund (IRC §6420- IRC §21) for federal excise taxes on gasoline used for farm purposes or specific other off-highway business purposes. Since the excise tax is either refunded or allowed as a credit, it is not allowed as a deduction for federal purposes.

The state fuel tax is also refundable through the State Controller. The refunds are includable in income, and will offset the fuel tax deductions for state purposes. Some taxpayers deduct the fuel tax for California purposes as a state adjustment similar to the adjustment for the jobs tax credit (MATM 6057). In such cases, the auditor should ensure that the state adjustment is offset with an adjustment to include the fuel tax refunds in income.

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6057 JOBS/ZONE WAGE TAX CREDITS

For federal purposes, if a taxpayer claims a jobs tax credit, their deduction for wages and salaries must be reduced by the amount of the credit (IRC §280C(a)). Although California does have a jobs tax credit (R&TC §23621, MATM 9070), the provisions differ from the federal provisions. The principal difference is that California does not reduce the taxpayer's deduction for wages and salaries by the credit. In all circumstances, the deduction for payroll and salary expense is allowable in its entirety for state purposes. If a federal jobs tax credit has been taken, there should be a Schedule M-1 adjustment for the payroll expense reduction. For California purposes, a state adjustment should be made to reverse the M-1 adjustment.

California law also provides credits for wages paid to qualified individuals in designated Enterprise Zones (R&TC §23622; MATM 9062), Program Areas (R&TC §23623; MATM 9062), Local Agency Military Base Recovery Areas (R&TC §23646; MATM 9084), and the Los Angeles Revitalization Zone (R&TC §23623.5, R&TC §23625; MATM 9092 - MATM 9094). If any of these credits are claimed, the deduction for wages paid to such individuals must be reduced by the amount of the credit generated in that taxable year. Since there are no comparable credits in Federal law, a state adjustment will result. For further details regarding economic development area tax incentives, refer to the Economic Development Areas Audit Manual.

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6058 RIDESHARING TAX CREDIT

For taxable years beginning on or after January 1, 1989, employers are allowed a California tax credit for participating in certain rideshare activities (R&TC §23605, MATM 9150). If a credit is taken, no deduction is allowed for the rideshare costs. Since there is no comparable credit under federal law, a state adjustment will be necessary to add back the rideshare expenses. In addition, the California basis of any ridesharing vehicle must be reduced by the amount of the corresponding credit. This will contribute to the overall federal/state depreciation difference.

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6060 EMPLOYEE STOCK OPTION PLAN TAX CREDIT

For compensation paid or accrued before 1987, an employer was allowed a federal tax credit for contributions to a tax credit employee stock ownership plan (commonly known as a PAYSOP). No deduction was allowed for contributions that were subject to the credit. California did not conform to these provisions, so the contributions continued to be deductible for state purposes. If a federal credit has been taken, there will usually be a Schedule M-1 adjustment for the related deduction. For California purposes, the federal Schedule M-1 adjustment should be reversed. An analysis of taxpayer's Federal Form 8007 (Federal tax credit employee stock ownership plan) and its related workpapers should also identify the allowable deduction for California purposes.

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6065 INTEREST ON GOVERNMENT BONDS

For California Franchise Tax purposes, gross income includes all interest received from federal, state, municipal or other bonds (R&TC §24272).

The U.S. Constitution prohibits a direct tax on interest income from U.S. obligations; therefore such interest is not taxable for California Income Tax purposes. The constitutional prohibition does not apply to the California Franchise Tax however, because it is not considered a direct tax (although it is based on income, it is actually a tax on the privilege of doing business). Since U.S. government interest is taxable for federal purposes, no state adjustment for such interest should be necessary for taxpayers subject to the franchise tax. Any state adjustments made by the taxpayer to back out the interest income should be reversed.

Interest on state and municipal obligations is generally not taxable for federal purposes. Such interest is only exempt for California Income Tax purposes if the obligations are on California or its political subdivisions. Interest on obligations of other states or foreign countries are subject to the California Income Tax. All state and municipal interest is subject to the franchise tax. Schedule M-l will disclose whether the taxpayer has exempt interest for federal purposes. If such interest exists, the auditor should verify that state adjustments have been made to add back the interest to the extent necessary for franchise or income tax purposes.

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6070 INTERCOMPANY PROFIT IN INVENTORY

Intercompany profit in inventory occurs when sales of products are made between members of a combined group. Profit from intercompany sales is generally not recognized until the goods are sold to an outside party. Therefore, to the extent that goods that had been subject to an intercompany sale remain in the inventory of the unitary purchaser, the profits from the intercompany transaction should not be recognized.

The department's policy, as set forth in Publication 1061, Guidelines for Corporations *Filing a Combined Report*, is that the intercompany profit in inventory should be eliminated from combined income (MATM 5260). Correspondingly, the profit in inventory should also be eliminated from the beginning and ending inventories for purposes of computing cost of goods sold, as well as for property factor purposes. (See MATM 7173 for property factor adjustments). The income adjustment for any one year will be the difference between the intercompany profit in the beginning inventory and the ending inventory of each affiliate which has intercompany purchases. As a general rule, a negative adjustment to income will be necessary if inventories increase from year to year; while a positive adjustment will result if inventories decrease. Examples of both cases are as follows:

	Increasing Inventory	Decreasing Inventory
Profit in Inventory - 01/01/xx	$ 100	$ 100
Profit in Inventory - 12/31/xx	150	50
Adjustment to Eliminate Intercompany Profit in Inventory	(50)	50

If the taxpayer has made an adjustment for intercompany profits in inventory, the computation should be reviewed to ensure that the amount is reasonable, that the taxpayer is applying the adjustment consistently from year to year, and that the factors have also been adjusted.

Under GAAP, intercompany profits in inventory are eliminated for book purposes. A reconciliation of Schedule M-1 book income to the financial statements (MATM 5130) should identify whether the book elimination adjustments have been picked up for federal purposes. If the Schedules M-1 reveal that the federal intercompany profits in inventory differ from the book amounts, then the auditor should determine whether a state adjustment is necessary.

For federal purposes, intercompany profits on sales of products are deferred rather than eliminated. (See MATM 5260 for a discussion of the federal deferral rules.) Neither method recognizes intercompany income in the year of the sale. The primary difference is that under the elimination method, the buyer takes the related seller's basis in the product so the gain is effectively recognized

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only when the product is ultimately sold to a third party. Under the federal deferral method, the buyer's basis is the consideration paid for the product. The deferred gain is recognized upon the occurrence of a "restoration event" such as a sale of the product to a third party or a disaffiliation of the buyer or seller. This distinction may create a federal/state difference when a restoration event other than a third party sale occurs. For federal purposes, the deferred intercompany profits would be restored into income, but no gain would be recognized for California. Federal/state differences may also occur when the taxpayer has intercompany profits in inventory with respect to entities that are not included in the consolidated Form 1120 (i.e., foreign entities).

Material issues may be created when inventory balances at the date of a water's-edge election include inventory purchased intercompany between foreign and domestic entities. See Chapter 17, Water's-Edge Manual for more discussion of this issue.

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6075 FOREIGN INVENTORY ADJUSTMENTS

Pursuant to R&TC §24701, California generally conforms to the federal rules for inventory valuations and methods (IRC §471 and IRC §472). In accordance with those rules, inventories are valued at either (1) cost or (2) lower of cost or market. For an inventory accounting method to be accepted under IRC §471, it must conform as nearly as possible to the best accounting practice in the trade, and it must clearly reflect income. Some of the inventory methods allowed for tax purposes are described in Treas. Reg. §1.471-5 through Treas. Reg. §1.471-11, and Treas. Reg. §1.472 (LIFO).

Both California and federal law allow the use of the Last-in First-out (LIFO) inventory method. California generally conforms to the IRC §472(c) requirement that the LIFO method will only be allowed for tax purposes if it is also used for financial statement purposes. Because LIFO is not an acceptable method in many foreign countries however, California will allow the use of LIFO for foreign operations even though the foreign inventories are computed on a FIFO basis for financial statement purposes (CCR §25106.5-10(b)(3)(B)(ii)).

Normally, the election to use LIFO must be made on the original return or on an amended return filed by the due date of the original return. This applies to foreign as well as domestic entities in the combined report. In cases where foreign corporations are combined for the first time at audit however, the taxpayer will be allowed to retroactively elect to use LIFO for valuation of the foreign corporation's inventory starting with the first year of combination.

Example
Audit combined the taxpayer on a worldwide basis for 1980 - 1989. All years are in litigation, appeals or protest. In 1996, the taxpayer now agrees that they are unitary on a worldwide basis. The taxpayer will be allowed to elect to use LIFO for inventory valuation starting in 1980.

Example
Assume the facts as in Example 1, except the taxpayer was previously audited for 1977 - 1979, and did not dispute the worldwide combination for those years. The years were closed without the use of LIFO inventory valuation. The taxpayer cannot use the LIFO method on a retroactive basis for any year. If the due date for the current year return has not passed, the taxpayer can elect to use LIFO for that year.

To verify the acceptability of the foreign inventory method, the following steps should be taken:

The auditor should determine the base of valuation for foreign inventories (i.e., cost, lower of cost or market, or another method). For some countries, the inventory balances themselves may not be adjusted to account for market fluctuations, but such fluctuations may be charged to reserve accounts. The financial statements will usually identify the inventory valuation used, and whether any

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reserves are used. Publications, which describe the accounting practices of the foreign parent's country, may also help to determine how inventory was valued -- see Exhibit J. If the valuation is not acceptable for California purposes and the difference is material, then adjustments to beginning/ending inventories and to the property factor should be considered. (But see CCR §25106.5-10 and MATM 5145 for criteria to consider before requiring a foreign corporation to conform its method of accounting to a California method.)

The auditor should determine the inventory method used to account for foreign inventories (i.e., FIFO, LIFO, etc.). The financial statements will usually identify the inventory methods used, and publications, which describe the accounting practices of the foreign parent's country, may provide additional information regarding those methods. If the inventory method is acceptable for California purposes, then the issue does not need to be pursued further. However, if the foreign corporations are being combined for the first time and the taxpayer wishes to elect an inventory method specifically for California worldwide reporting purposes, they should be given the opportunity to do so.

If the taxpayer wishes to convert to a LIFO inventory method for foreign inventories, the auditor should verify that the LIFO adjustments are correct. In the past, the department has required taxpayers to submit a CPA certification to support their LIFO values. This will no longer be required, although an auditor may still accept such a certification as one way for the taxpayer to meet their burden of proof regarding the LIFO valuations.

Rules for use of the LIFO method are provided in Treas. Reg. §1.472, and a description of LIFO is also contained in Chapter 17, Water's-Edge Manual. Although LIFO can be calculated based upon the quantity and cost of specific goods (e.g., unit method), most taxpayers use the "dollar-value" method:

For each pool of inventory, the cost for each item in the pool at the beginning of the first LIFO year will be aggregated to derive the base-year costs. The beginning inventory costs used for financial reporting purposes should generally be used. Because LIFO inventories are required to be stated at cost rather than at lower of cost or market, any previous write-downs of base-year inventory must be added back into income ratably over three years (IRC §472(d)).
For each LIFO year, the value of each pool of ending inventory must be determined using the cost that the inventory would have had in the base-year. The computational approaches available to restate ending inventory at base-year costs include the double-extension method, the index method, and the link-chain method. These methods are explained in Treas. Reg. 1.472-8.
The beginning and ending inventories (expressed in base-year costs) are compared. If the value has increased over the year, then the amount of the increase is multiplied by the ratio of current costs over base year costs to arrive at the value of the current year LIFO layer. If the value has decreased, then prior year LIFO layers are decreased (liquidated) accordingly.
Once inventory balances have been determined under the LIFO method, cost of goods sold must be recalculated. If financial statement net income was used as the base for California net income, the

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state adjustment should reflect the difference between cost of goods sold calculated for book and California tax purposes.

As discussed in CCR §25106.5-10 and MATM 5145, the department must consider the cost of compliance and materiality of the issue. For example, if a subsidiary operates solely within one foreign country and has a similar line of products, it may be reasonable to take a "short-cut" by treating all inventory in that country as one LIFO pool. On the other hand, the information needed to make LIFO computations is available in the ordinary course of the taxpayer's business, so estimations should not be accepted unless the auditor is comfortable that the estimate is a reasonable approximation of the actual numbers. For example, it is never reasonable to accept foreign LIFO valuations based on the ratio of domestic tax inventory to domestic book inventory.

When the inventory method used for California is different from the method used for book purposes, the auditor should verify that the correct inventory valuation has been included in the property factor. Book/tax differences may be revealed during the property factor reconciliation discussed in MATM 7110.

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6080 DEPLETION

For taxable years beginning on or after January 1, 1987 through December 31, 1992, California conformed to the federal rules for depletion, except with respect to percentage depletion for oil, gas and geothermal wells (R&TC §24831 - R&TC §24833). (For taxable years beginning on or after January 1, 1993, California repealed §24832 and §24833 and now conforms to federal depletion rules for oil, gas and geothermal wells.) The percentage depletion rates are listed in IRC §613. Prior to January 1, 1987, California's depletion rates differed from federal, and were listed in §24833. Another state/federal difference that existed prior to January 1, 1987 was California's limitation on the amount of percentage depletion on sulfur that could be deducted in any one year. This limitation was similar to the limitation on oil and gas that is discussed below.

Percentage depletion is a preference item for AMT purposes to the extent that it exceeds the basis of the property. See MATM 8530.

Oil, Gas & Geothermal Wells

Under federal law, percentage depletion is allowed for the following:

Regulated Natural gas
Natural gas sold under a fixed contract
Certain geothermal deposits
Certain independent producers and royalty owners subject to a 65%-of-taxable-income limitation.

For taxable years beginning on or after January 1, 1993, California follows the federal provisions for percentage depletion.

For taxable years beginning on or after January 1, 1987 through December 31, 1992, California does not restrict percentage depletion as provided under federal law, but provides for a depletion rate of 22% for oil, gas and geothermal wells. As long as the accumulated depletion does not exceed the adjusted basis of the property, the amount of depletion deductible in any year is limited only by the general 50%-of-net-income limitation (computed on a combined basis). Once basis is exceeded, however, an additional limitation will apply if the total depletion for all of the taxpayer's oil, gas and geothermal properties exceeds $1,500,000. In such a case, the depletion that would otherwise be allowable must be reduced by 125% of the amount by which the depletion allowance exceeds $1,500,000. Under this formula, if the accumulated depletion exceeds the cost basis and the current year depletion allowance is $7,500,000 or more, the depletion deduction for the current year will be phased out. The limitations on the depletion deduction must be computed for the combined group as a whole, not on a separate entity basis. (former §24833.)

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For years beginning prior to January 1, 1993, the auditor should verify that a state adjustment has been made to account for the state and federal depletion differences. If the state depletion deduction is material, the taxpayer's depletion workpapers should be reviewed to determine whether the limitation has been correctly applied.

Although California conforms to federal depletion provisions for years beginning on or after January 1, 1993, the auditor should be aware that the basis on which the cost depletion is calculated may differ. For example, if the original asset cost was $100 and federal cost depletion taken prior to 1993 was $80, a federal basis of $20 would remain. For California purposes, percentage depletion taken prior to 1993 might have been $90, leaving a California basis of $10. California cost depletion for 1993 should be based on $10.

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6085 INTANGIBLE DRILLING AND DEVELOPMENT COSTS

The California and federal laws are similar. For taxable years beginning prior to January 1, 1987, California did not conform to IRC 291(b), which only allowed a percentage of the intangible drilling costs (IDCs) to be currently deducted. Since the portion of the IDCs that was not currently deductible for federal purposes was allowed to be amortized over five years, this may result in a state/federal difference through 1991 (the five-year federal amortization period of IDCs capitalized in 1986 will end in 1991).

Another California-Federal difference involves geothermal wells. For federal purposes, IRC §263(c) allows taxpayers the option to currently expense IDCs for oil, gas and geothermal wells located within the United States. R&TC §24423 is substantially the same as IRC §263(c), but only applies to oil and gas wells. Therefore, California has no provision that would allow IDCs related to geothermal wells to be currently expensed.

For years beginning on or after January 1, 1987, neither Federal nor California permit expensing of IDC's relating to costs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States.

Intangible drilling costs may be an item of tax preference for alternative minimum tax purposes. See MATM 8530 for more details.

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6086 TERTIARY INJECTANT EXPENSES

A "tertiary recovery method" means any method that is described in Section 212.78(c)(1) through (9) of the June 1979 Energy Regulations, 10 CFT 212.78 (1979). Very broadly, this entails injecting hydorcarbon gas into an oil or gas well to increase pressure for recovery. For federal purposes, tertiary injectant expenses are deductible in the year that the injections were made (IRC §193; §263(a)(1)(F)). California does not conform to the federal treatment. R&TC Section 24422 adopts similar language as IRC §263, except for §263(a)(1)(F). In addition, California does not have a similar provision as IRC §193. For California and financial reporting purposes, if tertiary costs enhance the recovery process, they are capitalized and amortized over the life of the reserve. If the tertiary costs do not enhance the recovery process, they will be expensed.

An examination of the federal Schedule M-1 should identify if tertiary costs have been capitalized for books but expensed for federal tax purposes. If so, then state adjustments will be required to reverse the deduction in the year of the injection and to allow amortization in subsequent years.

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6090 SAFE HARBOR LEASING

Between 1981 and 1983, former IRC §168(F)(8) provided a safe harbor election that guaranteed that certain transactions would be treated as leases rather than as financing arrangements, even though the transaction would not otherwise qualify as a lease. In effect, this provision permitted the transfer of depreciation benefits and investment tax credits between taxpayers. California never adopted the Safe Harbor Leasing provision, and continued to follow case law and pre-safe harbor IRS guidelines in determining whether a transaction should be treated as a lease. A discussion of federal requirements for safe harbor leases, and guidelines followed by California in determining whether a transaction qualifies as a lease, may be found in FTB Legal Ruling 419 (1981).

Even though the safe harbor rules no longer exist under current law, the rules still apply for federal purposes for the duration of leases that were entered into under a valid safe harbor election. Therefore, federal net income may still include income and deductions related to safe harbor leases. Following is an example of how the safe harbor leases are structured:

Example: Corporation X purchases new equipment with a 10-year life for $1,000,000. X "sells" the equipment to Corporation Y for $200,000 cash and an $800,000 15-year note. Y then "leases" the equipment to X for 15 years, for an amount that exactly offsets the debt service. The only money that changes hands on the transaction is the $200,000 payment from Y to X. At the end of the lease Y sells the asset to X for one dollar. As the deemed owner under former IRC §168(f) (8), Corporation Y is entitled to an investment tax credit and accelerated depreciation with respect to its "leased" asset. Corporation X has the benefit of a rental deduction.

Schedule M-1 should disclose whether any transactions are being reported under the safe harbor rules for federal purposes. If so, state adjustments are necessary to reverse the income and deductions related to the transaction. These adjustments may include the following:

If the taxpayer is the lessor, depreciation on the leased property and interest deductions related to the note should be added back into income. Rental income should be eliminated.

If the taxpayer is the lessee, rental expense should be added back into income, and interest income from the note should be eliminated. The lessee should be allowed a depreciation deduction for the property based upon original cost less the down payment received from the lessor.

For state purposes, some taxpayers have attempted to deduct or amortize the down payment made on the safe harbor lease transaction (the $200,000 payment in the above example). As discussed in Legal Ruling 419, this payment is for the purchase of federal tax benefits. Since the federal income taxes themselves are not deductible, neither is the safe harbor lease down payment. This deduction

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should be disallowed. Since the adjustment may be netted with other safe harbor lease items, it is important to analyze the taxpayer's adjustments to verify that they are proper.

Adjustments to the property factor of both the lessor and lessee will also be necessary -- see MATM 7205.

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6095 SALES OF SUBSIDIARIES

Since California law is significantly different from federal law with respect to investments in subsidiaries, material issues may be found in this area.

When a parent and subsidiary are members of a consolidated group, the parent's basis in the subsidiary's stock is treated as an investment account for federal purposes. Accordingly, it is increased by the net income of the subsidiary, and decreased by net losses and distributions out of earnings and profits (Treas. Reg. 1.1502-32). To the extent that the negative adjustments would otherwise reduce the parent's basis in their stock below zero, an "excess loss account" is established (Treas. Reg. 1.1502-32(e)). When the subsidiary is sold, gain or loss on the disposition of the stock is computed using the parent's basis net of any investment adjustments. The balance of any excess loss account is recaptured into the parent's income (Treas. Reg. 1.1502-19). California has no similar provisions. For state purposes, gain or loss on the sale of the stock of a combined subsidiary is computed using the parent's original cost basis (net of any distributions that constituted returns of capital). Because of this difference, the sale of a consolidated subsidiary will almost always result in a state adjustment.

Federal/state basis differences may also occur with respect to stock in foreign subsidiaries. For federal purposes, certain income of controlled foreign corporations (CFCs) is treated as a deemed dividend to the U.S. shareholder. Such income is termed "subpart F" income. The basis of the CFC is increased by the amount of subpart F income that has been taxed to the U.S. parent, and decreased by any distributions that have been repatriated out of previously taxed subpart F income. (IRC §951 - IRC §964, see also MATM 6036.) Since California does not conform to these rules, gain or loss from the sale of a foreign subsidiary is again computed using the cost basis of the stock.

For federal purposes, the gain on the sale of stock in a CFC may also be deemed dividend income to the U.S. shareholder (IRC §1248). California conformed to this provision during a window period from taxable years beginning on or after January 1, 1987 to transactions occurring on or before August 20, 1990 in taxable years beginning on or after January 1, 1990. Outside of that window period, IRC §1248 dividends are treated as gains on the sale of stock for California purposes, and are not subject to R&TC §25106 elimination of intercompany dividends (see MATM 6036).

Reviewing Schedules D and M-1 of the Form 1120 may identify stock transactions. Annual reports and SEC Form 10-Ks may also identify dispositions of subsidiaries. When a subsidiary has been disposed of during the audit period, the auditor should determine how the disposition was reported for state purposes. To ensure that original cost was used, the taxpayer's basis computations should be reviewed.

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6100 TAXES MEASURED BY INCOME OR PROFITS

No deduction is allowed for taxes on, or according to, or measured by income or profits paid or accrued within the taxable year (R&TC §24345). Since state, local and foreign income taxes are generally deductible for federal purposes, the auditor should analyze the deduction for taxes to insure that all taxes measured by income have been added back for state purposes.

For purposes of R&TC §24345, the term "income" refers to gross income. It is important to distinguish between gross income and gross receipts because a tax measured by gross receipts is deductible. Gross receipt is a term generally used to describe gross proceeds including a return of capital (cost of goods sold). In order to arrive at gross income, gross receipts are reduced by cost of goods sold. The determination of whether a tax is on or according to or measured by income must be made on a case-by-case basis by looking at the make-up of the specific tax imposed. Certain types of receipts, such as rents or income received for the performance of services, do not contain a return of capital element. In these cases, gross receipts are the same as gross income, and the tax on that income will be considered to be a non-deductible income tax. For further guidance in determining whether a tax is based on income, see *Appeal of Huntington Alloys*, Inc. Cal. St. Bd. of Equal., September 12, 1984; *Appeal of Charles and Mary Haubiel*, Cal. St. Bd. of Equal., May 15, 1974; *Beamer v. Franchise Tax Board*, (1977) 19 Cal.3d 467, 475; MCA inc. v. FTB (1981) 115 Cal.App.3d 185.

Federal Environmental Tax:
The federal environmental tax imposed by IRC §59A is deductible for federal purposes. The computation of this tax is based on federal alternative minimum taxable income (AMTI). Since AMTI is merely net income computed under different rules than those used for federal regular tax purposes, the environmental tax is a tax based on net income. The environmental tax is therefore not deductible for California purposes, and should be added back as a state adjustment.

Michigan Single Business Tax:
The state of Michigan imposes a tax known as the Single Business Tax (MSBT). For purposes of computing the tax base, employee compensation is added back to federal gross income. Since a labor component is generally included in cost of goods sold, adding back the compensation will result in an element of cost of goods sold being included in the tax base. The State Board of Equalization has ruled that if the tax base includes any element of return of capital, then the tax is measured by something other than gross income, and is therefore deductible (*Appeal of Dayton Hudson Corporation*, Cal. St. Bd. of Equal., February 3, 1994). In order to determine whether a corporation has a labor component in cost of goods sold, the auditor should look to the federal standards under IRC §263A. If the corporation has as little as $1 of labor cost of goods sold, the MSBT will be deductible. Furthermore, in the *Appeal of Kelly Service, Inc and Subsidiary Corporations*, Cal. St. Bd.

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Of Equal., May 8, 1997, the State Board of Equalization concluded that the MSBT makes no distinction between activities of a taxpayer when calculating the measure of tax. The State Board of Equalization found that the MSBT is deductible as provided by R&TC §24345(b), regardless of the specific components of the MSBT base of the taxpayer claiming the deduction.

Although not specifically addressed in the *Dayton Hudson* case, the MSBT computation also includes a depreciation add-back. To the extent that the depreciation would be a component of cost of goods sold under the IRC §263A standards, it appears that the same rationale may also apply.

Alternative Taxes or Hybrid Tax:
Some states have an alternative tax system under which a tax is calculated under two different bases (i.e., net income and net worth), and the larger of the two taxes is assessed. In such cases, the auditor must determine which method was ultimately used to compute the tax in each year. For years in which the tax was based upon net income, the tax is not deductible. A review of the other state tax return should identify the base used to calculate the tax.

Other states have a hybrid tax. An example is the franchise tax that Texas has imposed since 1991. Under the Texas franchise tax, tax is computed separately on net taxable capital and net taxable earned surplus. To the extent of the tax on net capital, the franchise tax imposed will always be characterized as a non-income tax. But, if the tax on earned surplus exceeds the tax on net capital, the excess is characterized as a tax on earned surplus (an income tax). Since Texas itself bifurcates its franchise tax into income and capital elements, the FTB has taken the position that the portion of the tax that is imposed on earned surplus is not deductible.

Severance Taxes:
Severance taxes levied on mineral production based on the value and/or quantity of production are deductible for California because they are not based upon realized income. In a letter to CCH dated October 5, 1981, the department took the position that the Federal Windfall Profits Tax is deductible. This tax was repealed in September 1988.

Foreign Taxes:
Because of the difficulties involved with determining the nature of some foreign taxes, rules specifically for foreign taxes have been set forth in CCR §24345-7. The regulation contains a presumption that foreign taxes are income taxes. The burden of proof rests upon the taxpayer to establish that a particular foreign tax was not based on net income. Some countries impose a "dual capacity tax," which is defined as a tax, which is all or in part an income tax, but which is also for receipt of a specific economic benefit. In order to deduct any portion of a dual capacity tax, the taxpayer must prove that the portion of the tax is not an income tax. Once the taxpayer has established that it has paid a dual capacity tax, then it must determine the amount of such tax by

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either facts and circumstances or application of the safe harbor formula. See MATM 7795 for detailed guidelines on this matter.

Audit Techniques:
All annual reports of U.S. companies disclose the amount of income taxes. If the taxpayer has classified taxes as income taxes for book purposes, they should generally be added back as a state adjustment. The following test may be made to determine whether the income tax add-back is reasonable in relation to the income taxes disclosed on the audited financial statements:

	Income taxes per Annual Report	xxx
	Schedule M-1 adjustments:	xxx
Add:	State, local or foreign income taxes deducted in return but not for book purposes	
Deduct:	Federal income taxes booked but not deducted in the return	(xxx)
	State, local or foreign income taxes booked but not deducted in the return	(xxx)
	Minimum amount required to be added back as a state adjustment:	xxx
Less:	Amount added back per return	(xxx)
	DIFFERENCE	xxx

IMPORTANT: Adjustments should *not* be proposed based solely upon the above reconciliation. The reconciliation is only a test to identify whether additional work is required.

If there is a material difference between the above amount and the amount added back into income, the auditor should make a thorough analysis of the taxes deducted on the return and the tax provision in the financial statement footnotes. Following are some sources of information regarding amounts of foreign and domestic taxes:

supporting detail to Form 100 or 1120, lines:
2 (cost of goods sold), 17 (taxes), and 26 (other deductions); Schedule M-1; Federal Form 5471 (Information Return of U.S. Persons with Respect to Foreign Corporations); and Federal Form 1118 (Computation of Foreign Tax Credit - Corporations).

Note: Federal Form 1118 will provide information regarding foreign taxes taken as a credit, but it is not necessarily determinative as to whether a tax is or is not an income tax. A tax that qualifies for the foreign tax credit is generally a tax measured by income (assuming that the taxpayer filed their Federal Form 1118 correctly). On the other hand, the fact that a tax is not reported on Federal Form 1118 does not indicate that the tax is not measured by income, because taxpayers may elect to deduct foreign income taxes for federal purposes rather than take a credit.

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Once the taxes paid to particular jurisdictions have been identified, information regarding the nature of the taxes imposed by the various jurisdictions may be found in large public libraries. A review of the tax returns filed with the other jurisdictions is also helpful in identifying the nature of the tax and the composition of the tax base.

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7000 APPORTIONMENT FORMULA

Apportionment is the process by which business income is divided between taxing jurisdictions. The apportionment formula calculates the percentage of the property, payroll and sales of the unitary business, which are attributable to California. The total business income of the unitary business is multiplied by this percentage to derive the amount of business income apportioned to this state.

For purposes of the apportionment formula, the property factor generally includes all real and tangible personal property owned or rented and used by the taxpayer during the taxable year, and the payroll factor includes all forms of compensation paid to employees. These factors are intended to reflect the capital investment and labor activities that generate income. The sales factor generally includes all gross receipts from the sale of tangible and intangible property, and is intended to recognize the contribution of the market state towards the production of income.

Prior to 1993, California followed the model UDITPA formula (see MATM 0500). This was a three-factor formula that gave equal weight to the property, payroll and sales of the business. This formula operated as follows:

$$\frac{\boxed{\begin{array}{c}\textbf{Property Factor}\\ \text{Average}\\ \dfrac{\text{California Property}}{\text{Average Total Property}}\end{array}} + \boxed{\begin{array}{c}\textbf{Payroll Factor}\\ \dfrac{\text{California Payroll}}{\text{Total Payroll}}\end{array}} + \boxed{\begin{array}{c}\textbf{Sales Factor}\\ \dfrac{\text{California Sales}}{\text{Total Sales}}\end{array}}}{3} = \boxed{\textbf{California Apportionment Factor}}$$

For taxable years beginning on or after January 1, 1993, the apportionment formula has been modified to double-weight the sales factor. Giving more weight to the locations where the taxpayer makes its sales provides an incentive for companies to locate or expand in California by reducing taxes for companies with headquarters or major production facilities within the state. Conversely, the double weighting increases the tax burden of those companies that exploit California markets without locating productive capacity within the state. The apportionment formula is now computed as follows:

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$$\frac{\text{Property Factor}\ \frac{\text{Average California Property}}{\text{Average Total Property}} + \text{Payroll Factor}\ \frac{\text{California Payroll}}{\text{Total Payroll}} + (2 \times \text{Sales Factor}\ \frac{\text{California Sales}}{\text{Total Sales}})}{4} = \text{California Apportionment Factor}$$

There are certain classes of taxpayers (such as those in extractive, agricultural, savings and loan, and bank and financial industries) for whom the double-weighted sales factor does not apply. Those taxpayers will continue to use a single-weighted formula. For a discussion of these exceptions, see MATM 7005.

The above formulas calculate the amount of business income of the unitary group that is apportioned to California. The calculation of each taxpayer corporation's relative share of the California income is covered in MATM 7900 (*Intrastate Apportionment*).

In some cases, the standard apportionment formula will not fairly represent the taxpayer's activity within the state. CCR §25137 set forth apportionment procedures for certain industries and types of transactions that do not lend themselves to apportionment under the standard rules. These special rules are discussed in MATM 7700 – MATM 7815 along with other procedures that have been developed for dealing with some of the more common apportionment problems.

Taxpayers occasionally argue that the apportionment formula is inherently distortive because the wage rates, property values and sales prices in many countries are lower than those in California. Their position is that although $1 of capital or labor in many countries has more earnings potential than $1 of capital or labor in the U.S., the higher California values in the factors pull the income into this state. The U.S. Supreme Court has recognized that this potential for distortion exists, but has nonetheless validated California's system as a fair apportionment scheme on the basis that some degree of distortion is to be expected in any taxation system (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). The mere showing that property, payroll or sales in California are higher than in other jurisdictions will therefore not be sufficient to justify departure from the standard formula. See also *Appeal of Kikkoman International, Inc.,* Cal. St. Bd. of Equal., June 29, 1982; *Appeal of Evergreen Marine Corporation (Calif.) Ltd.,* Cal. St. Bd. of Equal., March 4, 1986.

In unusual situations where alternative apportionment procedures have not been developed and where application of the standard formula will produce incongruous results, the taxpayer may request

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permission for (or FTB may require) use of another method for allocating and apportioning its income. Such other methods may include separate accounting, exclusion of one of the factors, or the inclusion of an additional factor. The authority for use of a special apportionment method is found in CCR §25137, and is generally only invoked in exceptional cases. Auditors should consult with their supervisors if they come across a case, which may require development of a special formula not described in the CCR §25137, or in this manual. Procedures for handling a taxpayer's §25137 petition are covered in the §25137 Procedure Manual.

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7005 EXCEPTIONS TO THE DOUBLE-WEIGHTED SALES FACTOR FORMULA

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been modified to double-weight the sales factor. As an exception to this rule, taxpayers that derive more than 50% of their gross business receipts from conducting a "qualified business activity" will continue to use the single-weighted apportionment formula (R&TC §25128(b).). The following "qualified business activities" are described in R&TC §25128(c)(2) through (5):

An extractive or agricultural business activity (these exceptions apply for all taxable years beginning on or after January 1, 1993). On July 9, 1999, CCR §25128, CCR §25128-1 and CCR §25128-2 were finalized. These regulations provide guidelines for determining when a taxpayer qualifies as an extractive or agricultural activity for purposes of the single weighted sales factor.

A savings and loan activity (this exception applies for taxable years beginning on or after January 1, 1994).
A banking or financial business activity (this exception applies for taxable years beginning on or after January 1, 1996).

The "more than 50%" test for determining whether a taxpayer is in a qualified business activity applies to the combined gross business receipts of the unitary group. Once it is determined that a combined unitary group meets this test, the entire business income of the group will be apportioned using a single-weighted sales factor formula. (R&TC §25128(d)(7).) This distinction is important because even though individual members of the group may not be involved in qualified business activities, they will be subject to the single-weighted sales factor if the group as a whole meets the test.

For 1993 only, the language of R&TC §25128 accomplished the group application of these provisions by defining the term "taxpayer" to refer to all of the corporations included in the combined report. As explained in FTB Legal Ruling 94-1, that definition applies only for purposes of that provision, and has no application to other UDITPA provisions. In 1994, R&TC §25128 was revised to provide for the group application without reference to the term "taxpayer."

FTB Legal Ruling 96-1 was issued to clarify that if divisions of a single corporation conduct more than one trade or business, and those businesses are not unitary with each other, then the "more than 50% test" will apply separately for each line of business. Furthermore, if a corporation is a partner in a partnership, but is not unitary with that partnership, then the "more than 50% test" will be applied at the partnership level.

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7100 PROPERTY FACTOR

The numerator of the property factor is the average value of all real and tangible personal property owned or rented and used in California for the production of business income. The denominator is the total of all such property owned or rented by the taxpayer everywhere (R&TC §25129). This portion of the manual first discusses the general topics relating to the property factor. Next, specific rules and audit techniques are discussed with respect to certain items:

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7110 RECONCILIATION OF THE PROPERTY FACTOR

Denominator:
The starting point for examining the property factor should be a reconciliation of the denominator of the property factor with property per annual reports, SEC 10-Ks, or audited financial statements. If the combined group is not the same as the consolidated group included in the financial statements, the consolidating workpapers will usually disclose the data on a company-by-company basis. For small, privately held corporations that do not have audited financial statements, the reconciliation may be made directly to the taxpayer's trial balance and/or property records.

The balance sheet of the Federal Form 1120 may not be a reliable source for reconciliation. Since the Form 1120 balance sheet does not directly affect federal taxable income, it is not essential that it be accurate, and it is not always audited by the IRS. Property balances per the federal depreciation schedules are subject to IRS scrutiny, but those schedules may not include fully depreciated property or land. Although Form 1120 data is often a convenient source for performing preliminary test checks, the results should be verified against other sources.

The taxpayer's apportionment workpapers are helpful for determining how the factors were computed, but it is never acceptable to reconcile tax return figures to the workpapers unless the workpapers have themselves been reconciled to a reliable source (such as financial statements or property records).

The reconciliation is performed by averaging the beginning and ending property values per the financial statements, and comparing the result with the owned property in the denominator of the factor. The original cost basis of the property should be used for this reconciliation. If the balance sheets report depreciable assets net of depreciation, the notes to the financial statements will usually disclose the assets balances prior to depreciation. If construction-in-progress is identified in the financial statements, it should be excluded.

Rented property may be reconciled by multiplying rent expense per the Form 1120 return by 8, and comparing the result to capitalized rents in the denominator. Rents in the 1120 are most commonly located on line 16, in Cost of Goods Sold, or on line 26 "Other Deductions."

The taxpayer should be asked to reconcile any material differences identified in the property reconciliations. The property ledgers may be used for verification if necessary. Any unusual balances or unreconciled amounts should be flagged for further investigation.

One reason for property value differences between book and tax may be due to business acquisitions. For tax purposes, property is generally carried at historical cost, regardless of whether the stock of the corporation changes hands. For book purposes however, generally accepted

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accounting principles (GAAP) generally require that the "purchase method" be used to add newly acquired corporations to the consolidated financial statements. Under the purchase method, if the consideration given for the stock of the new corporation exceeds the book value of the assets and liabilities, then the balance sheet is reviewed. If any assets can be identified as being undervalued or overvalued, then adjustments are made so that the consolidated balance sheet will reflect the fair market value of those assets. The amount that is charged to goodwill is only the amount of excess purchase price over book value of the acquired corporation that cannot be specifically allocated to any asset. If the acquired corporation remains separately incorporated, the adjustments to asset values are consolidating adjustments and will not be posted to the separate books of the corporations. A review of the consolidation workpapers should reveal the adjustments. If the acquired corporation is merged into the acquirer, then the adjusted property values will be posted to the acquirer's books. To determine whether asset balances were materially adjusted, it may be necessary to review the journal entries accomplishing the merger or to compare pre-acquisition balance sheets or property ledgers of both the acquirer and acquired corporation with the post-acquisition balance sheet. (If asset values have been materially stepped-up, the auditor should also verify that depreciation or amortization of the stepped-up amounts is not being taken for California purposes. See MATM 6015.)

Numerator:
The taxpayer's records will usually show the location of property on a state-by-state basis. The total of all property as shown on this schedule should be compared to the amount reported in the denominator. If there is no material difference, the auditor will be assured that the numerator amounts shown for the different states account for all property. The auditor should keep in mind, however, that audit adjustments to the denominator might require corresponding adjustments to the numerator.

Property tax bills may also be examined to identify or verify the location of property.

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7115 REAL AND INTANGIBLE PERSONAL PROPERTY – IN GENERAL

Only real property and tangible personal property is included in the property factor (R&TC §25129). Since intangible property is not specifically included under the statute or regulations, it is generally excluded from the factor. (An exception to this rule is made under CCR § 25137-4 and CCR §25137-10 for banks and financial corporations. For unitary groups that include banks or financial corporations, refer to the Bank and Financial Handbook.

A question may sometimes arise as to whether an asset should be considered tangible or intangible. The Board of Equalization addressed this issue in the following case:

In *Appeal of Retail Marketing Services, Inc*., Cal. St. Bd. of Equal., August 1, 1991, the issue involved whether coupons were tangible personal property includable in the property factor. Merchants would sell the taxpayer coupons that had been redeemed from shoppers. The taxpayer then collated the coupons and resold them to the respective manufacturers. The coupons were recorded as inventory on the taxpayer's accounting records, and the taxpayer sought to include them in the property factor under the theory that they were tangible assets. The SBE disagreed, finding that property is intangible for property factor purposes if its intrinsic value is attributable to its intangible elements rather than to any of its specific tangible embodiments. In this case, the coupons had no intrinsic value to a consumer apart from the discount received upon presentation to the merchant. The coupons represented a customer's "right" to the discount, and property that is a right rather than a physical object is intangible. The SBE further held that the taxpayer had failed to prove that exceptional circumstances were present which would require a deviation from the standard apportionment formula.

For a discussion of the issue of tangible vs. intangible property in the context of computer software, see MATM 7152.

The notes to the financial statements should disclose the taxpayer's intangible assets. The reconciliation of property to the financial statements, along with a review of the accompanying notes, will reveal whether intangible assets have been included in the factor. A review of the taxpayer's apportionment workpapers may also be of assistance in identifying intangibles in the factor.

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7120 VALUATION OF OWNED PROPERTY

Property owned by the taxpayer is valued at its original cost before any allowance for depreciation (R&TC §25130, also see Regulations). This will generally be the federal tax basis at the time of acquisition by the taxpayer (adjusted by any subsequent capital improvements). In cases where there is a material difference between federal tax basis and the taxpayer's basis for California tax purposes, auditors may consider whether the facts warrant property factor valuation using the California basis as an exception to the general rule.

If the original cost of property cannot be determined, the property is included in the factor at its fair market value as of the date of acquisition.

Property acquired by gift or inheritance is included in the factor at the basis used for determining depreciation for federal income tax purposes (CCR §25130(a)(3)). In situations such as a tax-free reorganization where the transferor's basis carries over to the transferee, the transferor's original cost will also carry-over to the transferee for property factor purposes (CCR §25130(a)(1), ex. (B)). If the reorganization is not completely tax free, the original cost will be the transferor's basis plus the gain recognized on the transactions.

Replacement property acquired as the result of an involuntary conversion will generally be included in the property factor at the original cost of the converted property if nonrecognition treatment was received on the transaction. If gain was recognized on the conversion, then the cost of the replacement property will be used. See FTB Legal Ruling 409 (10/6/77), for more information regarding property factor treatment of replacement property acquired after an involuntary conversion.

Occasionally, taxpayers have the option of either capitalizing expenditures related to property (such as research expenditures), or currently expensing the costs. With the exception of intangible drilling costs (which are discussed in MATM 7795), only capitalized expenditures will be included in the property factor. The value of the property includable in the factor will therefore vary depending upon which method the taxpayer elects. See MATM 7153 for a further discussion of this issue with respect to research and software development costs.

In performing the reconciliation of the property factor to the balance sheets, the notes to the financial statements should be reviewed for any indication that the book values may be different than the federal tax basis. For example, if the financial statements indicated that assets had been revalued and written-down, the auditor should expect the property values in the denominator to be higher than the values in the balance sheets. Depreciable assets in the property factor may also be reconciled to the tax depreciation schedules. Any significant differences may indicate that the property is not valued at its federal cost basis.

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7121 Intercompany Profits In Assets

When assets are transferred in an intercompany sale, the economic position of the unitary group does not change. It is therefore the Department's position not to recognize any increase in basis of assets for property factor purposes where assets have been sold between members of a combined group and the gain has not been recognized.

For federal tax purposes, gain on intercompany sales of assets is generally deferred. Although the gain is not recognized in the year of the intercompany sale, the buyer's basis in the asset is stepped up to reflect their cost. Recognition of the deferred gain is triggered in increments as the buyer depreciates the stepped-up basis of the asset, or in full in the year that the asset is disposed of outside the consolidated group. (See Treas. Reg. 1.1502-13, also MATM 5260.) Although California allows taxpayers to defer recognition of most intercompany gains in accordance with the federal rules, such treatment is not allowed to extend to the apportionment formula. This interpretation prevents the manipulation that could occur if taxpayers were allowed to step-up the basis of property in certain states through intercompany sales.

Material intercompany transfers of assets due to reorganizations or business restructurings may be disclosed in the annual reports, SEC 10-Ks, or notes to the financial statements. An analysis of relative property balances between the members of the unitary group may also provide an indication that an intercompany transfer of assets took place. For example, if Corporation A had sold a material asset to Corporation B, Corporation A's property would decrease while Corporation B's property would increase. If the auditor suspects that an intercompany sale has taken place in a prior year, purchase documents should be examined to establish whether the asset was acquired from a unitary affiliate. If so, the value included in the property factor should be verified to be the unitary seller's original cost (unless the taxpayer made an election not to defer the gain or loss on the intercompany sale - see MATM 5260).

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7125 Averaging Property Values

The average value of owned property included in the factor is usually determined by averaging the values at the beginning and ending of the taxable year. The department may require or allow averaging by monthly values where necessary to properly reflect the average value for the taxable year (R&TC §25131). This may occur where significant assets were acquired or disposed of during the year.

In the *Appeal of Craig Corporation*, Cal. St. Bd. of Equal., March 3, 1987, the taxpayer disputed FTB's use of a quarterly average, asserting that only the annual inventory figures were audited, and accurate numbers. The SBE upheld the FTB determination, stating that the department had not abused its discretion. Since the same source of quarterly data was used in both the numerator and denominator, it did not appear that the flaws in the data would produce a distortive result. The SBE also allowed FTB's use of a quarterly average since monthly figures were not available.

CCR §25131 contains an example of a monthly average computation. The example computes a 12-month average based on the average property values for each month (the January value is the average of Jan. 1 and Jan. 31; the February value is the average of Feb. 1 and Feb. 28, etc.). Another way of computing a monthly average would be to add the beginning of the year property value to the month-end values for each month of the taxable year, and then divide by 13. (Example: [Dec. 31 + Jan. 31 + Feb. 28 + ... + Nov. 30 + Dec. 31] / 13 = monthly average.)

If a fluctuation in asset values occurs only with respect to one member of a combined group, or if one member is not included in the group for the entire year, it is possible to average the assets of that member separately from the remainder of the group. This avoids having to compute a monthly average or other weighted average for every member of the group. Following is an example of this computation:

Example
Assume that Corporations A, B, C and D are members of a unitary group filing on a calendar year-end. The property values of A, B and C remained relatively stable during 1993, but Corporation D was formed during the year and did not acquire any assets until October 1, 1993. The average value of the owned property for 1993 may be computed as follows:

Combined property of A, B & C, computed using a simple average of the values at January 1, 1993 and December 31, 1993:		$ 100,000
Property of D:		
October	20,000	
November	40,000	

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December	50,000	
	110,000	
Divide 12		
Weighted Average:		9,166
Average property of the combined group (A,B,C & D):		$ 109,166

When preparing schedules to compute adjustments to the property factor, care should be taken to determine the effect of the adjustments on the averages. In the preceding example for instance, Corporation D's property would not be included in the year-end balance for computing 1993 average property for the rest of the group. On the other hand, D's property *would* be included in the beginning balance for computing the 1994 average property of the group. This is an exception to the general practice of picking up the ending balances for one year as the beginning balances for the following year.

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7130 VALUATION OF RENTED PROPERTY

Rented property is valued at eight times its net annual rental rate. The net annual rental rate is the annual rental rate less any nonbusiness subrentals (R&TC §25130). Occasionally taxpayers will interpret R&TC §25131 as requiring rented property to be averaged somehow. This treatment is incorrect. The only allowable method for including rented property in the factor is pursuant to the capitalization described in R&TC §25130. The taxpayer's apportionment workpapers will usually disclose whether rents have been properly capitalized.

The taxpayer's chart of accounts is often a good way to identify the areas where rent expense has been booked. Once the accounts have been identified, the trial balance or general ledger can be used to verify rent expense. The notes to the financial statements in the annual reports or SEC 10-Ks will usually disclose rent expense incurred with respect to capital leases (see MATM 7200). This information is useful for reconstructing rent expense for worldwide combinations where foreign rents are not otherwise available, but the auditor should be cautious about the fact that the financial statements do not always disclose rent expense from operating leases. Likewise, rent expense deducted on the tax returns is sometimes buried in various accounts, and it is not always evident solely from reviewing the return.

The taxpayer's workpapers will often show rent expense on a state-by-state basis. The aggregate state amounts should be compared to the total rent expense to ensure that all rents are accounted for in the numerator.

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7131 Annual Rental Rate

The annual rental rate is the amount paid as rental for property for a 12-month period. If the property has been rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a short period of less than 12 months, the rent paid for the short tax period shall be annualized. In a combined report situation, everyone included in the combined report must have a short period in order to annualize the rents. If one of the corporations in the combined report has a short period, but not all of the corporations, the rent should not be annualized for the short period taxpayer because the entire property factor for this taxpayer needs to be weighted due to the fact that they are not included for the entire 12-months. CCR §25130(b)(2) contains examples of the annualization computation.

The purpose of annualization is to put rented property on a parity with owned property. If a taxpayer owns $800,000 of property at the beginning of a short period, and the same $800,000 at the end of the short period, its average value of owned property is $800,000. This is not true of rented property. Assume a taxpayer leases the property for $100,000 per year over a five-year period, and because of a change of accounting period has a short taxable year of only six months. Annualization requires the taxpayer to capitalize the annual rental rate of $100,000, for a value of $800,000 in the property factor. Without annualization, the taxpayer would capitalize the actual rent expense paid by 8, and only include a value of $400,000 ($50,000 x 8) in the property factor.

Annualization only applies if the rental term is for 12 or more months. Because month-to-month rentals are of uncertain duration, they are not considered to be "for a term of 12 or more months" for purposes of annualization.

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7132 Intercompany Rents

Intercompany rents between members of a combined report are eliminated from the property factor. The reason for the elimination is that the original cost of the asset has already been included in the factor by the lessor. Inclusion of the capitalized rents in the factor by the lessee would result in the asset being represented twice.

Consolidating working papers for the financial statements should identify intercompany rents in the eliminations column. Under the federal rules for intercompany transactions however, intercompany rents are generally a period expense (deductible by the paying member in the same period as they are reported by the receiving member), and are therefore usually not eliminated on the Federal Form 1120. When consolidating workpapers to the financial statements are not available in sufficient detail to be of assistance, an analysis of rental income may be necessary. The chart of accounts may also be useful in identifying intercompany rents. If the transaction is material enough, it may be disclosed in the notes to the financial statements.

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7133 Advance Rentals

Advance rentals are neither deductible in the current year nor capitalized in the property factor for that year. For example, assume that the first and last month's rent of a five-year lease are paid at the inception of the lease. The first month's rent is deductible in the first year, but an accrual basis taxpayer cannot deduct the last month's rent until the fifth year when the economic performance occurs (Treas. Reg. 1.461-4). Since the last month's rent is not paid for the use of the property during the first year tax period, it is not capitalized in the property factor until the fifth year.

If the taxpayer has reported rents correctly for federal purposes, rent expense per the Form 1120 return should not include advance rentals.

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7134 Nonbusiness Subrentals

Annual nonbusiness subrentals paid by subtenants of the taxpayer are deducted from the annual rental rate to arrive at the net annual rental rate. The reason for this reduction is that only a portion of the rented property is being used to generate business income, so only a corresponding portion of the rent expense should be capitalized. Subrents are not deducted when they constitute business income because the property is still being used for business purposes when it produces such subrents. Examples of business vs. nonbusiness subrents may be found in CCR §25130(b)(1). Analysis of rental income and rental expense per the Federal Form 1120 return or the general ledger accounts should disclose whether subrentals exist. If the subrents are material, the normal tests for determining whether they constitute business or nonbusiness income should be applied (MATM 4045).

If deduction of nonbusiness subrents produces a negative or clearly inaccurate value for the portion of the property used in the business by the taxpayer, CCR §25137(b)(1)(A) provides that another method of valuing the rented property may be applied. The Regulation contains an example of the minimum value that may be used in such a situation.

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7136 DEFINITION OF RENT

For purposes of the property factor, rents are defined as the actual sum of money or other consideration payable, directly or indirectly, for the use of the property. This includes payments that are computed as a percentage of sales, profits, or otherwise. The definition also includes amounts paid for interest, taxes, insurance, repairs, or any other items provided that such payments are made pursuant to the terms of the lease as additional rent or in lieu of rent (such an arrangement is often referred to as a "net lease"). An examination of the lease agreements should disclose the existence of such charges.

Rents do not include amounts paid for services (utilities, janitor services, etc.; see also MATM 7137 (Rent Expense vs. Payment for Services)). Nor do rents include items such as hotel accommodations or daily car rentals because such payments are considered to be incidental day-to-day expenses of the business. The nature of the rented property will not always identify whether the rents are includable in the factor. For example, automobiles may be rented on a daily basis (not includable), or may be subject to long-term lease contracts (includable). If material, it may be necessary to inspect the rental documents to determine the nature of the transaction.

Occasionally, non-includable service charges will be included in rents, but the amounts will not be segregated in the rental contract. For example, if a taxpayer rents storage space in a public warehouse for its inventory, a portion of the rent payment will be attributable to the use of the storage space, and a portion may be attributable to handling fees, inventory insurance, etc. (see CCR §25130(b)(3)(B), ex. (B)). If the fees are not broken down in the contract, it will be necessary to allocate the payments in accordance with the relative values of the rent and the other services. The taxpayer may be asked to obtain detail regarding the storage fees from the storage company, or the auditor may choose to make inquiries directly with the storage company.

The definition of rents does include royalties based on the extraction of natural resources that are paid or credited to a holder of an interest in the property, so long as the property for which the royalty payments are made is actually used by the taxpayer. FTB Legal Ruling 97-2 provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in *Appeal of Proctor and Gamble concluded that* 18 CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

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7137 Rent Expense Vs. Payment For Services

It is sometimes difficult to determine whether a contractual arrangement is a rental of property (includable in the property factor) or a service contract (excluded). Although this issue may arise in many contexts, it has been most commonly seen with respect to sea transportation contracts such as time charters, voyage charters, bareboat charters, contracts of affreightment, and similar arrangements.

Time or voyage charters are contracts whereby a vessel owner supplies a vessel, crew and supplies for a specified period of time or for a particular voyage. In a bareboat charter, the taxpayer contracts for the use of the ship, and provides its own crew and supplies. In a contract of affreightment, the contract is not for the entire vessel, but for a specified amount of space on the vessel.

Whether such contracts constitute leases or service contracts will depend upon the facts of each particular case. Prior to 1984, federal case law had developed certain criteria to apply to determine whether a contract was a service contract or a lease. Such criteria focused on the degree of possession and control enjoyed by the parties (See *Xerox Corporation v. United States*, 656 F2d 659 (1981)). In 1984, IRC §7701(e) was enacted to provide specific factors to be considered in making the determination. California conformed to IRC §7701(e) in 1985 (R&TC §23047). Auditors who are faced with this issue may also refer to the following Board of Equalization decision:

In *Appeal of Castle and Cooke*, Cal. St. Bd. of Equal., June 17, 1987, the taxpayer was engaged in buying, shipping and selling tropical fruit. The fruit was shipped from Latin America in refrigerated vessels under either time charter arrangements or contracts of affreightment. The taxpayer capitalized the transportation costs in the property factor as rental expenses. The SBE held that the costs were not leases, but merely transportation expenses. Using the criteria set forth in Xerox, the SBE found that the taxpayer did not have the type of control over the property requisite for the transaction to be a lease because the owners of the vessel not only retained access to the property, but also retained physical control over the vessel, its operations, and its crew. In addition, the SBE stated that what the taxpayer was really contracting for was an integrated package of services including adequate space and conditions for its produce while being transported, with payment being for the end result -- delivery at the port of destination. The fact that tangible personal property was used in achieving that end result does not change a transportation contract into a lease.

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7138 PROPERTY OF ANOTHER USED FOR NO COST OR NOMINAL COST

Occasionally, property owned by others may be provided for the taxpayer's use at no cost, or for nominal cost. CCR §25137(b)(1)(B) provides:

"If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property."

The inclusion of property owned by others in the property factor raises the following difficult issues:

Whether or not the taxpayer has a possessory interest in the property;

Whether or not such property has actually been "used" in the taxpayer's business; and

The determination of the "reasonable market rental rate."

The SBE has addressed this issue in the following published decisions:

In *Appeal of The Procter & Gamble Manufacturing Company*, et al., Cal. St. Bd. of Equal., September 26, 1989, the taxpayer had executed a Forest Management Agreement with the Province of Alberta, Canada for 3.5 million acres of timberland. Alberta retained title to the timberland, but the taxpayer was granted rights to harvest timber and to otherwise have extensive use of the land. The taxpayer agreed to pay Alberta $1.15 a cord for the harvested trees, and they were also obligated to pay an annual "holding charge" of $3 per square mile and a "forest protection charge" of $12.80 per square mile. The taxpayer included the timberland in the denominator of its property factor at a value of $399 million. This purportedly represented the fair market value of the entire timberland in the year that the land was placed in productive use.

The FTB contended that because the timberland was not "owned or rented and used" by the taxpayer, no value associated with it may be included in the property factor. The SBE disagreed, holding that CCR §25137(b)(1)(B) applied and that an appropriate amount must be included in the denominator. On the other hand, the SBE did not consider the fair market value of the property to be an appropriate substitute for the reasonable market rental rate. Although they did not prescribe a particular approach to be used in constructing the reasonable market rental rate, the SBE did not accept FTB's proposal to compute a rental rate of $15.80 per square mile (computed by adding the annual "holding charge" and "forest protection charge"), reasoning that it was still no more than a nominal rate of rent.

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The *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., April 5, 1984 (Union Carbide I), also dealt with the issue of whether the taxpayer properly included government-owned property in the property factor. During the appeal years, the taxpayer operated four nuclear facilities for the federal government under a "cost-plus-fixed-fee" contract. No rent was paid, but the taxpayer had exclusive use of the facilities. The taxpayer included a "value" for the property in the denominator.

The FTB excluded the "value" of the government-owned plants on the theory that the taxpayer could only invoke the use of CCR §25137(b)(1)(B) if they showed that exceptional circumstances existed for the use of a special apportionment method. The SBE found that by having a specific regulation on the subject, FTB must be considered to have implicitly agreed that the existence of property owned by others and used at no cost is in itself an exceptional circumstance requiring a special formula. No issue was raised in this case regarding the reasonableness of the value assigned to the property by the taxpayer.

The *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., January 13, 1993 (Union Carbide II) dealt with the subsequent audit cycle of Union Carbide. The FTB again excluded the government property from the property factor, this time on the basis that the taxpayer did not have a possessory interest in the property. The SBE rejected that argument and reaffirmed their holding in Union Carbide I.

The valuation issue was also addressed in this case. Both the FTB and the taxpayer had obtained appraisals to support a "reasonable market rental rate." The SBE determined that the FTB appraisal was based on the underlying assumption that the benefits to be received from using the property would be restricted to reasonable fees for managing the property. Apparently, however, the taxpayer received significant benefits from the property other than just management fees (for example, the taxpayer was able to utilize its research connected with the government contract to develop its own products). Since the FTB's valuation approach did not take these other benefits into account, the SBE concluded that the valuation did not reasonably approximate what the federal government could expect to receive from a willing lessee.

The taxpayer's appraisal derived a valuation that was intended to represent the return that a prudent investor would require on an investment in the property. Although the SBE made some modifications to the valuation computation, they accepted the general approach of this valuation.

In cases where a taxpayer has rights to extract minerals or harvest timber from property that it does not own, the issue of how (if at all) that property should be included in the property factor is contained in FTB Legal Ruling 97-2. The Ruling announces that the mineral or timber royalties paid by the taxpayer will be considered substantially equivalent to the reasonable market rental rate.

CCR §25130(b)(4)(B) specifically provides that royalties based on the extraction of natural resources are not included in the definition of "rents" for standard property factor purposes. However, the "use of

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property of another" provision is a deviation from the standard apportionment formula under the CCR §25137, and the Legal Ruling explains that these types of royalties are sufficiently equivalent to rents to be used as a reasonable approximation for purposes of R&TC §25137. An important concept to remember is that CCR §25137-1(b)(1)(B) requires that the property be used and that a net annual rental rate be capitalized. For example, a corporation that has a right to harvest timber over 99 years, but is limited to 1/99th of the timber each year is only using 1/99th of the total property. The amount of royalties paid during the year is presumed to be the annual rental rate.

The analysis in Legal Ruling 97-2 is an interpretation of existing law, so it applies retroactively to all open years. If you are auditing a taxpayer that conducts mining, oil & gas drilling or timber-harvesting operations on government-owned property (or on any other property not owned by the taxpayer), any adjustments to the property factor should be made on a basis consistent with this ruling. Note, however, that the ruling does not apply to other CCR §25137(b)(1)(B) issues such as a taxpayer's operation of a government-owned plant. Also, the burden of proof is upon the taxpayer to disclose the value of other types of property such as the free use of a government dry dock to overhaul a Navy ship.

Since the determination of whether property owned by another should be included in the property factor is based on the unique facts and circumstances of each particular case, it is essential that auditors fully develop the relevant facts and obtain documentary evidence of those facts. Following are some suggestions for information that auditors should obtain when faced with this issue:

- Full copies of all agreements and contracts between the taxpayer and the other entity involved. (As with any other contracts, signed copies should be requested to ensure that the final version has been provided.)
- Details of the taxpayer's separate accounting for the revenues and costs derived from activity related to the property.
- A full description of the relationship between the taxpayer and the owner of the property, and the relationship of the taxpayer to the physical property in question. Factors, which should be addressed, include:
- The rights of the owner with respect to the physical property. For example, did the owner retain possession or control, or a right of access?
- The rights of the taxpayer with respect to the physical property. For example, did the taxpayer have a right of possession or control, or a right to exclude the owner from the property? Did the taxpayer have a right to enter land to take timber or minerals, or for some other purpose?
- The use that the taxpayer makes of the property.
- Whether the taxpayer undertakes any risk as to loss of the property.
- Whether the owner reserves the right to provide substitute property.

Where the taxpayer has included a value for the property in the property factor, full documentation supporting the valuation. This would include copies of the calculations of the amounts claimed, as

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well as copies of any appraisals obtained by the taxpayer. Auditors may investigate whether the valuation of the property was at issue in a property tax case in the state or country where the property is located.

It may be appropriate at the audit stage for the department to contract for its own independent appraisal of the property. In cases where the auditor and supervisor determine that an outside appraisal is warranted, management should be consulted before any steps are taken to secure the appraisal.

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7140 USED OR AVAILABLE FOR USE

Property is included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the unitary business (CCR §25129(b)). Natural resources that are held in reserve are considered to be in use or available for use while in reserve status, so they are included in the factor even though active development of the resources has not yet taken place.

In *Appeal of Tosco Corporation*, Cal. St. Bd. of Equal., November 18, 1980, the issue was whether the taxpayer had properly included its interest in oil shale reserves in the property factor. Over a 20-year period, the taxpayer was engaged in the development of technology to recover hydrocarbons from oil shale rock. This development was intended to culminate in the construction of a commercial plant, although the plant had not been built as of the date of the appeal due to economic and environmental problems. Over the 20-year period, the taxpayer had been purchasing oil shale reserves in anticipation of the commercial production. FTB removed the reserves from the property factor on the basis that they were not capable of being used in the business since the plant had not yet been built. The SBE concluded that the oil shale reserves were available for use, and were therefore appropriately included in the factor.

Once property has been used in the regular course of the trade or business and included in the property factor, it remains in the factor until an identifiable event establishes its permanent withdrawal from the business (CCR §25129(b)). Conversion of the property to nonbusiness use would be an example of such an identifiable event. Property that is temporarily idle is still available for use, as is property that is for sale (however if the property has not been sold after an extended period of time (normally five years), it is removed from the factor). While property is held for sale, temporary rental of the property will not cause its removal from the factor. CCR §25129(b) contains several examples of what constitutes (or does not constitute) an identifiable event.

The *Appeal of Ethyl Corporation*, Cal. St. Bd. of Equal., March 18, 1975, was a pre-UDITPA case involving the taxpayer's exclusion of a partially dismantled plant from the property factor. Although it would only be economically feasible to resume operations at the plant under certain unusual conditions, the fact remained that the plant was available for limited use in the unitary business, and was capable of such use. The SBE held that it was properly includable in the factor.

In the *Appeal of Thor Power Tool Company*, Cal. St. Bd. of Equal., April 8, 1980, the taxpayer closed a plant and then held the property for sale. Since the building was deteriorated, the taxpayer demolished it to facilitate the sale of the land. The SBE concluded that although the building was appropriately removed from the factor when it was demolished, the land could still have been put to use in the unitary business. The demolition of the building therefore did not constitute an identifiable event resulting in the permanent withdrawal of the land from the property factor prior to its sale.

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7142 Construction In Progress

Property or equipment under construction during the taxable year is excluded from the property factor until such property is actually used in the regular course of the trade or business (CCR §25129(b)). The exception to this rule is inventoriable goods in process (see MATM 7171).

If the property is partially used in the regular course of the trade or business while under construction, only the value of the property to the extent used is included in the property factor (CCR §25129(b)). Since only the portion of the property that is being used is subject to depreciation, the taxpayer should have identified the basis attributable to the portions in use on their depreciation schedules.

In some industries, such as the electronics industry, equipment may be acquired subject to approval after the equipment has been operated for a period of time. Some taxpayers charge the assets to a "construction in progress" account until the equipment is finally accepted or rejected. In other instances, self-constructed property is held in the "construction in progress" account while it is being subjected to an extended period of testing in the actual production environment. Under both of these conditions, the equipment is being used in the current production of income, and should therefore be included in the property factor. If the auditor suspects that either of these conditions exist and the amounts are material to the property factor, the auditor should analyze the construction in progress account and inquire to what extent the assets are being used in the business.

Rent paid for tangible personal property used in the construction of an asset should be capitalized into the cost of the asset (Treas. Reg. §1.263A). For example, if a taxpayer constructed its own building using rented scaffolding, the scaffolding rent is capitalized into the cost of the building. Since the cost of the building is not included in the property factor until it is available for use, it follows that the rent paid for the tangible property used during the construction should not be reflected in the property factor as it is not being "used in the business." Therefore, the rent paid for the scaffolding would not be included in the property factor. Once the building is placed in service, the federal tax basis of the building will include the rents charged to the construction in progress account.

Construction in progress is usually disclosed in the notes to the financial statements. It is also generally segregated in the general ledger and the property ledger. An analysis of the components of the construction in progress account may reveal items that have been inappropriately excluded from the factor.

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7150 COMPUTER EQUIPMENT AND PROGRAMS

MATM 7151	Hardware
MATM 7152	Software
MATM 7153	Expense vs. Capitalization
MATM 7155	Foreign Property

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7151 Hardware

Computer equipment (hardware) is tangible personal property and is subject to the normal rules for inclusion in the property factor at original cost. If the hardware is rented, the net annual rents are capitalized by eight. If computer rentals are material to the property factor however, the auditor should review the rental agreement to verify that the transaction is actually a rental rather than fees paid for computer services.

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7152 Software

The treatment of computer software (programs) in the factor is more problematic. Since computer software consists of both a tangible element (the disk or other storage medium) and an intangible element (the intellectual content), issues have arisen regarding whether the software as a whole is tangible or intangible. In the past, the department had taken the position that canned or prewritten software should be treated as tangible property, and custom software should be treated as intangible property. This characterization was consistent with the treatment for California sales tax purposes. Based on the California Supreme Court's decision in *Navistar International Transportation Corporation v. State Bd. of Equalization*, (1994) 8 Cal.4th 868, however, the position may be taken that both canned and custom software are tangible property and therefore includable in the property factor:

The Navistar case involved the sale of a division to an unrelated third party. One category of the assets sold consisted of custom software that had been developed by Navistar for use in its business. This case dealt with whether the sale met the statutory sales tax exclusion for custom software. The Court cited Touche Ross & Co. v State Bd. of Equalization (1988) 203 Cal.App.3d 1057, in explaining that the reason for the sales tax exclusion was that:"the Legislature has recognized that the design, development or creation of a custom computer program to the special order of a customer is primarily a service transaction and, for that reason, not subject to sales tax. However, once the program has been created and in the possession of the original customer, the design or development service has been completed, and the program itself has become a tangible personal asset of the customer. A subsequent sale of that program by the initial customer can no longer be characterized as a `service' transaction, but rather is a transfer of a tangible personal asset produced by the original programmer's services."

Although *Navistar* was a sales tax case, the Court's express statement that computer programs are tangible personal assets is not based upon a sales tax statute, and should not be limited to that context. When applied in a property factor context, *Navistar* supports the position that as soon as custom software has been developed and is placed in service in the unitary business, it is tangible personal property includable in the property factor. (Note, however, that sales tax law governed the treatment of the software development for the special order of a customer. Auditors should continue to apply a facts and circumstances test to determine whether the programmer's transaction would constitute compensation for services or a sale of tangible property for sales factor purposes (MATM 7545).)

Issues may arise with respect to determining the numerator assignment of computer programs in the property factor. CCR §25129(d) provides that the numerator of the property factor shall include the tangible personal property "owned and rented by the taxpayer and used in this state." In some cases however, the tangible storage medium of the software (the disks) may be kept at one location, but the

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program itself will be accessed and used through computers in many states. Since it is the tangible elements of the software that result in its inclusion in the property factor, the consistent approach is to assign the software to the state where the tangible elements are located. If this does not fairly reflect the taxpayer's business activities within California, it may be necessary to develop an alternative method under the authority of R&TC §25137.

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7153 Expense Vs. Capitalization

Pursuant to IRC §174 and R&TC §24365 (and IRC §197 for property acquired after August 10, 1993), taxpayers have the option to expense research expenditures and software development costs currently, or to capitalize the costs.

For property factor purposes, property owned by the taxpayer is generally valued at its federal tax basis at the time of acquisition and adjusted by any subsequent capital improvements (CCR §25130(a)(1)). Capitalized research and software development expenses attributable to programs are considered to be capital improvements, and are therefore included in the value of the property. An issue may exist with respect to how these costs should be assigned to the numerator. The auditor will have to determine how best to achieve the allocation. One alternative is to prorate the costs among the copies of the program that have been produced. Another alternative may be to prorate on a receipts basis (similar to the way that CCR §25137-8 prorates the value of films based on the ratio of gross receipts in release in California over films in release everywhere -- see MATM 7740).

If the taxpayer elects to expense research and software development expenses currently for federal and state purposes, no adjustment is made to the federal tax basis of the property. Therefore, the expenses would not be included in the value of the programs for property factor purposes. An analysis supporting this conclusion can be found in *Appeal of Pauley Petroleum, Inc*., Cal. St. Bd. of Equal., February 1, 1982. (That decision dealt with intangible drilling costs, which were expensed by the taxpayer. Although the regulations have since been revised to expressly include intangible drilling costs in the property factor whether or not they have been expensed, the SBE's analysis is still valid with respect to other types of expenditures.) For some software companies, exclusion of expensed software development costs from the property factor may result in a situation where the business activity within the state is not reasonably reflected. If the problem is extreme enough to cause distortion, then the auditor may consider whether a modification to the apportionment formula is appropriate in accordance with R&TC §25137.

Occasionally, taxpayers may elect to expense research and software development costs for federal purposes, and capitalize the costs for state purposes, or vice versa (FTB Notice 92-6). The general rule is that *federal* tax basis is used in the property factor. However, in cases where state law does not conform to federal law and the issue is material, auditors may consider whether the facts of the case warrant use of the California tax basis as an exception to the general rule.

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7155 FOREIGN PROPERTY

The property factor should be calculated in the currency of the parent corporation unless the taxpayer and FTB agree that calculating the factor in U.S. dollars (or any other currency) fairly reflects the taxpayer's activities in California (CCR §25106.5-10(c)(1)). The following translation rules apply:

Fixed assets are translated at the historical exchange rate as of the date of acquisition.
Rented property, capitalized at eight times the net annual rental rate, is translated at the simple average of the beginning and end-of-year exchange rates.
Inventories are translated at the historical exchange rate as of the date of acquisition. The date of acquisition will depend upon the inventory method used by the taxpayer (i.e., LIFO, FIFO, etc.).

The detailed information needed to apply these translation rules is not always available to the auditor. Therefore, it is often necessary to make a reasonable estimation based upon available information. For example, rather than using the actual exchange rate as of the date an asset is acquired, it may be reasonable to apply the average exchange rate for a given year to all assets on hand that were acquired during that year. A translation schedule using this method is shown on page 5 of Exhibit H.

If the taxpayer's asset records are not grouped by acquisition year, it may be necessary to estimate the annual acquisitions. For example, assume a balance sheet reflects property, plant and equipment of $1,000,000 as of December 31, 1990. By December 31, 1991, the property, plant and equipment balance is $1,200,000. It may be reasonable to proceed with the translation illustrated in Exhibit H under the assumption that the $200,000 incremental increase in the property balances is representative of the property acquired during 1991. On the other hand, if the taxpayer had material asset dispositions during the year, then using the incremental change in property balances may not be reasonable. The auditor will have to consider the facts and circumstances of each case, and the materiality of the issue.

The translation should be applied consistently for both the numerator and denominator of the property factor. If the numerator is stated at original cost in U.S. dollars, and foreign assets in the denominator are translated at a current exchange rate, the denominator may be overstated or understated depending upon the history of the foreign country's exchange rate relative to the U.S. dollar. As always, an auditor faced with this issue should consider materiality.

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7160 GROWING CROPS

There is no regulation covering the valuation of growing crops in the property factor, so crops are subject to the general rule of valuation at federal tax basis. The property factor will therefore generally include only long-term crops such as orchards, vineyards, etc. because the costs associated with annual crops are normally expensed rather than capitalized (Treas. Reg. 1.162-12).

If the taxpayer does not elect to currently deduct expenditures for lime, fertilizer, etc., those costs are capitalized and included in the federal tax basis (IRC §180, R&TC §24377). Although the average value of the capitalized costs will be included in the property factor, they should be removed from the factor at the end of their useful life. The rationale for removing the costs is based on the fact the soil amendments are no longer available for use or capable of being used in the trade or business (see MATM 7140).

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7170 INVENTORIES

Inventories are included in the factor in accordance with the valuation method used for federal tax purposes (CCR §25130(a)(2)).

Foreign entities, which are not included in the federal return, may adjust their book inventory values to reflect the inventory valuation method used for computing unitary business income. Translation of the original cost of foreign inventories to U.S. dollars should be made using the exchange rate as of the date(s) of acquisition of the inventory (CCR §25106.5-10(c)(1)(C)). The date that the inventory is deemed to have been acquired will depend on the taxpayer's method of inventory valuation. Under the LIFO method, for example, the taxpayer will have multiple layers of inventory with different acquisition dates.

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7171 Work In Process

Work in process inventory is the exception to the rule that property under construction may not be included in the factor (CCR §25129(b)). Work in process inventory is valued in the same manner as it is for federal income tax purposes.

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7172 Excise Taxes

Excise taxes are imposed on certain goods such as alcoholic beverages, tires, and tobacco products. Since excise taxes are capitalized as part of the cost of the inventory for federal tax purposes (Treas. Reg. §1.263A), they are included in the value of inventory for property factor purposes.

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7173 Intercompany Profits In Inventory

Intercompany profit in inventory occurs when sales of products are made between members of a combined group. The department's policy, as set forth in Publication 1061, *Guidelines for Corporations Filing a Combined Report*, is that the intercompany profit in inventory should be eliminated from combined income (See MATM 6070). Correspondingly, the profit in inventory should also be eliminated from the beginning and ending inventories for purposes of computing cost of goods sold and for property factor purposes.

If the intercompany profits in inventory are material or if the taxpayer has eliminated the profits for income purposes, the auditor should verify that they have been eliminated from the property factor. Since intercompany profits in inventory are eliminated under GAAP, reconciliation of the Schedule R inventory to the financial statements may identify whether the elimination has been picked up for factor purposes. If an adjustment is necessary, the amount of intercompany profits in inventory can be found in the consolidating adjustments to the financial statements.

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7174 Verification Of Inventory In Denominator

The auditor should ascertain that the average inventory per the balance sheets agrees with the inventory value included in the property factor. Any material differences should be explained.

Since beginning and ending inventory balances are a component in determining the cost of goods sold, the inventory accounts are subject to scrutiny by the IRS. The Federal Form 1120 balance sheet may therefore be used to verify inventory. The auditor should also be alert to the fact that RAR adjustments to cost of goods sold may affect the inventory balances. If material adjustments to cost of goods sold are noted in the summary of federal adjustments, the RAR detail should be reviewed to determine whether the property factor would be affected.

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7175 Verification Of Inventory In Numerator

In addition to inventory that is located at a taxpayer's owned or rented location, the numerator of the property factor will also include inventory stored in a public warehouse or on consignment to a customer in this state. Inventory in transit to California is also includable in the numerator (see MATM 7176).

Generally, a taxpayer will have records that will list inventory by location in the various states. In addition to reconciling the inventory included in the numerator to this list, the auditor should ensure that the total for all the states/countries on the list agrees with the total inventory in the denominator. If there are differences, some inventories may be excluded from the by-state list. Another reason for differences may be that the by-state lists often do not reflect consolidating adjustments, and may therefore include intercompany profit in inventory.

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7176 Inventory In Transit

Property in transit to California is includable in the numerator of the factor even though it may not yet be physically present in the state by year-end (CCR §25129(d), also *Montgomery Ward & Co. Inc. vs. Franchise Tax Board*, 6 Cal.App.3d 149 (1970)).

In *The Appeal of Craig Corporation*, Cal. St. Bd. of Equal., March 3, 1987, one of the issues involved a disagreement over which state was the "destination" of inventory in transit. The taxpayer purchased the majority of their inventory from the Far East for distribution and sale throughout the U.S. and several foreign countries. All inventory ordered from manufacturers in the Far East and ultimately destined for U.S. markets was shipped to the taxpayer's California office. Upon receipt in California, the bulk shipments were subjected to quality control inspections and compliance with import and customs laws, and the products were separated for shipment to the various regional centers. The goods generally remained at the California facility for 1 to 10 days.

The taxpayer argued that to the extent the goods were ultimately destined for regional centers in other states, they remained "in transit" until they reached that ultimate destination and should not be included in the numerator. The SBE agreed with FTB that the goods in transit from the Far East were includable in the numerator. Their analysis stated that the goods did not remain in transit during their stoppage in California because the stoppage was not due to lack of immediate transportation, but was for the taxpayer's own purposes. Once the goods left the California facility for out-of-state regional centers, they would again be in-transit, and only at that time would they be considered to be destined for the states in which those centers were located.

The reconciliation of the taxpayer's by-state inventory lists to total inventory in the denominator may identify if inventory in transit has been omitted from the factor. Examination of bills of lading will reveal the destination of inventory in transit.

If the auditor is unable to identify the destination of inventory in transit through examination of the taxpayer's records, the auditor may consider using the following formula to estimate the inventory destined for California:

Inventory identified at the California location **over** Total inventories everywhere less inventories	**X**	Total inventory in transit	=	California inventory in transit

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in transit

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7180 LEASEHOLD IMPROVEMENTS

Leasehold improvements are treated as property owned by the lessee. This treatment applies regardless of whether the lessee is entitled to remove and retain possession of the improvements upon expiration of the lease. Accordingly, the original cost of leasehold improvements is included in the property factor. The value of leasehold improvements is *not* capitalized by eight. (CCR §25130(b)(5)).

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7185 MOBILE OR MOVABLE PROPERTY

Mobile or movable property includes construction equipment, trucks, leased electronic equipment, and other similar types of assets that may be used by the taxpayer both within and outside the state during the taxable year. This property presents no special problems with respect to the denominator of the property factor.

For purposes of the numerator, the original cost (or net annual rental expense capitalized by eight) of mobile or movable property is assigned to this state on the basis of total time spent within the state during the year (CCR §25129(d)). The regulation makes an exception for automobiles assigned to traveling employees. Such automobiles are included in the numerator if they are licensed in California.

Certain industries are subject to special formulas for dealing with mobile or movable property. For further discussion of these industries, see MATM 7735 (Air Transportation Companies), MATM 7765 (Bus Lines), MATM 7725 (Commercial Fishing), MATM 7770 (Freight Forwarding Companies), MATM 7760 (Sea Transportation Companies), MATM 7745 (Railroad Companies), MATM 7755 (Truck Lines).

The information necessary to determine the proper assignment to the numerator is often difficult to obtain and apply at audit. Therefore, if the mobile property owned or rented by the taxpayer is material to the factor, the auditor should first review the taxpayer's method of assigning the property to the numerator for reasonableness. If it is determined that an adjustment is necessary, the auditor should ask the taxpayer to explain how the location of the property is tracked so that the appropriate documents can be requested. The following formula may be used to determine the value assigned to California:

Number of days spent in California during the taxable year **Over** Total number of days used or available for use in the unitary business during the taxable year	**X**	Original cost (or net annual rent x 8)	=	Value assigned to the numerator

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7190 OFFSHORE AND OUTERSPACE PROPERTY

Offshore property generally consists of oil drilling rigs, pipelines, telephone cables, and similar assets. Since the use of these assets is generally restricted to the oil and gas industry (MATM 7795) and the telecommunications industry (MATM 7805), discussion of the treatment of offshore property in the factor may be found in those sections of the manual.

Outer space property generally consists of communications satellites. The treatment of such property in the factor is included in the discussion of the telecommunications industry (MATM 7805).

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7195 PARTNERSHIP PROPERTY

If a partnership's activities are unitary with the taxpayer's activities under established standards (disregarding the ownership requirement), then the taxpayer's share of the partnership's property will be included in the property factor (CCR §25137-1(f)).

The partnership's real and tangible personal property both owned or rented and used during the taxable year in the regular course of the unitary business is determined in accordance with the normal rules as set forth in CCR §25129 - CCR §25131 and CCR §25137. Such property shall be included in the factor to the extent of the taxpayer's interest in the partnership.

The value of property, which is rented by the taxpayer to the partnership (or vice versa) is either excluded from the property factor or eliminated to the extent of the taxpayer's partnership interest as necessary to avoid duplication.

Example 1
Corporation A's interest in Partnership P is 20 percent. Corporation A's distributive share of Partnership P's income is included in A's unitary business income. Corporation A owns a building (original cost of $100,000), which is rented to Partnership P for $12,000 per year. Corporation A must include the original cost of $100,000 for the building in its property factor. Since the entire value of the building is already represented in the factor, no portion of P's capitalized rents attributable to the building will be included.

Example 2
Same facts as in Example 1, except Partnership P owns the building and rents it to Corporation A. Corporation A will include $20,000 (20% of $100,000) of the original cost in its property factor because of its interest in Partnership P. Since only 20% of the cost is reflected in the factor, Corporation A will also take into account $9,600 ($12,000 less 20% thereof) of rental expense into its property factor in order to give weight to the rented building used in Corporation A's operation. The full value of the building to be included in the property factor of Corporation A is $96,800 ($20,000 plus 8 x $9,600).

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term construction contracts may be found in CCR §25137-1(h).

Examination of items making up "Other Income" (line 10 of the 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the property factor to the financial statement balance sheet should identify if

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partnership property has been included in the factor (if the property in the denominator matches the average property per the balance sheet, partnership property was not included). Partnership financial statements (or copies of partnership returns if financial statements were not prepared) can be used to determine the appropriate amounts to include in the factor.

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7200 PROPERTY SUBJECT TO A LEASE

Lease transactions are broadly classified as either operating leases or financial leases. An operating lease is a lease in which the lessor retains the asset on its books and claims the depreciation deduction, and the lessee deducts rental expense. Financial leases are deemed to be financing transactions or conditional sales contracts rather than true leases; therefore, the assets are capitalized on the books of the lessee rather than the lessor. The lessee is entitled to the depreciation deductions, and the rent expense payments are considered to be nondeductible payments in consideration for the asset. The lessee establishes a corresponding liability account for the present value of the future lease payments discounted at their incremental borrowing rate. The lessor reports gain from the sale of an asset.

Except for "safe harbor leases" (see MATM 6090 and MATM 7205), California treatment is the same as federal with respect to whether transactions should be treated as operating leases or capitalized as conditional sales contracts. The determination is based on facts and circumstances, and Federal case law and IRS guidelines provide guidance. See FTB Legal Ruling 419 (1981) for a summary of the law in this area. For financial statement purposes on the other hand, GAAP provides an essentially bright-line test that classifies leases as capitalized leases if one or more of the following criteria is met:

By the end of the lease term, ownership of the leased property is transferred to the lessee.
The lease contains a bargain purchase option.
The lease term is substantially (75 percent or more) equal to the estimated useful life of the lease property.
At the inception of the lease the present value of the minimum lease payment, with certain adjustments, is 90 percent or more of the fair value of the leased property.

The existence of financial leases will be disclosed in the notes to the financial statements. Since leases that are treated as capitalized leases for financial statement purposes are not necessarily treated as conditional sales contracts for tax purposes, the financial statement treatment of leases is not controlling for California. With respect to the lessee, federal Schedule M-1 adjustments adding back depreciation expense and deducting rent expense will indicate that leases have not been capitalized for tax purposes. If this treatment is determined to be acceptable, the auditor should verify that the rent expense has been capitalized by eight in the property factor and that the original cost has been excluded. With respect to the lessor, the fact that leases have not been capitalized for tax purposes will be indicated by Schedule M-1 adjustments deducting tax depreciation on leased property. If satisfied with this treatment, the auditor should verify that the original cost of the asset is included in the factor.

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The auditor should also verify that the taxpayer has treated leased assets consistently in both the denominator and numerator of the property factor.

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7205 Safe Harbor Leases

Between 1981 and 1983, federal law provided a safe harbor lease election that treated certain transactions as leases rather than financing transactions, even though the transactions would not otherwise qualify as leases. See MATM 6090 for a discussion of the safe harbor provisions and an example of how the transactions are structured. Since California never conformed to these provisions, transactions entered into under a federal safe harbor lease election are generally treated as sale/leasebacks or conditional sales contracts for state purposes.

For federal purposes, the "lessor" in a safe harbor lease transaction is deemed to be the owner of the leased assets, and the "lessee" is allowed to deduct rent expense. California disregards this treatment and considers the assets to be owned by the "lessee." Accordingly, the assets subject to the safe harbor lease will not be included in the property factor of the lessor. The lessee will include the assets in the factor at their original cost, less the amount of any cash down payment received from the lessor. The lessee's rent expense is disregarded, and is not reflected in the property factor.

Example: Corporation X acquires property for $1 million. In a transaction structured pursuant to the safe harbor rules, X transfers the property to Y for $100,000 in cash and a note for $900,000 plus interest. Y then leases the property back to X for an amount of rent exactly equal to Y's $900,000 net obligation plus interest. The property will not be reflected in Y's property factor. X will include the property in its factor at a value of $900,000 ($1 million original cost less $100,000 cash received from Y). No capitalized value of rent expense is included in the factor.

If the Schedule M-1 discloses that transactions are being reported under the safe harbor lease rules for federal purposes, the auditor should verify that the lease transactions have not been reflected in the property factor. Since safe harbor leases are not recognized for financial accounting purposes, the reconciliation of the denominator of the property factor to the financial statement balance sheets may identify whether the taxpayer has reflected such leases in the factor. If the taxpayer has based its property factor on financial statement figures, the taxpayer's apportionment workpapers may also identify whether adjustments were made to reflect the lease transactions. Care should be taken in determining the source that the taxpayer used to compile their apportionment workpapers however, because if the figures are based on the federal Schedule L balance sheet, the safe harbor transaction may already be included in the base and separate adjustments would therefore not be found in the apportionment workpapers.

If the taxpayer is involved in safe harbor lease transactions, the auditor should ensure that the appropriate state adjustments have been made -- see MATM 6090.

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7210 WASTING ASSETS (NATURAL RESOURCES)

Mineral deposits and oil reserves are included in the property factor at original cost. In accordance with the general property factor principles, no reduction to cost is made for depletion.

Capitalized expenditures are included in the property factor. For taxable years beginning on or after January 1, 1990, all capitalized intangible drilling and development costs are included in the property factor even if they have been expensed for federal or state tax purposes (CCR §25130(a)(1)).

An amount representing royalties paid in connection with the extraction of natural resources generally is includable in the property factor, so long as the property for which the royalty payments are made is actually used by the taxpayer. The amount to be included in the taxpayer's property factor is determined by multiplying the annual royalties paid times eight. FTB Legal Ruling 97-2 provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in *Appeal of Proctor and Gamble* concluded that CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

For additional discussion of the property factor treatment of natural resources, see MATM 7780 (Mining) and 7795 (Oil & Gas Industry).

Because timber is a renewable resource that grows back, it is not treated as a wasting resource. See MATM 7810 for the treatment of timber properties in the apportionment factors.

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7300 PAYROLL FACTOR

The numerator of the payroll factor is the compensation considered to be paid in this state under the tests described in MATM 7370. The denominator is the total compensation paid everywhere during the taxable year (R&TC §25132.) The payroll must be incurred in the unitary trade or business -- compensation related to nonbusiness activities is excluded (CCR §25132(a)(2)).

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7310 RECONCILIATION OF PAYROLL FACTOR

Denominator
If the tax return contains enough detail, it is generally a good starting point for testing the reasonableness of the denominator. Payroll expense on the Form 100 or Federal Form 1120 is most commonly found on line 12 (Compensation of Officers), line 13 (Salaries and Wages), and as a component of cost of goods sold or overhead. Foreign payroll is sometimes identified in the financial statements attached to the Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*). The SEC 10-Ks will sometimes contain detailed employee information that may also be helpful in reconciling the denominator. Material differences between the denominator of the payroll factor and the payroll identified on the tax returns or 10-Ks should be flagged for further investigation. The auditor should keep in mind, however, that valid differences do sometimes occur (see MATM 7340, *Cash vs. Accrual*; MATM 7350, *Capitalized Payroll*).

Auditors should generally request the Federal Forms 940 (Em*ployer's Annual Federal Unemployment (FUTA) Tax Return*) or 941 (*Employer's Quarterly Federal Tax Return*) to verify domestic payroll. (Copies of these forms are shown at Exhibit D.1 and Exhibit E.1.) Compensation reported on Forms 940 and 941 is usually determined in the same manner as for payroll factor purposes, although some adjustments may have to be made to account for cash vs. accrual differences (MATM 7340).

In cases where the payroll factor has been computed on an accrual basis or where the taxpayer's fiscal year-end does not coincide with the end of a quarter, the auditor may or may not be able to reconcile the payroll factor to the payroll tax returns. Even if such a reconciliation is not possible, the auditor can compute the ratio of California payroll to Total payroll per the payroll tax returns. Used in conjunction with the reconciliation of payroll in the denominator to the tax returns, this ratio will allow the auditor to determine the reasonableness of the reported payroll factor.

Example
Assume that the taxpayer has a 4/30/xx year-end, and the auditor is not able to verify the payroll using the quarterly Forms 941. The California payroll tax returns (DE-6's) and the Federal Forms 941 for the 12 months ending 3/31/xx disclose payroll of $5,000,000 and $8,000,000 respectively, for a California percentage of 62.5% (the taxpayer has no foreign payroll). Although the actual amounts in the payroll factor will vary between the 3/31 and 4/30 year-ends, the percentage can be expected to remain relatively stable. Therefore, by comparing the 3/31/xx percentage of 62.5% to the 4/30/xx payroll factor percentage as filed, the auditor can determine whether the factor appears reasonable.

When using this technique to test the reasonableness of the payroll factor, the auditor should be alert for circumstances that may prevent the percentage constructed from the payroll tax returns from being representative of the actual payroll factor. Such circumstances may include large bonuses paid

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at year-end, the acquisition/disposition of a subsidiary, or a material fluctuation in the workforce (such as a strike) occurring at either the beginning or end of the period.

Numerator:
California payroll tax returns (Form DE-6) are filed quarterly with the Employee Development Department (EDD) (see Exhibit F for a copy of the Form). As with the Federal Forms 940 and 941, compensation reported on Form DE-6 is generally determined in the same manner as for payroll factor purposes (although some special industry formulas may source payroll differently, see MATM 7700 et al.). Since taxpayers are required to track payroll data for each state for unemployment tax purposes, by-state payroll records should also be available to verify California payroll. If by-state records are used, the auditor should verify that the total for all states reconciles to the denominator of the factor to ensure that all compensation is accounted for.

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7320 COMPENSATION DEFINED

For payroll factor purposes, the term "compensation" means salaries, wages, commissions and any other form of remuneration paid to employees for personal services (R&TC § 25120(c); CCR §25132(a)(3)). To the extent that the value of board, rent, housing, lodging and any other benefits or services provided to employees constitutes taxable income to the employee under the Internal Revenue Code, such amounts are included in the definition of compensation. Generally, this will be the same amount of compensation that is reported for unemployment and payroll tax purposes.

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7321 Deferred Compensation (401k Plans)

Although deferred employee compensation items (such as 401K plans) are not taxable to employees until some future date, such compensation is generally expensed by the employer in the year paid or accrued (IRC §404). The department's policy is to include such deferred compensation in the payroll factor in the year that it is expensed by the employer. Deferred compensation is reportable on the Federal Form 940 (since 1984) and the California Form DE-6 (since 1985), so the reconciliation of the payroll factor to these payroll reports should verify whether it has been picked up in the factor. Verifying the inclusion of 401K amounts through reconciliation to a Form 941 is a bit trickier: Since deferred compensation is not included in the employees taxable wages, it is not included on the Form 941 line entitled "Total wages and tips subject to withholding." Deferred compensation is included on the Form 941 lines entitled "Taxable social security wages" and "Taxable Medicare wages and tips." (See Exhibit E.1 for a copy of the form.)

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7322 Stock Options

Employees sometimes receive stock options as a form of compensation. Stock options give the holder the right to purchase shares of the corporation at a fixed price on a specified date or within a specified period of time. The options are generally classified as either nonqualified or qualified. Qualified stock options are options meeting the requirements of IRC §422 or IRC §423. Options not described under those sections are termed nonqualified stock options. The payroll factor implications of granting stock options will vary depending upon the type of option:

Nonqualified options with a readily ascertainable fair market value (as defined in Treas. Reg. §1.83-7(b)): The difference between the value of the option and its cost (if any) to the employee is taxed to the employee and deducted by the employer at the grant date. The same amount would be considered to be compensation includable in the payroll factor for the period in which the option was granted. In all practicality however, options seldom have a readily ascertainable fair market value.

Nonqualified options without a readily ascertainable fair market value: Taxation is not triggered until the option is exercised. The amount of compensation recognized by the employee and deducted by the employer will be the value of the stock at the exercise date, less any amounts paid for the stock or the option. Since the compensation is considered to be received at the exercise date, that is the period in which the compensation will be included in the payroll factor. Since this is also the treatment reflected on the Federal Forms 940 and 941, and the California Form DE-6, no special problems should arise with respect to identifying or reconciling this item for payroll factor purposes.

Qualified options: Neither the grant nor the exercise of qualified stock options is a taxable event for the employee, and no compensation related to such transactions will be included on the payroll tax reports. Furthermore, the employer corporation is not generally allowed a compensation deduction related to such options. Since no compensation is considered to be paid or received, there will be no compensation reflected in the payroll factor. (An exception may occur if there is a disqualifying disposition of stock, in which case compensation may be deemed to occur in the year of the disqualifying disposition (IRC §421 - IRC§423).)

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7323 Compensation Paid By Another Entity

Frequently, an employee will perform services for which no compensation will be directly received. For example, an individual may be an officer of both a parent corporation and its nonunitary subsidiary (the taxpayer). Although the individual performs services for the subsidiary in his or her capacity as an officer/employee, the parent pays the officer's entire salary. Since the subsidiary does not actually pay compensation for the services, no salary will generally be included in the subsidiary's payroll factor. [An exception to this rule might occur if the compensation was clearly related to services performed for the subsidiary, in which case the salary paid by the parent might be deemed to be a contribution to the capital of the subsidiary, and constructively paid by the subsidiary to the employee. An example of this type of situation may be found in Rev. Rul. 84-68, 1984-1 CB 31.]

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7330 EMPLOYEE DEFINED

The term "employee" is defined in CCR §25132(a)(4) as any officer of a corporation, and any individual who has the status of an employee under common-law rules. Generally, an employment relationship exists when the corporation for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the results to be accomplished, but also as to the details and means of accomplishing that result (Coleng v. Ramsdell, 19 Cal.App.2d 376).

In the *Appeal of Lipps, Inc*., Cal. St. Bd. of Equal., March 3, 1987, the taxpayer contracted for an unrelated company in Mexico to provide the labor and facilities to assemble the taxpayer's products. The taxpayer paid the Mexican company a fee pursuant to the production contract, and the Mexican company in turn paid the workers. The taxpayer included the wages paid to the workers in its payroll factor. The SBE held that since the compensation was not paid *directly* to the workers by the taxpayer, it was not includable in the payroll factor. Moreover, the SBE found that the workers were not employees of the taxpayer under the common law definition. The most important aspect of an employee relationship, the right to control the manner and means of accomplishing the desired results, was found to be lacking in this case.

In most cases, if a person is considered to be an employee for payroll tax or unemployment tax purposes, they are also considered to be an employee for apportionment factor purposes. Therefore, unless the auditor has reason to believe that persons included on a correctly completed Federal Form 940 or 941 or California Form DE-6 are not true employees under common law, we will generally accept the payroll reported on those filings.

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7335 Employees vs. Independent Contractors

Only compensation paid to employees is included in the factor. Amounts paid to agents, brokers and other independent contractors are excluded. Agents and brokers receive gross commissions or fees from which they must pay their own expenses such as travel, entertainment, rent, telephone, etc. There is therefore no reasonable comparison between compensation paid an employee and a commission paid an independent contractor. Including such commissions in the payroll factor would unduly weight the numerators of those states where agents or brokers are located.

For an exception to the rule that fees paid to independent contractors are not included in the factor, see the special formula for Film Producers, MATM 7740.

Since commissions or fees paid to independent contractors are not included in the Federal Forms 940 and 941 or the California Form DE-6, the reconciliation of payroll to those sources will generally disclose whether material payments to U.S. independent contractors have been included in the factor. Some taxpayers conduct their foreign marketing and distribution activities through agents. If the combined report includes foreign payroll, the auditor should consider determining whether the recipients of these payments are actually employees. The SEC 10-Ks will sometimes contain detailed employee information that may be helpful in identifying this issue.

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7340 CASH vs. ACCRUAL

Under the general rule stated in CCR §25132(a)(2), the payroll included in the factor should be determined on the basis of the taxpayer's accounting method. Since most multistate taxpayers use the accrual method of accounting, the payroll factor should reflect compensation accrued during the period. For unemployment compensation purposes however, most states require corporations to file their payroll tax returns on the cash method even though their books are kept on the accrual method for other purposes. Many corporations therefore maintain their by-state payroll records on a cash basis. Recognizing this fact, CCR §25132(a)(2) allows taxpayers to elect to report compensation using the cash method for payroll factor purposes.

If the cash method is used, the auditor should verify that it is used consistently for both the numerator and denominator.

If the taxpayer computes its payroll factor using the accrual method, it is still possible to reconcile the payroll factor to the cash basis payroll tax reports by analyzing the opening and closing accrual adjustments. These adjustments are usually made on the general ledger trial balance. Even if a thorough reconciliation is not possible, the payroll tax reports may still be useful for testing the reasonableness of the payroll factor as explained in MATM 7310.

NOTE: Use of the cash method is an election of the taxpayer. If the taxpayer does not wish to report compensation under the cash method, the auditor may not require use of that method. If the payroll amounts reported by the taxpayer do not appear to be reasonable and the auditor is unable to verify the figures, it is generally acceptable to substitute the "as reported" payroll with amounts from the Forms DE-6 and 940/941, but the taxpayer should be given the opportunity to provide the appropriate accrual adjustments. This adjustment should only be made when the discrepancies are material and the auditor is unable to verify the accrued payroll; it should not be viewed as a routine adjustment.

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7345 COMPENSATION ATTRIBUTABLE TO NONBUSINESS INCOME

Compensation paid to employees for services rendered in connection with nonbusiness activities is excluded from the payroll factor (CCR §25132(a)(2)). If the taxpayer has nonbusiness activities, an analysis of the related nonbusiness expenses should be made (see MATM 4060). Any payroll expenses allocable to the nonbusiness activity should be eliminated from the payroll factor.

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7350 CAPITALIZED PAYROLL

Compensation is included in the payroll factor in the year that it is paid or accrued by the taxpayer, even if the compensation has been capitalized rather than expensed. CCR §25132(a)(2) Example (A) describes a situation where the taxpayer's employees are used in the construction of a storage building which, upon completion, will be used in the unitary trade or business. Although the wages paid to those employees are capitalized into the cost of the building, the wages are nevertheless included in the payroll factor.

The Forms DE-6, 940 and 941 include compensation that has been capitalized. If the payroll factor is developed from other sources, the auditor should verify that compensation paid employees for the construction of fixed assets has been included.

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7355 FOREIGN PAYROLL

Translation of foreign payroll is made at the simple average of beginning and end-of-year exchange rates unless there is a substantial fluctuation in the value of the currency during the year, in which case a weighted average is used (CCR §25106.5-10(c)(2)).

In the case of employees in foreign countries, CCR §25132(a)(3) provides that the determination of whether benefits would constitute income to the employees shall be made as though such employees were subject to the Internal Revenue Code. The payroll costs for some foreign countries will include amounts paid for fringe benefits that would not be taxable to employees under the Internal Revenue Code. Consequently, care must be taken in developing or verifying the payroll for foreign entities in order to ensure that such nontaxable payments are excluded from the factor. Conversely, some payroll items that are nontaxable in the foreign country may be includable in the factor. In Japan for example, bonuses paid to corporate directors are posted directly to equity and are not deducted against income. Such bonuses are included in the denominator of the factor. Several publications are available which summarize the significant accounting principles of various countries (see Exhibit J). Such publications may provide clues regarding what has been included in a taxpayer's foreign compensation.

When auditing a taxpayer with foreign subsidiaries, auditors should be alert for the fact that some taxpayers conduct their foreign marketing and distribution activities through agents or brokers rather than employees. If the combined report includes foreign payroll, the auditor should consider determining whether the recipients of these payments are actually employees. The SEC 10-Ks will sometimes contain detailed employee information that may be helpful in identifying this issue.

If detailed income statements are available for foreign affiliates, they may be used to verify foreign payroll. Often such income statements may be found as a supporting schedule to the Form 5471s (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*). Translated foreign financial statements may contain notes that are helpful in determining what has been included in payroll expense. Consolidating workpapers to the annual reports may also be used to verify the payroll of foreign entities. Corporations with employees in Canada are required to file a Form T4 (*Summary of Remuneration Paid*), with the Canadian Revenue Department. This form is comparable to the U.S. Form 940 and may be used to test the reasonableness of Canadian payroll. Similar reports used to report payroll to other governmental agencies may also be available, and the instructions to those forms may provide insights as to the types of benefits that are being included in the total payroll figures. As discussed above, auditors need to use caution in relying upon sources such as foreign financial statements or payroll tax returns because of differences that often exist between U.S. and foreign rules for payroll reporting.

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If foreign income statements and other sources are not available or do not provide enough detail for reconciliation, the auditor may wish to test the reasonableness of the foreign payroll by performing a ratio analysis (for example, the ratio of payroll expense to sales or cost of goods sold could be examined). Library sources on economic statistics may also reveal information such as average monthly earnings for employees in various countries. The estimates that an auditor can draw from these sources will be very rough, but will provide a starting point if no other information is supplied.

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7356 Payroll Equalization

Some taxpayers, especially those with operations in low wage economies, may make adjustments to "equalize" foreign payroll expense to reflect equivalent U.S. wage rates. Their position is that $1 of labor in many countries has more earnings potential than $1 of labor in the U.S., therefore distortion is created when the higher California values in the factors pull the income into this state. The U.S. Supreme Court has recognized that this potential for distortion exists, but has nonetheless validated California's system as a fair apportionment scheme on the basis that some degree of distortion is to be expected in any taxation system (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App3d 988 (1981)). The mere showing that property, payroll or sales in California are higher than in other jurisdictions will therefore not be sufficient to justify departure from the standard formula. (See MATM 7000 for a discussion of distortion in the apportionment formula.) In unusual cases where distortion is believed to be present, the auditor should develop as many facts as possible concerning the activity and labor force in the foreign country. The taxpayer may have internal documents such as staffing reports that will aid in the examination.

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7360 PARTNERSHIP PAYROLL

If a partnership's activities are unitary with the activities of its corporate partner under established standards (disregarding the ownership requirement), then the partnership's payroll attributable to unitary business activities is includable in the corporation's payroll factor to the extent of their partnership interest (CCR §25137-1(f)(2)).

Example: Corporation A owns a 20% interest in unitary Partnership P and its distributive share of P's income is included in unitary business income. Corporation A's payroll is $1,000,000, and P's payroll is $800,000. For purposes of the payroll factor, A's total payroll shall be $1,160,000 ($1,000,000 plus 20% of $800,000).

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term construction contracts may be found in CCR §25137-1(h).

Examination of items making up "Other Income" (line 10 of the Form 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the payroll factor to the Form 1120 return or the Federal Forms 940/941 and California Forms DE-6 should identify whether partnership payroll has been included in the factor. The partnership tax returns (Form 565, or the foreign equivalent) will normally disclose the total payroll amounts. If the partnership operates both within and outside the state, it will normally provide its partners with a schedule disclosing the California property, payroll and sales.

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7365 OFFSHORE PAYROLL

Offshore payroll issues generally relate to compensation paid to employees working on offshore oil platforms or on ocean-going vessels. Discussion of this issue may be found in MATM 7795 (*Oil & Gas Industry*), and MATM 7760 (*Sea Transportation*).

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7370 COMPENSATION ASSIGNED TO NUMERATOR

R&TC §25133 provides that compensation is deemed to be paid within this state if any one of the following tests is met:

- The employee's service is performed entirely within the state.
- The employee's service is performed both within and without the state, but the service performed without the state is incidental to the service within the state. In this context, "incidental" is defined to mean any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.
- The employee's service is performed both within and without the state, and
- the employee's base of operations is in this state; or
- there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or
- the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

The tests are to be applied consecutively. If the first test is not applicable, the second is applied. If the second is not applicable, the third is applied, etc.

CCR §25133 defines the term "base of operations" as the place from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers, to replenish stock, repair equipment, or perform any other necessary functions. The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

In *Appeal of Photo-Marker Corporation of California*, Cal. St. Bd. of Equal., November 19, 1986, the issue was whether the compensation of two employees should be included in the numerator. The employees performed services in California for the appellant, but also traveled frequently to New York to perform services in their capacities as officers of the taxpayer's unitary parent corporation. The taxpayer argued that the officers' executive duties in New York were more important and permanent than their jobs in California, and that the base of their operations was at the corporate headquarters in New York. Although the SBE found that the employees' services in New York were more than "incidental," the employees were able to discharge their obligations to the parent by making short-term business trips to New York. Their long-term presence performing services in California led the SBE to hold that the base operations were in this state.

R&TC Section 25133 was patterned after the Model Unemployment Compensation Act, which California has adopted for payroll tax purposes. Therefore, compensation reported to California on

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EDD Form DE-6 (*Quarterly Payroll Report*) is generally the same as compensation includable in the numerator of the payroll factor. For situations where the Form DE-6 may include payroll that is not includable in the payroll factor, see MATM 7376 (Expatriate Employees) and MATM 7374 (Payroll in States Where the Taxpayer is Immune From Tax). The workpapers for the Federal Forms 940 will often contain a breakdown by state, which may be used to verify the numerator if the Forms DE-6 are not available.

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7372 Mobile Employees

The general rules discussed above in MATM 7370 assign the compensation paid to any particular employee to one state, even though the services may have been performed in more than one state. Exceptions exist for employees in certain industries that use special formulas. See MATM 7735 (Air Transportation), MATM 7765 (Bus Lines), MATM 7725 (Commercial Fishing), MATM 7770 (Freight Forwarding Companies), MATM 7760 (Sea Transportation Companies), MATM 7745 (Railroad Companies), and MATM 7755 (Truck Lines).

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7374 Payroll In States Where Taxpayer Is Immune From Tax

Generally, employee activities sufficient to result in the assignment of payroll to the numerator of the factor will create nexus for California to impose a tax. In accordance with the provisions of Public Law 86-272 however, a corporation will be immune to taxation in a state if its activities within that state are limited solely to the solicitation of sales (see MATM 1200 - MATM 1240 for a discussion of P.L. 86-272). If no member of the combined report has activities within California that exceed the P.L. 86-272 definition of solicitation, any payroll that would otherwise be assigned to California shall be excluded from the numerator of the payroll factor. (Note that in order for payroll to be excluded from the numerator, *no member of the combined report* can be taxable within California. This reflects the "Finnigan" rationale explained in MATM 7530.)

Likewise, the rules for assignment of payroll to the states will sometimes result in payroll being assigned to another state in which all members of the combined report are immune from tax under P.L. 86-272. Since there are no provisions that would allow such payroll to be excluded, it is included in the denominator of the payroll factor even though it will not be included in the numerator of any state ("Nowhere Payroll"). Unlike the sales factor, the payroll factor has no "throwback" provisions allowing the assignment of such compensation to other states.

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7376 Expatriate Payroll

U.S. executives working in foreign countries who report on a regular basis to their superiors in the United States are often termed "expatriate employees." Although non-residents for California income tax purposes, expatriates from California frequently desire to be covered by the California unemployment and disability provisions. These employees will therefore appear on the Forms DE-6. Since the compensation paid to these employees is not considered to be paid in California pursuant to the rules described in MATM 7370, it is not includable in the numerator of the payroll factor. Wages paid to expatriate employees may be identified on the "Exempt Payments" line of the Federal Form 940 (Part I, Line 2) as wages paid outside of the United States. By comparing a list of the expatriate employees exempted on the Form 940 to the names of the employees whose wages are included on the Form DE-6, the auditor can verify whether such employees have been included in the California payroll.

The presence of expatriate employees as indicated on the Federal Form 940 should also alert the auditor to the possibility of a unitary relationship with a foreign entity.

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7500 SALES FACTOR

The numerator of the sales factor is the total sales in this state during the taxable year. The denominator is the total sales everywhere during the taxable year. (R&TC §25134.) Only sales derived from business activities are considered in the sales factor -- nonbusiness sales are excluded.

Historically, there were two schools of thought with respect to the sales factor. Since the property and payroll factors primarily reflected manufacturing or production activities, some authorities felt that a sales factor was needed to balance the other two factors and give weight to the market. Others thought that a sales factor was unnecessary and a two-factor formula of payroll and property was sufficient. The opponents to the sales factor cited the difficulty of assigning sales to a particular location or state. They argued that sales could arbitrarily be assigned to origin, destination, or even state of manufacture. The model formula under UDITPA uses an equally weighted three-factor apportionment formula that generally assigns sales to the state of destination, and this is the method that California used prior to 1993.

In recent years, many states have been using tax policy to create economic incentives. Accordingly, there has been a trend towards double-weighting the sales factor (this involves using a four-factor apportionment formula which includes the sale factor twice). By shifting the weight in the formula more heavily to the market states in which the taxpayer makes its sales, an incentive is provided for taxpayers to locate or expand in the taxing state. Double-weighting the sales factor generally reduces taxes for companies with headquarters or major production facilities within the state. Conversely, the tax burden is increased for those companies which exploit the markets in the state but who do not contribute to the state by creating jobs or paying property taxes. When other states began double-weighting the sales factor, California companies were disadvantaged because their taxes in those states were increasing. To promote investment within our state, California moved to a double weighted sales factor for taxable years beginning on or after January 1, 1993. There are still some exceptions to the general rule of double weighting the sales factor however, and these are covered in MATM 7005.

This section of the manual first discusses the general topics relating to the sales factor. Next, specific rules and audit techniques are discussed with respect to certain types of sales:

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7505 RECONCILIATION OF SALES FACTOR

If the entities included in the combined group are the same as those in the annual report or SEC 10-K, then those sources are an excellent tool for testing the sales factor denominator. If the reporting group is different, then the by-company detail in the workpapers to the financial statements can be used to piece together the sales for the combined group, although adjustments may have to be made to take into account consolidating adjustments for intercompany sales.

Although the Federal consolidated Form 1120 may be used to test the sales of domestic entities, it will not contain sales of foreign entities or of unitary affiliates that are owned less than 80%. When sales are compiled from separate Forms 1120 or from Forms 5471 (In*formation Return of U.S. Persons With Respect to Certain Foreign Corporations*), be aware of the fact that intercompany eliminations will not have been made. Although the Form 5471 contains a section for listing intercompany sales, it may not always be reliable.

By comparing the gross receipts from the financial statements to the denominator of the sales factor per Schedule R, you should be able to identify whether intercompany eliminations have been made, and whether the sales factor includes any types of sales other than trade receipts. Any significant differences between the financial statement sales and those reported in the sales factor should be flagged for examination.

If there are any unitary partnerships, remember that a share of the partnership receipts should be reflected in the reconciliation. The partnership receipts may be reconciled against the partnership financial statements or tax return. See MATM 7570 for further information regarding partnership sales.

While reconciling the sales factor, be alert for any unitary implications that may affect other areas of your examination. For example, substantial intercompany sales that are being eliminated for book purposes between the taxpayer and a nonunitary affiliate may be noticed during a reconciliation of sales from the consolidating workpapers. This should alert you to the possibility that a unitary relationship may exist between those companies.

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7510 DEFINITION OF SALES

The term "sales" is defined for apportionment purposes in R&TC §25120(e) as all gross receipts of the taxpayer not allocated under R&TC §25123 through R&TC §25127. In other words, sales are defined to include all gross receipts giving rise to business income. Gross receipts from nonbusiness activities are excluded. This definition expands the meaning of sales beyond merely trade revenues, and includes receipts from the sale of business assets, rental income, commissions, interest, and other types of receipts generated by the business. Receipts from nonrecognition transactions (i.e., like-kind exchanges, IRC §351 transfers, reorganizations, etc.) should generally not be considered in the sales factor. The treatment of various types of receipts in the factor is discussed in detail in the following sections.

CCR §25134(a)(2) places some parameters on the broad inclusion of all gross receipts in the factor by providing that receipts may be disregarded in some cases in order for the apportionment formula to operate fairly. Special rules for these exceptions are contained in CCR §25137(c), and provide for the exclusion of substantial receipts from incidental or occasional sales, insubstantial amounts from incidental or occasional activities, and income from intangible property for which no particular income-producing activity can be attributed. These exceptions are discussed in MATM 7512 -MATM 7516.

Intercompany sales are eliminated from the sales factor to avoid double-counting receipts. See MATM 7518.

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7512 Substantial Receipts

CCR §25137(c)(1)(A) provides:

"Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded."

On October 15, 1997, Legal Ruling 97-1 was issued. This Legal Ruling provides that if substantial amounts of gross receipts arise from an incidental or occasional sale of intangible property, held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. This is comparable to the treatment of substantial receipts from an incidental or occasional sale of fixed assets.

In the *Appeal of Fluor Corporation,* Cal. St. Bd. of Equal., December 12, 1995, the SBE held that if a sale satisfies the conditions stated in the above regulation (i.e., the gross receipts are *substantial*, and arise from an *incidental or occasional sale of a fixed asset*), then the regulation applies and no further showing of distortion is required in order to exclude the receipts from the sales factor. On the other hand, if either the taxpayer or the FTB objects to the exclusion of the receipts from the factor, then that party bears the burden of proof for establishing that application of the regulation does not fairly represent the extent of the taxpayer's activities in the state. The Fluor decision overrules the earlier decision in *Appeal of Triangle Publications*, *Inc*., Cal. St. Bd. of Equal., June 27, 1984, wherein the SBE had held that distortion must be proven before the regulation could be applied. For further discussion of CCR §25137 and deviations from the standard apportionment formula, see MATM 7701.

The presence of substantial gross receipts can usually be identified rather easily. The gain and loss schedule (Schedule D) will reveal large sales of business assets. Large dispositions of business assets are also usually disclosed in the annual reports, SEC 10-Ks and the notes to the financial statements. The reconciliation of the denominator of the sales factor (MATM 7505) will identify whether the taxpayer has included receipts other than trade revenues in the sales factor, and the taxpayer's apportionment workpapers will provide detail as to what items have been included in the factor.

Once substantial receipts have been identified, the nature of the taxpayer's business may give the auditor an indication of whether the receipts are from an incidental or occasional sale as contemplated by the regulation. For example, if a large retail grocery chain owns its own fleet of wholesale delivery trucks and replaces them pursuant to a regular replacement program, then the dispositions are a regular and routine part of the business activity and are not eligible for exclusion

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under CCR §25137(c)(1)(A) even if the amounts are substantial. On the other hand, suppose that the grocery chain decided to sharply cut back its trucking activities by making a large one-time reduction in its fleet. Since this would be an incidental or occasional transaction, it is the type of sale contemplated by the CCR §so long as it is "substantial" relative to the taxpayer's other activities.

It is important to remember that in order for CCR §25137(c)(1)(A) to apply, the receipt in question must not only be substantial, it must also be from an incidental or occasional sale. Not all receipts meet both criteria. For example, a disposition of business assets may qualify as an incidental or occasional transaction. However, the receipt may not be substantial. Alternatively, the taxpayer may have substantial receipts from a transaction, which do not meet the incidental or occasional transaction test. The receipt must meet both criteria before it can be excluded from the computation of the sales factor.

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7514 Insubstantial Receipts

CCR §25137(c)(1)(B) states that insubstantial gross receipts from incidental or occasional transactions or activities may be excluded from the factor so long as such exclusion does not materially affect the amount of income apportioned to California. By way of example, the regulation states that gross receipts from the sale of office furniture, business automobiles, etc., may be included or excluded from the sales factor at the taxpayer's option if the receipts are insubstantial and are the result of incidental or occasional transactions. The purpose for this provision is to ease the compliance burden to taxpayers by not requiring them to keep track of minor miscellaneous receipts for sales factor purposes.

Note: The taxpayer should be consistent in its treatment of such receipts from year to year. However, the exclusion of insubstantial receipts from the sales factor is at the taxpayer's option. Auditors may not use CCR §25137(c)(1)(B) to remove receipts which the taxpayer has included in the sales factor.

The main issue with respect to insubstantial receipts is one of materiality. In order for the taxpayer to exclude receipts from the sales factor under this test, the inclusion of the receipts must not materially affect net income apportioned to this state. There are no bright line tests for determining materiality. Exclusion of incidental receipts of $50,000 to a taxpayer with trade revenues of $500,000 may be substantial and will probably require further analysis. That same $50,000 in incidental receipts to a taxpayer with trade revenues of $50,000,000 is certainly immaterial and should be left to the option of the taxpayer whether to include or exclude. Situations that are not as readily determinable as those described above will require auditor judgment. By calculating apportioned net income with and without the incidental receipts, the potential tax change can be determined. If the taxpayer has been consistent in its treatment of these gross receipts and the potential tax change is not material, the taxpayer's method should not be adjusted.

If the test check turns out to be material and the receipts are not excludable under any other provisions of the law and regulations, then they should be included in the computation of the sales factor.

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7516 Unassignable Income From Intangible Property

Receipts from transactions involving intangible property are assigned to the numerator of the sales factor if the income producing activity is in this state. Receipts from transactions involving intangible property are also assigned to the numerator of the sales factor if the income producing activity is both in and outside the state if the greater proportion of the income producing activity is performed in this state, based on costs of performance (see MATM 7560). Where business income from intangible property cannot be attributed to any particular income producing activity of the taxpayer, the receipts cannot be assigned to the numerator of any state. CCR §25137(c)(1)(C) provides that such unassignable income shall also be excluded from the denominator of the sales factor.

CCR §25136(b) defines the term "income producing activity" to mean the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as activities conducted by an independent contractor. However, income-producing activities would include activities performed by other members of the combined report as long as the activities are directly related to the generation of the income. Acts of agents would also be attributed to the principal in determining the location of the income producing activity. The regulation specifically states that the mere holding of intangible personal property is not, of itself, an income producing activity.

To illustrate the application of these provisions, CCR §25137(c)(1)(C) provides the following examples of income from intangibles:

dividends received on stock
royalties received on patents or copyrights
interest received on bonds, debentures or government securities

If such income results from the mere holding of the intangible asset (i.e., stock, patents or bonds) and there is no income producing activity, then the receipts are excluded from the factor.

If the taxpayer's receipts from intangible property are material to the factor, the auditor should determine whether an income producing activity exists for each item of income. This determination cannot usually be made based solely upon the type of income. For example, if the taxpayer earns interest and dividend income from investments of excess cash that are managed by an unrelated investment firm, no income producing activity is engaged in by the taxpayer with respect to that income. On the other hand, if the taxpayer maintains an investment department staffed by employees whose function is to manage the investments, then those employees are performing an income-producing activity traceable to their work location.

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Material sales of stock should be excluded from the sales factor if the location of the income producing activity cannot be determined, or if it is a substantial, occasional sale to which Legal Ruling 97-1 applies.

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7518 Intercompany Receipts

Intercompany revenues between members of a combined reporting group are eliminated from the sales factor. This avoids duplication and prevents an opportunity for manipulation of the factor. If Corporation A sells goods to B at $90 and B resells the same goods to outsiders at $100, only the $100 is included in the sales factor; the $90 is eliminated as an intercompany sale. See MATM 5260 for additional discussion of intercompany transactions.

Neither the statute nor the regulations specifically provide for the elimination of intercompany revenues. However, in Chase Brass & Copper Co., Inc. v. Franchise Tax Board [(1977), 70 CA 3d 457, 138 CRptr 901], the California Court of Appeal affirmed FTB's exclusion of sales between members of the unitary group. The Court reasoned that since the intercompany sales do not result in apportionable net income, there is no reason to represent those sales in the sales factor.

Only intercompany revenues within the combined unitary business are eliminated. Sales from a unitary business activity to a nonbusiness activity would not be eliminated. Similarly, sales between two nonunitary divisions of a corporation would not be eliminated. In a water's-edge group, sales to a non-combined foreign entity or possessions corporation, which is a United States domestic entity that has made an election pursuant to Internal Revenues Code section 936, would not be eliminated even though the entities might be unitary. Also, in a water's-edge group that has partially included entities where intercompany sales are involved, the auditor must take into consideration the partial inclusion element when determining the appropriate amount of intercompany sales to be eliminated.

The following are some common types of intercompany revenues that are eliminated:

- Sales
- Dividends
- Services fees
- Rents
- Management fees
- Royalties
- Interest
- Administrative fees

The eliminating adjustments in the workpapers to the consolidated financial statements should identify intercompany items. The chart of accounts may also reveal accounts that are reserved for intercompany revenues.

Although some intercompany eliminations may be made on the federal return, intercompany revenue from "period expenses" may not be identified for federal tax purposes. Period expenses are items for

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which the seller/service provider recognizes income in the same period as the buyer/service recipient deducts a corresponding expense. An example of a period expense would be intercompany rents, which are generally reported as income by the lessor in the same period as the related lessee deducts the rent expense. Since the income and expense are a wash in the consolidated return, they are not eliminated for federal tax purposes.

While reviewing the consolidating workpapers for evidence of intercompany sales, the auditor should be alert for significant intercompany activity with affiliates that have not been included in the combined report. Such activity can be an indication of a unitary relationship.

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7520 ASSIGNMENT TO NUMERATOR – TANGIBLE PERSONAL PROPERTY

Sales of tangible personal property are assigned to California and included in the numerator if:

The product is delivered or shipped to a purchaser in this state and the taxpayer (or another member of the combined report) is taxable in this state (the destination rule); or
The product is shipped from an office, store, warehouse, factory, or other place of storage in this state and neither the taxpayer nor any other member of the combined report is taxable in the state where the goods are delivered or shipped (the throwback rule).

Thus, under #1 above, goods shipped to a California destination from any point of origin are California sales so long as a member of the combined report is taxable in this state. Under #2, goods shipped from California to another state will also be California sales if no member of the combined report is taxable in the other state. Only sales of tangible personal property are covered by these rules (MATM 7522). The rules do not apply to sales of real property, services, or intangibles. Also, there is an exception to these rules for sales made to the U.S. Government (MATM 7535).

Note: The rules described above are set forth in R&TC §25135. That section refers to whether the "taxpayer" is taxable within a state. The departments's position regarding whether the word "taxpayer" means just the selling entity or all members of the combined reporting group has changed over the years. This issue is explained in more detail below, and is also covered in MATM 7530.

The first step in assigning sales of tangible personal property to the numerator of the sales factor is to identify the state to which the property was delivered or shipped (MATM 7525). Once this has been identified, the next question is whether the corporation is taxable in that state. To answer this question, the auditor must determine whether the state has sufficient nexus to tax the seller. With respect to domestic sales, the auditor must further determine whether the taxpayer is immune to taxation within the state under the provisions of Public Law 86-272. For a discussion of what is necessary to establish nexus or loss of immunity under P.L. 86-272, see MATM 1100 – MATM 1240.

The determination of whether a corporation is immune from taxation in a state is made on an entity-by-entity basis. For apportionment factor purposes prior to 1999 however, sales may be assigned to a state if any member of the combined reporting group is taxable in that state. This can result in situations where the sales factor numerator will contain sales attributable to a member that is not taxable in this state (such sales are often termed "reverse Finnigan sales"). In such cases, a special formula is required to apportion the California income among the taxable members of the combined reporting group. For more information on this issue, see MATM 7530 (Throwback sales) and MATM 7905 (The "Finnigan" Computation).

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If no member of the combined reporting group is taxable in the state to which goods are delivered or shipped, then the sales are assigned to the state *from* which the goods were shipped (MATM 7530).

Most taxpayers selling tangible personal property maintain sales records by destination since assignment on that basis is standard under UDITPA. Taxpayers also usually maintain sales by origin or from point of shipment. To ensure that these by-state records include all of the taxpayer's sales, the total for all states should be compared to the sales included in the denominator of the factor and any differences should be reconciled. In addition, the auditor should review the by-state sales records to verify that all sales on the list are assigned to a particular state. Sometimes, the by-state schedules contain amounts designated as "unassigned sales" or "sales to nontaxable states." If material amounts of sales are not specifically assigned, the auditor should determine whether any portion of those sales are attributable to California. Specific steps for auditing the various numerator issues are discussed in detail in the following sections.

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7522 Tangible Personal Property Defined

Tangible personal property is perceptible to the senses and is usually discernible from intangible personal property. For assets such as computer software however, the distinction between tangible and intangible property can become blurred. See MATM 7152 for a discussion of this issue.

Occasionally, taxpayers will argue that a transaction is something other than a sale of tangible personal property in order to avoid the rules found in R&TC §25135. The following cases illustrate the importance of gaining an understanding of the taxpayer's activities and how its sales are structured and reported.

In *Appeal of Babcock and Wilcox Co*., Cal. St. Bd. of Equal., January 11, 1978, the taxpayer fabricated subunits for large steam generating systems in another state, and assembled the systems at the purchaser's location in California. Completed systems might cover an area as large as a city block. In addition to the fabrication, performance of the contracts for completed systems required many service functions such as planning, drafting, engineering, installation and testing. The taxpayer's position was that since performance of the contract involved so many elements, the transaction must be something other than the sale of tangible personal property. Therefore, the taxpayer argued that the sale should be assigned to the other state where the greater proportion of the income-producing activities was performed. The SBE did not agree with the taxpayer, stating:

"It is hard to imagine any manufactured product which, to a greater or lesser degree, does not involve many elements such as planning, design and engineering in its production. Nevertheless, the existence of such fact does not prevent the finished product from being classified as tangible personal property."

By looking to statutes (including the California Civil Code and the Revenue and Taxation Code) and cases, the SBE confirmed that the property was correctly classified as tangible personal property assignable to California as the state to which it was delivered or shipped.

On the other hand, in *Appeal of Mark IV Metal Products, Inc*., Cal. St. Bd. of Equal., August 17, 1982, the California-based taxpayer attempted to use the destination rule to assign revenue outside of California. The taxpayer manufactured tables and chairs from metal. A principal customer was a Texas company, which shipped unfinished steel to the taxpayer in California for fabrication into seat parts. The finished parts were then shipped by common carrier back to the Texas company. The taxpayer never held title to the metal or the metal products. By taking the position that the transactions were sales of tangible personal property, the taxpayer sought to have the sales assigned to Texas, the state to which the property was delivered or shipped. The SBE disagreed, holding that the sales were sales of services, not sales of tangible personal property. Since sales of services are

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assigned to the state where the income producing activity was performed, the SBE concluded that the sales were includable in the numerator of the sales factor.

In *Appeal of Dart Container Corporation of California*, Cal. St. Bd. of Equal., July 30, 1992, the taxpayer attempted to treat a portion of the sales price of its products as royalties assignable to the state where the income producing activity was performed. Sales orders were submitted to the parent, who then purchased the products from its manufacturing subsidiary nearest the customer, and resold them to the customer. The selling subsidiary drop-shipped the product to the customer. The parent paid the subsidiary a percentage of the selling price (76.5% - 88%) and was liable for all expenses associated with the sale. The taxpayer characterized the amount of the sales price retained by the parent as reimbursement for the costs connected with the sale, and the remainder as a royalty payment from the subsidiary for the use of the parent's technology. The taxpayer attempted to assign the portion of the selling price, which represented the royalties to the state in which the technology was developed.

The SBE did not allow the taxpayer's treatment, finding that there was no separate sale of an intangible item. Since tangible personal property was sold for a single price, the entire amount of the sales price constituted gross receipts from the sale of tangible personal property subject to the destination rule.

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7525 Delivered Or Shipped Defined

As discussed in MATM 7520, R&TC §25135 provides that sales of tangible personal property are assigned to California if:

the *property is delivered or shipped* to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or
the property is shipped from an office, store, warehouse, factory or other place of storage within this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

In order to properly assign sales under R&TC §25135, the determination of where goods are considered to have been delivered or shipped is often a key issue.

In the past, the department's position with respect to this issue was stated in Legal Ruling 348 (dated 1/24/72). This position was challenged in *McDonnell Douglas v. Franchise Tax Board* (1994) 26 Cal.App.4th 1789. In its decision, the Court of Appeal declined to follow the rationale of Legal Ruling 348. FTB subsequently issued Legal Ruling 95-3 (dated 7/20/95) to announce that Legal Ruling 348 is withdrawn and that the department will follow the holding in *McDonnell Douglas*. Legal Ruling 95-3 also discusses how the *McDonnell Douglas* analysis will be applied in various situations.

In the McDonnell Douglas decision, the taxpayer manufactured aircraft at a facility in California. The taxpayer's customers took physical possession of the aircraft in California, and then flew the aircraft to the state or country where the aircraft was to be used. The taxpayer took the position that R&TC §25135(a) would assign sales to California only if there was a "purchaser . . . within this state." Since the aircraft was destined for use outside California, the taxpayer argued that the purchaser was not "within this state."

FTB argued that the statute should be read to include sales if the property was "delivered . . . to a purchaser within this state," regardless of the ultimate destination of the goods.

Pointing out that the objective of the sales factor is to recognize the contribution of the consumer states to the production of income, the Court held that the statute requires that there be a purchaser within this state, and that the purchaser is not "within this state" if the goods are destined for use outside this state.

Appeal of Mazda Motors of America (Central), Inc., Cal. St. Bd. of Equal., 11/29/94, was decided by the SBE shortly after the McDonnell Douglas decision. In *Mazda Motors*, the taxpayer imported vehicles and parts from Japan for sale in the United States. The vehicles and parts enter the U.S. through two ports of entry in California, and some vehicles are placed in storage facilities maintained

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by the taxpayer while awaiting further shipment to their ultimate destination. According to an agreement between the taxpayer and its Gulf coast distributor, vehicles are deemed delivered to the distributor at the port of entry at 5:00 p.m. of the first day on which customs clearance is obtained. Title and risk of loss pass to the distributor upon such delivery, and the distributor is responsible for all taxes arising after that time. The taxpayer stores, assembles, installs accessories, repairs and services vehicles at the port of entry pursuant to the distributors directions. The distributor would then direct the taxpayer where and to whom to ship the vehicles and the taxpayer would arrange for the transportation at the distributor's cost. The taxpayer charged the distributor for all of these services.

The taxpayer argued that since the distributor did not take possession and control of the vehicles in California, delivery did not occur in this state. The SBE disagreed, stating that the taxpayer's own contracts clearly specified that delivery to the distributor occurred in California. Although the distributor did not take physical control over the vehicles, it exercised sufficient control to manifest an ownership interest. Furthermore, the activities of the distributor in directing the taxpayer as to the type of accessories to install "are indicative of something much more substantive than mere temporary storage in California for purposes of further shipment elsewhere in the stream of interstate commerce." The SBE found that those activities distinguished this case from a *McDonnell Douglas*-type situation where the out-of-state purchaser merely picked up the goods in this state.

To reflect the holdings in these decisions, the department has taken the position that a purchaser's receipt of goods within California for the mere purpose of immediate transportation to another state is not adequate to meet the R&TC §25135 requirement of a purchaser "within" the state.

On the other hand, if goods are shipped to a physical location of a purchaser in California, or if a purchaser takes possession (or constructive possession through an agent or bailor) in this state for purposes such as warehousing, repackaging, adding accessories, etc., the property is "delivered . . . to a purchaser within the state, " and the sale is a California sale. Any subsequent transportation of the goods to another state will not affect the California assignment of the sale.

NOTE: Once the goods have been delivered to the purchaser, the purchaser will have records to support the ultimate destination of the goods, but the seller will generally not have access to such records. It will be difficult for both auditors and taxpayers to know whether a receipt by the purchaser is the ultimate destination or merely the first step in an interstate transportation of the goods. Therefore, it should be presumed that any goods taken into possession by the purchaser in California have been delivered or shipped to a purchaser within this state. This presumption may be rebutted if the taxpayer can demonstrate that the purchaser immediately transported the property to another state. The auditor should therefore be careful to consider the relevance and reliability of any evidence provided by the taxpayer to determine whether they have met their burden of proof.

Conversely, sales delivered to a purchaser outside this state but ultimately transported to a destination within this state are California sales so long as the seller is taxable in this state. Since the

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information needed to establish the ultimate destination of goods will generally be in the control of third parties, it will usually be difficult to identify and examine this issue. Auditors should be sure to weigh the materiality of the issue against the resources that may be needed to secure the necessary documentation.

In order to be consistent with both the *McDonnell Douglas* holding and the purpose behind R&TC §25135(b), "shipment" will be considered to have occurred if either (1) the purchaser transports property to another state immediately after taking delivery from the seller, (2) the seller transports property to its purchaser in another state, or (3) a common carrier is used to transport property to the purchaser. Where goods are shipped from California, but neither the taxpayer nor any other member of the combined report is taxable in the state of the purchaser, the sales will be "thrown back" to California under the provisions of R&TC §25135(b) (see MATM 7530).

CCR §25135 contains examples of when a sale is delivered or shipped to a purchaser within this state. The following examples illustrate the application of these rules is some additional situations:

Example 1
A seller manufactures machinery in California, and sells it to a purchaser who has a place of business in State A and State B. The purchaser picks up the machinery in California using its own trucks, and transports the machinery to its own place of business in State A.

The machinery is considered to be shipped to the purchaser in State A. If the seller is taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California. This outcome will result whether or not the purchaser happens to have a place of business within California.

Example 2
Assume the same facts as in Example 1, but a few days after the machinery arrives at the purchaser's place of business in State A, the purchaser transports it to its place of business in State B.

Sales will generally be assigned to the first physical location of the purchaser. In this situation, the machinery is considered shipped to a purchaser in State A. The sale is considered terminated at that point, and the subsequent transportation to State B has no effect on the assignment of the sale. If the seller is taxable in State A, the sale is a State A sale. If not, the sale is thrown back to California.

Example 3
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a common carrier in State A and arranges shipment to its place of business in State B.

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The purchaser did not have possession in California or in State A for purposes other than in the process of shipment. The ultimate destination is therefore considered to be State B. If the seller is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

Example 4
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery directly to its own customer in State C.

The purchaser did not have possession in California for purposes other than in the process of shipment. The purchaser's customer will be considered the "purchaser" for purposes of R&TC §25135(a). If the seller is taxable in State C, the sale is a State C sale. If not, the sale is thrown back to California.

Example 5
A seller manufactures machinery in California. While the machinery is still stored at a location maintained by the seller, the seller transfers title to the machinery to the purchaser. The seller adds accessories to the machinery at the direction of the purchaser, and then places the machinery with a common carrier for transportation to State C.

Because title to the machinery passed to the purchaser in this state, and the purchaser took constructive possession of the property in this state for purposes other than in the process of shipment (as evidenced by the fact that the purchaser directed the seller to install accessories), the purchaser is considered to be "within this state" at the time possession was constructively delivered to the purchaser. The sale is a California sale.

Example 6
Assume the same facts as in Example 1, except that the purchaser does not transfer the machinery to its own place of business in State A. Instead, the purchaser transports the machinery to a location owned by a third party in State B. Under a separate contract, the third party adds accessories and repackages the machinery at the direction of the purchaser's customer. The goods are then transported to the purchaser's customer in State C.

Because the purchaser's customer has constructive possession of the machinery in State B under the *Mazda* holding, and because the machinery was not delivered or shipped to the purchaser in any state, the purchaser's customer is considered the purchaser for purposes of R&TC §25135(a). If the seller is taxable in State B, the sale is a State B sale. If not, the sale is thrown back to California.

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7530 THROWBACK SALES

NOTE: On April 22, 1999 the SBE issued its decision in *Appeal of Huffy Corporation*. In this case the SBE reviewed their *Finnigan/Nutrasweet* interpretation of §25135 and concluded that its "pre-*Finnigan* decision in *Appeal of Joyce, Inc.* is the better law." The decisions deal with the term "taxpayer" for throwback sales purposes. The general rule for determining which state a sale of tangible personal property should be apportioned (the numerator assignment) is the state of destination. An exception to this rule is where the taxpayer shipping the goods is not taxable in the state of destination perhaps due to PL 86-272. The Joyce rule provides that you look to each separate entity to determine if that entity is taxable in the destination state. Therefore, under the Joyce rule, sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state. The *Finnigan/Nutrasweet* decisions held that the unitary group is the taxpayer. Accordingly, under the Finnigan rule sales are not thrown back to the state of origination if any member of the unitary group is taxable in the destination state.

In *Huffy*, the SBE noted that both FTB and taxpayers have relied on the *Finnigan* decision for the past eight years and ruled that their holding for a renewed implementation for the Joyce rule should be applied prospectively from the date of their decision. Therefore, for taxable years beginning on or after April 22, 1999, the FTB and taxpayers will again use the Joyce rule. For taxable years beginning before April 22, 1999, Finnigan is the rule.

When the taxpayer ships goods from this state to a state where the taxpayer is not taxable, the sales are assigned to the California numerator under the provisions of §25135(b). This is termed the "throwback" rule. As discussed in MATM 1200 – MATM 1240, Public Law 86-272 precludes states from taxing businesses whose activities within the state do not exceed solicitation of sales. Under the destination rule that is normally used to assign sales, this restriction on a state's ability to tax would frequently result in sales being assigned to a destination state in which the taxpayer would be immune from taxation. To prevent this result, the throwback rule requires such sales to be "thrown back" to the numerator of the state from which the goods were shipped.

There are three aspects of this issue that the auditor must consider:

If a corporation is selling goods destined for California, and that corporation's activities within California exceed the P.L. 86-272 threshold (i.e., the corporation is a California taxpayer), then the auditor should verify that the corporation is not throwing-back California destination sales to the states from which they were shipped. The auditor should also verify that the selling corporation has an assigned California corporation number.

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If a seller's activities within California do not exceed the P.L. 86-272 threshold, but any member of the combined report is a taxpayer in this state, then the California destination sales are not thrown back to the state from which they were shipped.

If a taxpayer is shipping goods from California, the auditor should verify that the taxpayer is taxable in the destination states.

Note regarding foreign commerce: For sales between the U.S. and a foreign country, the standard for determining whether a corporation is taxable is constitutional nexus, *not* P.L. 86-272. See MATM 1240 for more discussion.

Identification of throwback issues:

When examining the by-state records for property and payroll, the auditor should be on the lookout for states in which the taxpayer does not have significant amounts of property or payroll. A throwback issue may exist if the by-state sales records reveal that the taxpayer makes sales to these states. To aid in identifying throwback issues, it may be helpful to construct a workpaper schedule for each year similar to the following nexus chart:

Destination states for products with a CA shipping origin	Nexus Indicators:				
	Return filed	Inventory	Assets	Rented Property	Payroll
1.					
2.					
3.					
4.					
5.					

Positive nexus items for each listed state should be listed across the chart. Filed returns should only be listed if they indicate bona fide activity within the state (as opposed to mere qualifying returns reporting a minimum tax). If the chart indicates that nexus has been established by way of a filed return or by property or rented facilities within a state, that state may be eliminated as a throwback candidate. Sales to remaining states with no returns or property have throwback potential and should be examined further.

NOTE: The above chart must be prepared for the combined reporting group as a whole for tax years beginning before April 22, 1999 to reflect the Finnigan rule. Sales to a destination state will not be thrown back to the shipping state if *any member* of the combined group is taxable in the destination state in accordance with the SBE decisions in *Finnigan/Nutrasweet*.. After April 22, 1999, the chart

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must be prepared on a separate entity basis to reflect the Joyce rule. Sales are thrown back to the state of origin if the selling corporation is not taxable in the destination state in accordance with the SBE decision in Huffy.

In the *Appeal of Finnigan Corporation*, Cal. St. Bd. of Equal., August 25, 1988 ("Finnigan I"), the SBE ruled that in the context of §25135(b)(2), the word "taxpayer" means all members of the combined reporting group. Therefore, the SBE held that when a member of a group conducting a unitary business in California shipped sales from California to another state, the throwback rule does not apply if *any* member of that combined reporting group is taxable in the destination state.

Example: CF Company is an interstate trucking company that operates and delivers in all states west of the Mississippi. It files a combined return with TM Company, a trailer manufacturer, whose operations are solely in California. TM sells trailers to CF and to other customers, and the two companies are unitary. TM ships trailers to a customer in Arizona.

Holding (1): For tax years beginning before April 22, 1999, even though TM does not have any operations outside of California, its sales to Arizona would not be thrown back to California because CF is taxable in Arizona. This is the Finnigan rule.

Holding (2): For tax years beginning on or after April 22, 1999, TM sales are thrown back to California because TM is not taxable in Arizona. This is the Joyce rule.

FTB filed a petition for rehearing from the decision in *Finnigan I*, and the SBE then issued its *Opinion on Petition for Rehearing* ("Finnigan II") on 1/24/90. In Finnigan II, the SBE agreed that its opinion in Finnigan I was "analytically and philosophically incompatible" with *Joyce*, and expressly overruled *Joyce.* The opinion also clarified that this was strictly an apportionment rule. Although sales made by an entity that is immune from taxation can be included in the sales factor of the combined reporting group, the entity itself cannot be taxed. When it is necessary to identify the tax liabilities of each taxpayer in the unitary group, the presence of "Finnigan sales" will require a modification to the normal intrastate apportionment rules. These calculations are described in MATM 7905.

The *Finnigan I and II* opinions had dealt with a situation where sales were shipped from California and were deemed to be assignable to the numerator of the destination state. A question remained as to whether the same result would apply to sales shipped from another state to a California destination ("reverse Finnigan sales"). The SBE confirmed that its decision in Finnigan I and II applied equally to reverse Finnigan sales in *Appeal of The Nutrasweet Company*, Cal. St. Bd. of Equal., October 29, 1992.

Note that the Finnigan rationale only applies to combined reporting group members. Therefore, the fact that a unitary foreign affiliate has nexus in a particular location is not considered in determining

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the throwback sales for a water's-edge taxpayer if the affiliate is excluded from the combined report because of the water's-edge election.

Audit steps for examining throwback issues:

Once potential throwback sales are identified, the auditor can question the taxpayer as to their proper classification and possibly the issue can be resolved without additional work. If the taxpayer maintains that they are taxable in the destination state-, the following steps -should be taken:

If a taxpayer has filed a return and/or paid taxes to another state because of an audit adjustment in that state, and that state has an income or franchise tax, it is usually presumptive evidence that the taxpayer is taxable in that state. If so, the auditor should ask the taxpayer to produce copies of the other state return or other state audit adjustment. If a taxpayer voluntarily files and pays a tax, or pays a minimal fee for qualification, organization or for the privilege or doing business in the state, but does not actually engage in business activity within the state sufficient to establish nexus, then the taxpayer is not taxable in the state (Regulation 25122(b)(1)). The auditor should therefore scan the other state returns to gain additional assurance that taxability exists. Unless there is a material tax effect however, the auditor should not spend a great deal of time on the issue if tax returns have been filed or tax has been paid pursuant to the other state's audit adjustment.

However, if the potential tax effect of a throwback sale is material, the fact that the taxpayer has filed a return in the destination state may not resolve the issue. A taxpayer, may self-assess or agree with the other state's audit determination if the result in assigning the sale to the destination state results in a net reduction in tax. The definition of materiality for the purposes of throwback sales is a large difference in tax between the additional tax paid to the destination state and the California tax savings by not throwing the sale back to California. The auditor should discuss this issue with his/her supervisor.

The auditor may pursue factual development of the potential throwback sale issue, assuming the tax effect is material, even though the taxpayer has filed a return in the destination state or agreed with the other state's audit adjustment. Audit adjustments may be proposed if the taxpayer does not have nexus in the destination state or is exempt under PL 86-272.

If a taxpayer has not filed returns or paid taxes in the destination state for the year at issue, taxability in the destination state for the year in issue must be established by incontrovertible evidence that the taxpayer's activities within the state cause nexus under the U.S. Constitution and exceed the activities protected by P.L. 86-272. (A complete discussion of nexus requirements and P.L. 86-272 may be found in MATM 1100 – MATM 1240.)

The *Appeal of The Olga Company*, Cal. St. Bd. of Equal., June 27, 1984, stated in part:

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"Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86.272. We believe that this weighs heavily against appellant and that, in order to prevail, appellant must clearly establish that its activities within the foreign states go beyond mere solicitation."

When the situation exists of a taxpayer not filing returns or paying taxes in the destination state for the year at issue, the taxpayer should be asked to complete Form FTB 4505 "*Declaration to Support Claim of Taxability in Other States of the United States."* A copy of the form is included at Exhibit G.

Since the Form FTB 4505 contains the taxpayer's declaration, it should be completed by the taxpayer, not the auditor. The declaration itself will not suffice for relief from throwback. Activity claimed in the declaration is still subject to audit verification. The completed declaration should be submitted as part of the completed audit report, and Corporation Audit will furnish a copy to the destination state. The purpose for this form is to provide accountability by ensuring that sales that may not be thrown back to California are brought to the attention of the destination state where the taxpayer is claiming taxability.

Once the Form FTB 4505 Declaration has been completed, the claimed activities should be reviewed to determine whether they are sufficient to establish taxability. If the materiality of the issue warrants it, the auditor should verify the existence of the claimed property or activities in the state. For example, if the taxpayer claims that inventory is stored in a public warehouse within the destination state, the auditor may want to request the inventory confirmation letters that would have been sent by the taxpayer's outside accountants during the annual audit.

If the taxpayer will not sign the Declaration, then the auditor should continue the factual development. Consistent with the SBE decision in *The Olga Company* and CCR §25122 the taxpayer has the burden to clearly show that they are taxable in the destination state. Sales will be thrown back to California if the taxpayer cannot meet this burden.

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7532 Double Throwback

CCR §25135(a)(7) provides a rule for situations where the taxpayer is not taxable in *either* the state of destination or the state of origin. This situation might occur if a taxpayer's salesman located in California directs an unaffiliated manufacturer in one state to ship merchandise directly to the taxpayer's customer in another state. For example, assume a California sales office of the taxpayer directs a manufacturer in Colorado to ship merchandise directly to taxpayer's customer in Arizona. If the taxpayer is taxable in Arizona, then the sale is assigned to that state under the destination rule. If the taxpayer is taxable in Colorado, but not Arizona, then the sale is assigned to Colorado as a throwback sale. If taxpayer is not taxable in either Colorado or Arizona, then the Regulation provides that the sale would be assigned to California. This is known as the "double throwback" rule.

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7535 SALES OF TANGIBLE PERSONAL PROPERTY TO THE U.S. GOVERNMENT

Sales to the U.S. Government are an exception to the normal destination rule for assigning sales of tangible personal property. Regardless of whether the taxpayer is taxable in the destination state, sales to the U.S. Government are assigned to the state *from* which the goods are shipped (R&TC §25135(b)). The reason for using origin rather than destination is because the government often gives coded destination instructions to vendors for security reasons, hence the destination of products is not always known. This treatment applies only to sales of *tangible personal property* to the *United States* Government. Sales to state and local governments or foreign governments are subject to the normal rules for assigning sales.

In order to qualify as sales to the U.S. Government, CCR §25135(b) provides that the payments must be made directly by the government to the seller pursuant to the terms of a contract. When the party to the government contract is a prime contractor, sales made by the taxpayer as a subcontractor to the prime contractor are not included in this category even though the government is the ultimate recipient and the work is subject to government approval.

A sale of tangible personal property to the U.S. government is assigned to California when shipment takes place from an office, store, warehouse, or other place of storage in this state. Some sales to the government involve work done on a product in stages in several states. For example, work on a missile may be started in Florida. The missile may then be moved to Arizona where more components are added. Finally, the missile is moved to California where it is completed. Sale and shipment of the finished missile to the government takes place in California. If the taxpayer performed the entire project, the sale is assigned to California in its entirety. On the other hand, if the government pays different contractors for the work completed in various states, only the incremental work done by the taxpayer is included in the factor. Examination of the government contracts, annual reports or 10-Ks, or direct questioning of the taxpayer may reveal if this issue exists. If so, the auditor should verify that the sales have been treated correctly in the factor.

Where sales to the government are a mixture of tangible personal property and other types of receipts, a breakdown between the types of revenue is necessary. For instance, assume that the contract price for a sale of computers to the U.S. Government includes a service contract, and the amounts of the service fees are specified in the contract. The portion of the sales price attributable to the computer sale is subject to the special rules for sales of tangible personal property to the government while the portion attributable to the service contract is assigned under normal rules for service revenue.

Audit verification:
Schedule R of the tax return has a line item for California government sales. Even if no sales are indicated on this line, the auditor may want to look deeper for government sales, particularly if the

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taxpayer is in an industry, which commonly deals with the government (aerospace contractors, for example). When examining these types of taxpayers, it is a good idea to inquire about the presence of government sales during the initial interviews as part of the auditor's familiarization with the taxpayer. Additional sources for this information are annual reports and SEC Forms 10-K, which may disclose business segments involved in government contracts.

If government revenues exist, the auditor must determine the type of revenues involved. Sales of tangible personal property must be segregated from other types of sales so that the appropriate assignment rules may be applied. The taxpayer can generally provide this information. The auditor may wish to verify revenue by examining contracts with the government, sales reports or runs, and general ledger summaries.

Once the amount of sales of tangible personal property to the U.S. Government are known, then amount of the sales shipped from California must be determined. The taxpayer's sales runs or similar records will generally identify the origin of the sales. As discussed above, however, the auditor needs to be careful to consider whether the sales records properly treat sales where no shipment was made and sales where components were added on in various states.

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7540 TRADE RECEIPTS

CCR §25134(a)(1)(A) provides rules for inclusion of gross receipts from sales of goods or products held primarily for sale to customers in the ordinary course of the trade or business. The amount of such receipts includable in the sales factor is computed as follows:

Gross Sales
- \- Returns and allowances
- \+ All interest income, service charges, carrying charges or time-price differential charges incidental to such sales.
- \+ Federal & State excise taxes (including sales taxes and value added tax) if such taxes are passed on to the buyer or included as part of the selling price of the product.
- \= Amount includable in sales factor

Returns and Allowances:

"Returns" are goods that have been returned for credit, and "allowances" include shortages in shipping, breakage, spoilage, inferior quality, and similar situations. The sales reported on Line 1 of both the Federal Form 1120 and the California Form 100 are "gross sales less returns and allowances," and should correspond to the amounts reported in the sales factor. Note that cash discounts for prompt payment of invoices do not reduce the gross sales price for factor purposes.

Excise Taxes:

CCR §25134(a)(1)(A) states in part "federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such receipts are passed on to the buyer or included as part of the selling price of the product." In regard to the value added tax (VAT) charged by many foreign countries, the issue of inclusion of the VAT in the sales factor rests on the definition of "federal and state" and the determination if the VAT is an excise tax.

R&TC Section 25120(f) defines state as "...any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof." State includes foreign countries for the purposes of formula apportionment.

The term "excise tax" is a broadly defined term and includes a tax on the sale of goods as well as taxes based on consumption. A value-added tax is a tax assessed on goods and services on the value added by each producing unit. The value-added tax is essentially a consumption tax. Most VAT models exempt export sales from VAT.

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The value-added tax qualifies as a state excise tax and therefore meets the criteria of CCR §25134(a)(1)(A) for inclusion in the sales factor.

The gross amount of the VAT should be included in the sales factor as opposed to the net amount paid. The distinction between gross and net and the mechanism behind the VAT is important to understand in order to include the correct amount.

As explained above, the value added tax (VAT) is a tax on the goods and services based on the value added by each producing unit. That is, in general, VAT is levied on the sale of goods or services, and a deduction (or credit) is allowed for any VAT paid on purchased goods and/or services.

For example, assume Corporation Ltd. manufactures umbrellas in the UK. During the month of April, Corporation Ltd. purchased £10,000 of materials to make umbrellas and sold £25,000 worth of umbrellas. Also assume the VAT rate is 20%. Corporation Ltd. would have withheld £5000 worth of VAT on the sale of umbrellas. In addition, the seller of the materials would have withheld VAT of £2000 on Corporation Ltd. purchases. The VAT return of Corporation Ltd. would disclose VAT of £5000 on sales, VAT of £2000 on purchases and a net VAT payable of £3000 to the British government.

The accounting entries are:

	Dr.	Cr.
Purchases	10,000	
VAT Recoverable	2,000	
Accounts Payable		12,000
To record inventory purchase.		

	Dr.	Cr.
Accounts Receivable	30,000	
Sales		25,000
VAT Payable		5,000
To record sales.		

	Dr.	Cr.
VAT Payable	5,000	

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VAT Recoverable	2,000
Cash	3,000
To record payment of VAT liability.	

CCR §25134(a)(1)(A) states in part: "Federal and state excise taxes (including sales tax) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product." The department will treat the amount of VAT paid by the purchaser to the seller as the amount of excise tax passed on to the buyer and included in the sales factor. In the Corporation Ltd. example, VAT of £5000 would be included in the sales factor.

In some instances the VAT return may show a net refund due to the corporation as the VAT paid on purchases exceeds the VAT on sales as not all of the sales were subject to tax. In such situations, the net refund due will not be included in the sales factor. Of course, the actual VAT on sales will be included in the sales factor.

Most countries assess the VAT on all goods and services. CCR §25134(a)(1)(A) only includes excise tax in the sales factor for a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products. Accordingly, the VAT on services or use of intangibles should not be included in the sales factor. Auditor judgment needs to be used in deciding to pursue this issue. For example:

The taxpayer is in the business of selling tangible personal products. The taxpayer also offers a warranty contract for extended product servicing. The warranty contract is most likely incidental to the sale of the product. The VAT on the service component of the sale should not be pursued.

The taxpayer is an international firm providing a service such as management consultant. VAT should not be included in the sales factor based on the taxpayer's business description.

The taxpayer's subsidiary in the foreign country is in the business of selling a product and licensing others to manufacture other products. The foreign country assesses the VAT on the products and royalty income. The royalty income is material based on a review of the federal Form 5471. The auditor should determine or if necessary, estimate the amount of VAT on the royalties and exclude that portion of the VAT.

Possible Audit Steps for the VAT:

An understanding of information is basic to resolving this issue. Possible items to consider include:

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How is the VAT accounted for in the books of original entry? Are separate accounts for receivables and payables kept in the books of original entry? What are the debits and credits concerning the VAT?

Obtain a copy of the VAT return.

Do the footnotes in the annual report provide the amount of VAT paid? If so, additional audit steps might not be necessary.

Does the management discussion of the year's activities in the annual report provide the amount of VAT paid?

The auditor also needs to have an understanding of the taxpayer's operations in the foreign country. If the taxpayer only exports to a foreign country and does not have a presence in that country, the law of the foreign country may provide that the purchaser pays the VAT directly to the government. If so, there will be no VAT for the seller to take into account. Additionally, the type of business the taxpayer engages in is important to ensure that the correct VAT rate is used since some countries have different VAT rates for different products.

Similar to all issues, auditor judgment should be exercised. For example:

The taxpayer filed a claim for six years to include the VAT in the sales factor. The taxpayer only has source information for the two most current years. The auditor is comfortable that the taxpayer's methodology is reasonable given the facts and circumstances. The auditor could accept the first four years amounts based on the audit of the last two years.

The auditor knows from interviewing employees of the taxpayer that their foreign country operations are limited to the resale of inventory purchased from its parent. Export sales are not an issue. The taxpayer has a copy of the VAT return for the most current period and no export sales are listed on the return. The foreign country operations are limited to the sale of tangible property so that the VAT on personal services or use of intangibles is not an issue. The taxpayer through the Federal Form 5471 identified the amount of gross sales and intercompany sales. Since intercompany sales are eliminated from the sales factor the VAT on intercompany sales should likewise not be included in the sales factor. In such facts and circumstances it would be reasonable to estimate the VAT based on gross sales less intercompany sales times the VAT rate.

The taxpayer wants to estimate the amount of the VAT based on gross receipts in the federal Form 5471 times the VAT rate. This would not be reasonable without a showing of how the taxpayer takes into account the VAT on purchases, export sales, intercompany sales, etc.

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CCR §25106.5-10, formally CCR §25106.5-3 and CCR §25137-6, requires the FTB to consider the effort and expense required to obtain the necessary information. CCR §25106.5-10(e)(1) provides "In computing the income and any of the factors required for a combined report, the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information. In appropriate cases, such as when the necessary data cannot be developed from financial records maintained in the regular course of business, the Franchise Tax Board shall accept reasonable approximations."

Note: In many instances the information needed to compute the amount of VAT to include in the sales factor is under the control of foreign entities. The auditor will have to address CCR §25106.5-10 and the "reasonable approximation" standard of the US Supreme Court decision in *Barclay Bank Plc. V. Franchise Tax Board*, docket No. 92-1384 and docket No. 92-1839, June 20, 1994, 114 S. Ct. 2268, 512 US 298 mod. January 1, 1995.

It is important to remember in the Barclays' litigation that the California Supreme Court remanded the case back to the Court of Appeals to address the issue of whether the administrative burden for a foreign parent complying with worldwide combined report violates either the nondiscrimination component of the dormant commerce clause or the due process clause. The US Supreme Court extensively quoted the Court of Appeals decision. The Court of Appeals decision (California Court of Appeal, Third Appellate district Affirmed, California Tax Reports, New Matters at 402-279, 402-529 and 402-530) must be read in conjunction with the US Supreme Court holding to fully understand the issue of reasonable approximations. The Court of Appeal looked at current CCR §25106.5-10(e)(1), formally CCR §25137-6, and stated "it is this mandatory consideration of the effort and expense against the backdrop of data developed from the regularly maintained documents that circumscribes the Board's discretion under CCR §25137-6 and provides a framework for meaningful judicial review if the Board arbitrarily exercises that discretion." The Court of Appeal went on to say "the board must consider the cost and effort of producing WWCR (worldwide combined report) information in deciding whether to accept reasonable approximations, and that consideration is to use regularly maintained or other readily accessible corporate documents as the cost guideline."

The US Supreme Court in Barclays' Bank Plc. reviewed the Court of Appeal's application of the regulation. The Court concluded that the state's application of the regulation did not violate the taxpayer's constitutional rights.

As with any audit issue, auditor judgment as to materiality of the issue versus the burden on both the auditor and the taxpayer to resolve must be used to determine the technical correctness and the extent of documentation needed to allow the VAT in the sales factor.

Note: Individual country VAT information can be obtained from the BNA-Foreign Income Series Portfolio.

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In addition to the value-added tax, other foreign taxes may qualify as excise taxes. For certain types of products such as alcoholic beverages, tobacco products or tires, the excise taxes may be quite material.

Inquiries of the taxpayer will usually reveal whether excise taxes have been included in the sales factor. Taxpayers are merely collectors of sales and excise taxes, and are responsible for remitting those taxes to the federal or state taxing authorities. Therefore, they will maintain sales records indicating the amounts of taxes. Depending upon how the records are compiled however, as stated above, reconstructing the excise taxes includable in the factor may be time consuming and should only be pursued when material.

Audit verification:

The audit steps for reconciling trade revenues in the denominator of the factor to the audited financial statements and/or the Federal 1120s are described in MATM 7505. Initial procedures for using the taxpayer's by-state sales records to verify numerator amounts are covered in MATM 7520. The auditor should verify that the trade receipts included in the denominator of the sales factor tie to the trade receipts reflected in the by-state sales records. Any material differences revealed by these reconciliations should be investigated further.

A problem that is commonly encountered with respect to the sales factor is that the by-state sales runs used to prepare the numerator may not be reported on the same basis as the sources used for the denominator figures. For example, the by-state sales runs of some taxpayers are shown at gross rather than net of returns and allowances. Since the information necessary to correct the numerator is not always available in a by-state format, taxpayers (or auditors) faced with this problem may attempt to use estimates to convert numerator sales to the proper amount. This is usually accomplished by applying percentages of the variances ratably to each state. For example:

Total Gross Sales	1,100,000
Total Returns & Allowances	-100,000
Total Net Sales	**1,000,000**

Sales from By-State Records :	
California	500,000
Arizona	400,000
Oregon	200,000
Total	**1,100,000**

$$\frac{\text{Total net sales}}{\text{Total gross sales}} = \frac{1{,}000{,}000}{1{,}100{,}000} = 91\%$$

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By-State Sales at Net:	
California ($500,000 x 91%)	455,000
Arizona ($400,000 x 91%)	363,000
Oregon ($200,000 x 91%)	182,000
Total	1,000,000

The auditor should review the taxpayer's calculation to ensure that the method of estimation is reasonable.

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7545 GROSS RECEIPTS FOR PERFORMANCE OF SERVICES

Gross receipts received by a taxpayer for the performance of personal services by its employees are includable in the sales factor. If the services were performed in California, the receipts would be assigned to this state. If the services are performed in more than one state, then the receipts from the services are usually assigned to this state based on the ratio that time spent performing such services in this state bears to total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation, which gave rise to the receipt. The determination of whether receipts from personal services should be assigned to the numerator of the sales factor is made separately for each item of income.

Income producing activities associated with service receipts are identified separately for each item of income, and would include the rendering of personal services by employees or the use of tangible and intangible property by the taxpayer in performing a service. Income producing activities must be engaged in directly by the taxpayer, and therefore do not include activities performed on *behalf* of a taxpayer, such as activities performed by independent contractors. However, income-producing activities would include activities performed by other members of the combined reporting group as long as the activities are directly related to the generation of the service income. Income producing activities of an agent on behalf of its principal would be considered an income producing activity of the principal.

CCR §25136(d)(2)(C) provides the following example to illustrate this assignment of receipts from services:

Example
The taxpayer, a public opinion survey corporation, conducted a poll by its employees in State X and in this state for a sum of $9,000. The project required 600 person hours to obtain the basic data and prepare the survey report. Two hundred of the 600 person hours were expended in this state. The receipts attributable to this state are $3,000.

200 person hours **over** 600 person hours	**X**	$9,000	=	$3,000

Note that gross receipts from personal services might not necessarily be assigned to the same state to which the corresponding payroll is assigned. In the above example, if the base of operations for

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the employees performing the public opinion surveys were in California, all of the payroll would be assigned to the payroll factor numerator even though the gross receipts are allocated amongst the states in which the services were performed. For information regarding the numerator of the payroll factor, see MATM 7370.

Some contracts may involve elements of both personal services and other types of activities. For example, although an architect performs a service by creating blueprints for a structure, the end product is the blueprints, a tangible item. The auditor should address this issue by examining the substance of the transaction: is the client paying for a service or purchasing the end product? If the end product is only incidental to the service being performed, then the fee should be treated as compensation for the performance of services. Similar rationale is used for determining whether printers sell property or perform services (MATM 7785). On the other hand, the *Appeal of Babcock and Wilcox Co*. (Cal. St. Bd. of Equal., January 11, 1978) dealt with a situation where a contract for the fabrication of a steam generating system did involve service elements, but the SBE held that the contract as a whole was a sale of property. This case is summarized in MATM 7522. Resolution of this issue will depend on the facts and circumstances of each case. Factors that the auditor should consider in making the determination include how the transaction is characterized in the contracts as well as in the taxpayer's representations to others (i.e., annual reports, 10-Ks, etc.), and the relative costs of the various elements of the contract.

In some situations, contracts can be broken down between receipts for services and receipts from property. For example, a contract for the sale of machinery may include a maintenance agreement for the servicing of the machine by the seller's employees. Where such a situation exists, the contract price should be severed between the payment for services and the payment for property. The auditor will be able to identify this issue by reviewing the contract evidencing the transaction in question.

Incidental personal service receipts, such as from a maintenance contract, are not always evident on the return. The income may appear as gross receipts in "other income," or may be netted with any applicable expenses. In other cases, the income may be buried as a reduction in cost of sales or "other deductions." The taxpayer's type of business may indicate the possibility of such income. For example, a computer manufacturer could very easily have this type of income while a tire manufacturer would not. If a taxpayer is likely to have material personal service income but a scan of the tax return does not reveal the existence of such income, the taxpayer should be questioned directly.

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7550 FSC / DISC SALES

FSCs:
A foreign sales corporation (FSC) is a corporation organized under the laws of a foreign country that meets certain requirements specified in IRC §922. For federal purposes, a portion of a FSC's foreign trade income may be exempted from federal income taxation. Since California does not conform to the federal FSC provisions, FSCs are treated the same as any other corporation for state purposes. A more detailed discussion of the FSC provisions can be found in MATM 5220.

There are two types of FSCs, commission FSCs and sales FSCs. Different sales factor issues exist depending upon the type of FSC.

Commission FSCs: Commission FSCs are those that perform services for the U.S. affiliates, or that sell goods for the affiliates on a commission basis. Since the service fees or commission income received from members of the combined report are intercompany receipts, they are eliminated from the sales factor. Consequently, commission FSCs will generally have no sales to include in the sales factor.

Sales FSCs: Sales FSCs purchase goods from the U.S. affiliates to sell abroad. The primary sales factor issues involving sales FSCs will be verifying the FSC receipts, ensuring that intercompany eliminations have been made, and determining whether any throwback issues exist.

FSC gross receipts are not all reported in one place on the 1120-FSC return. The following computation illustrates the general method for reconstructing total gross receipts from the 1120-FSC return, but since the line numbers and format of the form change slightly from year to year, care must be taken to adapt the following computation if necessary.

Total foreign trading gross receipts (1120-FSC, Sch. B, line 6a)	$ xxxx
Nonexempt foreign trade receipts (1120-FSC, Sch. F, line 4)	xxxx
Nonforeign trade receipts (1120-FSC, Sch. F, line 17)	xxxx
Less excess receipts from small FSCs (already included in total foreign trading gross receipts) (1120-FSC, Sch. F, line 7)	(xxxx)
Total FSC receipts from 1120-FSC return	$ xxxx

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If the FSC is selling goods purchased from the U.S. affiliate, the sales will be included in the factor when the goods are sold by the FSC to unrelated parties. Therefore, the intercompany sales from the U.S. affiliate to the FSC should be eliminated from the factor. If the intercompany items are material, the reconciliation of the sales factor denominator (MATM 7505) should identify whether eliminations have been made. If an issue is identified, the first step should be to interview the taxpayer to gain an understanding of exactly what the FSC does, and what types of intercompany items will be present. The 1120-FSC return (or the workpapers supporting that return) can then generally be used to identify the intercompany items. This procedure is best performed in conjunction with the 1120-FSC reconciliation described in MATM 5220 so that the auditor has a clear understanding of what income is being reported.

Transactions involving FSCs are primarily paper transactions. Therefore, it is not uncommon for goods sold through a FSC to be shipped to the customer directly from an affiliate's warehouse in California. If no member of the combined reporting group has property, payroll or sales in the destination country, a throwback issue may exist. See MATM 7530 for a discussion of the throwback rules, and MATM 1240 for the rules regarding nexus in foreign jurisdictions.

DISCs

A Domestic International Sales Corporation (DISC) is a domestic corporation that meets certain requirements set forth in IRC §992, including the requirement that 95% or more of its gross receipts be "qualified export receipts." For federal purposes, DISCs are subject to favorable transfer pricing rules and partial deferral of income on foreign sales. California does not recognize the federal DISC provisions, and treats a DISC the same as any other corporation. A more detailed discussion of DISCs may be found in MATM 5220.

DISCs have been substantially phased out by FSCs, but they are still seen occasionally. DISCs and FSCs present identical sales factor issues with respect to intercompany eliminations and throwback potential.

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7555 GOVERNMENT FACILITIES / COST PLUS FIXED FEE CONTRACTS

Some taxpayers will manage a U.S. Government-owned facility for the benefit of the government. The output of the facility is sold to the government by the taxpayer. Under a typical arrangement, the taxpayer will be reimbursed for all costs of management plus a fee. Costs can include reimbursable salaries, wages, manufacturing and operating costs. In some cases, the fee will represent the entire profit from the management of the facility and sale of output to the government. In other cases, the fee may be nominal (such as $1) and the taxpayer's profit will be realized from the sale of goods or services to the government from the managed facility.

In any event, any reimbursement, fee, and sale of output by the taxpayer to the government is includable in the sales factor (CCR §25134(a)(1)(B)). Since the facility and the product or service sold to the government actually belongs to the government, inclusion of all revenues received for expense reimbursement and profit in the sales factor gives weight to the taxpayer's business activity of operating the facility.

The primary audit problem in this area is knowing whether a taxpayer is involved in managing a government facility. As a first step, the auditor can consult the Schedule R of the tax return to see if the taxpayer reports any revenue from government sales to California. If the taxpayer is a public company, annual reports and S.E.C. Forms 10-K will usually disclose any material contracts or business dealings with the government. Once the auditor determines that the taxpayer has a cost plus fixed fee arrangement, the next step is to verify that the revenues have been reported correctly in the sales factor. The taxpayer should be asked about their treatment of the revenues. The taxpayer's apportionment workpapers will probably also have some details of the revenue from such contracts. If the contract is not top secret, it should be examined to verify the amounts that were paid and what the payments were for. The taxpayer's sales journal or general ledger summaries may be examined to insure that the proper amount of revenue has been included.

If the contract includes sales of tangible personal property to the U.S. government, those sales will be assigned to the numerator of the sales factor in accordance with the rules discussed at MATM 7535. All other types of sales related to cost plus fixed fee contracts with the government will be sourced in accordance with the normal sales factor rules. In most cases, revenues associated with the management of a government-owned plant will be assigned to the state in which the plant is located.

For special property factor problems related to management of government-owned plants, see MATM 7138.

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7560 INCOME FROM INTANGIBLES

Gross receipts from intangible property are included in the sales factor. The primary issue with respect to income from intangibles in the sales factor involves the proper assignment of the income for numerator purposes. R&TC Section 25136 provides that gross receipts from transactions other than sales of tangible personal property are assigned to this state if:

the income producing activity which gave rise to the receipts is performed wholly within this state; or the income producing activity is performed within and outside the state, but the greater proportion of the income producing activity is performed in this state, based upon costs of performance.

CCR §25136(b) defines the term "income producing activity" to mean the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business. The sale, licensing or other use of intangible personal property would be considered an income producing activity. Activities performed on behalf of a taxpayer, such as by an independent contractor, are not considered income-producing activities. Income producing activities performed by an agent are attributable to the principal, and would be considered income-producing activities of the principal. In addition, the Regulation specifically states that the mere holding of intangible personal property is not, of itself, an income producing activity.

The first issue with respect to assigning income from intangibles involves the identification of the income producing activity, which gave rise to the income. In some instances, no income producing activity can be identified, or the item of business income cannot be attributed to any particular income producing activity of the taxpayer. Where receipts cannot be assigned to the sales factor numerator of any state, CCR §25137 provides that the receipts shall be excluded from both the numerator and the denominator of the sales factor. This adjustment is discussed in MATM 7516. Special problems with respect to various types of income from intangibles will be discussed in the following sections.

The examples in the Regulation indicate that where the income producing activities are performed in this state, the receipt is assigned to the numerator of the sales factor. Alternatively, where the income producing activity occurs both within and outside this state, the receipt is assigned to the location where the greater proportion of income producing activity occurs, based on costs of performance. Not all receipts generated in more than one state from a single contract require a cost of performance analysis. Often there are separate income-producing activities in each state for which specific payments are received. In such cases, it would not be necessary to determine the state in which the majority of the income-producing activity was performed. The receipt would be assigned to the state where the underlying income producing activity occurred.

The auditor should review the underlying contractual agreement to determine whether a cost of performance analysis is required. In the cases where this determination is necessary, the proportion

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of the income producing activity within the state is measured by costs of performance. CCR §25136(c) defines costs of performance as direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the taxpayer's trade or business. Only costs of performance that have a clearly identifiable beneficial and causal relationship to the income from the intangible should be considered in the analysis.

One of the issues in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., Cal. St. Bd. of Equal., June 2, 1989, involved the numerator assignment of margin interest. Under margin account contracts, some of the taxpayer's customers would leave their securities on deposit with the taxpayer. The taxpayer would advance funds in connection with the customer's trading activity, and the customer would be charged interest on any such advances. The FTB auditor revised the sales factor numerator to include the portion of the margin interest attributable to California customers. The taxpayer argued that the margin interest should not be included in the numerator of the sales factor because the income-producing activities giving rise to the income occurred in New York.

The SBE disagreed with the taxpayer's position, stating that the recordkeeping and billing functions that occurred in New York were primarily ministerial functions. It was the local brokers' taking and placing orders directly from the California customers that created the debts upon which the interest was paid, and the brokers handled most other day-to-day transactions which affected the balance of the customer's margin accounts. The SBE determined that it was the rendering of personal services by the brokers that was the relevant income producing activity. The SBE concluded that the margin interest paid by California customers should be included in the California numerator.

When the relevant income producing activity is performed in more than one state, the general rule is that receipts from intangibles should be assigned to the state in which the greater proportion of the income producing activity is performed. This is an "all or nothing rule." The decision in the *Merrill Lynch* case supports the position that the income-producing activity and costs of performance must be determined on a transaction-by-transaction basis, rather than by aggregating the transactions. (If the test were applied to the aggregate margin interest, then all of the margin interest would have been assigned to the one state with the greatest costs of performance as measured by the brokers' services.)

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7562 Dividend Income

As discussed above in MATM 7560, income from intangibles is attributed to the state where the income producing activity (or greater proportion of the income producing activity) is performed. With respect to dividend income, the income producing activity is often difficult or impossible to identify with any certainty. Only income-producing activities that are directly engaged in by the taxpayer are considered (CCR §25136(b)), therefore the activities of the dividend payor are not relevant to this determination. Because the mere holding of stock is not an income producing activity, the dividend income should be excluded from the sales factor if the taxpayer does not engage in any other identifiable activity with respect to the stock (see MATM 7516). On the other hand, if the taxpayer has an active treasury department, which manages a stock portfolio, the treasury function activities may be considered to be income-producing activities with respect to dividend income arising from that portfolio.

The audit techniques for examining this area are similar to the techniques for examining interest income in the sales factor. These techniques are covered in MATM 7564.

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7564 Interest Income

Income from intangibles, including interest income, is attributed to the state where the income producing activity (or greater proportion of the income producing activity) is performed (MATM 7560). The key sales factor issue with respect to interest income is whether the income producing activity can be identified. In order to make this determination, the source of the interest needs to be identified, and the auditor needs to consider the taxpayer's facts and circumstances.

If the taxpayer has an active treasury department, which manages its working capital, the treasury function activities may be considered to be income-producing activities. Interest income generated by those activities would be assigned to the state where the greatest proportion of the treasury activities was performed (based on costs of performance -- i.e., the costs of performing the treasury activities).

Interest earned from investments that are managed by banks or investment firms is generally not included in the sales factor because the income producing activity is not performed directly by the taxpayer as required by CCR §25136(b). Similarly, interest from long-term investments in bonds, debentures, government securities, etc. may not be included in the factor if the instruments are merely held by the taxpayer. MATM 7516 contains a discussion of this issue.

Interest income may not only be generated from investments, but also in connection with accounts receivable, goods sold on installment plans, deferred payment arrangements, and other routine transactions. This type of interest income is generally traceable to a particular sale, and the underlying sale is considered to be the income-producing activity. See MATM 7560 for a discussion of the SBE's analysis of this issue in the context of margin interest.

The principal difficulty in this area is segregating includable from excludable interest. If the issue is material, the taxpayer should be asked to prepare a breakdown of its various types of interest income by activity, and identify the locations of those activities. Since the taxpayer's accounting system will generally segregate interest income by type or by source, the general ledger summaries can be used to verify the amount of interest from each source. The auditor may want to question the taxpayer's methodology for assigning interest income that is incidental to sales transactions (such as interest on accounts receivable) to ensure that the assignment corresponds to the assignment of the sales themselves. If the taxpayer claims to have employees whose activities generate interest income (i.e., an active treasury function), the auditor should verify the activities of those employees. This may be accomplished by examining the job descriptions of the employees, reviewing any policy or procedure manuals related to their duties, and by interviewing the employees.

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7566 Royalty Income

Royalty income is included in the sales factor if it is unitary business income. As with other types of revenues, the gross royalties includable in the factor are not reduced by related expenses such as depletion or amortization. There are basically three types of royalties:

Royalties from natural resources such as oil and gas;
Royalties from tangible personal property such as machinery; and
Royalties from intangible personal property such as patents, licenses, and copyrights.

Royalties from natural resources and tangible personal property are assigned to the locations where the property is extracted or utilized (§25136(d)(2)). These types of royalties do not usually present any particular problems for auditors.

With respect to royalties from intangible property however, there must be an identifiable income producing activity on the part of the taxpayer in order for the royalties to be includable in the sales factor (see MATM 7560). The mere holding of a patent or copyright is not considered to be an income producing activity. Ministerial acts, such as the recording of payments onto the books and records or depositing the checks, are also not considered to be relevant income producing activities. On the other hand, if a taxpayer licenses a number of patents to others and employs a staff to monitor and service the patents, then an income producing activity may exist.

If the income producing activity with respect to a single item of royalty income is performed in more than one state, then the income must be assigned to the state in which the greater costs of performance were incurred. Costs to consider in making this determination would be direct costs such as salaries, office costs, and other expenses incurred in direct connection with the servicing of the intangible property or the licensing agreement.

If royalty income is material, the auditor will need to determine the source of the royalty and the activities involved in producing the income. The taxpayer may be asked to prepare a schedule of each type of royalty income, including a detailed description of the nature and location of the related income producing activities. Information on these schedules may be verified through interviews with the taxpayer's employees and by review of job descriptions or licensing contracts. The taxpayer should also have income and expense information for each profit center or location that may be useful in determining where the greater proportion of the costs of performance was incurred.

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7570 PARTNERSHIP SALES

If a partnership's activities are unitary with the taxpayer's activities under established standards (disregarding the ownership requirement), then the taxpayer's share of the partnership's sales will be included in the sales factor (CCR §25137-1(f)).

The partnership's sales are determined in accordance with the normal rules as set forth in R&TC §25134 - R&TC §25136. Such sales, net of any intercompany eliminations, shall be included in the factor to the extent of the taxpayer's interest in the partnership.

Example
Corporation A has a 20% interest in unitary Partnership P. Corporation A has total sales of $20,000,000 and P has sales of $10,000,000. A's total sales for purposes of the sales factor is $22,000,000 ($20,000,000 plus 20% of $10,000,000).

CCR §25137-1(f)(3) provides special rules for eliminating intercompany sales between the taxpayer and the partnership. Although the rules are summarized here, that regulation contains numerous examples and should be consulted if significant intercompany sales exist.

Sales by the taxpayer to the partnership:

Sales by the taxpayer to the partnership are eliminated to the extent of the taxpayer's interest in the partnership.

Example Corporation A's interest in unitary Partnership P is 20%. Corporation A's sales were $20,000,000 for the year, $5,000,000 of which were made to P. Partnership P made sales of $10,000,000 during the same year, none of which were to Corporation A or to other partners. Corporation A's denominator is determined as follows:

	Sales by Corporation A	20,000,000
Add:	A's interest in P's sales (10,000,000 x 20%)	2,000,000
Less	The intercompany portion of A's sales to P (5,000,000 x 20%)	(1,000,000)
	Sales included in A's denominator	21,000,000

(CCR §25137-1(f)(3)(C), Example 1.)

Sales by the partnership to the taxpayer:

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Sales by the partnership to the taxpayer are eliminated, but only to the extent that they do not exceed the taxpayer's interest in all partnership sales to partners.

Example: Corporation A's interest in unitary Partnership P is 20%.
Sales for the year were as follows:

Corporation A:			20,000,000
Partnership P:	To Corp A		3,000,000
	To other partners		6,000,000
	To nonpartners		1,000,000
Sales by Corporation A			20,000,000
Add:	A's interest in P's sales to nonpartners (1,000,000 x 20%)		200,000
A's interest in P's sales to all partners	(9,000,000 x 20%)	1,800,000	
Less: Intercompany sales from P to A[1]		(1,800,000)	0
Denominator of A's sales factor			20,200,000

[1] The intercompany sales may only be eliminated to the extent that they do not exceed A's share of P sales to all partners, or $1,800,000. If A's share of P sales to all partners had exceeded $3,000,000, then A would have been able to eliminate all of its $3,000,000 sales from P.

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term contracts are found in CCR §25137-1(h). As explained in MATM 7710, the completed contract rules have been substantially phased out due to changes in the laws concerning long-term contracts.

Each partner, whether general or limited, is considered for purposes of sourcing income to be conducting the trade or business activity of the partnership (see CCR §26137-1(a), (f), and (g). see also *Valentino v. Franchise Tax Board* (2000) 87 Cal. App. 4th 1284, applying the business activity attribution principles to an S Corporation shareholder). Therefore, if a partnership has activities in a state that exceed the P.L. 86-272 threshold (see MATM 1200 – MATM 1240), then the unitary corporate partner will be considered to be taxable in that state. Even if the corporate partner has no activities of its own in that state, sales to the state will not be thrown back.

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A corporate general partner will be considered "doing business" in California if the partnership is "doing business" in the state. Accordingly, the corporate general partner is subject to the franchise tax. (However, if a corporation's only connection to California is as a limited partner in a partnership that is doing business within the state, then the corporate partner will not itself be considered to be "doing business" for purposes of the franchise tax. A partner in a limited partnership has no interest in specific partnership property. (Cal. Corp. Code, §15671.) Therefore, absent a unitary relationship with the partnership, the corporate partner will be taxable under the corporate income tax on its California source distributive income rather than the franchise tax. See *Appeal of Amman & Schmid Finanz AG, et. al.,* Cal. St. Bd. of Equal., April 11, 1996, also MATM 1310.) Note that under the income tax, interest income from California and federal obligations is excluded from income.

Examination of the items making up "Other Income" (line 10 of the Form 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the sales factor to the annual reports or 1120s will normally disclose whether partnership sales have been included in the factor. The partnership returns (California Form 565, or Federal Form 1065) can be used to verify the total sales amounts. If audited financial statements have been prepared for the partnership, they will usually disclose any material intercompany transactions between the partners and the partnership.

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7575 OFFSHORE SALES

Offshore sales issues generally relate to oil and gas operations or ocean-going vessels. Discussion of this issue may be found in MATM 7795 (*Oil & Gas Industry*) or MATM 7760 (*Sea Transportation*).

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7580 RENTS

Gross rents incurred in the unitary business are included in the denominator of the sales factor. The rules for assigning rents to the numerator of the sales factor are described in CCR §25136. As the Regulation explains, the income producing activity, which generates the rents, is the actual rental or leasing of the property. Therefore, the gross rents are assigned to the state where the property is located.

If the property is used both within and outside this state during the rental period, the rental in each state is considered to be a separate income producing activity. Gross receipts attributable to California in such cases will be measured by the following formula:

$$\text{Total Gross Rents} \times \frac{\text{Days property was physically present or used in this state}}{\text{Total time or use of the property Everywhere}}$$

Rental income can usually be found on line 6 of the 1120 or Form 100. Occasionally, it may also be reported in the "other income" section of the return. Since this income is often reported net of any related expenses such as maintenance or depreciation, the auditor should verify that the sales factor reflects only gross amounts. The taxpayer will usually maintain records, which will identify the rental sources on a by-state basis, and these should be requested to verify the numerator. If necessary, the locations and amounts from the by-state records can usually be verified by the general ledger summaries and property ledgers. Rental income included in the sales factor should be net of intercompany payments.

Although it is more difficult to obtain information regarding the location of mobile property, taxpayers will generally keeps these records available because they are necessary for property tax purposes. If the materiality of the issue warrants reconstructing the location of mobile property during a rental period, the taxpayer should be asked to identify the types of documents, ledgers, job cards, etc., that they use to track this information.

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7585 SALE OF ASSETS

Generally, the gross sales price of assets used in the business is includable in the sales factor. Exceptions to this rule may be made to exclude substantial receipts from incidental or occasional sales, insubstantial receipts from incidental or occasional activities, and receipts from sales of intangibles for which no particular income-producing activity can be attributed. These exceptions are discussed in MATM 7512 – MATM 7516.

Taxpayers will often include net gains from asset sales in the factor rather than the gross receipts. If the sales price is substantially higher than the net gain, this can result in material adjustments. The Schedule D or Form 4797 may identify the sales price for the asset sales. If not, the auditor should request the supporting workpapers for those schedules. Unless the transaction meets one of the exceptions to inclusion in the sales factor computation, gross receipts from the sale of assets should be used in computing the sales factor.

Sales of tangible personal property are subject to the rules under R&TC §25135, and the numerator assignment of such sales is covered in detail in MATM 7520. Sales of real property are assigned to the state in which the real property is located (CCR §25136(d)(2)(A)).

Sales of intangible property are more difficult to assign to a particular state. If the income producing activity can be identified and attributed to a particular state, the sale will be assigned to that state. For example, if a taxpayer has a cash management department that buys and sells short-term securities on an ongoing basis, the gross receipts from those sales will be attributed to that location. If the income producing activity is both within and outside the state, then a cost of performance analysis may be required to determine whether the gross receipts are includable in the numerator of the factor. When the receipt from the sale of an intangible cannot be attributed to any particular income producing activity, then CCR §25137(c)(1)(C) provides that the sales must be excluded from the factor altogether. See MATM 7516 for further details regarding this issue.

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7587 Installment Sales

When a taxpayer reports sales under the installment method, gains are reported in periods subsequent to the year of sale. In contrast, because the apportionment factors are intended to reflect the activities that give rise to income, the entire gross receipts from installment sales are included in the sales factor in the year of sale. In the subsequent periods when the gains from the installment sales are recognized, those gains are apportioned using the factors from the year of sale (FTB Legal Ruling 413; upheld by the CA Court of Appeal in Tenneco West, Inc. v. Franchise Tax Board, (1991) 234 Cal.App.3d 1510).

Example
In Year 1, Corporation X sells an asset on an installment basis. The sales price was $1,000,000, and X recognized a gain of $500,000. The installment proceeds were received in two equal payments in Years 2 and 3.

X had an apportionment factor for Year 1 of 20%, which includes the entire $1,000,000 installment sale. No portion of the installment sale is reflected in the factors for Years 2 and 3, and the apportionment factor was 10% for each of those years.

X's income apportioned to California for Years 1, 2 and 3 will be computed as follows:

Year 1:					
Income other than installment sale:	$3,000,000	x	20%	=	$600,000
Installment gain:	0				0
Total apportioned to Calif.					$600,000
Year 2:					
Income other than installment sale:	$2,000,000	x	10%	=	$200,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$250,000
Year 3:					
Income other than installment sale:	$4,000,000	x	10%	=	$400,000
Installment gain:	250,000	x	20%	=	50,000
Total apportioned to Calif.					$450,000

Legal Ruling 413 indicates that dealers who regularly sell tangible personal property on an installment basis are not required to apportion installment gains using year-of-sale factors if the factors do not

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vary significantly from year to year. Since dealers are not permitted to use the installment method in most circumstances after 1987, this exception will not arise very often.

Since the installment method is used only for tax purposes and not for book or financial accounting purposes, the presence of installment sales should be reflected on Schedule M-1. If a material installment sale is detected, the auditor should examine the taxpayer's apportionment workpapers to insure that the installment sale has been correctly reported in accordance with Legal Ruling 413.

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7700 SPECIAL FORMULAS AND INDUSTRIES WITH UNIQUE APPORTIONMENT PROBLEMS

In cases where the standard apportionment provisions will not fairly represent the taxpayer's business activities within the state, R&TC §25137 permits a departure from the standard formula. Such a departure may be separate accounting, the exclusion of one or more of the factors, the inclusion of one or more additional factors, or the employment of any other method which will result in fair apportionment and allocation of the taxpayer's income to this state.

Special procedures have been established in the regulations for certain industries and types of transactions where the FTB has determined that the standard apportionment formula will not produce appropriate results. The special formulas are contained in CCR §25137 through CCR §25137-11 and CCR §25101.

There are additional industries and types of transactions that present unique apportionment problems, but for which specific solutions are not set forth in the Regulations. The department has developed apportionment procedures to deal with these situations. Since these procedures are not found in the law or regulations, it is important for auditors who are proposing to use these rules to clearly communicate to the taxpayers the distortion or unclear reflection of activities within the state that occur when the special methods are not applied, and to cite R&TC §25137 as our authority for deviating from the standard apportionment rules to correct those problems. The areas where the department has developed special apportionment procedures are bus transportation, freight forwarding companies, mining, printers, professional sports, oil and gas industry, stockbrokers, telecommunications companies, timber, and vessels such as tug boats, barges, etc.

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7701 APPLICATION OF CCR §25137 IN GENERAL

R&TC Section 25137 permits a departure from the standard allocation and apportionment provisions only in limited and specific cases where the standard formula produces incongruous results. CCR §25137 recognize that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, and provide special apportionment procedures for those situations. In the *Appeal of Fluor Corporation*, Cal. St. Bd. of Equal., December 12, 1995, the SBE clarified the role of the special formulas provided by the regulations:

General Rule	Unless . . .	In Which Case . .		
Both the taxpayer and FTB are required to use the standard apportionment and allocation rules under UDITPA.	The party seeking to deviate from the standard formula establishes by clear and convincing evidence that the standard formula does not fairly represent the extent of the taxpayer's activities in the state.	The formula may be modified to reflect a method which will result in fair apportionment.		
	or		Unless . . .	In Which Case . .
	The taxpayer's situation satisfies the conditions and circumstances provided for in Regulations §§ 25137 - 25137-11 and §25101.	Both the taxpayer and FTB are required to use the method prescribed by the regulations.	The party seeking to deviate from the regulations establishes by clear and convincing evidence that the method in the regulations does not fairly represent the extent of the taxpayer's activities in the state.	The formula may be modified to reflect a method (including the standard UDITPA formula) which will result in fair apportionment.

The significance of the SBE's holding in Fluor was that as long as the taxpayer's circumstances satisfied the terms and conditions provided in CCR §25137, neither the taxpayer nor the FTB had to prove distortion in order to apply the special formula prescribed by the regulations. Prior to the *Fluor* decision, the SBE's decision in *Appeal of Triangle Publications, Inc*. (Cal. St. Bd. of Equal., June 27, 1984) had stated that the FTB could not apply the apportionment procedures specified in CCR §25137(c)(1)(A) without first establishing that the standard formula would not result in fair apportionment because of the taxpayer's exceptional circumstances. To the extent that the opinion in Triangle Publications conflicts with the decision expressed in *Fluor*, the *Triangle Publications decision* was overruled.

The *Fluor* decision also recognized that even if a taxpayer meets the terms and conditions for applying a special formula prescribed by CCR §25137, situations may arise where application of the

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special formula will not fairly represent the taxpayer's activities within the state. Therefore, either the taxpayer or the FTB may deviate from the method prescribed by the regulations if they can establish distortion.

CCR §25137(b) and CCR §25137(c) provide special apportionment rules to correct specific property and sales factor problems. These rules are covered in MATM 7134 (property factor) and MATM 7512 - MATM 7516 (sales factor). CCR §25137-1 through CCR §25137-12 provide apportionment rules for certain industries and types of transactions. In addition, CCR §25101 provides apportionment rules for the sea transportation business. These special formulas are discussed in MATM 7705 through MATM 7760. The department has identified several other industries that present unique apportionment problems, and has developed apportionment procedures to deal with those situations. These apportionment procedures are discussed in MATM 7765 through MATM 7815, but are only intended as guidance for auditors seeking to correct distortion problems. Because these procedures are not found in the regulations, an auditor can not force a taxpayer to apply the special rules without first establishing that application of the standard formula does not clearly reflect the business activities within California.

R&TC Section 25137 provides that a taxpayer may petition for the Franchise Tax Board to allow a departure from the standard formula. In order for relief to be granted under R&TC §25137, the problem identified by the taxpayer must be a result of the apportionment and allocation provisions set forth in R&TC §25120 - R&TC §25139. R&TC Section 25137 does not operate as a cure for other alleged inequities created by other provisions of the Revenue and Taxation Code. (*Appeal of CTI Holdings*, Cal. St. Bd. of Equal., February 22, 1996.)

The department will broadly interpret that an issue comes within R&TC §25137, although judgement is to be used. Each taxpayer and each year will be evaluated on its own unique set of facts and circumstances to determine if a R&TC §25137 issue exists. Any time a taxpayer, or an auditor, deviates from the standard allocation and apportionment rules established by R&TC §25120 through R&TC §25137, and the regulations adopted pursuant thereto, a potential R&TC §25137 issue exists.

To ensure consistent treatment of similarly situated taxpayers, all audit staff recommendations regarding the use of R&TC §25137 are to be forwarded to the Multistate Audit Specialist. The Multistate Audit Specialist will review the file to ensure that the issue is factually developed. The Multistate Audit Specialist will route the file with his/her recommendation to the Legal Division R&TC §25137 Petition Coordinator.

The R&TC §25137 Petition Coordinator will be responsible for reviewing the petition, coordinating staff’s recommendation, submitting the appropriate information to the three member FTB, and other duties. The taxpayer has the right to request the three member FTB to review the petition.

What is distortion?

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The apportionment formula is a method for approximating a taxpayer's California source income. Because methods of apportioning income are just an approximation, such methods will not be considered to be distortive just because another method may produce a slightly better result. In order for the standard apportionment formula (or a modified formula described in CCR §25137) to be set aside, it must be shown to produce an unreasonable result. There are no bright-line tests for determining whether distortion is present, so determinations of distortion must be based on the unique facts and circumstances of each case. Auditors should consider whether changes in the apportionment factors are significant in relation to the overall factor. It is also helpful to look beyond the numbers and consider whether the purpose for the individual apportionment factors is being met. The following cases may be looked to for guidance:

In The *Appeal of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978, several of the companies in the unitary group maintained pools of working capital which were invested in short-term securities. The largest of these pools was located in New York. Because of the turnover of the securities, *gross receipts* from the investments averaged 36% of the total gross receipts from all unitary activities, but the *income* generated by the investments was less than 2% of total unitary business income. Arguing that the standard formula resulted in unreasonable apportionment of income from the taxpayer's communications business, FTB sought to deviate from the standard formula by including the net income (rather than the gross receipts) from the investment activities in the sales factor.

The SBE allowed FTB's modification to the formula. They concluded that the standard UDITPA provisions did not fairly represent the extent of the taxpayer's business activities within the state as evidenced by the fact that an incidental part of the business caused 11% of The Bell System's entire unitary business activities to be attributed to New York.

In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, Cal. St. Bd. of Equal., June 2, 1989, the taxpayer conducted a securities trading business. Its California activities consisted primarily of brokerage sales in which the taxpayer earned commission income from the buying and selling of securities for customers. The taxpayer also traded in securities as a principle or underwriter, purchasing securities for its own account and remarketing them. Unlike the commission income, the gross receipts from the principle and underwriting transactions included the underlying cost of the security. Most of these transactions were conducted in New York, so were reflected only in the denominator of the sales factor.

The FTB's position was that the principle and underwriting transactions were virtually identical to the brokerage transactions, and that applying the standard formula to those transactions would have the effect of overweighting the sales in the denominator and underweighting sales in the numerator. Reasoning that both types of transactions should reflect similar weight in the formula, FTB adjusted the sales factor to use gross profits (rather than gross receipts) to reflect the principle and underwriting transactions. The SBE did not agree that the two types of transactions were identical,

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and held that FTB had not met the burden of proving that the statutory apportionment provisions did not fairly reflect the business activity in this state.

Of importance in this case is the SBE's finding that distortion in one factor does not necessarily result in unfair reflection of the business activity within the state; the other two factors may mitigate the distortive effect of the third. Whether the apportionment formula produces an unreasonable result will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination. In this case, the deviations from the standard formula proposed by the FTB revised the overall apportionment percentage from 3.4323 to 5.8637 in the year of the largest difference. The percentage difference for the appeal years was a 23% to 36% average increase in the apportionment formula. The SBE held that this difference was much too slight to justify application of R&TC §25137.

The differences in fact patterns may have led to the contrasting results in the *Pacific Telephone* and *Merrill Lynch* decisions. In *Pacific Telephone*, the treasury activities were only an incidental part of the business, yet if the standard formula were applied, the receipts from those activities would have significantly affected the apportionment of income from the primary business activity. In *Merrill Lynch*, the underwriting transactions constituted one of the taxpayer's two primary activities, and could therefore be expected to significantly affect the overall apportionment. FTB was not able to demonstrate why the apportionment results in *Merrill Lynch* were not reasonable.

In *The Appeal of New York Football Giants, Inc., Opn. on Pet. Rhg*., Cal. St. Bd. of Equal., June 28, 1979, the issue involved whether FTB properly deviated from the standard formula by excluding from the sales factor the portion of the taxpayer's gate receipts that they were obligated to turn over to the visiting teams under NFL by-laws. Although the SBE acknowledged that FTB's approach was reasonable and perhaps even superior to the standard sales factor, they held that deviations from the normal rules are not authorized unless it is established that the UDITPA formula does not fairly represent the extent of the taxpayer's business activity in this state. A change in the sales factor from 4.08% to 5.71% was not found to be distortive.

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7705 PARTNERSHIP INCOME

CCR §25137-1

The rules for apportionment and allocation of partnership income are found in CCR §25137-1. In general, if a member of a combined reporting group is a partner in a partnership, and the partnership's activities are unitary with the activities of the combined reporting group under established standards (disregarding the ownership requirement), then the partner's share of the partnership's property, payroll and sales will be included in the apportionment factors. Further discussion of this issue, as well as examples illustrating the application of this regulation can be found in MATM 7195 (Partnership Property), MATM 7360 (Partnership Payroll) and MATM 7570 (Partnership Sales).

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7710 LONG-TERM CONTRACTS

CCR §25137-2

CCR §25137-2 sets forth the rules for apportioning income from long-term contracts. (Rules for partnerships engaged in long-term contracts are found in CCR §25137-1(h).) At the time the regulation was written, taxpayers were allowed to elect either the percentage of completion method or the completed contract method for reporting the income from the contract. Since that time, the rules for long-term contracts have been substantially revised, and the completed contract method has been substantially phased out. Although the regulation will still apply with respect to contracts using the percentage of completion method, the application of the regulation provisions concerning the completed contract method will become much more limited.

The first step in dealing with the issue of long-term contracts is to determine which set of rules applies to the contracts. For contracts entered into on or before February 28, 1986, taxpayers were allowed to elect either the percentage of completion method or the completed contract method. Under the percentage of completion method, gross income from a long-term contract was reported annually according to the percentage of the contract that was completed during that year. The taxpayer was allowed to compute the appropriate percentage based upon either the percentage of total estimated contract costs incurred, or the percentage of total estimated work performed. If the completed contract method were used, the net profit from the entire job would be reported in the year in which the contract was completed and accepted.

For contracts entered into after February 28, 1986, IRC §460 was amended to provide that (1) under the percentage of completion method, the appropriate percentage must be computed by comparing the construction costs incurred over the total estimated construction costs (the computation based upon percentage of work performed was no longer allowed); and (2) any contracts not accounted for under the percentage of completion method must use the "percentage-of-completion-capitalized-cost method." Percentage-of-completion-capitalized-cost was a hybrid method, which allowed the taxpayer to account for 60% of the net income from a contract under their normal method (such as the completed contract method) and the remaining 40% of the contract under the percentage of completion method.

In addition, any portion of a contract that was accounted for using the percentage of completion method would be subject to a "lookback" rule. The lookback provision under IRC §460 is applied at the completion of the contract, and requires the taxpayer to compute the amount of tax that should have been reported in each year on the percentage-of-completion portion of the contract based upon the actual costs incurred each year in relation to the total actual contract costs. To the extent the recomputed income differs from the income that was reported based upon estimated construction

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costs, interest adjustments must be made. The taxpayer will be subject to interest on underreported amounts and will receive interest on overreported amounts.

California conformed to these federal changes for taxable years beginning on or after January 1, 1987 (R&TC §24673.2).

Subsequent revisions to federal law were made to adjust the percentage of the contract required to be reported using the percentage of completion method from 40% to 70% for contracts entered into after October 13, 1987; to 90% for contracts entered into after June 20, 1988. Most long-term contracts executed after July 10, 1989 must be fully accounted for under the percentage of completion method, although certain exceptions are made for small construction contracts and residential construction contracts. California incorporated these changes for taxable years beginning on or after January 1, 1990. For California purposes, contracts outstanding on January 1, 1990 would become subject to the federal rules in effect as of the date that the contract was entered into. The conformity provisions provide that adjustments to correct any overreporting or underreporting of income resulting from the change in the method of reporting the contracts shall be made in the year that the contract is completed.

Note: The regulation does not reflect the federal changes, which California conformed to for taxable years beginning on or after 1/1/87 nor does the regulation reflect subsequent revisions to federal law, which California conformed to for taxable years beginning on or after 1/1/90. Furthermore, the regulation does not make mention of double-weighting the sales factor for taxable years beginning on or after 1/1/93, but continues with a single-weighted sales factor for apportioning income from long-term contracts.

The percentage of completion method is generally required for book purposes. Therefore, adjustments on Schedule M-1 will be present if the taxpayer is using any other method for federal purposes. If the federal method has not been followed for California purposes, state adjustments will be present. Since more than one method may have been used during the transitional period, it may be necessary to analyze the taxpayer's workpapers to determine whether the appropriate method has been used based upon the date of each contract. Once the auditor is satisfied that the income has been correctly reported, the apportionment factors may be reviewed.

Property Factor:

COSTS IN EXCESS OF PROGRESS BILLINGS: Capitalized costs of construction are only included in the property factor to the extent that they exceed progress billings accrued (or received for cash basis taxpayers) under the contract. The excess of construction costs over the progress billings reflects the taxpayer's net investment or equity interest in the contract. If progress billings exceed construction costs, they will not be reflected in the factor because they will reflect a liability rather than

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an investment. Each contract must be treated separately; excess costs on one contract may not be offset against excess billings on another contract.

Example: The taxpayer's costs attributable to the contract are $1,000,000 at the end of the first year. The client has been billed for $600,000. The net difference of $400,000 should be included in the property factor. The excess costs may not be netted against other contracts with billings in excess of costs. A continuation of this example illustrating the treatment of excess costs in the second year of this contract may be found in CCR §25137-2(d)(4)(A).

Some contracts, such as cost-plus-fixed-fee government contracts provide that title to property on hand and future purchases passes to the government when the first progress payment is made. Despite the legal title being vested in the government, the taxpayer has an equitable interest in the property to the extent of its net investment. The excess costs will therefore still be included in the property factor.

Costs in excess of progress billings will generally be disclosed in the financial statements either in footnote form or as a separate line item on the balance sheet.

RENTS: CCR §25137-2(d)(4)(B) provides that rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though the rent expense may be included in the construction costs.

Payroll Factor:

Compensation paid to employees is includable in the payroll factor even though such compensation may be included in costs of construction that are otherwise not reflected in the factor. Compensation paid to employees engaged in performing services at a construction site is attributed to the state in which the services are performed. This is the case even though the taxpayer will report such compensation to the state where the employees' base of operations is located for unemployment tax purposes (CCR §25137-2(d)(5)).

Sales Factor:

Under the percentage of completion method, the sales factor for each year will include the portion of the gross contract price that corresponds to the percentage of the entire contract that was completed during that year. For example, if the taxpayer completes 30% of a project during the year, and the project had a bid price of $9,000,000, then the gross receipts includable in the sales factor will be $2,700,000. Progress billings are not considered under this method. (CCR §25137-2(d)(6)(B).)

If the completed contract method is used, the sales factor will include the portion of the progress billings that were accrued or received during the taxable year. (CCR §25137-2(d)(6)(C).) The sales

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factor will therefore reflect the revenue from the contract during the years in which the contract is being performed. This is in contrast to the income from the contract, which will not be recognized until the contract is completed.

Gross receipts derived from the performance of a contract will be attributed to this state if the construction project is located in this state. If the project is located partly within and partly outside the state, the gross receipts will be allocated to this state based on the ratio of construction costs incurred within the state during the taxable year over the total costs for the project. (CCR §25137-2(d)(6)(A).)

Application of Apportionment Formula:

Except as indicated above with respect to the composition of the apportionment factors, no special apportionment computations are necessary for the percentage of completion method. To the extent that the completed contract method is used however, a special formula is described in CCR §25137-2(e).

Under the completed contract method, recognition of income from the contract is deferred until the year in which the contract is completed. On the other hand, the factors representing the business activities that generated that income will have been reflected in earlier years. In order to achieve proper matching between the income and the factors, the formula operates as follows:

Business income from sources other than completed contracts is apportioned in accordance with the apportionment percentage for the taxable year.
For each contract completed during the year, the portion of the gross receipts attributable to each year of the contract (based on the percentage of costs incurred in each year) will be determined. The gross receipts for each year will then be netted with the costs incurred during that same year to derive the contract income or loss attributable to each year of the contract. The contract income or loss for each year will be multiplied by the apportionment percentage for that year. The products are totaled, and the resulting income or loss will be the amount of business income from the contract derived from sources within the state.

The Regulation contains several examples of these computations and audit schedules for these calculations are available on PASS.

Note: The use of the completed contract formula was approved by the SBE in the *Appeal of Donald M. Drake Company* (Cal. St. Bd. of Equal., March 2, 1977). Subsequently, in the *Appeal of J.F. Shea*, the SBE refused to allow application of the formula in a situation where the early years of a contract pre-dated the acquisition of two subsidiaries, resulting in no completed contract income attributable to those years being apportioned to the subsidiaries. The precedential value of the *J.F. Shea* decision is limited to the specific facts present in that case.

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The calculations for apportioning income from contracts using the completed contract method can be very time-consuming if multiple contracts are involved. Before adjustments are pursued in this area, the auditor should carefully consider the tax implications. Any approximation of tax potential needs to take into account the fact that the completed contract method may only be allowable for a portion of the contract under the percentage-of-completion-capitalized-cost rules. In general, if all contracts are completed within the same time frame (i.e., two years), additional tax will most likely result from application of the special formula if:

the aggregate of completed contracts is a loss and the apportionment factor is larger in the year being tested than in earlier years;

or

the aggregate of completed contracts is a gain and the apportionment factor is smaller in the year being tested than in earlier years.

If the taxpayer has a few significant contracts, which run much longer than the other contracts, a quick look at the apportionment factors from the earlier years of those contracts will help place the overall tax impact in better perspective.

If the test check reveals that the tax potential of placing a taxpayer on this formula does not warrant the audit time, the decision to forego this issue should be explained in the audit narrative. If application of the formula will result in a refund, and a substantial amount of work would be required to apply the special formula, the taxpayer should be notified in writing and given the opportunity to complete the work. If the taxpayer does not wish to do the work, the audit should be closed and the returns accepted as filed.

If the test shows a material amount of additional tax, the special formula will need to be applied. The information that will be needed to make the adjustments are:

The contracts completed in each year under audit.
The profit or loss on each contract.
The total direct costs of each contract and the year(s) in which they were incurred.
The apportionment factor for each year involved.

Use of the Schedule M-1 as a starting point is generally useful in obtaining supporting data for the above items. Commonly, the taxpayer will have a schedule showing work-in-progress at the end of the year, which will tie to the Schedule M-1. This schedule can be compared to the end of the year for the prior period and any missing contract numbers will be contracts that have been completed in the current year. After identifying the contract numbers, the profit or loss can be determined and a

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supplemental schedule showing the direct costs by year should be easily obtained. In many cases, the work-in-progress schedule will show all the data that is needed.

The apportionment factors used for each year should reflect the proper method of reporting. For example, if the taxpayer used separate reporting in earlier years and a combined report was proper, the earlier years apportionment factor will need to be recomputed on a combined basis even if the statute is closed. (No income adjustment, of course, would be made on closed years.) FTBs basis for recomputing income and factors from closed years in the context of NOL carryovers is discussed in MATM 8000.

Reviewed: December 2002

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7715 FRANCHISORS

CCR §25137-3

The following special rules are provided in CCR §25137-3 for the allocation and apportionment of income of franchisors.

Payroll Factor:

Franchisors will typically employ personnel whose duties include regularly traveling to the franchisees' locations to provide administrative or advisory services. Under the normal payroll factor rules, the compensation paid to such employees would be assigned to the one state in which their base of operations was located (MATM 7370). In accordance with CCR §25137-3(b)(1) however, compensation paid to such employees will be assigned to the numerator of the payroll factor on the basis of the following ratio:

Time spent performing administrative and
advisory services at franchisee locations in
California
Over
Time spent performing such services everywhere

Sales Factor:

Franchisors generally provide various services for their franchisees, for which they receive fees. The regulation provides that fees received for (1) national and regional advertising placed by the franchisor; (2) administrative or advisory services; or (3) site investigation, selection and acquisition of a place of business for a franchisee shall be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in the state of the franchisee, the receipts shall be attributed to the state in which the principal office of the employee performing the services is located. If the services are performed by an independent contractor rather than by an employee of the taxpayer, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

Fees or royalties received for the use of the franchisor's trademark, trade name, or the right to market a product or service shall be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in such state, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

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7720 BANKS AND FINANCIAL CORPORATIONS

CCR §25137-4.1 and CCR §25137-4.2 (effective for taxable years beginning on or after 1/1/96)

The unique rules developed to deal with the allocation and apportionment of income from banks and financial corporations are covered in detail in the Bank and Financial Handbook. Auditors should refer to that manual if they are auditing taxpayers in this industry.

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7725 COMMERCIAL FISHING

CCR §25137-5

A special formula has been devised under CCR §25137-5 for commercial fishing boats operating within and outside California waters. The property, payroll, and sales factors attributable to boat fishing activity in California are determined by a "port day ratio." A ratio of California port days to total port days is applied to the total ship property, payroll and revenue for each fishing boat to determine the California portion. This formula only applies to boat activity. Land-based activities such as dockside facilities and equipment, and dockside payroll are assigned to the numerators of the factors under the normal apportionment rules.

A port day is defined as a day or part of a day spent in port or on the seas while the vessel is in operation. A port day will begin when a ship enters an area within which a state has jurisdiction to tax or asserts jurisdiction over fishing. Likewise, a port day will end when the boat leaves that jurisdiction or goes out of operation.

The definition of a state includes a foreign country. Thus, when a boat is on the high seas and not in the territorial waters of any state or foreign country, that time is not counted in the computation of port days. Jurisdictional limits vary by state and country. Countries like Mexico and some Central and South American countries assert a 200-mile limit and claim fishing jurisdiction in that area. Thus, tuna boats which begin and end their voyages in California, but which fish off the coast of Mexico will probably include time spent in both California and Mexico jurisdictions for the port days computation. Some larger tuna boats that fish in the Eastern Pacific may be subject to California jurisdiction at the beginning and end of their voyages, no jurisdiction of any state or country while enroute, and possibly jurisdiction in areas of the possession islands located in the Eastern Pacific Ocean. Port days would be counted while in California waters and while fishing within possession island jurisdiction, but not while enroute.

A boat is considered to be in operation when engaged in pre-voyage and post-voyage activities as well as when it is searching for fish, fishing, or transporting fish. Pre-voyage and post voyage activities include activities such loading, unloading, refueling, provisioning the ship, and minor ship repairs. A boat that has been out of operation will begin being in operation for a voyage when it is manned with a full crew and the vessel is ready for a fishing voyage. It ends being in operation after a voyage when the vessel is unloaded and cleaned, including the preparation of the fish wells to a fish-carrying condition.

A boat is not in operation when it is out of service. Out-of-service time includes, but is not limited to, time while a ship is idle between voyages, time for repairs in shipyards (including drydocking), and time during which a boat is seized by a foreign government and held under restraint pending

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disposition of charges alleging violation of such government's law. A boat is also out of service when it is involuntarily waiting to unload. Out-of-service time is not included in the port days.

The denominators of the apportionment factors are computed under the normal apportionment rules. The numerators are computed as follows:

Property Factor: The port day ratio for each boat is applied to the cost of the boat and its equipment to derive the portion attributable to the California numerator. Land-based property, such as dockside buildings and equipment, is assigned to California under normal property factor rules.

Payroll Factor: The port day ratio for each boat is applied to compensation paid to the boat's personnel and fishermen to determine the amount attributable to the California numerator. The payroll of land-based employees is assigned under the normal rules.

Sales Factor: The port day ratio for each boat is applied to total revenues from that boat to determine the amount includable in the California numerator. Other gross receipts are assigned to California using the normal rules.

Local fishing boats generally do not have significant issues in this area because their operations generally will be contained within California's three-mile limit or in waters not subject to a jurisdiction. Such boats would have a port day ratio of 100% to California.

The main audit problems identified in this area deal with long-range tuna clippers that sail from San Diego and San Pedro to fish off Mexico and Central America for yellowfin tuna. San Diego boats may also travel to the Eastern Pacific Ocean area to fish. Typical tuna voyages involve preparing the boat for sailing, traveling to the fishing areas, searching for fish, catching fish, storing the fish in refrigerated holds, and returning to port. The fish is sold to canneries in San Diego, San Pedro, Samoa, Puerto Rico and other locations. Refueling of the boat sometimes takes place at foreign ports. As long as adequate catches are being made, a voyage will usually last as long as it takes to fill the holds (anywhere from a week to two or three months). If fishing is good, a boat may return to port, sell its fish, and immediately depart on another voyage. When fishing is not good or when it is off-season for tuna, the boat lies at dock idle, and is out of operation.

To develop port day information, the auditor must examine the ship's logs and other ship records to know when, where, and for how long a boat is in a jurisdiction area. These records will also show the time spent out of service and the time spent in areas of the ocean not under any fishing jurisdiction. Total port days will only include time that the boat is in operation and under a jurisdiction. Drydock, idle time, and extended repair time are not counted in port days. Once the port day ratio has been developed for each boat, the auditor need only examine the taxpayer's general ledger summaries or other records to determine each boat's revenue, property, and payroll factor amounts. These

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amounts are usually segregated by each boat. If not, the taxpayer can be asked to provide such segregation.

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7730 FOREIGN COUNTRY OPERATIONS

CCR §25137.6

The rules for determining income and factors from foreign country operations were formerly set forth in CCR §25137-6. As of March 21, 1995, the regulation was renumbered CCR §25106.5-3. And once again the regulation was renumbered to 25106.5-10 as of August 12, 1999. For discussion of how particular items of income or factors should be treated by foreign corporations, refer to the sections of this manual, which cover those income or factor issues.

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7735 AIR TRANSPORTATION COMPANIES

CCR §25137-7

The unique formula for air transportation companies was designed to recognize "bridge" states in the apportionment formula. Under the formula, a portion of the income of airlines is assigned to bridge states (the states the aircraft fly over, but do not land in) as well as to the states wherein they make their arrivals and departures. The rules for inclusion of air carrier property in the numerator of the property factor have been codified in R&TC §25101.3. These rules are based on provisions for valuing aircraft within the state for property tax purposes. CCR §25137-7 has since been promulgated to somewhat conform the computations of the payroll factor and the sales factor to the property factor calculation.

For purposes of the special formula, the business of air transportation applies to scheduled airlines, supplemental airlines, and air taxis (see below for application of the rules to air express companies). Aircraft owned or rented by the taxpayer are divided into class types such as DC-10 or L10-11, and the special formula is calculated and applied separately for each type of aircraft.

Property Factor:

Aircraft owned or leased by a taxpayer may be used by another airline under an exchange program. Such exchange transactions do not constitute rentals or subrentals. Such aircraft are to be accounted for in the property factor of the taxpayer owning (or leasing) the aircraft. CCR §25137-7(b)(1)(A)(i)

The value of property assigned to the numerator of the property factor is calculated using the following formula:

Time aircraft spent in the state during the year (both in air and on ground)				**(a)**
Over	X	75%	=	Time Factor
Total time everywhere during the year				
				(b)
Number of arrivals & departures from airports within the state during the year				
Over	X	25%	=	Arrivals & Departures Factor
Total number of arrivals & departures from airports everywhere during the year				

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		Sum of (a)+(b)
Multiply by value of owned or rented property in denominator:	X	Value
Value assigned to numerator of factor		$ xxxx

Payroll Factor:

As with the property factor, flight payroll is computed for each class of aircraft. Compensation paid to flight personnel is attributable to this state based upon the ratio that air and ground time spent in this state bears to the total air and ground time spent performing services everywhere. For purposes of this calculation, ground time includes time spent performing pre-flight and post-flight activities, as well as time on the ground at intermediate stops for loading and unloading of passengers, freight, mail, etc. Air and ground time used for training purposes to maintain proficiency of flight personnel shall also be included. The resulting California flight payroll for each class of aircraft is added to the payroll of nonflight personnel in this state to arrive at the California numerator. (CCR §25137-7(b)(2))

Sales Factor:

Aircraft revenue from hauling passengers, freight, mail and excess baggage is generally assigned to this state using a formula similar to the formula described for the property factor, but with the following modifications:

The numerator of the time factor includes airtime only.
The denominator of the time factor includes "block to block" time.
The time factor is weighted at 80% rather than 75%, and excludes time for flight training purposes.
The arrivals and departures factor is weighted at 20% rather than 25%, and excludes arrivals and departures for flight training purposes.

Based upon the above modifications, the numerator of the sales factor is as follows:

Airtime aircraft spent in the state during the year				**(a)**
Over	X	80%	=	Time Factor
Total airtime everwhere during the year (block to block)				
Number of arrivals & departures from airports within the state during the year (by type of aircraft)				(b)
Over	X	20%	=	Arrivals & Departures Factor
Total number of arrivals & departures from airports everywhere during the year (by type of aircraft)				
				Sum of (a)+(b)

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Multiply by total revenue:	X	Value
Value assigned to numerator of factor		$ xxxx

If records of actual revenue by type of aircraft are not maintained, then the total aircraft revenue is segregated into passenger revenue and freight revenue and allocated to aircraft type based upon ton-miles for each type of aircraft. This allocation is described in more detail in CCR §25137-7(b)(3)(B).

Airlines file numerous reports with the Civil Aeronautics Board (CAB) or Department of Transportation that should contain the necessary data to compute the elements of the special formula. The auditor should ask the taxpayer to identify the reports that they are required to file, and request copies of relevant reports to verify the apportionment factor. If the annual statistics necessary for computing the formula are not available, the Regulation contains procedures for using statistics from a "representative period."

Exempt Income:

When dealing with corporations involved in air transportation, auditors need to be aware of R&TC §24320 that exempts income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States.

Federal law contains a similar exemption under IRC §883, however there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50% of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. Auditors should verify that the taxpayers qualify for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries which are known to grant equivalent exemptions for various types of international shipping or aircraft income is contained in Rev. Rul. 97-31, I.R.B. 1997-32, 4, July 22, 1997. Since treaty provisions are subject to change however, the full text of the relevant documents should be consulted if this is a material issue.

Income exempt from taxation under this provision is included in both combined business income subject to apportionment and in the denominator of the sales factor. Property and payroll related to the exempt activities is included in the denominators of the property and payroll factors. By excluding the property, payroll and sales from the apportionment factor numerators of any state, the income is effectively exempted from state taxation. This treatment is comparable to the treatment of nontaxable

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income from activities on the Outer Continental Shelf (MATM 7796), and the U.S. Supreme Court has affirmed the method as not resulting in extraterritorial taxation (*Shell Oil Company vs. Iowa Department of Revenue*, 488 US 19, 102 L Ed 2d 186, 109 S Ct 278).

Air Express Companies

Overnight air express companies generally operate by receiving packages at points of origin around the country, shipping those packages to a central hub location for sorting by the various destinations, and then delivering the packages to the end destinations. The fee for this service is generally a flat rate rather than a rate based upon mileage. Application of the Air Transportation rules under CCR §25137-7 may not result in fair apportionment of income for this industry because it assigns sales to "bridge" states that do not reflect the market for the air express companies. For example, if a package is being shipped from Sacramento to Los Angeles, the air express company may route it through Houston for sorting. The Air Transportation rules would assign sales to each of the states between Texas and California. Since the customer is only contracting for shipment of the package within California, the sales should logically be assigned only within this state. The air express company's activities in Houston and enroute would be taken into account in the property and payroll factors.

If the auditor determines that an air express company's use of the CCR §25137-7 Air Transportation rules results in distortion, then a modification to those rules may be made under the authority of R&TC §25137. A modification that would be appropriate for curing distortion in a typical air express company situation would be to calculate the sales factor by assigning 50% of the revenues from air express companies to the point of origin and 50% to the point of destination. The property and payroll factors for such air express companies may generally continue to be determined in accordance with the provisions of CCR §25137-7.

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7740 FILM PRODUCERS AND TELEVISION NETWORKS

CCR §25137-8

Regulations dealing with apportionment issues in the motion picture and television industries were adopted in 1987, effective for taxable years beginning on or after January 1, 1982. Prior to the adoption of the regulations, the department had followed a somewhat similar methodology pursuant to a "Guideline for Motion Picture and Television Film Producers and Television Network Broadcasters Apportionment Formula" that FTB had issued in 1974. To ease past confusion as to how film costs should be included in the property factor however, auditors are to apply the provisions of CCR §25137-8(c)(1)(B)(iii) and (iv) for all open years.

The regulation applies to motion picture and television film producers, producers of television commercials, and to television networks. The regulation will also apply under certain circumstances to independent television stations operating collectively or as network affiliates.

The standard apportionment factors for taxpayers covered under the Regulation are modified as follows:

Property Factor:

RENTED STUDIOS
If studios are rented, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage and other permanent equipment such as sound recording equipment. Additional equipment that is not covered in the studio's basic rental charge or that is rented from other sources shall also be included providing that it is used for one week or longer (even though it may be rented on a day-to-day basis). In the case of a lump sum rental payment covering more than one taxable year, the payment must be assigned ratably over the rental period CCR §25137-8(c)(1)(A)(i).

VALUE OF FILMS
Films are deemed to be tangible personal property pursuant to CCR §25137-8(b)(4). The value of a film is the original cost of producing the film as determined for federal income tax purposes, prior to any adjustments for federal credits, which have not been claimed for state purposes, and will include talent salaries.

Films of a topical nature (including news, current events programs, sporting events, interview shows, etc.) generally have no lasting value, and are expensed for California purposes at the time of production. Such films shall be included in the property factor at their original cost for one year beginning with the release date (the "release date" is defined as the date when it is first telecast or

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exhibited to the primary audience for which it was created). If the value of such films is material to the property factor, it may be necessary to calculate a monthly average (see MATM 7125) of the film values in order to more accurately reflect the 12-month inclusion.

All other films are included in the property factor at their at original cost for twelve years beginning with the release date.

After the initial one-year or twelve-year period has elapsed, any films for which income has been received during the taxable year shall be aggregated and treated as a single film property. Such property will be valued at eight times the aggregate gross receipts generated by those films during the year, but may not be valued at an amount greater than the total original cost of the aggregated film property.

The value of films will be assigned to the numerator in accordance with the ratio of the total California receipts from those films over the total of such receipts everywhere. The film receipts are determined for this purpose in the same manner as they are determined for sales factor purposes (see below).

TANGIBLE PERSONAL PROPERTY OTHER THAN FILMS
If tangible personal property (other than films) is used within and outside the state during the year, the portion of its value included in the numerator shall be in the same ratio which the number of days the property was located or used in this state bears to the total number of days such property was owned or rented during the taxable year.

Videocassettes and discs intended for home viewing are not considered films under CCR §25137-8(b)(1). Such property shall be included in the property factor at its inventory cost.

Payroll Factor:

The payroll factor includes all compensation paid to employees during the taxable year, including talent salaries. Residual and profit participation payments also constitute compensation paid to employees. In many cases, actors or directors will be employees of personal service or "Alter Ego" corporations, and producers will contract with such corporations to provide the services of the actors or directors. The amounts paid to such corporations for those services, if substantial, will be included in the producer's payroll factor as if it were compensation paid directly to an employee.

Compensation of employees engaged in the production of a film on location must be attributed to the state where the services are or were performed. Compensation of all other employees is determined according to the normal rules.

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Sales Factor:

The special rules applicable to the sales factor involve the assignment of gross receipts to the numerator.

FILMS
The numerator of the sales factor should include gross receipts from films in release to theaters and television stations located in this state. Gross receipts from films in release to or by a television network for network telecast shall be attributed to this state in the ratio that the California audience for such network stations bears to the total audience everywhere. Although CCR §25137-8(c)(3)(B) indicates that published rate card values are to be used to determine the audience, those rate card values are no longer published. Alternatives named in the Regulation for determining audiences are other published market surveys, or population data published by the U.S. Bureau of Census. The taxpayer may have internally generated audience information that may be used if it appears reasonable. (Note that most independent radio and TV stations are not subject to this regulation since they operate in localized areas. Therefore, advertising revenues of those stations are assignable to the state where the broadcast originated under the normal rules of CCR §25136. The location of the listening audiences is not considered for these taxpayers.)

Gross receipts from films in release to subscription television telecasters shall be attributed to this state in the ratio that the California subscribers bear to the total subscribers everywhere.

VIDEO CASSETTES AND DISCS
Receipts from sales and rentals of videocassettes and discs are included in the sales factor in accordance with the normal rules for tangible personal property under Regulations 25135 and 25136.

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7745 RAILROADS

CCR §25137-9

The special rules for apportionment of railroad companies are found in CCR §25137-9.

Railroad companies are broadly classified by the Interstate Commerce Commission (ICC) into three classes for reporting purposes:

Class I:
Those having annual operating revenues of $50,000,000 or more. For this class, ICC Annual Report Form R-1 is required to be filed.

Class II
Those having annual operating revenues between $10,000,000 and $50,000,000. For this class, Annual Report Form R-2 is filed.

Class III
Those having annual operating revenues of $10,000,000 or less. For this class, Annual Report Form R-3 is filed.

The Annual Reports filed with the ICC contain some of the data needed to compute the denominator of the special formula, and should be requested by the auditor. The California Public Utilities Commission (PUC) also requires an Annual Report (which is simply a copy of the R-1 or R-2). In addition, a form called State Statistics is required for Classes I and II, and this is the form which will contain the data needed to compute the numerator.

The following terms are used in the Regulations:

LOCOMOTIVES: self-propelled units of equipment designed solely for moving other equipment.
LOCOMOTIVE MILES: the movement of a locomotive a distance of one mile under its own power.
CAR MILES: the movement of a unit of car equipment a distance of one mile.

Property Factor:

TEMPORARY RENTS
It is common in the industry for railroad cars owned and operated by other railroads to be temporarily used by the taxpayer in its business. The taxpayer will be charged a per diem or mileage charge for the use of those cars. Such payments are excluded from the definition of rents pursuant to CCR

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§25137-9(a)(1)(A)(ii), and are not included in the property factor. Likewise, the taxpayer may receive per diem charges for equipment, which they own but temporarily rent, to other railroads. Although the property is temporarily rented out, the original cost of the property is included in the taxpayer's property factor.

MOBILE OR MOVABLE PROPERTY
Mobile or movable property includes property such as passenger cars, freight cars, locomotives and freight containers that are located within and without this state during the taxable year. Locomotives shall be included in the numerator of the property factor in the ratio which locomotive-miles in the state bear to total locomotive-miles. Other railroad cars shall be included in the numerator in the ratio which car-miles in the state bear to the total car-miles everywhere.

The State Statistics filed with the PUC contain data regarding the mileage within California and total mileage (Form SC-931, Statistics of Rail-Line Operations-Within the State). The R-1 or R-2 filed with the ICC discloses the cost of locomotives and cars against which the ratio is applied.

Payroll Factor:

CCR §25137-9(a)(2) provides that compensation paid to enginemen and trainmen performing services on interstate trains shall be included in the numerator of the payroll factor in the ratio which the compensation required to be reported to California for withholding tax purposes bears to the total compensation required to be reported to the IRS. (Under former 49 USC 11504, now 49 USC 11502, compensation of enginemen and trainmen is generally subject to income tax only in their state of residence.)

Sales Factor:

REVENUE FROM TEMPORARY RENTS
Per diem and mileage charges arising from the temporary use of the taxpayer's railroad cars by other railroads are excluded from the sales factor. This is consistent with the property factor rules that do not recognize such rentals.

REVENUE FROM HAULING FREIGHT, MAIL AND EXPRESS
The portion of the revenue from hauling freight, mail and express that is attributable to this state includes:

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All receipts from shipments which both originate and terminate within this state; and
For shipments passing through, into, or out of this state, the portion of the revenues in the ratio that the miles traveled by such shipment in this state bears to the total miles from the point of origin of the shipment to the destination.

REVENUE FROM TRANSPORTATION OF PASSENGERS
The portion of the revenue from transportation of passengers that is attributable to this state includes:
All receipts from the transportation of passengers (including mail and express handled in passenger service) which both originate and terminate within this state; and
That portion of the receipts from the transportation of interstate passengers (including mail and express handled in passenger service) determined by the ratio which miles traveled by such passengers on the taxpayer's lines within this state bear to the total miles traveled from point of origin to the destination.

The total revenue against which the mileage ratios are applied can be found in the report to the PUC, State Statistics, 5C-210 Railway Operating Revenues Earned within the State.

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7750 COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS

CCR §25137-10

Unitary businesses, which are predominantly engaged in financial activities, are subject to apportionment under the rules set forth in CCR §25137-4. Some unitary businesses, however, will contain one or more entities that are classified as financial corporations, but the predominant activity of the business as a whole will not be a financial activity. CCR §25137-10 was added in 1990 to provide special apportionment rules to properly reflect the income of these businesses. The provisions of CCR §25137-10 (as well as the apportionment procedures that were used prior to the effective date of that regulation) are covered in detail in the FTB Bank and Financial Handbook. Auditors should refer to the regulation and to that handbook when examining a combined report that contains both general and financial corporations.

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7755 TRUCKING COMPANIES

CCR §25137-11

For years prior to 1991, the Franchise Tax Board had developed a special formula for the apportionment of income from trucking operations. Effective for taxable years beginning on or after January 1, 1991, CCR §25137-11 was enacted to provide the rules for apportioning such income. Since audits of taxable years prior to 1991 are still being performed, both sets of rules will be covered in this section of the manual.

CCR §25137-11 METHOD:

The Regulation applies not only to trucking companies, but also to companies which are not predominantly trucking, but which do conduct some trucking activities. For such companies, the apportionment factors directly related to trucking activities must be separately identified. To the extent that trucking companies also transport goods through methods other than by truck, the property and payroll attributable to such movement shall be assigned to the numerator of the property and payroll factors in accordance with normal rules (or under CCR §25137-7 and CCR §25137-9 if air or rail transportation is involved).

The following terms are used in the regulation:

MOBILE PROPERTY: all motor vehicles, including trailers, engaged directly in the movement of tangible personal property.
MOBILE PROPERTY MILE: the movement of a unit of mobile property a distance of one mile (whether loaded or unloaded).
UNIT OF MOBILE PROPERTY: a single unit of mobile property includes a tractor and trailer, which are connected together for movement.
INTERSTATE RATIO: the ratio that the mobile property miles traveled within this state bears to the total mobile property miles everywhere during the year.

The trucking formula is based upon the interstate ratio. The ratio is computed by aggregating all units of mobile property operated by the taxpayer.

Example: A taxpayer has 10 units of mobile property, all of which operate in more than a single state during the year. One mobile property unit travels 40 miles within California and 60 miles outside the state for a total of 100 miles. The other nine units travel a total of 50 miles each, none of which is within this state. The interstate ratio assigned to California is:
40/(100 + (9x50)) = 40/550 = 7.273%

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The interstate ratio will be applied to determine the amounts within California for (1) mobile property located in more than one state during the year, (2) compensation paid to personnel which operate and maintain mobile property for services performed in more than one state, and (3) receipts from shipments which originate in one state and terminate in another state.

Mobile property which is located solely within California during the taxable year, and compensation paid to personnel for operating or maintaining mobile property solely within this state are included 100% in the numerator of the property and payroll factors. Likewise, all receipts from any shipments that both originate and terminate within California are included 100% in the numerator. The interstate ratio is not applied to these wholly California items.

The regulation contains a de minimis standard which will not require apportionment to California if: (1) the taxpayer does not own any property in California other than mobile property which operates within and outside the state; (2) the taxpayer does not make any pick-ups or deliveries within the state; (3) the taxpayer does not travel more than 25,000 mobile property miles (provided total mobile property miles traveled within the state does not exceed 3% of total mobile property miles) within the state; (4) and the taxpayer does not make more than 12 trips into the state.

The regulation contains a requirement that the taxpayer maintain the records necessary to identify the mobile property, which operates in more than one state, and the miles traveled by such property in each state. Diesel tax reports filed with the Board of Equalization should also show mileage in and out of California, as should the report filed with the California Public Utilities Commission. The taxpayer will have individual manifests, which can be checked on a test basis.

PRE-1991 RULES:

The formula that the department used prior to the adoption of the current Regulation is authorized under the general authority of R&TC §25137, which allows special allocation and apportionment methods when the normal methods do not fairly represent the extent of the taxpayer's business activity within the state. The old formula operated in a similar manner to the current Regulation, except as follows:

Mobile property and compensation paid to the drivers of mobile property were assigned to the numerators of the property and payroll factors based upon the ratio of "ton miles" in California to ton-miles everywhere. Ton-miles represented truck capacity in tons times the miles traveled. For example, a 20-ton truck driven 100 miles would represent 2000-ton miles. This formula weighted the mileage traveled within the state by the carrying capacity of the trucks. If ton-miles for each truck were not available, trucks were grouped into similar sizes, e.g., 5-ton, 10-ton, 20-ton, etc., and the total mileage for each group would be used to compute ton-miles.

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Receipts from interstate trucks were attributed to California based upon the ratio of revenue miles in California to total revenue miles everywhere. Revenue miles represent miles traveled hauling cargo, and exclude any miles when the truck was traveling empty because empty mileage does not generate revenue.

Reports filed with the Interstate Commerce Commission should disclose total ton-miles and revenue miles, and California data may be derived from reports filed with the California Public Utilities Commission.

Department practice had been to apply the above guideline only to interstate trucking activity, and to determine factors from trucking activity carried out solely within the state using the normal apportionment rules. In the *Appeal of United Parcel Service, Inc*., Cal. St. Bd. of Equal., May 6, 1986, the SBE ruled that the trucking guidelines issued by the FTB did not make any distinction between interstate and intrastate trucks or drivers, therefore the taxpayer was entitled to use the formula for all of its trucks and drivers. This problem was taken care of prospectively in the Regulation through clear language stating that intrastate trucking activities are assigned entirely within this state.

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7757 PRINT MEDIA

CCR §25137-12

The apportionment rules under CCR §25137-12 apply to taxpayers in the business of publishing, selling, licensing or distributing newspapers, magazines and other types of printed materials. Such taxpayers derive a large percentage of their revenues from the sale of advertising space, and the regulation clarifies the treatment of advertising revenues in the numerator of the sales factor.

Gross receipts from the sale of printed materials delivered or shipped to a purchaser (or subscriber) within California is included in the numerator of the sales factor in accordance with the normal rules for sales of tangible personal property (see MATM 7520). Gross receipts derived from advertising or from the sale, rental or other use of customer lists is attributed to California based upon the taxpayer's "circulation factor." The circulation factor must be established each year, and for each of the taxpayer's publications, and consists of the following ratio:

The publication's in-state circulation to purchasers and subscribers
Over
Total circulation for that publication

The circulation should be determined by reference to rating statistics as reflected in sources such as Audit Bureau of Circulations. If no satisfactory sources are available, the circulation can be determined from the taxpayer's books and records.

If specific items of advertising can be shown to have been distributed only to a limited region within the total circulation area of the publication, then a regional or local geographic circulation factor should be used in lieu of the overall circulation factor for that publication.

If the purchaser or subscriber is the U.S. government or if the taxpayer is not taxable in a state, then a throwback rule applies. All gross receipts (including receipts from advertising and customer lists) that would have been attributed to the other state by the circulation factor will be included in the sales factor numerator of this state if the printed materials were shipped from a place of storage or business in this state.

This regulation was effective November 3, 1995. For taxable years beginning before that date, similar treatment was required under FTB Legal Ruling 367 (1973).

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7760 SEA TRANSPORTATION ACTIVITIES

CCR §25101(b)

The apportionment rules for sea transportation activities are located in CCR §25101(b). For purposes of the special formula, sea transportation means ocean vessels carrying cargo, freight, mail, passengers or similar items. In 1995, R&TC §25101(b) was retroactively amended to clarify that the special formula applies to any sea transportation activity regardless of whether or not the taxpayer's primary business is sea transportation. Commercial fishing activities and vessels that are not engaged in sea transportation are not covered by this regulation, and are discussed in MATM 7725 and MATM 7815.

The property, payroll, and sales factors related to vessels and their employees are determined in part under the concept known as "voyage days." A voyage day is defined as a day, or part of a day, that a ship is in operation for the purpose of transporting cargo, freight, mail, passengers, and the like. The days that a ship is in operation include all sailing days, even though a ship is returning empty or is enroute to a port of call to load passengers or cargo, all days in port while loading and unloading, and all days that the ship is laid up for ordinary repairs, refueling, or provisioning. Voyage days do not include time a ship is out of service or during the time it is laid up for extended repairs, overhaul, modification, or is in drydock.

A California voyage day includes all days from the time a vessel enters the California three-mile limit until it leaves that three-mile limit. Since it is unlikely that vessels of the size contemplated herein would remain continuously within the three-mile limit when sailing between California ports, a portion of the voyage may not be included in California voyage days.

The voyage day ratio is derived by dividing California voyage days by total voyage days. The ratio must be calculated separately for each ship. In calculating the apportionment factors, it is important to note that the voyage day ratio is only applied to property, payroll and sales related to the ocean vessels. Property, payroll and sales not connected with the ships (such as port restaurants, port facilities, land based offices, etc.) are subject to the usual rules of factor assignment.

Property Factor: All property owned or rented by the taxpayer, with the exception of ships, is subject to the normal rules for inclusion in the property factor. The value of each ship is multiplied by that ship's voyage day ratio to determine the value to include in the numerator of the factor.

To the extent that bare boat charters, time charters and similar contracts constitute leases under established guidelines (see MATM 7137), the expense incurred for the charter will be capitalized by eight in the denominator of the property factor. The voyage day ratio will be applied to determine the portion of the capitalized value to include in the numerator. The owners of the ships that are leased

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under such contracts are receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the voyage day ratio will not be applicable to those owners, and the rules described in MATM 7815 will be used. Taxpayers who charter ships under contracts that are determined to be service contracts will not include any value in the property factor.

When examining the property factor of American shipping companies, the auditor should verify that the cost basis of the ships has not been reduced by "capital construction fund" amounts -- see below for an explanation of this issue.

Payroll Factor: The California payroll factor for ocean-going personnel is determined by applying the voyage day ratio to total payroll for such personnel. Land-based payroll is included in the California numerator using the regular payroll rules.

Sales Factor: The numerator of the sales factor is determined by multiplying the California voyage day ratio times the total revenue from transportation related receipts (receipts from cargo, passengers, freight, mail, and the like). All other receipts are assignable to the California numerator using the standard assignment rules.

The main problem encountered in this type of audit is determining the California voyage day ratio and segregating ocean-going property, payroll and sales from land-based factors. Each ship keeps a detailed log, which shows the exact location of the ship shown in hours, minutes, and seconds. California voyage days can be computed from the time each ship enters or leaves the three-mile limit. Taxpayers will probably use the logs to compute voyage days, and the data may be summarized on apportionment workpapers. The workpapers should be requested to help guide the auditor through the information contained on the logs. The logs should also have detail on extended repair and drydock time that must be removed from both total and California voyage days. The auditor should be careful to ensure that only major repair and drydock time has been removed. Ordinary minor repair time, refueling, and provisioning time are not removed.

The taxpayer's general ledger summaries, revenue runs, property ledgers, payroll records, and other records will show the revenues, property, rent expense, and payroll for each vessel. Once this information is verified, the voyage day ratio for each vessel can be applied to determine the California portion. California property, payroll and revenue for nonocean-going or land-based items can be determined using techniques described in other parts of this manual.

Exempt Income: Under R&TC §24320, income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country may be exempt from taxation. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States.

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Federal law contains a similar exemption under IRC §883, however there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50% of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. Auditors should verify that the taxpayers qualify for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries, which are known to grant equivalent exemptions for various types of international shipping or aircraft income, is contained in Rev. Rul.89-42, 1989-1 C.B. 234. Since treaty provisions are subject to change however, the full text of the relevant documents should be consulted if this is a material issue.

Income exempt from taxation under this provision is included in both combined business income subject to apportionment and in the denominator of the sales factor. Property and payroll related to the exempt activities is included in the denominators of the property and payroll factors. By excluding the property, payroll and sales from the apportionment factor numerators of any state, the income is effectively exempted from state taxation. This treatment is comparable to the treatment of nontaxable income from activities on the Outer Continental Shelf (MATM 7796), and the U.S. Supreme Court has affirmed the method as not resulting in extraterritorial taxation (*Shell Oil Company vs. Iowa Department of Revenue*, 488 US 19, 102 L Ed 2d 186, 109 S Ct 278).

Merchant Marine Capital Construction Fund: American shipping companies are subsidized to an extent by the federal government. This subsidy involves the taxpayer placing funds in a special account for ship replacement. Under IRC §7518, U.S. citizens that own or lease qualified vessels may establish tax-deferred reserve funds, called capital construction funds, under Section 607 of the Merchant Marine Act of 1936, for the replacement or addition of vessels. Generally, amounts deposited into a capital construction fund are deductible from taxable income, and earnings from the investment of amounts held in the fund are not taken into account. Withdrawals made for the acquisition, construction, or repair of a qualified vessel are "qualified withdrawals" and do not generate income. Nonqualified withdrawals generate income and are taxed in the year they are made.

For taxable years beginning before 1/1/97, California did not conform to these rules, therefore a state adjustment reversing the capital construction fund deduction and restoring the related income should be made. Since the basis of vessels acquired or constructed through fund withdrawals is reduced for federal purposes by the nontaxable fund contributions, federal/state basis differences will also be present. This will create additional state adjustments for depreciation and gain or loss on the sale of the vessels. For property factor purposes, the cost of the property should not be reduced by the capital construction fund withdrawals.

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For taxable years beginning after 1996, California incorporates and modifies IRC §7518. California modifies IRC §7518 to reflect California cross-references, the dividend deduction percentage requirements, and California's tax rate. California incorporates the federal provisions that allow United States citizens that own or lease qualified vessels to establish tax-deferred reserve funds, called capital construction funds, for the replacement or addition of vessels (R&TC §24272.5).

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7765 BUS TRANSPORTATION

The normal rules under CCR §25129(d) for apportioning income from mobile property are based on time spent within and outside the state. Bus lines involved in interstate transportation of passengers and goods do not generate revenue based upon time within a state, but upon mileage traveled. Therefore, the standard formula may not result in a clear reflection of income for such taxpayers. Under the authority of R&TC §25137, the department has developed modifications to the standard formula to reflect the special characteristics of this industry. The modifications are similar to the special rules authorized for railroads (MATM 7745) and trucking companies (MATM 7755).

The normal apportionment rules should be applied to property, payroll and sales not related to interstate busing. Property subject to the normal rules will include stationary assets such as terminals and offices, as well as *intrastate* buses (buses that do not cross state borders as part of their normal activity).

Interstate buses (buses which travel across state borders as part of their normal activity) will be included in the numerator of the property factor in the ratio which miles traveled in California bears to total miles traveled everywhere. The compensation paid to interstate drivers will also be assigned to California based upon that ratio.

Revenue is not generated when the bus is traveling empty. Therefore, the sales factor is calculated based only upon miles traveled while hauling passengers (revenue miles). Empty miles are excluded from the calculation. Revenue from interstate bus trips is assigned to the numerator of the sales factor in the ratio which revenue miles traveled in California bears to total revenue miles traveled everywhere.

Reports, which the bus lines are required to file with the Interstate Commerce Commission, should disclose total miles traveled. Diesel tax reports filed with the Board of Equalization and reports filed with the California Public Utilities Commission should identify mileage in and out of California.

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7770 FREIGHT FORWARDING COMPANIES

Freight forwarding companies arrange for the shipment of goods by air, sea, rail or truck common carriers, and receive fees for their services. In addition, many forwarders will provide their customers with truck trailers that may be transported by independent highway haulers or rail piggyback services.

When the freight forwarding company does not provide trailers but only arranges transportation by a common carrier, the revenue is generated by the service of making the arrangements. Past experience has shown that the income producing activities of freight forwarders generally take place relatively equally at the points where the shipments originate and terminate. Therefore, in order for the sales factor to clearly reflect the business activities within the state, the department's practice has been to use R&TC §25137 to assign 50% of the revenue from freight forwarding services to the point of origination, and 50% to the point of destination. Some freight forwarders may ship to and from states in which they have no employees or activity, and nexus may not exist in those states. In such a situation, the sales should be assigned to the location where the income producing activity occurred.

Provision of Trailers:

To the extent that the freight forwarding companies provide their own trailers for transporting customer goods, their revenue is a function of the mileage traveled rather than time spent within and outside the state. In order to clearly reflect the activities within this state, the apportionment rules developed for the trucking, rail, sea or air transportation industries (whichever are applicable) should be applied to the property, payroll and sales related to this activity. Although freight forwarders will not generally fall within the definitions of truck, rail, sea or air transportation companies under the regulations, the general authority of R&TC §25137 may be used to permit application of those rules to freight forwarders in cases where necessary to clearly reflect activities within the state.

Unlike trucking and rail companies that will have nexus in all states in which they operate, it is possible that a freight forwarding company's activities within a state may not be sufficient to establish nexus. In such cases, the mileage ratio calculated for freight forwarding companies should exclude miles traveled through states where nexus has not been established.

In *Appeal of John H. Grace* Co., Cal. St. Bd. of Equal., October 28, 1980, the SBE held that nexus was not established in California when a corporation's only connection with the state was through railroad cars leased by the corporation to industrial companies who in turn arranged for railroad companies to transport their products in those cars. The railroad cars would occasionally pass into or through California. The SBE held that the presence of railroad cars in California, while under the control of the corporation's lessees' bailees, was "too attenuated to satisfy the statutory nexus requirement." As a practical matter, this type of fact pattern will probably not apply to freight

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forwarders because they make the transportation arrangements and are therefore not as far removed from the movements of their trailers. In order to determine whether a taxpayer has nexus in a particular state, the auditor should refer to the nexus requirements discussed in MATM 1100.

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7780 MINING

Taxpayers who derive more than 50% of their gross business receipts from conducting an extractive business activity may be required to use a three-factor apportionment formula (no double-weighted sales). See MATM 7005.

Valuation of depletable or wasting assets in the property factor is an issue for the mining industry, and is discussed in MATM 7210. Federal/state depletion issues are covered in MATM 6080.

Payments that are made for leased mining rights are considered royalties or a similar form of economic interest in the property. For the limited purpose of CCR §25137(b)(1)(B), royalty payments are treated equivalent to rents and are included in the property factor as such (rent expense), reflecting an eight-multiple capitalization rate under CCR §25130 (MATM 7138). To the extent that payments such as lease bonuses are capitalized, they are included in the factor as owned property. (See MATM 7795 for an explanation of lease acquisition costs or bonuses).

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7785 PRINTERS

An apportionment problem that commonly arises with taxpayers involved in the printing industry is whether to treat printing receipts as sales of tangible personal property (assigned to the state of destination) or as receipts for personal services (assigned to the state where the services are performed).

Printers will generally produce a product in accordance with the customer's specifications, and in many cases the customer will provide the paper used in the printing process. If the printer does not market the finished product for its own account, the issue is whether the printer is merely providing a fabrication service or is in fact selling a tangible personal product.

The determination of the nature of the printing receipts must be made on a case-by-case basis taking into account the taxpayer's facts and circumstances. Paper makes up the highest component cost of the printing process. If the customer supplies the paper and the printer only supplies incidental materials, then the printer will usually be considered to have provided a service.

On the other hand, if the printer supplies the paper, then the determination becomes more difficult. Some factors to consider would include the extent of the activities performed by the printer, the manner in which the parties treated the transactions (copies of the contracts should be requested), and the relative value of the paper and other components as compared to the finished product. An analysis of this issue is contained in *Wm. H. Wise & Co. vs. Rand McNally & Co*., (U.S.District Court S.D., N.Y.) 195 Fed. Supp. 621 (5/29/61). For additional information that may help in making the determination, see MATM 7522 and MATM 7545.

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7790 PROFESSIONAL SPORTS

Generally speaking, all the sports income of California-based professional sports teams will be apportioned to California and none of the sports income of non-California-based professional sports teams will be apportioned to California (R&TC §25141). For exceptions to this rule in cases where other states or countries follow a different rule, see R&TC §25141(d). Notwithstanding these provisions, the non-California-based teams are still subject to the minimum franchise tax if they play within the state. These rules are only intended to operate as stated above, and should not be construed as an inference that the unitary concept is being modified or limited. R&TC Section 25141 is effective for taxable years beginning on or after January 1, 1986. Prior to that date, apportionment rules for professional sports teams were contained in former CCR §25137-10.

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7795 OIL & GAS INDUSTRY

The oil and gas industry is one of the largest and most important segments of the U.S. economy. The importance of the petroleum industry to the economy of the United States has led Congress and California to pass specialized tax laws that are unique to the oil and gas industry. Petroleum industry accounting records have been adapted to the specialized nature of the industry. As a result, an efficient and effective audit of a return with oil and gas investments, transactions, or operations will require some specialized knowledge of the industry and the tax laws involving the industry. Although many of the basic auditing techniques ordinarily used when auditing income, expense items, state adjustments and apportionment factors will be essentially the same in auditing oil and gas operations, the specialized nature of the industry and its accounting records necessitates the use of additional audit techniques that are not common in other industries.

Overview of the Industry:

The exploration, development, and production of oil and gas require enormous amounts of capital. To obtain the funds needed, companies sometimes join together and pool their resources to explore for oil. Large integrated oil companies, as well as small companies and individuals, participate in the exploration, development, and production phase of the oil and gas industry. Many times partnerships are formed to enable outside investors to invest in drilling ventures. The investors may have little knowledge of the oil and gas industry, but are willing to invest funds in risky drilling ventures because of favorable tax benefits and the possibility of large economic benefits.

Primarily because of the extremely large capital requirements, the transportation, refining, and marketing of oil and gas are phases of the industry that are dominated by the large integrated oil companies.

Specialized aspects of the oil and gas industry that are discussed separately in this manual are offshore drilling operations (MATM 7796) and pipeline companies (MATM 7797). Since many oil companies operate shipping lines to transport the oil, they may also be subject to the sea transportation rules discussed in MATM 7760.

State Adjustments:

Although not apportionment issues per se, there are several state adjustments that are unique to the oil and gas industry and that deserve mention in this section. State adjustments for depletion, intangible drilling and development costs, and tertiary injectants will be present in most cases, and are discussed in MATM 6080, 6085 and 6086. Prior to 1987, state adjustments with respect to exploration expenses may also be necessary (former § 24837, 24837.5).

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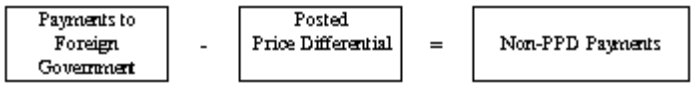
A material issue for the oil and gas industry involves the deduction for foreign taxes. R&TC Section 24345 generally allows a deduction for taxes paid or accrued during the taxable year, but an exception is made for taxes on or according to or measured by income or profits (see MATM 6100). Many oil-producing countries impose a tax, which is in part an income tax, and in part a compulsory payment in exchange for a specific economic benefit. Such taxes are termed "dual capacity" taxes. Since dual capacity taxes consist of two distinct elements, those elements are separated under rules set forth in CCR §24345(c) in order to determine the portion of the tax that is deductible.

In order for a taxpayer to deduct any portion of a dual capacity tax, the burden is upon the taxpayer to prove (1) that the imposition of the foreign tax is directly related to the receipt or future receipt of a specific economic benefit from the foreign country, and (2) the amount (if any) that is not an income tax. This may be accomplished if the taxpayer claiming a deduction establishes, based on all relevant facts and circumstances, the specific amount of the dual capacity tax that is not an income tax.

Alternatively, the Regulation provides for a safe harbor method. Under the safe harbor method, the taxpayer makes an election on its California return with respect to the foreign country, which asserted the tax upon an entity included in the combined report, and applies the safe harbor formula to determine the deductible portion of the tax. In very general terms, the safe harbor formula operates as follows:

Step 1
Some payments to foreign governments are calculated based upon the "posted" price of crude oil. Since the oil is sold at the market price, the posted price is not representative of realized income to the extent that it exceeds the market price. Therefore, the portion of the payments that are attributable to the differential between the posted price and market price cannot be considered "income" taxes.

The first step in the safe harbor formula is to reduce the actual payments to the foreign government by any payments attributable to a posted price differential (PPD). The method for computing the amount of PPD payments is explained in CCR §24345-7(c)(5)(A).



Step 2
A reasonable amount of "income tax" is estimated by multiplying the taxpayer's income in the foreign country by 52% (55% for 1986 and prior).

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Income from Activities in Foreign Country	x	52%	=	Amount of Payment Considered to be an Income Tax

Step 3
Any excess of the non-PPD payments over the portion of those payments that are considered to be income taxes (from Step 2) are added to the PPD payments (from Step 1). The result is the deductible portion of the dual capacity tax.

Non-PPD Payments	-	Amount of payment considered an Income Tax	=	Deductible Portion of Non-PPD Payments (not less than zero)
Deductible portion of Non-PPD payments	+	PPD Payments	=	Total Deduction Allowed for the Dual Capacity Tax

These steps are an over-simplified summary of the mechanical rules described in CCR §24345-7, and the auditor should refer to that regulation if issues arise in this area.

Property Factor Issues:

LEASE ACQUISITION COSTS - The lease acquisition costs are costs incurred in connection with acquiring an oil and gas lease. The initial consideration paid by the lessee to the lessor known as a "bonus" does not represent rents and instead represents an economic interest in the property (Treas. Reg. 1.612-3(a)(3)). These costs are capitalized as part of the cost of acquiring a lease (IRC §178) and therefore should be included in the property factor.
OIL & GAS TANKERS - See MATM 7760, Sea Transportation Companies, for general rules.
ITEMS EXPENSED FOR TAX PURPOSES, CAPITALIZED FOR BOOK PURPOSES. As a general rule, items, which are expensed for tax purposes, are not includable in the property factor (see MATM 7120). Intangible drilling costs (IDCs) are capitalized for book purposes, but are usually expensed for tax purposes. Prior to 1990, auditors should ensure that IDCs have been excluded from the factor if they have been expensed on the return. For taxable years beginning on or after January 1, 1990 however, CCR §25130(a)(1) was revised to include IDCs in the property factor regardless of whether they have been expensed or capitalized. The property factor inclusion is not limited to IDCs incurred after January 1, 1990, but applies to all IDCs that are still capitalized on the taxpayer's books, even though they may have been expensed for tax purposes in a prior year.

If an auditor is unsure whether a cost associated with the development of a well is correctly classified as an IDC, it may be helpful to review the definition of IDCs provided in Treas. Reg. §1.612-4, as well as federal Revenue Rulings and case law on the subject.
GEOLOGICAL AND GEOPHYSICAL COSTS - Geological and geophysical costs, which result in the acquisition or retention of oil properties, must be capitalized as part of the cost of these properties

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(Rev. Rul. 77-188, 1977-1 C.B. 76, and Rev. Rul. 83-105, 1983-2 C.B. 51). The average yearly value should be included in the cost value of the property and thus will be includable in the property factor.

In the event that the acquisition or retention of the oil properties does not occur, these costs are deductible as a loss under IRC §165. Since the costs are no longer capitalized, they are not includable in the property factor.
DELAY RENTALS - Generally, oil and gas leases will require the development of an oil property within a set period of time, usually one year. In lieu of abandoning the project if development is not commenced within the contractual period, the lessee may pay the lessor a delay rental, which will extend the period for development. Delay rentals are considered carrying charges which may be expensed, or which the taxpayer may elect to capitalize under the provisions of IRC §266 and R&TC §24426 (Treas. Reg. 1.612-3(c)(2)).

The general rule provides that the capitalized value of expenditures will be includable in the property factor, and no value will be included if the taxpayer has elected to expense the item (MATM 7120). However, if an analysis of the contract reveals that the delay rental is really in the nature of a rent (a payment for the ability to use the land), then the property factor should include eight times the annual rental rate (MATM 7130). Such an analysis need only be performed if the item is material.
ROYALTY PAYMENTS - A mineral lease contract provides that the lessee will make royalty payments to the lessor. The lessor (owner of the minerals) retains a royalty interest in the minerals and is entitled to receive a specific portion of the oil and gas produced or a specified portion of the value of such production. Historically, the typical royalty on oil and gas properties has been a one-eighth share. An amount representing royalties paid in connection with the extraction of natural resources generally is includable in the property factor of the lessee, so long as the property for which the royalty payments are made is actually used by the lessee/taxpayer. The amount to be included in the lessee's property factor is determined by multiplying the annual royalties paid times eight. FTB Legal Ruling 97-2 provides that such royalties shall be treated as equivalents to rental payments. Also, the State Board of Equalization in Appeal of Proctor and Gamble concluded that CCR §25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

OFFSHORE PROPERTY - See MATM 7796.

DRILLING SHIPS AND BARGES - Drilling ships and floating barges are included in the denominator of the property factor regardless of location. Vessels operating within the California jurisdictional limits (three miles) are included in both the numerator and the denominator. In the event that the operations of these vessels are conducted both within and outside of the California jurisdictional limits, the value of property to be included in the numerator will be computed on the basis of a modified port day formula (see MATM 7796).

Note: The voyage day formula should not be used as these vessels are not used for sea transportation purposes.

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OTHER PROPERTIES - Undeveloped properties, shale oil, tar sands, geothermal steam properties and non-producing leases are all generally included in the property factor as property available for use (see MATM 7140). For the SBE's analysis of this issue, see *Appeal of Richfield Oil Corporation*, Cal. St. Bd. of Equal., November 17, 1964; and *Appeal of Union Oil Co. of California*, Cal. St. Bd. of Equal., November 17, 1964.

Payroll Factor Issues:

PAYROLL ATTRIBUTABLE TO OFFSHORE PROPERTY - See MATM 7796.

OIL AND GAS TANKERS - See MATM 7760, Sea Transportation Activities.

DRILLING SHIPS AND BARGES - See MATM 7796, Offshore Operations.

Sales Factor Issues:

SALES FROM OFFSHORE PROPERTY - See MATM 7796.

ROYALTY INCOME - Royalties received should be included in the sales factor and assigned to the state in which the income-producing activity is located (See MATM 7566). Generally, this will be the location of the drilling operations.

EXCHANGE TRANSACTIONS IN RELATION TO OIL TRANSFERS - To achieve efficient delivery, storage or processing of petroleum, gasoline or similar products, one company may trade its inventory for another company's inventory. Following are examples of such transactions:

Company A ships crude oil-by-oil tanker with its intended destination being Company A's Los Angeles refinery. At some point during the shipment, it is determined that the Los Angeles refinery facilities are full and the oil cannot be delivered for processing. Company B has a refinery that can handle the oil. Company A contracts for Company B to take the delivery and, in exchange, Company B will supply Company A's refinery with oil at a later date.

Company X has crude oil in Texas. Company Y has crude oil in California. Company Y, a dealer in crude, needs oil in Texas to fill a contract for delivery to a customer in that state. Arrangements are made with Company X to exchange its crude in Texas for Company Y's crude in California.

In both instances, there is an exchange of inventory for inventory. These transactions have the potential to distort the sales factor because the exchange does not reflect a true market for the

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product. If the value of the inventory is included in the sales factor as a result of the exchange, a double counting of sales will result when the replacement inventory is subsequently sold. If the auditor determines that the inclusion of the exchange transactions in the sales factor is distortive, the exchanges may be excluded under the authority of §25137. See MATM 7701 for a discussion of when application of the standard formula will be deemed to be distortive.

Reciprocal agreements are sometimes entered into whereby Corporation A agrees to buy inventory from Corporation B at a specific location for a specified cash amount in exchange for an agreement by B to purchase inventory from A at a different location. Such arrangements are essentially exchange transactions, and should be given the same treatment as described above. Such transactions may or may not be identified as exchange transactions on the taxpayer's books of account or workpapers, and therefore may be difficult to identify. The auditor may be able to determine whether such transactions exist by interviewing taxpayer personnel familiar with the overall operations of the integrated production process.

SALES OF TRADING COMPANIES OR BROKERS - Oil companies may have subsidiaries which are trading companies or brokers. The function of these subsidiaries is to find buyers for the company product. They may either receive a commission or they may actually purchase and resell the product. When a combined report includes a trading company or broker that purchases and resells the product, the auditor should consider the propriety of including the "gross receipts" in the sales factor. The trading company or broker will typically only have a few employees and minor facilities, and may have less than a one percent profit margin since it is effectively only taking a commission for finding a buyer for the product. The size of the receipts may therefore be disproportionate to the activity conducted. If the auditor determines that the inclusion of the gross receipts in the sales factor is distortive, then an adjustment may be made under the authority of R&TC §25137 to include only the gross profit. For guidance in resolving this issue, see *Appeal of Pacific Telephone and Telegraph Company*, Cal. St. Bd. of Equal., May 4, 1978; and *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*., Cal. St. Bd. of Equal., June 2, 1989; also MATM 7701.

EXCLUSION OF ROYALTY PAYMENTS FROM THE SALES FACTOR - Companies which pay royalties to a landholder or to the holder of an overriding royalty interest sometimes reduce their sales by an amount equal to the royalty payments. For example, if an oil producer has $800 receipts on which it owed a one-eighth royalty to the landholder and a one-eighth royalty to the holder of the overriding interest, it may record $600 as sales, and record the remaining $200 as payables. For purposes of administrative ease, the department will allow the sales to be reduced by the royalties for sales factor purposes so long as that treatment is used on a consistent basis. Since the statute requires the use of gross receipts however, that treatment should only be allowed when the amounts involved are not material.

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7796 Offshore Drilling Contractors

Offshore drilling contractors and builders of oil platforms on the high seas operate in an area over which the U.S. Government has asserted exclusive jurisdiction. The states are prohibited from taxing activity within the federal jurisdiction, either directly or indirectly.

Through the enactment of the Submerged Land Act (43 U.S.C. 1301 et seq.) and the Outer Continental Shelf Lands Act of 1953 (67 Stat. 462, 43 U.S.C. 1331 et seq.), the U.S. Government's exclusive jurisdiction extends to the subsoil and sea bed of the outer continental shelf, and to all artificial islands and fixed structures erected thereon for the purpose of oil exploration, development, removal and transportation. These acts have been interpreted to also cover barges used for the exploration and drilling of the wells (FTB Legal Ruling 396). For California purposes, the federal jurisdiction covers the continental shelf beyond the three-mile limit.

All business income derived from activities on the Outer Continental Shelf is included in total business income subject to apportionment. Property, payroll and sales attributable to offshore activities are included in the denominators of the apportionment factors. By excluding Outer Continental Shelf factors from the numerators, income attributable to the Outer Continental Shelf will not be taxed by California. Similar inclusion of Outer Continental Shelf income in the unitary tax base has been approved by the U.S. Supreme Court in *Shell Oil Company vs. Iowa Department of Revenue* (488 US 19, 102 L Ed 2d 186, 109 S Ct 278) as not amounting to extraterritorial taxation. California's apportionment rules detailing the treatment of offshore property, payroll and sales may be found in FTB Legal Ruling 366.

Property and payroll attributable to offshore activities may only be included in the numerators of the apportionment factors if they are located within three miles of the California coast.

Barges and similar vessels that are used in offshore drilling operations may travel from one offshore location to another. Property, payroll and sales attributable to these vessels should be assigned to the numerator based upon a modified version of the "port day" ratio. As described in MATM 7815 (and MATM 7725), the standard port day formula only takes into account time spent within the jurisdictional waters of a state or foreign country. This results in 100% of the income from the vessels being taxed to those jurisdictions. In order to accomplish the assignment of income to the federal waters on the Outer Continental Shelf, the denominator of the port day ratio must be modified to include time spent in those waters. Sales are also excluded from the numerator unless they take place within the three-mile limit. In order to determine whether the sales factor has been properly computed, it is important for the auditor to obtain an understanding of where the offshore drilling sites are located and how the oil is sold. The oil may either be pumped from these locations through pipelines to mainland refineries or placed directly in tankers for delivery to refineries. The sales may

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occur at the well site or at a mainland or refinery location. Once the auditor has determined how the oil is sold, the usual rules for assignment of tangible personal property will apply. For example:

If the well site is within the California three-mile limit, then sales of oil at the well site are California sales. If the well site is outside the three-mile limit, the sales are excluded from the numerator.
If the oil or gas is pumped ashore to California from outside the three-mile limit for sale to a California customer, the sale is included in California's numerator. Oil in transit to a California location would also be considered California property includable in the numerator of the property factor (CCR §25129(d)).
If the oil or gas is pumped ashore to California for storage and subsequent sale, the subsequent sale would be treated as a sale of tangible personal property shipped from California.

The taxpayer should have records identifying the locations of offshore drilling sites. The annual reports or SEC Forms 10-K might also have this information. The auditor's primary concern should be to identify whether any of the offshore locations are within the three-mile limit off the California coast.

See MATM 7815 for rules regarding the property factor treatment of vessels that spend time both within Outer Continental Shelf areas and within the three-mile limit.

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7797 Pipeline Companies

Property Factor:

Determining the property to be included in the denominator of the property factor should pose no special problems beyond those encountered in a standard apportionment audit. Pipelines are included in the denominator at original cost, including any portions of the pipelines that run to offshore drilling platforms located outside the three-mile limit.

Interstate pipelines are included in the numerator as shown in the following calculation:

Pipeline Mils in California **Over** Pipeline Miles Everywhere	X	Original Cost of Pipeline

With respect to pipelines running from offshore oil platforms, pipeline miles that run within the three-mile limit are considered pipeline miles in California.

Sales Factor:

Revenue derived from an interstate pipeline will be assigned to California based on a ratio of the barrel miles transported within California to the total barrel miles. If natural gas were transported through a pipeline, the means of measurement would be in cubic feet of gas.

Example: An interstate oil pipeline is 1,000 miles long and has one million barrels of crude oil transported through it during a taxable year. Those barrels of oil travel through 200 miles of the pipeline located within California. One-fifth (200/1000) of the revenue earned by the pipeline from the transportation of oil would be assigned to the numerator.

All revenue earned from a pipeline located entirely within California should be assigned to the numerator. The barrel miles traveled through wholly California pipelines should not be aggregated with the barrel miles of an interstate pipeline.

The auditor should examine I.C.C. and P.U.C. reports to determine the number of barrels of oil or cubic feet of gas that travel through California and through the total length of the pipeline.

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7800 STOCKBROKERS

Stockbrokers present some unique apportionment problems. The property and payroll factors are calculated under the normal rules, but the department's practice has been to apply special sales factor procedures to a stockbroker's commission income. The sales factor issues for stockbrokers are as follows:

COMMISSION INCOME
Commission income is generated from the buying and selling of stocks or bonds for a customer's account. The stockbroker never actually takes title to the stocks or bonds, but merely earns a fee for arranging the transaction.

STOCKS
Most of the large stockbrokerage firms are headquartered in New York with branch offices around the country. When a customer orders a transaction from one of the branch offices, the resulting revenue is attributable not only to the activity of the sales personnel in that office, but also to the fact that the order is traded on a stock exchange. The normal sales factor rules for assignment of receipts from intangibles would assign all of the receipts to the state in which the greatest proportion of the income producing activity occurred. In order to more clearly reflect income, FTB instituted a practice of attributing 60% of commissions from the buying and selling of stocks to the state in which the originating office is located, and 40% to the state where the exchange is located. Under these rules, commissions from transactions that originate in California branch offices are assigned 100% to California if they are consummated on the Pacific Stock Exchange or if the transactions were not conducted on any exchange. Otherwise, only 60% of the commissions will be assigned to this state. The taxpayer's records will generally segregate revenue by originating office and by how the transaction was consummated.

BONDS
Following the same general rationale as explained above with respect to stocks, commissions from bond transactions that involve an underwriter will be assigned 50% to the state of the originating office, and 50% to the state where the underwriter is located.

COMMISSIONS VS. GROSS RECEIPTS
In addition to arranging transactions for a commission, many stockbrokers will also engage in trades as a principal or underwriter. In such transactions, the taxpayer will purchase securities on its own account for resale. Although the net profit on the resale of the securities is comparable to the commission that would have been received from a brokerage transaction, the gross receipts from the resale will be much greater because they will include the cost of the underlying security. Since most "dealer" transactions take place in the headquarters offices in New York, inclusion of the gross receipts in the denominator of the sales factor has the potential to skew the factor to divert income out

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of California. In the *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. (Cal. St. Bd. of Equal., June 2, 1989) the department attempted to correct this problem by requiring the taxpayer to use gross profits rather than gross receipts to reflect these transactions. The SBE did not allow that deviation from the standard formula, stating that FTB had not met their burden of proving that distortion existed. (This case is described in more detail in MATM 7701). As a result of this decision, auditors should allow taxpayers to include gross receipts from dealer sales in the sales factor unless it can be *clearly and persuasively established* that such inclusion would not fairly reflect the taxpayer's activities in California.

Note: The 60/40 and 50/50 splits discussed above *only* apply to the assignment of commission income. The splits do not apply to gain from the sale of securities, interest income, or any other type of income. Gross receipts from the sale of securities should be assigned in full to the state in which the greatest proportion of the income producing activity was performed. For a discussion of what to consider in determining where the income producing activity took place, see MATM 7560.

INTEREST & DIVIDEND INCOME

In addition to the above types of income, stockbrokers will generally have substantial amounts of interest and dividend income. Such income should be assigned to the location where the income producing activity was performed in accordance with the normal rules under R&TC §25136. In order to determine whether an identifiable income producing activity exists and where such activity takes place, the auditor will need to obtain a clear understanding of how each item of intangible income is generated. Some general tips for examining this issue are described in MATM 7560 - MATM 7564. MATM 7560 also discusses the SBE decision in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. (Cal. St. Bd. of Equal., June 2, 1989) where margin interest of a brokerage was determined to be assinged to the state of the originating office.

RENT EXPENSE IN THE PROPERTY FACTOR

If rent expenses incurred for ticker tape machines and display boards are material to the property factor, auditors should ensure that they have been included correctly. Generally, such rental expenses will include two elements. A portion of the payment will represent the rental for the machine itself, and this portion is properly capitalized by eight and included in the property factor. The other portion of the payment represents a charge from the particular exchange for the quotation information. This latter charge is a service, and should be excluded from the factor.

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7805 TELECOMMUNICATIONS COMPANIES

Communications satellites:

Communications satellites located in space are included in the denominator of the property factor in accordance with the normal rules. If the satellite system is directly or indirectly connected to facilities located in California, then satellites will be included in the numerator based upon the ratio of the value of property in California (excluding satellites) to the value of total property everywhere (excluding satellites). For sales factor purposes, the revenues will be included in the numerator based upon the ratio of income producing activities in this state to income producing activities everywhere. The following California Court of Appeals decision contains the authority for this treatment, as well as an example of a sales factor ratio that was considered to be a reasonable measure of the income producing activity.

In *Communications Satellite Corp. v. FTB*, (1984) 156 Cal.App.3d 726, the taxpayer was an operator and part owner of a global commercial communications satellite system. The satellites were in "synchronous" orbit so that they appeared to remain stationary over a fixed point on earth. They were positioned over the Atlantic, Pacific and Indian Oceans, and never passed over California. The system also included earth stations, one of which was located in California. Revenues were generated from the leasing of "half circuits" to communications common carriers. A half circuit is a two-way communications channel between a satellite and an earth station. When combined with another half circuit between the satellite and another earth station, this channel permitted communications to be transmitted between earth stations. The system operated as follows: (1) A communications signal destined for a foreign country or an offshore U.S. point is received at the California earth station from its place of origin in the U.S. through terrestrial facilities owned and operated by communications carriers; (2) The earth station transmits the signal to a satellite in orbit, which in turn transmits the signal to another earth station in a foreign country or an offshore U.S. point; (3) Likewise, communications from foreign countries are received via satellite by the California earth station and are then transmitted to their point of destination in the United States.

PROPERTY FACTOR
The taxpayer only included the California earth station in the numerator, and excluded the value of their interest in the satellite. On audit, FTB included a portion of the value of the taxpayer's interest in the satellite based on the ratio of the value of the taxpayer's interest in property on the ground in California over the value of the taxpayer's interest in property on the ground everywhere. The Court of Appeal agreed with the FTB's treatment, and concluded that there is "an invisible, but apparently continuous and very real connection between the earth station and the satellites. The earth station has a value only because this connection exists, and it is otherwise of no value." Because the taxpayer owned an interest in the satellites, and because the satellites functioned in California at and

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through the California earth station, the Court held that they were tangible personal property owned and used in this state within the meaning of R&TC §25129.

SALES FACTOR
In addition to revenues from the leasing of half circuits, the taxpayer also reported its share of the income from the joint venture that owned the satellite system. The joint venture's revenues consisted of use charges paid by the participants. For numerator purposes, the taxpayer had only included a "ground percentage" of sales attributable to the California earth station. This formula resulted in revenues from the use of satellites being omitted from the numerator of any state. FTB revised the numerator computation to include a percentage of sales everywhere based upon the ratio between the number of half-circuits leased at the California earth station and the number of half circuits the taxpayer leased everywhere. Since the revenue from both the leasing of half circuits and from the share of joint venture income are intrinsically related to the function of the earth stations, the SBE upheld the FTB's calculation as reasonable.

NOTE: The method described in the *Communications Satellite* case differs from the treatment used in the *Appeal of American Telephone and Telegraph Company*, Cal. St. Bd. of Equal., June 29, 1982. The department no longer follows the *American Telephone* SBE decision.

International Transmission Cables:

International transmission cables that cross the high seas are similar to satellites in that they are located (at least in part) outside the jurisdiction of any country, but have value only because of their connection with land-based facilities. Therefore, the department's policy is to apply the "Comsat" method for assigning the value and revenue from such assets to the property and sales factors. Use of this method for the apportionment of non-jurisdictional communications satellites was approved by the California Court of Appeals in *Communications Satellite Corp. v. FTB*, (1984) 156 Cal.App.3d 726 (discussed above). As applied to transmission cables, the formula will operate as follows:

Property Factor: All property is included in the denominator of the property factor under normal valuation rules. Property and cable located within California's three-mile limit will be included 100% in the numerator. The portion of the cable that is located beyond the Outer Continental Shelf will be included in the numerator based upon the ratio of property factor values in California (excluding non-jurisdictional assets) to total property factor values everywhere (excluding non-jurisdictional assets).

Sales Factor: For sales factor purposes, the revenues will be included in the numerator based upon the ratio of income producing activities in this state to income producing activities everywhere. In order to construct a reasonable ratio, the auditor should obtain an understanding of how the income producing activity is conducted. Interviews with taxpayer personnel who are familiar with how the revenues are generated will usually be a good source for this information.

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Telephone Companies:

Other than the problems discussed above with respect to communications satellites and international transmission cables, telephone companies do not present any unique property or payroll factor issues. The difficulties that arise in apportioning income from this industry generally relate to the sales factor. The department's position is as follows:

Revenues from intrastate calls (calls between two California points) will be included 100% in the numerator of the sales factor.

Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call. The rationale for this position is that the operation of the facilities constitutes the income producing activity that generates the revenue. The value of the net plant facilities is the best measure of this activity. Since the "all or nothing" approach provided by the normal rules under R&TC §25136 would not reflect the fact that a market exists at both ends of the telephone call, this allocation is made under the general authority of R&TC §25137 in order to fairly reflect the activities within the state.

When auditing a telephone company, the auditor should request a copy of the reports required to be filed with the Federal Communications Commission (FCC). Such reports will contain information regarding plant values and revenues that will be useful for verifying the apportionment factors. Some blank FCC forms are available on the Internet at http://www.fcc.gov. Auditors may scan the forms and instructions in order to determine the type of information that is reported and the titles of the forms or reports that they want to request from the taxpayer.

Contributions in Aid of Construction:

Contributions in aid of construction (CIACs) are amounts that are received by a utility company to encourage the provision of services to or for the benefit of the person making the contribution. An example of CIACs occurs when new housing developments are started. The utility companies servicing the area will collect a one-time fee from the developers or homeowners to fund construction of facilities to provide power to the new homes. If the ratepayers consume enough power to pay for the construction, then the fees will be refunded. If sufficient power is not consumed, the utility company will keep the fees.

R&TC Section 24324 provides that CIACs are excluded from the gross income of regulated public utilities that provide electric energy, gas, water or sewerage disposal services. This exclusion does not extend to telephone companies. Cases have been noted, however, where telephone companies

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have attempted to exclude such income. If the return contains Schedule M-1 adjustments or state adjustments deducting net CIACs received, those adjustments should be reversed. (Adjustments may also be necessary to allow additional depreciation if the taxpayer reduced the basis of its assets by the amount of the CIACs that it excluded from income -- former §24554.)

Pursuant to R&TC §24325, CIACs made on or after January 1, 1992 will no longer be excluded from the income of any public utility.

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7810 TIMBER

The problem unique to the timber industry is that of valuation of timber tracts in the property factor. CCR §25130(a)(1) provides that owned property shall be valued at its original cost, which is generally federal basis at the time of acquisition, adjusted by any capital improvements and partial dispositions. With respect to timber tracts, the costs are constantly changing as old trees are logged off and new growth takes place. To take the changing value of the timber tracts into account in the property factor, the department interprets the cutting of timber as constituting a partial disposition of the timber property requiring a reduction to original cost basis by an amount equivalent to the depletion adjustment.

An understanding of the basic federal tax treatment versus California's treatment will help the reader to better understand the problem of valuation of timber tracts in the formula and the reasoning behind California's interpretation of original cost for determining the property factor.

Capital Expenditures:

When timberland is purchased, an allocation of the purchase price is made between the land and the timber. The purchase price includes costs of timber cruising, appraisal, land survey, title search and insurance, recording fees, and legal services.

The land account includes the land itself, and depreciable and nondepreciable improvements. Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other structures and improvements. Nondepreciable land improvements include earthwork betterments of a permanent character such as clearing, grading, and ditching of roads with an indeterminable life. Permanent roads for administration, fire access or logging are regarded as partly depreciable to the extent that the bridges, culverts, and graveling may be depreciated over their physical life. Temporary roads, which are abandoned after a logging operation has been completed, are usually expensed when cutting begins.

The timber account is divided into three categories: (1) timber for sale (merchantable timber); (2) young growth; and (3) deferred reforestation. The portion of the purchase price of a timber tract, which is attributed to the timber, is allocated to merchantable timber and young growth. These accounts will also include costs of timber cruising and other expenses directly associated with the timber purchase.

The deferred reforestation account is charged with costs of planting timber. These costs include expenditures for the preparation of the timber site for tree planting or seeding and for the cost of seedlings or tree seeds. Site preparation costs include expenditures for tree girdling, brush or stump removal, and the leveling and conditioning of land to facilitate planting. Other expenses capitalized in

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this account are tool expenses, depreciation of equipment used in planting and the cost of labor employed in tree planting or seeding.

As timber becomes merchantable, the young growth and deferred reforestation accounts are credited, and such amounts are then debited to the merchantable timber account for recovery through timber depletion.

The federal revenue rulings and case law that clarify the rules for capitalization of timber related costs are applicable for California purposes. To the extent that these expenditures have been capitalized, they will be included in the property factor (net of depletion) as part of the cost of the timber tracts.

Timber Depletion:

For taxable years beginning on or after January 1, 1987, California conforms to the federal rules for depletion of timber tracts (R&TC §24831, Treas. Reg. §1.611-3).

At the time timber tracts are purchased, the total quantity of merchantable timber acquired is determined and expressed in board feet, log scale, cords or other units. The quantity of timber is updated each year to (1) deduct the units of timber that were cut in prior years, (2) add the new units that have been acquired, transferred from new growth accounts or gained by growth, and (3) add or deduct any units necessary to correct the estimate of the number of units available in the account. For each year, the basis (total purchase cost and capitalized expenses, less prior year depletion) allocated to the merchantable timber is divided by the total unit quantity of such timber to determine the unit cost (depletion unit).

The number of units of timber cut during the year multiplied by the depletion unit for that timber account shall be the amount of depletion allowable for the year. To establish the basis of the timber when it is sold, the depletion unit for the year in which the timber was cut will be multiplied by the quantity of timber sold.

In addition to the above rules for depletion, California law contains an election under R&TC §24372.5 by which the taxpayer may amortize certain reforestation expenses over a period of 60 months or more. Although depletion due to the cutting of timber will reduce the value of the timber tracts in the property factor, no such reduction is made for R&TC §24372.5 amortization. The reasoning behind this is that the reforestation amortization is based on time and does not relate to the sale or disposition of the property. Consequently, timber will normally be included in the property factor at its net post-depletion federal basis.

Election to Treat Cutting of Timber as a Sale:

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For taxable years beginning on or after January 1, 1987, California conformed to IRC §631(a), which provides an election to treat the cutting of timber as a sale or exchange. In accordance with Treas. Reg. §1.631-1(d)(4), the gain or loss shall be given IRC §1231 treatment (capital gain, ordinary loss) even though the timber might be an inventoriable asset for the taxpayer.

To qualify for the benefits of IRC §631(a), the timber must be cut for sale or for use in the taxpayer's trade or business, and the taxpayer must have owned either the timber or a contract right to cut it for more than one year (six months for property acquired before January 1, 1988). Once the taxpayer makes an election to use IRC §631(a), the election is binding with respect to all timber that the taxpayer owns or has a contract right to cut unless the Commissioner permits revocation of the election.

If IRC §631(a) is elected, the tax effect is as follows:

The cutting of timber is considered to be a sale or exchange of such timber in the taxable year in which it is cut. This provision is based upon the concept of a hypothetical sale of the timber by the taxpayer to itself at the time of cutting.
Capital gain or loss is recognized in an amount equal to the difference between the adjusted basis for depletion of the timber and the fair market value of such timber as of the first day of the taxable year. The fair market value is thereafter considered to be the cost of the cut timber. For example, if the taxpayer is engaged in the manufacture of lumber or other wood products, the fair market value of the timber used to calculate gain at the time of cutting becomes the cost of the timber for purposes of determining the profit or loss upon sale of the lumber or wood product.

The following example will illustrate the application of the above points:

Example: At the start of the taxable year, the taxpayer owned timber with a cost basis of $16,000 and a fair market value of $40,000. During the taxable year, all of this timber was cut. The taxpayer therefore realized a capital gain of $24,000 ($40,000 less $16,000). During the same year, the taxpayer sold all the cut timber for $60,000. The total taxable income from the timber is $20,000 of ordinary income ($60,000 less $40,000) and $24,000 capital gain income. If no timber had been sold during the current year, the basis of the cut timber for future sales would have been $40,000.

For taxable years beginning on or after January 1, 1987, California treatment will be the same as federal with respect to calculating income under a IRC §631(a) election. Since this is effectively a deemed intercompany sale and does not reflect the true market for the timber, the deemed sale price from the cutting of timber should not be included in the sales factor. Although the fair market value of the cut timber at the time of the deemed sale is considered the cost of the cut timber "for all purposes for which such cost is a necessary factor," R&TC §25137 may be used to reflect the original cost basis in the property factor ($16,000 in the above example) in situations where the use of fair market value would be distortive.

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Prior to 1987, California had no provisions similar to IRC §631(a). If all the timber was sold in the year cut, no adjustments to income or factor items would be necessary. To the extent that cut timber was not sold, adjustments would be required to back out the IRC §631(a) income and basis adjustments.

Example: Assume the same facts as in the previous example, but assume that the timber was cut prior to California's conformity with IRC §631(a). If none of the timber was sold in the year in which it was cut, $24,000 of income and sales would need to be removed from the amount reported for federal purposes. In addition, the inventory basis of $40,000 used for federal purposes would need to be reduced to $16,000 for the California property factor.

The election of IRC §631(a) for federal purposes should be apparent on Schedule M-1.

Timber Leases and Cutting Rights:

Long-term cutting agreements exist in many forms, ranging from simple purchase-and-sale contracts to more complicated leases or cutting agreements for a term of years with right or license to the lessee to cut and remove the timber. Such agreements may extend to all the timber on the lands covered in the lease, to trees of certain size classes, or to timber yet to be grown if the agreement covers a sufficiently long period.

Most of the timber companies acquire federal cutting rights from the U.S. Forest Service. The Forest Service advertises the amount of timber to be cut and its fair market value for competitive bid. The stated fair market value of the timber includes an allowance for the cost of logging roads in the tract. The successful bidder is typically required to cut the timber within two years after the cutting contract is awarded. Since no payments are made until the logs are sold or delivered to the mill for cutting into lumber, timber companies are required to post a bond for payment of the bid price when the contract is awarded. The Forest Service cutting lease includes a price index escalation clause, which may increase or decrease the bid price of the timber. This adjustment is made at the time the timber is logged, and is based upon the then current price index for each timber classification.

With respect to the lessee, Treas. Reg. §1.631-2(e) provides that payments for timber or timber cutting rights are a capital expenditure and must be treated as part of the lessee's depletable basis for such timber regardless of whether the payments are designated as rentals, royalties or bonuses. The rationale is that rental payments, taxes, fire protection assessments, and other similar payments to or in behalf of the landowner are payments for future growth and not for the use of land. However, there is a split of authority as to the propriety of this regulation (Union Bag-Camp Paper Co. v. U.S. (5th Cir.), 325 Fed. 2d 730; U.S. v. Regan (9th Cir.), 410 Fed. 2d 744.)

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The inclusion in the property factor of timber acquired or to be acquired under a cutting contract depends upon the nature of the contract. If the contract provides for the purchase of timber for a lump sum, the contract price of such timber or trees will be included in the property factor. If, on the other hand, the purchase contract is the more typical "pay-as-cut" or "no stated value" contract where the seller is to be paid a stated amount per unit harvested and only for the units harvested, title is not deemed to pass until the trees are cut. (U.S. Forest Service and Bureau of Land Management contracts fall into this class.) Until the trees are cut and the exact purchase price can be determined, costs are generally excluded from the property factor. In *Appeal of The Proctor & Gamble Manufacturing Company, et al.* (Cal. St. Bd. of Equal, 9/26/89) however, the SBE determined that inclusion of a value for the entire timberland was warranted. A determination in this area will require an in-depth analysis of the nature of the agreement and the particular facts and circumstances of the case. For a detailed discussion of this issue, see MATM 7138.

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7815 VESSELS SUCH AS TUG BOATS, BARGES, ETC.

The regulations contain special formulas for commercial fishing boats (CCR §25137-5, MATM 7725) and ships engaged in transporting cargo, freight, mail, passengers or similar items (CCR §25101(b), MATM 7760). Other types of sea-going vessels that are not covered by those regulations are discussed in this section. Such vessels include tug boats that service large vessels that enter or leave a California port; dredges that are used in various harbors for repair work; service and repair boats for ocean oil platforms; research vessels used on the ocean for gathering scientific data; and various other types of vessels.

If a bareboat charter or similar charter is deemed to be a lease (see MATM 7137), then the owner of the ship is receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the sea transportation rules will not be applicable to that owner even though the ship may be chartered for use in sea transportation. The owner will include the ship in the numerator of the property factor in accordance with the rules described in below.

The property, payroll and sales attributable to the ocean-going activities of these types of vessels will be included in the numerators of the factors based upon a "port day" ratio. A ratio of California port days to total port days is applied to total property, payroll and sales for each vessel to determine the California portion. Additional detail with respect to calculating the port day ratio may be found in MATM 7725.

The use of the port day method is authorized under the general authority of R&TC §25137, and was approved by the California Court of Appeals in *Luckenbach Steamship Co. vs. FTB*, 219 Cal. App. 2d 710. The court explained that the port day method more clearly reflected the taxpayer's activities than the voyage day method (voyage days are used for sea transportation -- see MATM 7760). The voyage day formula operates as if income were attributable evenly to every location through which the vessel traveled. On the other hand, the port day formula recognizes that the greater part of the income producing activity of the vessels occurs at ports rather than at sea. The port day method attributes the income to the ports where the bulk of the income producing activity takes place rather than to the high seas.

In order to determine whether the port day formula will apply, the auditor must first gain an understanding of the types of activities performed by each of the taxpayer's vessels. For example, a tugboat, which guides large ships in and out of harbors, is very localized. If the tug is located in a California port, then no activity is likely to be outside the three-mile limit and 100% of the property, payroll and revenue related to the tug will be assigned to California.

Scientific ships do research in various ocean areas. If such a vessel is based in California and takes a trip for research in water not subject to any state or country's taxing jurisdiction, then all activity is

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assignable to California. If the vessel does research in waters subject to Mexico's jurisdiction, then time spent in California ports or within the California three-mile limit would be included in the numerator, and port days in both Mexico and California jurisdictions would be included in the denominator.

Vessels involved in offshore oil and gas operations (except for vessels used for transportation of oil which are subject to the voyage day formula -- MATM 7760) must use a modified version of the port days formula that includes time spent on the Outer Continental Shelf in the denominator. This issue is discussed in MATM 7796.

All the above-mentioned vessels should have logs that detail time, location, and activity of the vessels. In addition, taxpayer's apportionment workpapers, general ledger summaries, and property ledgers will aid the auditor in determining the proper apportionment factors.

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7900 INTRASTATE APPORTIONMENT

Even though unitary business income is geographically apportioned on the basis of a combined report, each taxpayer member of a combined group is subject to its own tax liability. The minimum franchise tax and alternative minimum tax are applied on an individual entity basis, as are net operating losses and most tax credits. A taxpayer's nonbusiness income or losses may only be offset against the California business income apportioned to that taxpayer. When separate Notices of Proposed Assessment are issued, each Notice must reflect only the tax deficiency for that particular taxpayer.

Since unitary business income is combined and apportioned on a group basis, it is necessary to further apportion the California income among the taxpayer members of the group. This process is referred to as *intrastate apportionment*. (If any member of the unitary group has sales assigned to the numerator of the sales factor, but is not itself taxable in this state under the immunity of P.L. 86-272, it is also necessary to calculate the relative California factors of the taxpayer members. This computation is described in MATM 7905.)

Effective for cases closed after June 30, 1996, intrastate apportionment schedules showing the separate tax liabilities for all taxpayers in the combined report will generally be required. Exceptions will only be permitted in those cases where the data necessary to compute intrastate apportionment is not readily available, it is unlikely that there will be a future need for determination of separate tax liabilities, and the taxpayer has not requested separately stated tax liabilities. The reasons for not preparing intrastate apportionment computations should be explained in the audit narrative, and the NPA should include a statement indicating that separate tax liabilities will be provided upon request.

The following examples illustrate situations where not preparing intrastate apportionment schedules may be justified:

A single notice applies to more than 10 California taxpayers. There are no NOL carryovers, AMT, tax credits or nonbusiness items. None of the taxpayers have been disaffiliated, and none are suspended or pending bankruptcy. The income levels of the taxpayers makes it unlikely that they will ever be subject to the additional 2% interest on unpaid tax. Separate computations would require substantial audit time. The taxpayers did not report intratstated tax liabilities on their Schedule R-7, and do not now request the computation.
Desk audit activity results in statutory adjustments, and there has been no contact with the taxpayer. There are no NOL carryovers, AMT, tax credits or nonbusiness items. Information available to the auditor does not indicate that any of the taxpayers have been disaffiliated, and none are suspended or pending bankruptcy. The income levels of the taxpayers make it unlikely that they will ever be subject to the additional 2% interest on unpaid tax. This fact pattern may commonly arise with respect to RAR adjustments.

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On many group returns, the self-assessed tax liabilities of each of the taxpayer members are not identified on the Schedule R-7. In order to calculate the additional tax or refund on an intrastate apportioned basis, the auditor will have to:

Intrastate apportion revised net income based upon apportionment data per the audit, and also Intrastate apportion the total previously assessed tax paid by the key corporation based upon the combined report income and apportionment data from the original return as filed.

If the information necessary to intrastate apportion the self-assessed tax is not disclosed in the tax return itself, then the auditor should attempt to reconstruct the intrastate apportionment using the best available information supplied by the taxpayer or obtained during the audit. If the data needed to intrastate apportion the previously assessed tax cannot otherwise be developed, then the previously assessed tax should be credited in a manner, which is reasonable under the circumstances. These procedures are explained in FTB Legal Ruling 95-2. The methodology of FTB Legal Ruling 95-2 was approved by the SBE in the *Appeal of First Pacific Bancorp,* Cal. St. Bd. of Equal., November 9, 1995.

Computation of intrastate apportionment:
The intrastate apportionment computations are explained in FTB Legal Ruling 234 and modified by FTB Notice 1990-3. Basically, combined California business income is divided among corporations having activities in this state in accordance with the ratio that the California factors of each corporation bears to the total factors of the group. If any member of the combined report group has California property, payroll or sales, but is not itself taxable within the state, then the intrastate apportionment computation described in MATM 7905 must be used. However, if all members with California property, payroll and sales are California taxpayers, the following intrastate apportionment computation may be used as a shortcut:

Example: Corporations A, B and C are members of a unitary group. None of the corporations has any nonbusiness income. Assume the following facts:

		(a) **Corp A**	(b) **Corp B**	(c) **Corp C**	(d) **Combined**
Separate income:		100,000	300,000	600,000	1,000,000
Everywhere:	*property*	500,000	64,000	36,000	600,000
	payroll	300,000	74,000	26,000	400,000
	sales	4,000,000	600,000	400,000	5,000,000
California:	*property*	24,000	36,000	60,000	

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payroll	14,000	26,000	40,000
sales	150,000	450,000	400,000

For each taxpayer, divide California property, payroll and sales (columns (a) thru (c)) by combined property, payroll and sales (column (d)):

Property	4%	6%	10%	20%
Payroll	3.5%	6.5%	10%	20%
Sales	3%	9%	8%	
Double-weighted sales	6%	18%	16%	40%
Total property, payroll & double weighted sales	13.5%	30.5%	36%	80%
Average Intrastate Apportionment % (divide by 4)	3.375%	7.625%	9%	20%

Apply each taxpayer's average intrastate apportionment percentage to the combined unitary business income of $1,000,000:

33,750	76,250	90,000	200,000

This represents the income that has been intrastate apportioned to each of the taxpayers.

The PASS audit schedules will perform these calculations.

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7905 INTRASTATE APPORTIONMENT AFTER FTB NOTICE 1990-3

(THE FINNIGAN COMPUTATION)

As discussed in MATM 7530, sales shipped to a California destination from another state may not be thrown back to the state of origin if any member of the combined report is taxable in California. All such sales must be included in the numerator of the California sales factor. The same principle will apply to California property and payroll belonging to an entity that is immune from California tax under P.L. 86-272. For example, an entity may have California payroll attributable to salesperson salaries, but if the activities of the salespeople do not exceed solicitation of orders for sales, then the entity would not be taxable in California (see MATM 1200 - MATM 1240). If any member of the combined report is taxable in this state however, then any property and payroll must be included in the California numerators of the apportionment formula.

Since one or more members of the group may have California property, payroll or sales, but may not themselves be taxable within this state, the intrastate apportionment computation originally devised in FTB Legal Ruling 234 was refined so that no income would be apportioned to the nontaxable entities. The computations that have been developed to deal with this situation are described in FTB Notice 1990-3. Following is an example of the computation:

Example
Corporations A, B and C are members of a unitary group. None of the corporations has any nonbusiness income. Assume the following facts:

		(a) **Corp A**	(b) **Corp B**	(c) **Corp C**	(d) **Combined**
Business income:					1,000,000
Everywhere:	property				600,000
	payroll				400,000
	sales				5,000,000
California:	property	24,000		36,000	60,000
	payroll	14,000		26,000	40,000
	sales	150,000	450,000	400,000	1,000,000

For each taxpayer, divide California property, payroll and sales (columns (a) thru (c)) by combined property, payroll and sales (column (d)):

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Property	4%	0%	6%	10%
Payroll	3.5%	0%	6.5%	10%
Sales	3%	9%	8%	
Double-weighted sales	6%	18%	16%	40%
Total property, payroll & double weighted sales				60%
Average (divide by 4)				15%

Income Apportioned to California (1,000,000 x 15%) 150,000

To compute the relative percentages, only corporations, which are taxable in California, are considered.

			Total
Property Factor %	4%	6%	10%
Payroll Factor %	3.5%	6.5%	10%
Sales Factor % (double weighted)	6%	16%	22%
Total	13.5%	28.5%	42%
Average	3.375%	7.125%	10.5%

Divide each taxpayer's average percent (columns (a) and (c)) by the combined average (column (d)).

Relative Percent	32.1429%	67.8571%	100%

Apply each taxpayer's relative percent to the income apportioned to California of $150,000:

	48,214	0	101,786	150,000

Reviewed: September 2003

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8000 NET OPERATING LOSS

In general, California conforms to IRC §172, modified by R&TC §24416, relating to net operating losses (NOLs). The specific rules for California NOLs have changed over the years however. Prior to 1984, California law did not have a provision for NOLs. From 1984 through 1986, California allowed NOL carryovers in limited situations. These provisions were repealed in 1987. Additionally, most NOLs incurred in 1985 and 1986 were only allowed to be carried over to 1987, 1988 and 1989. The discussion below is limited to NOLs incurred in 1987 and after. If the auditor is examining an NOL that was incurred prior to 1987, the appropriate version of R&TC §24416 should be reviewed.

For California purposes, several different NOL provisions are available. Each NOL has different qualifications, as well as different carryover percentages and periods.

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8010 GENERAL NOL (R&TC §24416)

Prior to 1994, losses incurred after 1986 could be carried forward at 50% for 15 years. Effective January 1, 1994, the carryover period was shortened to 5 years.

The deduction of general NOLs was suspended for taxable years beginning in 1991 and 1992. However, the carryover period was extended:

If the NOL is incurred in taxable years beginning in 1987 through 1990, the NOL can be carried forward two additional years. As such, 1994 is the last year a NOL incurred in 1987 can be deducted as a NOL carryover.

If the NOL is incurred in a taxable year beginning in 1991, the NOL is allowed to be carried over one additional year, until 1997.

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8020 QUALIFIED BUSINESS NOL (R&TC §24416.1)

NOLs incurred from activities conducted in an Enterprise Zone, Program Area, or Los Angeles Revitalization Zone (LARZ) may be carried forward for 15 years at 100%. For years beginning on or after January 1, 1995, losses from business activity in a Local Agency Military Base Recovery Area (LAMBRA) may also be carried forward for 15 years at 100%.

NOTE: Program areas and enterprise zone statutes were repealed, effective the close of the applicable 1996 year end. Previous program areas and enterprise zones were then reenacted as enterprise zones effective for taxable years beginning on or after January 1, 1997. R&TC statutes were renumbered and partially changed. All carryover amounts from program areas and enterprise zone incentives are allowed to be carried over under the new enterprise zone provisions.

NOLs are only allowed for the activities conducted in these areas during the time the location was designated as an Enterprise Zone, Program Area, LARZ, or LAMBRA. A listing of the zones or areas and respective approval dates can be found in FTB Publications 1047 (Enterprise Zones) or 1048 (Program Areas – expired for taxable years beginning on or after January 1, 1997), 1044 (LARZ– expired for taxable years beginning on or after January 1, 1998) or FTB Form 3805Z. Further assistance can be received from the Enterprise Zone Specialist at [(916) 845-3464].

The taxpayer must elect to treat the NOL as a Qualified NOL. Generally, the NOL election must be made on the original return. However, since FTB did not distribute the LARZ forms and booklets until August 1993, the 1992 LARZ NOL election can be made on an amended return. The amended return must have been filed by June 30, 1994. This extension does not apply to the Enterprise Zone or Program Area NOL elections. For years starting in 1993 and after, all LARZ elections must be made on the original return. (FTB Notice 1994-1.)

The amount of the NOL generated in one of the above areas is determined based on the apportionment factor formula. The apportionment factor formula differs for each zone or area, and changes over the years at issue. Reference to the specific section is necessary to determine the correct formula.

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8030 NEW BUSINESS NOL (R&TC §24416(b)(2))

A business that commences in California on or after January 1, 1994 can deduct 100% of the NOL incurred in its first three years of business. The carryover periods are as follows:

1st year's loss carried over 8 years
2nd year's loss carried over 7 years
3rd year's loss carried over 6 years

Legal Ruling 96-5 sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC §24416, relating to net operating losses. In addition, Legal Ruling 99-2 clarifies that a water's-edge election will not limit the computation of the asset test for purposes of the new business NOL, or the gross receipts test for purposes of the small business NOL.

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8040 SMALL BUSINESS NOL (R&TC §24416(b)(3))

NOLs after January 1, 1994 and incurred by businesses with less than $1 million in gross receipts can be carried over at 100% for five years.

If a taxpayer qualifies as both a new business for purposes of R&TC §24416(b)(2) and a small business for purposes of R&TC §24416(b)(3), it will be treated as a new business during the first three years of operation.

If the taxpayer is involved in multiple businesses, the rules relating to new business NOLs will be applied first to any portion of the loss that is from a new business, after which the rules for small business NOLs will be applied to any remaining portion of the loss that is from an eligible small business. If the NOL is greater than the loss incurred by the new business and eligible small business, then the excess will be subject to the normal NOL rules (50% of the loss carried over for five years).

Legal Ruling 96-5 sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC §24416, relating to net operating losses. In addition, Legal Ruling 99-2 clarifies that a water's-edge election will not limit the computation of the asset test for purposes of the new business NOL, or the gross receipts test for purposes of the small business NOL.

Reviewed: September 2003

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8050 NOL FOR MEMBERS OF A COMBINED REPORT

Corporations, which are members of a combined report, must separately compute their share of the NOL using intrastate apportionment rules. Likewise, each member of the combined report will have its own NOL carryover that may only be applied against the income intrastate apportioned to that member in subsequent years. (R&TC §25108; see MATM 7900 for an explanation of intrastate apportionment.) An example of the computations involved in determining and applying an NOL in a combined report is included in FTB Publication 1061, *Guidelines for Corporations Filing a Combined Report*.

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8060 LIMITATION FOLLOWING OWNERSHIP CHANGE

R&TC §24451 conforms to IRC §382, pertaining to the carryover of NOLs after certain ownership changes. Special limits generally apply to NOL carryovers when a corporation has any ownership shifts or equity structure shifts that cause the percentage of stock owned by any one or more "5% shareholders" to increase by more than 50 percentage points over the lowest percentage of stock owned by such shareholders during the testing period (usually three years). The NOL carryover limitation is limited to the corporation's value (fair market value of its stock) immediately prior to the change in ownership, multiplied by the federal long-term tax-exempt rate. (Revenue Rulings are issued monthly to publish this rate. The Revenue Ruling for any given month may be found by looking under "interest" in the index of the Internal Revenue Cumulative Bulletin for the appropriate year.) If this limitation exceeds the taxable income, the next year's limitation amount will be increased by the excess amount.

EXAMPLE
S Corporation has a $10 million NOL. On January 1, 1990, B Corporation buys all the stock of S for $1,000,000. The tax-exempt long-term bond rate on that date is 7.30%. During 1990 S has net income of $2 million. Under IRC §382, B can use only $73,000 ($1,000,000 x 7.30%) of the NOL carryover.

EXAMPLE
Assume the same facts as above, except that S only has $40,000 in income for this example. S can now offset the full $40,000 in 1990 and the limitation for 1991 will increase to $106,000 ($33,000 + $73,000).

The allowable loss will be reduced to zero if the surviving corporation does not continue the "old" corporation's historic business activity for two years after the date of the ownership change.

Note: The IRC §382 limitation applies not only to NOLs, but also to any unrealized built-in losses that exist as of the date of the ownership change. Also, to the extent that the loss corporation has net unrealized built-in gains when the ownership change occurs, the limitation for any one year may be increased by the amount of the built-in gain that is recognized in that year.

This is a very general overview of the IRC §382 limitation, and the actual application of the limitation can become very complex. The federal regulations under IRC §382 are extensive, and auditors should refer to those regulations if issues arise in this area. Auditors should be aware, however, that there are some unique California problems that arise when the federal rules are applied to an apportioning taxpayer.

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Generally, auditors should be alert for IRC §382 issues when a corporation has undergone an ownership change and is deducting NOL carryovers or other losses that are large in relation to the value of the corporation.

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8070 NOL FOR WATER'S-EDGE TAXPAYERS (R&TC §24416(c))

When a water's-edge election is made, the taxpayers sometimes have NOL carryovers that were generated in worldwide years. To the extent that the NOL carryover was generated by a corporation that is not in the water's-edge group due to the water's-edge election, the carryover will not be allowed. To determine whether the NOL carryover is limited, the NOL must be recalculated as if the taxpayer had filed on a water's-edge basis in the year in which the NOL was incurred. Although the carryover may be limited as a result of this recalculation, NOL carryovers cannot be increased based upon a water's-edge recalculation. Examples of the computations necessary to adjust the water's-edge NOL carryover may be found in Chapter 16(c), Water's-Edge Manual.

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8080 RECOMPUTING PRIOR YEAR NOL CARRYOVERS

It has been well established through federal case law that income items may be examined and recomputed in years barred by the SOL in order to determine the correct amount of NOL carryover to apply in a current year. Since California conforms to the federal NOL provisions (IRC §172), the case law interpreting those federal provisions is applicable for California purposes (*Lone Manor Farms, Inc. v. Commissioner*, 61 T.C. 436, 440 (1974), *Phoenix Coal Co. v. Commissioner* [56-1 USTC para 9366], *K.C. Hill v. Commissioner*, 95 TC 437 (1990).). Although there are no citable California cases on point, the SBE has upheld the recomputation of NOLs from closed years in a mini-decision (*Appeal of Eastern Trading & Contracting*, 10/5/94). Therefore, if a material NOL carryover is deducted, the auditor should review prior years, even if barred by statute, to ensure that the income that generated the NOL carryover was reported correctly.

This issue can be material in unitary cases where the method of filing in the prior year is incorrect. An adjustment to the prior years' method of filing may reduce or eliminate the NOL carryover. The auditor should also always take into consideration any prior audit findings when examining the NOL carryover deduction.

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8500 ALTERNATIVE MINIMUM TAX

The Federal alternative minimum tax (AMT) was enacted as a response to perceived abuses of the tax system. Congress believed that many taxpayers with substantial economic income were able to avoid paying income tax by utilizing exclusions, deductions, and tax credits. The Federal AMT is an alternative tax structure that responds to this problem by applying a single rate of tax to a tax base, which is intended to be more representative of "true economic income." It is a tax system unto itself, which is entirely distinct from, and runs parallel to, the regular tax system.

The current federal AMT took effect for tax years beginning in 1987. Effective for taxable years beginning on or after January 1, 1988, California substantially conformed to the federal AMT by incorporating with modifications IRC §55 - IRC §59 (R&TC §23400).

The AMT rules are still evolving, and quite a few changes have been made since the original enactment. When considering issues in this area, auditors should always refer to the law for the particular year they are examining to determine the applicable rules for that year. Since the rules are very specific, the discussion in this manual is intended only to provide a general overview of the major AMT provisions and to point out significant federal/state differences.

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8510 OVERVIEW OF THE AMT MECHANICS

The new AMT provisions create an entire parallel system of taxation that is required to be computed by all corporations with income over $40,000.

The AMT is based on Alternative Minimum Taxable Income (AMTI). The basic calculation of the AMT is as follows:

Basic AMT Calculation	**Discussion:**
Net Income After State Adjustments ± Adjustments + Preference Items = Pre-Adjustment AMTI before ACE Adjustment and NOL	The computation starts with regular California net income after state adjustments. Net income is then reduced or increased by adjustments, and increased by preference items to derive "pre-adjustment AMTI."
Apportionment provisions are applied. = California pre-adjustment AMTI	At this point, the separate AMTI amounts of the members of a unitary group are combined, and apportionment and allocation procedures are applied to derive the California AMTI.
± ACE Adjustment = AMTI before NOL - AMT NOL Deduction = AMTI before Exemption	The ACE Adjustment and AMT NOL are applied on an individual taxpayer basis as explained in MATM 8540.
- Exemption = AMTI	A maximum exemption of $40,000 is allowed for each taxpayer.
x 7% Tax Rate = Tentative Minimum Tax (TMT)	After being reduced by the exemption amount, AMTI is taxed at a 7% rate to derive TMT.
- California Regular Tax = Alternative Minimum Tax	If the TMT exceeds the regular tax, the excess is the alternative minimum tax (AMT).

The AMT for general corporations is the incremental portion of the tentative minimum tax (TMT) that exceeds the regular tax. If the regular tax exceeds the TMT, there is no AMT. This concept can be illustrated as follows:

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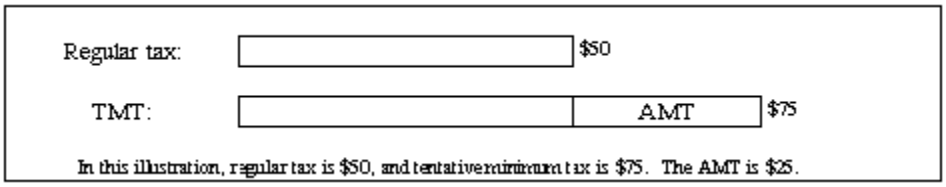

Since AMT is the excess of TMT over the regular tax liability, an increase to regular tax may decrease or possibly eliminate AMT. This is a factor that auditors need to consider when determining the materiality of an audit issue.

Before surveying a return on the assumption that the AMT effect will result in insufficient tax potential however, the auditor and supervisor should consider the fact that the AMT is generally considered a prepayment of tax. In years when the TMT exceeds the regular tax, a minimum tax credit is generated (see MATM 8580). That credit can be carried forward to offset the regular tax in years when the regular tax exceeds TMT. Although increasing the regular tax and reducing AMT may not result in a large tax effect in the current year, the minimum tax credit carried over to subsequent years will be reduced. This may have a substantial effect in future years. Furthermore, by the time that the minimum tax credit is used, the SOL for the year of the income adjustments may have expired. If a timely NPA has not been issued, we may be barred from revising the amount of the minimum tax credit carryover (see MATM 9010).

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8520 ADJUSTMENTS

IRC §56, which California incorporates with modifications in R&TC §23456, requires taxpayers to treat certain items differently in the calculation of alternative minimum taxable income (AMTI) than those items would be treated in the calculation of regular taxable income.

Depreciation: For AMT purposes, most property placed in service after 1986 must be depreciated using the methods described in IRC §56(a). Generally, real property is depreciated using the straight-line method over a specified life. Personal property that has not been depreciated under the straight-line method for regular tax purposes must generally use the 150% declining balance method for AMT purposes, changing to the straight-line method in the first year in which the straight-line method yields a higher deduction. The AMT adjustment is the difference between the depreciation deduction computed under the AMT method and the depreciation computed for regular tax purposes.

Although California adopts this provision without modification, there will usually be federal/state differences in the amount of the adjustment because of differing depreciation methods used for regular tax purposes. Unless the taxpayer has used the straight-line or 150% declining balance method for regular tax, there should always be a depreciation adjustment for AMT.

Basis adjustments in determining gain or loss from sale or exchange of property: For AMT purposes, the adjusted basis of property is equal to the cost of the asset less accumulated AMT depreciation. Obviously, if the adjusted basis is different for AMT purposes than for regular tax purposes, there will be a different gain or loss on disposition. In years where the corporation sells an asset, there should be two adjustments to AMTI, the depreciation adjustment and the gain adjustment [IRC §56(a)(7)].

Mining and exploration and development costs: The federal requirement that certain mining exploration and development costs be amortized for AMT purposes over a ten-year period applies in California only to expenses incurred during taxable years beginning after January 1, 1988 (under federal law, the requirement applies to costs incurred after December 31, 1986) [IRC §56(a)(2); R&TC §23456(a)(1)]

Long-term contracts: The percentage-of-completion method must be substituted for the completed-contract method in the determination of AMTI for any long-term contracts entered into on or after March 1, 1986. For certain small construction contracts, simplified procedures for allocation of costs must be used [IRC §56(a)(3)]. California conforms to this provision without modification. Because of federal/state differences in the effective dates of long-term contract rules for regular tax purposes, there may be some federal/state differences in the amount of the AMT adjustment.

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Pollution control facilities: The five-year depreciation method available under IRC §169 for such facilities must be replaced for AMT purposes by the alternative depreciation system specified under IRC §168(g) (straight-line method, without regard to salvage value) [IRC §56(a)(5)]. Unlike federal law, California law allows the use of the five-year depreciation provision only if the facility is located in California and certified by the State Department of Health Services (prior to 1993) or the State Air Resources Board or State Water Resources Control Board (1993 and subsequent) (R&TC §24372.3). Therefore, federal/state differences may arise in connection with facilities located outside the state. [R&TC §23456(a)(2)]

Installment accounting method: The installment method may not be used in AMTI computations for dispositions of property described in IRC §1221(1). Gains from an installment sale must be recognized in the year of disposition.

Merchant Marine capital construction funds: California does not conform to this adjustment.

Blue Cross Blue Shield Organizations: California law does not provide for this deduction, therefore there is no adjustment for California AMT purposes.

Energy Preferences: From 1990 - 1992, federal law allowed a deduction from AMTI based upon energy preferences (IRC §56(h)). California did not conform to this deduction. (R&TC §23456(f).)

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8530 TAX PREFERENCE ITEMS

California incorporates, with modifications described below, IRC §57, which designates as tax preference items (TPIs) certain items that are accorded favorable tax treatment. Because TPIs have the effect of reducing regular taxable income, the amounts described below must be added back in the computation of alternative minimum taxable income (AMTI):

In the calculation of the AMTI, the following items are considered tax preference items:

Accelerated depreciation or amortization of pre-1987 property: For federal purposes, depreciation on property placed in service before January 1, 1987 is a preference item to the extent that it would have been considered a tax preference item under federal law prior to the 1986 Tax Reform Act [IRC §57(a)(6)]. The preference item will generally be the amount by which accelerated depreciation on real property exceeds straight-line depreciation. California modifies the language of this provision, but also considers depreciation deducted on pre-1987 real property to be a tax preference item to the extent that the amount exceeds the depreciation computed under the straight-line method (R&TC §23457(d)). Because of the differences in accelerated depreciation methods for federal and state purposes, there will usually be a federal/state difference in the amount of the preference item.

Depletion: The excess of the percentage depletion deduction over the adjusted basis of the property at the end of the taxable year is a tax preference item for both federal and state purposes [IRC §57(a)(1); R&TC §23457].

Intangible drilling costs: For both federal and state purposes, tax preference items include the amount by which "excess intangible drilling costs" (as defined in IRC §57(a)(2)(B)) exceed 65% of the taxpayer's net income from oil, gas, and geothermal properties (IRC §57(a)(2); R&TC §23457).

Bad-debt reserves of financial institutions: The amount by which the reserve deduction allowed for regular tax purposes exceeds the amount that would have been allowable on the basis of actual experience is a tax preference item [IRC §57(a)(4)]. For California purposes, this provision affects banks for 1988 through 1990 only, and savings and loan associations for 1988 and thereafter.

Tax-exempt interest: Although interest from specified private activity bonds is added back as a tax preference item for federal purposes, California does not incorporate that federal provision. This is not a preference item for California purposes. [R&TC §23457(a)]

Charitable deduction for appreciated property: For AMT purposes, deductions for charitable contributions of appreciated property are limited to the adjusted basis of the property. For contributions made on or before June 30, 1992 (or December 31, 1992 depending on the type of

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property contributed), if the fair market value of the appreciated property was allowed as a deduction for federal regular tax purposes, then a federal preference item would be required to add back the amount of the deduction that exceeded the adjusted basis of the property (IRC §57(a)(6)). California law is more limited than federal law with respect to allowing charitable deductions that exceed the adjusted basis of the contributed property. As a result, the California AMT add-back of excess charitable deductions may not be required, or may be smaller than the federal add-back.

The federal preference for contributions of appreciated property was repealed for contributions made after June 30, 1992 (or December 31, 1992). The repeal was pursuant to P.L. 103-66, which was not enacted until August 1993. California conformed to the Internal Revenue Code as it existed on January 1, 1993 until 1997. Then, for taxable years beginning on or after January 1, 1997, R&TC §23457 was revised to specifically include excess deductions for contributions of appreciated property as a preference item. Therefore, for California purposes, excess contributions of appreciated property are and have continued to be a preference item.

Capitalization of certain costs: IRC §59(e) provides for an optional amortization period for certain items that would ordinarily be tax preferences. If taxpayers make this election, then the items will not be not be treated as tax preference items under IRC §57(a), and no AMT adjustments under IRC §56 will be required. For corporations, these items include mining exploration and development costs and intangible drilling costs. (R&TC §23459.)

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8540 APPORTIONMENT & ALLOCATION OF PRE-ADJUSTMENT AMTI

The result of adjusting net income or loss after state adjustments by AMT adjustments and tax preference items is the Pre-Adjustment AMTI before BURP/ACE adjustments and NOL.

Generally, the calculation of AMTI must incorporate the same concepts used in the calculation of regular California taxable income. Furthermore, AMTI may consist of both business and nonbusiness amounts. The pre-adjustment AMTI of the members of a combined group must therefore be combined, allocated or apportioned to California, and intrastate apportioned to each member in the same manner as is regular taxable income. These computations may be performed by running pre-adjustment AMTI through the Schedule R, or through computerized audit schedules that will calculate the apportionment. An example of the necessary computations may also be found in the FTB Publication 1061, *Guidelines for Corporations Filing a Combined Report.*

The apportionment factors used to apportion pre-adjustment AMTI should reflect AMT rules, and this may create factor differences if the taxpayer has significant long-term contracts, installment sales, or intangible drilling costs.

When performing the allocation and apportionment computations, remember that the amount of any nonbusiness income or loss for AMT purposes should include any increases or decreases for tax preference or adjustment items, such as accelerated depreciation directly related to such income. For regular tax purposes, nonbusiness income or loss allocable outside California is not included in the tax base, and the same holds true for AMT purposes. Once the apportionment and allocation computations are performed, only the California AMTI will remain.

In addition to apportioning and allocating AMTI to California, AMTI must be intrastate apportioned among each of the California taxpayers using the computations described in MATM 7900 and in the FTB Publication 1061. From this point on, the AMT calculations will be made on a taxpayer-by-taxpayer basis. Each taxpayer in the combined report will calculate its own ACE adjustment, AMT NOL, exemption amount, AMT liability, and tax credits.

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8545 BOOK UNTAXED REPORTED PROFITS (BURP) ADJUSTMENT

For taxable years beginning in 1988 or 1989, AMT included a Book Untaxed Reported Profits (BURP) adjustment (IRC §56(f); R & TC §23456(d)). (Beginning in 1990, the BURP adjustment was replaced by the ACE adjustment; see MATM 8550.) The BURP adjustment is an inclusion of net income from the corporation's financial earnings rather than just a modification of an item on the tax return. This concept was influenced by publicity of major corporations paying no income taxes in years when they reported substantial earnings.

The BURP adjustment increases taxable income by 50% of the excess of adjusted net book income (ANBI) over AMTI. The BURP adjustment may never decrease AMTI. The computations involved in making the adjustment are as follows:

	Net Book Income per Applicable Financial Statements
±	Adjustments to Book Income
=	Adjusted Net Book Income (ANBI)
-	Taxable Income after certain AMT adjustments
=	Difference
X	50%
=	BURP adjustment

Net book income is the starting point in the computation and is defined in Treas. Reg. §1.56-1(b). The term generally means the income or loss reported in the "Applicable Financial Statement." Net book income must include all items of income, expense, gain or loss for the taxable years (whether or not such items were recognized for tax purposes), including extraordinary items, results from discontinued operations and cumulative adjustments resulting from accounting method changes. IRC §56(f) (3) provides the definition of the applicable financial statements, and provides an order of priority for use in determining which financial statement to use.

The adjustments required to compute the adjusted net book income are listed in IRC §56(f), as modified by R&TC §23456(d).

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8550 ADJUSTED CURRENT EARNINGS (ACE) ADJUSTMENT

For taxable years beginning on or after January 1, 1990, the BURP adjustment is replaced by the Adjusted Current Earnings (ACE) adjustment. Like the BURP adjustment, the ACE adjustment is also intended to make AMTI more representative of economic income. The ACE adjustment is computed by adjusting the pre-adjustment AMTI by 75% of the difference between "adjusted current earnings" and pre-adjustment AMTI. The adjustment follows this formula:

	Adjusted Current Earnings
-	Pre-adjustment AMTI
=	Difference
X	75%
=	ACE adjustment

Unlike the BURP adjustment, which may only increase AMTI, an ACE adjustment may either be positive or negative. If adjusted current earnings are greater than pre-adjustment AMTI, a positive adjustment will result; if adjusted current earnings are less than pre-adjustment AMTI, the adjustment will be negative. Negative ACE adjustments are limited however, and will only be allowed to the extent that the corporation's aggregate positive ACE adjustments in prior years exceeded that corporation's aggregate negative adjustments in prior years. Negative adjustments that are not allowed in one year due to this limitation cannot be carried over to any other taxable year.

The ACE adjustment must be made on a post-apportionment basis, and is calculated for each taxpayer in a combined group. To perform this calculation, pre-adjustment AMTI is combined, apportioned or allocated to California, and intrastate apportioned to each taxpayer as described in MATM 8540. Adjusted current earnings are also combined, apportioned or allocated to California, and intrastate apportioned to each taxpayer in the same manner. Each taxpayer in the combined group then calculates its ACE adjustment by comparing its share of California pre-adjustment AMTI with its share of California adjusted current earnings. An example of this computation can be found in the FTB Publication 1061, Guidelines for Corporations Filing a Combined Report.

Adjusted Current Earnings
To derive "adjusted current earnings," pre-adjustment AMTI is modified by the adjustments listed in IRC §56(g)(4) and R&TC §23456. The adjustments necessary to compute adjusted current earnings are as follows:

Depreciation
California adopted the federal ACE depreciation adjustments specified in IRC §56(g)(4)(A), with certain modifications (R&TC §23456(e); R&TC §23456(g) beginning in 1994). Generally, the straight-line method must be used to compute depreciation for ACE purposes. The depreciable basis and the

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recovery period will vary depending upon when property was placed in service. The adjustment required is the difference between the depreciation allowable for ACE purposes and the depreciation allowable for alternative minimum taxable income purposes.

For ACE purposes, the adjusted basis of property must reflect the depreciation allowable under the ACE rules. [IRC §56(g)(4)(I)]

Inclusion of Items Included in Earnings & Profits
Generally, IRC §56(g)(4)(B) provides that adjusted current earnings shall include all income items which are not taken into account in determining pre-adjustment AMTI but which are taken into account for E & P purposes. Treasury Regulation 1.56(g)-1(c)(6) provides a partial list of these items.

Federal/state differences may occur due to differences in the way that items are reported for regular tax purposes. For example, interest on state and local bonds is generally excludable from federal AMTI, but is an adjustment for federal ACE purposes because it is included in earnings and profits. For California purposes, only interest from California obligations is excludable from AMTI. Therefore, the California ACE addback may differ from the federal addback. In addition, if a corporation is subject to the corporate income tax rather than the franchise tax, R&TC §23456(f)(4) provides that the amount of interest income included in adjusted current earnings may not exceed the amount included for purposes of the regular tax.

Disallowance of Items not Deductible in Computing Earnings and Profits
IRC §56(g)(4)(C) provides that adjusted current earnings may not be reduced by deductions not allowable against E & P, even if the deductions were taken into account in determining pre-adjustment AMTI. California law modifies the federal provisions as follows:

California does not follow the federal provisions relating to dividend deductions. Instead, California allows dividends to be deducted from adjusted current earnings in accordance with the dividend deductions allowed for regular tax purposes. (R&TC §23456(f)(1)).

California's interest offset rules (R&TC §24344) must be applied in determining the amount of interest deductible for purposes of adjusted current earnings. In addition, no deduction from adjusted current earnings will be allowed for interest expense allocable to income that has not been included in the measure of tax (R&TC §24425). (R&TC §23456(f)(4).)

Intangible Drilling Costs, Circulation and Organizational Expenses
For ACE purposes, these expenses are required to be capitalized rather than currently deducted. Since there may be federal/state differences in the treatment of these items for regular tax purposes, there may be differences in the amount of the adjustment required for ACE.

Depletion

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For any property placed in service in a taxable year beginning after 1989, the depletion deduction for ACE purposes must be computed under the cost depletion method. (An exception is made for independent oil and gas producers and royalty owners.)

Other Adjustments Required to Compute Adjusted Current Earnings
In addition to the adjustments summarized above, IRC §56(g)(4) requires adjustments related to life insurance contracts, LIFO inventory adjustments, installment sales, exchanges of debt pools, and certain ownership changes.

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8560 AMT NOL DEDUCTION

The key features to remember about AMT net operating losses (NOLs) are:

AMT NOLs must be computed on the basis of AMTI; and
an AMT NOL deduction may not offset more than 90% of the AMTI for any taxable year.

In other respects however, the computation of the AMT NOL is subject to the same rules and limitations as regular tax NOLs (i.e., the 50% limitation, water's-edge NOL limitations, IRC §382 limitations, etc.; see MATM 8000). As with regular tax NOLs, each taxpayer in a combined group must apply its separately apportioned or allocated share of California AMT NOL to its apportioned or allocated share of AMTI.

NOTE: Taxpayers often forget to apply the 50% California NOL limitation to AMT NOLs, or forget to limit the AMT NOL to 90% of AMTI. Since these are fairly common mistakes, auditors should be especially careful to review taxpayers' AMT computations for these issues.

The federal AMT NOL provisions are IRC §56(a)(4) and IRC §56(d). California conforms to those provisions, but modifies the applicable dates pursuant to R&TC §23456(c)(1). Legislation in 1994 added R&TC §23456(d) to clarify how California's NOL rules for apportioning taxpayers interact with the AMT rules.

Since NOLs arising from tax years beginning before January 1, 1988 cannot be based upon AMTI, former R&TC §23456(c)(2) provided rules for determining the amount of AMT NOL to carry forward from those years.

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8565 EXEMPTION AMOUNT

California incorporates IRC §55(d), which exempts the first $40,000 of alternative minimum taxable income from the alternative minimum tax. The exemption amount is reduced (but not below zero) by an amount equal to 25% of the amount by which the AMTI of a corporate taxpayer exceeds $150,000. The exemption is zero if the AMTI is greater than or equal to $310,000. (R&TC §23455)

Each California taxpayer in a combined group has its own $40,000 exemption, and applies its own $150,000 limitation. The exemption and limitation are applied against the California AMTI apportioned and allocated to that taxpayer.

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8570 TENTATIVE MINIMUM TAX

For general corporations, the tentative minimum tax is 7% of that portion of the taxpayer's alternative minimum taxable income (AMTI) that exceeds the exemption amount (R&TC §23455(a)). Corporations with valid S-Corporation elections are not subject to the AMT.

The tentative minimum tax (TMT) is compared to the taxpayer's regular tax. For purposes of this comparison, the "regular tax" is defined as the corporation franchise tax, the corporation income tax, or the tax on the unrelated business income of an exempt corporation. The comparison is made before the application of any tax credits.

If the TMT exceeds the regular tax, the difference is the Alternative Minimum Tax. Notwithstanding tax credits, the taxpayer is effectively required to pay the higher of the TMT or the regular tax for the taxable year.

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8575 INTERACTION WITH TAX CREDITS

Once the tentative minimum tax (TMT) and alternative minimum tax (AMT) have been determined, then any tax credits may be applied. Most tax credits are not allowed to reduce the tax liability below the TMT amount. Only certain credits may reduce the regular tax below the TMT amount, and only carryovers from certain repealed versions of the solar energy credit are allowed to offset the AMT.

The credits that are allowed to reduce the tax liability below the TMT are listed in R&TC §23036. That section also provides the ordering rules for applying credits. Those rules are also discussed in MATM 9010.

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8580 ALTERNATIVE MINIMUM TAX CREDIT

To the extent that a taxpayer's TMT exceeds the regular tax, a Minimum Tax Credit (MTC) is generated. The MTC may be carried forward and applied against the regular tax in a year when regular tax exceeds TMT. The amount of MTC that can be applied in any one-taxable year is limited because the MTC cannot reduce regular tax below the TMT, but any unused MTC can be carried forward indefinitely. (IRC §53, R&TC §23453.)

The MTC reflects the intent of Congress for the alternative minimum tax system to be largely a pre-payment of tax. Many AMT adjustments are timing adjustments or deferrals that will turn around in subsequent years. The theory is that if taxpayers pay AMT on an item, they will be allowed a benefit in the subsequent year when the item results in a smaller deduction for regular tax purposes than for AMTI. In fact, for 1988 and 1989, a MTC was only generated to the extent that the AMT resulted from deferral items. For taxable years beginning on or after January 1, 1990, the MTC was expanded to apply whether the AMT was due to deferral items or permanent differences.

Minimum Tax Credits Generated in 1988 and 1989:

For 1988 and 1989, the MTC could only be generated to the extent that the AMT resulted from deferral items. Permanent items such as the preference items for depletion and appreciated property charitable contributions would not produce any MTC. If the normal AMT computation resulted in an AMT liability (TMT exceeds regular tax), a "with and without" computation was required to identify the portion of the AMT that was not due to deferral items.

Example: Assume that in 1989, the taxpayer has regular taxable income of $3,000,000 and has a regular tax liability of $279,000. The taxpayer's AMT preference and adjustment items are as follows:

Depletion (permanent item)	$ 1,250,000
Accelerated Depreciation	750,000
Mining Exploration and Development Costs	2,000,000
Total AMT Preferences/Adjustments	$ 4,000,000

Tentative Minimum Tax [$3,000,000 + $4,000,000) x 7%]	$ 490,000
Regular Tax	279,000
AMT	$ 211,000

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Question: How much of the $211,000 AMT amount is available for carryforward as a MTC?

Answer: $192,500, the AMT less the AMT computed with only permanent items:

TMT computed with only permanent items ($3,000,000 + 1,250,000) x 7%)	$ 297,500
Regular Tax	279,000
AMT generated solely by permanent items	18,500
AMT computed with all items	211,000
Difference: AMT attributable to deferral items	$ 192,500

Minimum Tax Credits Generated After 1989:

For taxable years beginning on or after January 1, 1990, the MTC for corporations is no longer limited to deferral items (IRC §53(d)(1)(B)(iv)). The MTC may now be produced by the entire amount of AMT. If the facts of the previous example had occurred in 1990, the MTC generated would have been $211,000.

Application of MTC carryover:

The following example will illustrate how the MTC carryover is applied:

Example: The first year in which the taxpayer's tentative minimum tax exceeded its regular tax was 1990. Assume the following facts for 1990 and 1991:

	1990	**1991**
Tentative Minimum Tax	147,856	120,000
Regular Tax	54,928	140,000
AMT	92,928	--

Since the TMT exceeded the regular tax, a minimum tax credit of $92,928 was generated in 1990.

In 1991, regular tax exceeded TMT by $20,000. Assuming that the taxpayer has no other tax credits, $20,000 of the MTC may be applied in 1991 to reduce the regular tax liability to $120,000. The remaining $72,928 MTC will be carried forward to subsequent years.

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9000 TAX CREDITS

Once the proper tax rate is applied to California net income, tax credits are subtracted in determining the proper tax under California law. The rules for determining tax credits are very detailed, and frequently the rules will change from year to year. An in-depth discussion of the specific rules for each credit is beyond the scope of this manual. Instead, this section of the manual is intended only to provide a general overview of many of the available credits. Auditors examining tax credits should always refer to the specific statute for the credit and the year involved.

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9010 GENERAL INFORMATION

Tax credits must reduce tax in the following order (R&TC §23036(c)):

- Credits, which can not be carried over
- Credits, which can be carried over
- Alternative Minimum Tax credit (see MATM 8580)
- Credits for taxes withheld.

Credits cannot reduce tax below the minimum franchise tax. Additionally, only the credits specifically listed in R&TC §23036(d)(1) may reduce regular tax below the tentative minimum tax, and then only after the alternative minimum tax credit has been allowed. The only credits that are allowed to reduce AMT are carryovers of the solar energy credit provided by R&TC §23601 (repealed effective January 1, 1987) and the commercial solar energy credit provided by R&TC §23601.4 (repealed effective December 1, 1989).

Generally, the amount of credit that exceeds the minimum franchise or the tentative minimum tax may be carried over to offset tax in subsequent years. A credit may be carried over regardless of whether the statute providing for the credit has expired or been repealed.

Unless otherwise specified in the statute, tax credits may be claimed only by the taxpayer incurring the cost (*Appeal of AeroVironment, Inc*., Cal. St. Bd. Of Equal., January 10, 1997 and *Appeal of Guy F. Atkinson Company,* Cal. St. Bd. Of Equal., March 19, 1997)(The California Superior Court has heard the Guy F. Atkinson case and has also ruled in favor of the FTB. The decision is currently being appealed to the next level.). As of January 1, 1992, if two or more taxpayers share in the costs, then each taxpayer may claim the tax credit in proportion to the costs paid or incurred. (R&TC § 23036(g))

Unless specifically stated otherwise (i.e., low-income housing, Enterprise Zone wage and LAMBRA wage credits), corporations that are members of a combined unitary group must compute credits and apply the credit carryovers on a separate basis. The auditor should determine the allowable tax credits of a combined taxpayer through intrastate apportionment. (See MATM 7900 for an explanation of intrastate apportionment.)

SOL Considerations for Credit Carryovers:

By the time that a credit carryover is used, the statute of limitations has often expired for the prior year in which the tax credit was generated. An expired SOL will not bar the auditor from examining the prior year credit in order to determine the affects on the open years. Therefore, if a material credit

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was not thoroughly reviewed in the year that it was generated, it should be reviewed in the year that the carryover results in a tax effect.

On the other hand, once the SOL has expired for a particular year, income from that year may not be recomputed to reduce the amount of tax credit available to be carried forward. R&TC §19043.5 (effective January 1, 2002) eliminated adjustments to credit carryovers from the definition of "deficiency", thereby, eliminating the need to issue zero-balance NPA's. R&TC §19043.5 provides that instead of issuing zero-balance NPA's, FTB may mail to the taxpayer a notice of proposed carryover adjustmentformerly 25662.1(b)(3)) provides that adjustments to income are deemed to be deficiencies to the extent that they reduce the amount of credit available to be carried forward, even though there may be no tax effect in that year. Those adjustments must therefore be reflected on a zero-balance NPA issued prior to the expiration of the SOL.

Reviewed: December 2002

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9020 ALCOHOL FUEL DEVICE CREDIT (R&TC §23603)

For years 1982 through 1990 a credit is allowed for converting a car or truck to use alcohol fuel, consisting at least 85% methanol or ethanol. There is no comparable federal provision. The auto must be registered in California. The credit is equal to 55% of the cost of conversion and is limited to $1,000 per vehicle. The credit cannot reduce tax below the tentative minimum tax. The credit may not be carried over to subsequent years.

Reviewed: December 2002

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9030 CHILD CARE CREDIT (R&TC §23617 & R&TC §23617.5)

Since 1988 California has allowed two separate credits for employee child care expenses: the credit for start-up costs and referral service fees and the credit for contributions to a child care plan. Both credits apply to costs incurred on or after September 23, 1988. Both may be carried over indefinitely, but cannot reduce the tax below the tentative minimum tax. There are no comparable federal credits.

Reviewed: December 2002

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9032 Start-Up Costs & Referral Service Fees (R&TC §23617)

For years 1988 through 1997, employers may take a credit for establishing a childcare program or facility or contributing to a California childcare information and referral service for the benefit of their employees. In addition, for years beginning after January 1, 1993, owners of commercial buildings may claim a tax credit for the above-mention childcare services that they provide to the employees of the tenants of their buildings. In any event, the facility must be in California and either on-site or near-site.

The credit is equal to 30% of the start-up expenses. The amount of credit, including any carryover amount, claimed against tax in any year cannot exceed $50,000. Legal Ruling 93-2 contains several situational examples that provide clarification of the credit limitation and carryover amounts in each year.

Any business expense deductions for which the taxpayer would otherwise be eligible must be reduced by the amount of the credit. Alternatively, the taxpayer may elect to take depreciation instead of a credit.

Reviewed: September 2003

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9034 Contributions To A Child Care Plan (R&TC §23617.5)

For years 1988 through 1997, a credit for contributions, on behalf of employees, to a qualified child care plan for care of the employees' dependents is allowed. However, after 1994 there were several changes to the credit provisions. The auditor should refer to the appropriate version of R&TC §23617.5 when reviewing this credit.

Prior to 1995, the credit is equal to 50% of the contribution, limited to $600 per dependent. After 1994 the credit is calculated at 30% and limited to $360 per dependent. To qualify for the credit in years 1988 through 1994, the dependent must be no more than 15 years old. The age limitation was lowered to 12 years for years after 1994.

Before 1995, a contribution may either be a direct payment to the childcare provider and/or a reimbursement payment to the employee. Legal Ruling 93-1 states employer contributions include amounts designated by an employee in salary reduction agreements, even though the amount is excludable from the employee's taxable income. However, the credit is limited to the amounts contributed to the childcare program. For years after 1994, the contribution must be only a direct payment to the childcare provider.

Other requirements are:

- The facility must be located in California and licensed, if required. The employee's spouse, dependent or children under the age of 19 may not provide childcare.
- No credit is allowed to the extent that the sum of the employer's contributions plus the employee paid fees exceed the total cost of providing care.
- If the contributions are used at a facility owned by the employer, the basis of the facility must be reduced by the amount of the credit.
- A business expense deduction is not allowed for the amount of the credit.
- If two or more taxpayers share the costs eligible for the credit, each taxpayer is eligible to receive a tax credit with respect to its respective share of the costs paid or incurred (R&TC §23617(d)).

Reviewed: December 2002

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9040 CLINICAL TESTING (ORPHAN DRUG) CREDIT (R&TC §23609.5)

For years 1987 through 1992 California allows a credit for the cost of clinical testing and development of (orphan) drugs for rare diseases. California basically conforms to IRC §28, with the following exceptions:

- The clinical testing must be performed in California
- California allows a credit of 15% of the clinical testing expenses; federal law allows 50%.
- Carryover of the credit is allowed for California purposes

Deductions for corresponding expenses must be reduced by the amount of the credit claimed. (R&TC §24440.)

The credit is allowed to reduce tax below the tentative minimum tax.

Reviewed: September 2003

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9050 DONATED AGRICULTURAL PRODUCTS CREDIT (R&TC §23608)

For years 1989 through 1991 a credit is allowed for agricultural products, which are donated to nonprofit organizations. The credit is equal to 10% of inventory costs, defined under IRC §263A and includes farming operations.

The nonprofit organization is required to provide the taxpayer a certificate containing the donor's name, the type and quantity of product donated and the donee's name and address. The auditor should request this certificate when examining the credit.

The taxpayer must reduce any deduction that would otherwise be allowed by the amount of the credit claimed. Since there is no comparable federal credit, a state adjustment may be required. (See MATM 6055.)

The credit may not reduce tax below the tentative minimum tax, but may be carried forward until exhausted.

Reviewed: December 2002

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9060 ENTERPRISE ZONE AND PROGRAM AREAS CREDITS

Since 1984 specific Wage and Sales & Use tax credit provisions have been enacted to stimulate development and employment in selected areas in California. Enterprises Zones (zones) are economically depressed areas. Program Areas (areas) are locations with high levels of unemployment.

The credits may only be claimed for operations after the zone or area has received final approval. Locations have been designated as zones and areas on different dates throughout the years; therefore the auditor should verify the date of designation.

The credits are limited to the tax on taxpayer's business income attributable to the business operations located within the zone or area. If the business is located both within and outside of, or in more than one incentive area, the taxpayer must determine the portion of income or loss of its business operations attributable to the enterprise zone or program area. For taxable years beginning before January 1, 1991, this income is determined by multiplying the worldwide business income by the standard three-factor formula. For taxable years beginning on or after January 1, 1991 through taxable years ending on or before December 31,1996 a two-factor formula of payroll and property is applied. For taxable years beginning on or after February 1, 1996, (1996 fiscal year taxpayers, 1997 calendar year taxpayers) business income of the incentive area will be apportioned by use of the four-factor apportionment formula. For taxable years beginning on or after January 1, 1998, business income is apportioned to the zone by multiplying the taxpayer's total California source business income by a two-factor formula of property and payroll. For corporations filing a combined report, the taxpayer's California source business income is the intrastated California business income of the corporation operating within the zone. Both credits can reduce tax below the tentative minimum tax for years 1993 and after. The unused amounts may be carried over to future years.

Program areas and enterprise zone statutes were repealed, effective the close of the applicable 1996 year end. Previous program areas and enterprise zones were then reenacted as enterprise zones effective for taxable years beginning on or after January 1, 1997. R&TC statutes were renumbered and partially changed. All carryover amounts from program areas and enterprise zone incentives are allowed to be carried over under the new enterprise zone provisions.

A listing of the zones or areas and respective approval dates can be found in FTB Publications 1047 (Enterprise Zones), 1158 (for taxable years beginning on or after January 1, 2001) or 1048 (Program Areas – expired for taxable years beginning on or after January 1, 1997) or Form FTB 3805Z. On October 14, 2001, a portion of the Mid-Alameda Corridor enterprise zone, City of Lynwood, expired. All other enterprise zones, or portions thereof received approval for a five-year extension period.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: January 2004

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9062 Hiring Credit

(R&TC §23622 And R&TC §23623 – Both §'S Repealed For Taxable years Beginning On Or After January 1, 1997)(R&TC §23622.7 Enacted For Taxable years Beginning On Or After January 1, 1997)

Businesses operating in either a zone or area may claim a credit for a portion of the wages paid to qualified disadvantaged individuals. The credit provisions (i.e., qualified individuals) differ depending on whether the business is in a zone or area. Furthermore, for years after 1994, the definition of "qualified disadvantaged individual" for an Enterprise Zone credit was broadened. Prior to 1995 individuals are required to be in a state or federal jobs program. Beginning in 1995, individuals must only be eligible for the programs. The auditor should refer to the appropriate code sections when reviewing this credit.

To determine if a specific employee qualifies the taxpayer for the credit, the auditor should obtain the information listed below on each employee.

- Unemployment history, if a program area
- Address of employee, if a program area
- Date of employment
- Amount of wages paid
- Description of duties performed
- Location of employment
- Voucher

For enterprise zones, a qualified employer is one that has obtained and retained a voucher to certify that their employee meets any one of the qualifying criteria. Failure to obtain the voucher results in the taxpayer not meeting all the qualifications of a qualified taxpayer eligible for the hiring credit.

Generally, the amount of the credit is 50% of qualified wages in the first year after commencement of the employment, 40% in the second year, 30% in the third year, 20% in the fourth year, and 10% in the fifth year. The percentage is applied to the lesser of the actual hourly wage or 150% of the minimum hourly wage. For example in 1994, the maximum wage the credit could be based on is $6.37 (150% of $4.25).

The amount of either credit must be reduced by the Jobs Credit (R&TC §23621) or the federal Target Jobs credit (through 1995) (IRC §51) or the Work Opportunity Credit (beginning in 1997) (IRC §51). The business expense deduction for wages under R&TC §24343 (IRC §162) must be reduced by the amount of the credit allowed. A state adjustment will result since there is not a comparable federal credit. (See MATM 6057)

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If an employer terminates an employee within 270 days of employment, credits previously claimed will be recaptured as additional tax in the year of termination. There are several termination exceptions, therefore, the auditor should consult the statute when examining this issue.

The Program Area and Enterprise Zone credits may be carried over until exhausted

Regarding the Enterprise Zone Hiring Credit: All employees of corporations that are members of the same controlled group are considered employed by a single employer. As such, the credit allowed to each member is determined by its proportionate share of qualified wages. (R&TC §23622(e); R&TC §23622(f) after 1994)

Reviewed: December 2002

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9064 Sales & Use Tax Credit

(R&TC §23612 – Repealed For Taxable years Beginning On Or After January 1, 1997)(R&TC §23612.2 – Enacted For Taxable years Beginning On Or After January 1, 1997)

The amount of sales or use tax paid on the purchase of qualified machinery or parts used in an Enterprise Zone or Program Area may be allowed as a credit against tax. The machinery must be used only within the designated zone or area. The credit is allowed for the tax paid on the first $20 million of the machinery cost. The auditor should verify the type of property purchased, the amount of sale or use tax paid, and the location where the property was used.

The credit is only allowed on out-of-state purchases when machinery of a comparable quality and price was not available in California. The auditor should have the taxpayer substantiate that attempts were made to purchase comparable machinery in California.

If the credit is claimed, the sales or use tax paid may not be included in the basis of the machinery. Unused credit may be carried over until exhausted.

Reviewed: December 2002

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9070 JOBS TAX CREDIT (R&TC §23621)

Since 1979, California law has allowed a credit for wages paid to employees in specified disadvantaged and disabled categories. R&TC §23621 is generally similar to IRC §51 with the following exceptions:

California's credit amount is equal to 10% of qualifying wages in the first two years of employment. The federal credit is 40% of the first years wages. There is no federal credit in the second year.
California limits the credit to $600 per employee and total qualifying wages of $3,000 per year. The aggregate federal limit is $6,000.
California has a narrower list of categories of qualified employees.
The California credit cannot be claimed if the employee begins work after December 31, 1993. For federal purposes the credit expires December 31, 1994.
The California credit is in addition to other deductions to which the taxpayer is entitled. However, an employer who claims this credit cannot also claim an Enterprise Zone, Program Area or Los Angeles Revitalization Zone credit for the same wages. (See MATM 9062, MATM 9092 & MATM 9094.)

The employer must have received certification from the Employment Development Department (EDD) or made a written request to the EDD for certification prior to the date the employee begins work. The auditor should request the certification and verify the dates. The credit is not allowed for wages paid prior to the contact with EDD or if the certification is revoked.

The credit does not apply to wages paid to any employee who is a dependent of the corporation's 50% or more owner. Also, the credit may not be claimed for payments made for services provided during labor disputes. The credit may not reduce tax below the tentative minimum tax. There is no provision in the statute for a carryover of this credit.

Reviewed: December 2002

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9080 LOCAL MILITARY AGENCY BASE RECOVERY CREDIT

In an effort to encourage employment in certain military base areas, specific locations have been designated as Local Agency Military Base Recovery Areas (LAMBRA). Two credits (Sales or Use Tax Credit and Hiring Credit) have been established for LAMBRA businesses.

To qualify for either credit the LAMBRA business must have a net increase of one employee in a LAMBRA during the first two years. At the end of the second year, if the number of employees has not increased, the credit previously claimed will be added to the second year's tax.

The amount of either credit (or both, if applicable) may not exceed the amount of tax on the enterprise zone or program area business income in any year. If the taxpayer qualifies for any other type of Sales or Use Tax Credit or Hiring Credit due to the business overlapping with another designated zone (i.e. Targeted Tax Area and LAMBRA), the taxpayer may claim only one Sales or Use Tax Credit and one Hiring Credit.

The LAMBRA credits cannot reduce tax below the tentative minimum tax.

For further details regarding economic development area tax incentives, refer to the Economic Development Areas Audit Manual.

Reviewed: December 2002

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9082 Sales And Use Tax (R&TC §23645)

A sales or use tax credit is allowed for LAMBRA businesses that purchase qualified property to be used in LAMBRA. This credit is similar to the provisions of R&TC §23612.2 - Sales Tax Credit on Qualified Property for Use in Enterprise Zones and Program Areas (See MATM 9064).

Qualified property includes high technology equipment, aircraft maintenance equipment, aircraft components and IRC §1245 property. R&TC §23645 contains several examples of the type of property that is included in these categories.

Property must be *manufactured* in California, unless property of a comparable quality and price was not available from a California manufacture. The auditor should have the taxpayer substantiate that attempts were made to purchase California manufactured property.

If within two years of its purchase the property is disposed of by the LAMBRA business or is no longer used within the LAMBRA, the credit amount will be added to the tax liability in the year of nonuse or disposition.

Reviewed: December 2002

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9084 Hiring Credit (R&TC §23646)

A LAMBRA business may qualify to claim a credit for a portion of the wages paid to qualified disadvantaged individuals and displaced military base employees. Generally, this credit parallels the Enterprise Zone Wage Credit allowed under R&TC §23622 (R&TC §23622.7 for taxable years beginning on or after January 1, 1997). However, the LAMBRA qualified employee requirements are much broader than those under the Enterprise Zone credit provisions. Furthermore, the wage amount used to compute the LAMBRA credit is limited to $2 million in each year. The auditor should be familiar with the provisions of R&TC §23646 when reviewing the LAMBRA credit.

Reviewed: December 2002

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9090 LOS ANGELES REVITALIZATION ZONE CREDIT

For taxable years beginning after 1991 and before 1998, three tax credits were enacted to aid the economic growth, create jobs and encourage rebuilding of businesses in the part of Los Angeles County that suffered physical and economic damage from civil disturbances in April and May 1992. The three credits are the Hiring Credit for Construction Workers, the Hiring Credit for Employees Other than Construction Workers, and the Sales and Use Tax Credit.

Information regarding the boundaries of the LARZ can be found in FTB Publication 1044. Further assistance with these credits can be found in FTB Booklet 3806, from the Enterprise Zone Specialist at [(916) 845-3464], and in the Economic Development Areas Audit Manual.

All three credits are similar to the Hiring and Sales or Use Tax Credits allowed for Enterprise Zone employers. (See MATM 9060) For instance:

1. The wage credits must be reduced by credits claimed for other state and federal job or wage tax credits. Likewise, any wage or salary business deduction must be reduced by the amount of the credit.
2. The credits must not exceed the amount of tax on the income attributable to the business activities within the LARZ. A two-factor apportionment formula of property and payroll is used to determine income attributable to LARZ business activity. For 1992 and 1993, unitary business income is apportioned to the LARZ by multiplying the worldwide business income by the ratio of the LARZ taxpayer's property and payroll occurring in the LARZ, over the group's property and payroll worldwide. For 1994 and later, business income shall be apportioned to the LARZ by multiplying the taxpayer's California source business income by the same two-factor formula of property and payroll except that the denominator will be the separate property and payroll of the LARZ taxpayer in the state of California. For corporations filing a combined return, the California source business income will be the intrastated California business income of the corporation operating within the LARZ.
3. The credits may be carried forward for the longer of the life of the LARZ or 15 years.

Reviewed: December 2002

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9092 Wages Paid To Construction Employees (R&TC §23625)

A credit is allowed for a specified amount of wages paid by an employer in hiring a construction worker who is a **resident** of the LARZ. The employee must perform **construction** work in the LARZ. The amount of the credit is based on the date the employee was hired and is limited to wages paid during that period:

Date Hired	Credit Percentage	For Wages Paid Between
5/1/92 - 6/30/93	100%	5/1/92 – 6/30/93
7/1/93 - 12/31/93	75%	7/1/93 – 12/31/93
1/1/94 - 12/31/97	50%	1/1/94 – 12/31/97

No credit is allowed if the employee is hired before May 1, 1992 or after December 31, 1997, the date R&TC §23625 is repealed.

For years 1993 and after, this credit can reduce tax below the tentative minimum tax.

The remaining provisions are similar to the Enterprise Zone Wage Credit under R&TC §23622 (R&TC §23622.7 for taxable years beginning on or after January 1, 1997). (See MATM 9062.)

Reviewed: December 2002

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9094 Wages Paid To Qualified Disadvantaged Employees (R&TC §23623.5)

LARZ employers are also allowed a credit for hiring qualified disadvantaged individuals. This credit is substantially similar to the Enterprise Zone Employer's Credit (MATM 9062), except that the qualified employees must be *residents of the LARZ and hired on or after May 1, 1992*.
This credit may not reduce tax below the tentative minimum tax in years 1992 or 1993. The tentative minimum tax can be reduced by this credit for years beginning on or after January 1, 1994.

Reviewed: December 2002

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9096 Sales & Use Tax (R&TC §23612.6)

A LARZ business may claim a credit for the amount of sales or use tax paid on the purchase of building materials to replace or repair the taxpayer's building and fixtures, and machinery or equipment to be used within the LARZ. The property must be purchased on or after May 1, 1992. There is no limitation on the amount of property purchased.

If another credit is available for such property, the taxpayer is allowed only one credit.

The basis of the property may not be increased by the amount of credit claimed.

If the property is disposed of or is no longer used by the taxpayer within the zone before the close of the second taxable year after the property is placed in service, the amount of the credit will be added to the tax liability in the year of non-use or disposition.

For years 1993 and later, the credit may reduce tax below the tentative minimum tax.

Reviewed: December 2002

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9100 LOW EMISSION VEHICLE CREDIT (R&TC §23603)

In 1991 the Low Emission Vehicle Credit was enacted with the intent of reducing air pollution by encouraging the use of low emission vehicles. The credit is equal to 55% of the differential cost of low emission vehicles or costs of conversion devices, limited to $1,000 per vehicle (or $3500 if the vehicle weighed over 5,750 pounds). Federal law does not contain a comparable credit.

The taxpayer must obtain a certification from the State Energy Resources Conservation and Development Commission (CEC) before qualifying for the credit. If the credit is material, the auditor should request a copy of the CEC's certification from the taxpayer for each low emission vehicle purchased or converted.

The credit is allowable in years 1991 through 1995. It may not reduce tax below the tentative minimum tax. However, this credit can be carried over until exhausted.

Reviewed: December 2002

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9110 LOW-INCOME HOUSING CREDIT (R&TC §23610.5)

After 1986, California allows a credit to taxpayers who invest in low-income housing projects. The credit is computed in accordance with the federal credit under IRC §42. This discussion covers the areas where California law differs from federal. Whether or not the IRS has examined the federal credit, the auditor should examine these areas.

The low-income housing project must be located in California. The credit must be allocated and authorized by the California Tax Credit Allocation Committee (CTCAC). In addition, the CTCAC must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the credit under IRC §42(h)(4)(B).)

A copy of the CTCAC certification must be attached to any return in which the credit is claimed. The auditor should review the return for the certification. If the certification is not attached and the taxpayer cannot provide a certification, the credit may be disallowed.

California allows the credit to be claimed over a four-year period, not ten years as required under federal law. The applicable percentage of cost for computing the credit has changed over the years. In addition, the applicable percentage may depend on the highest federal rate and if the project is federally subsidized. The auditor should refer to R&TC §23610.5 and IRC §42 when verifying the credit computation.

An additional credit may be claimed if the basis of a low-income housing building has increased since the CTCAC allocated the original credit. The CTCAC must authorize the additional credit.

California does not conform to the federal provision that allows the owner of a low-income housing unit occupied entirely by full-time students to qualify for the credit

There is no California provision similar to the federal provision that allows an election to claim 150% of the credit in the first year ending after October 24, 1990.

California requires a 30-year "compliance period", whereas the federal law only requires 15 years. The California law contains no provision, similar to the federal provision, for recapture of the credit if a project owner fails to comply with restrictions during the compliance period.

Unlike most credits, which may only be claimed by the entity incurring the costs, any portion of this credit may be assigned to one or more affiliates by election of the taxpayer. However, the affiliate must be 100% commonly owned. Once the election is made it is irrevocable for the year the credit is claimed, but the election may be changed in subsequent years. This credit assignment provision is effective for taxable years beginning on or after January 1, 1993. (R&TC §23610.5(q); formerly (r).)

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The credit may reduce tax below the tentative minimum tax and may be carried forward until exhausted. The California credit remains in effect as long as the federal credit does. In 1993, the federal credit was extended indefinitely.

Reviewed: December 2002

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9120 MANUFACTURERS' INVESTMENT CREDIT (R&TC §23649)

To stimulate employment in California, the State Legislature enacted three provisions to alleviate the basic sales tax for manufacturing companies on purchases of manufacturing equipment. The Sales and Use Tax Code §6377 provides a partial sales tax exemption for new manufacturing companies equal to 5% of the 6% basic sales tax. As an alternative to the partial sales or use tax exemption, qualified taxpayers may claim a credit against tax on the California income or franchise tax return under R&TC §23649. Or, in lieu of claiming the sales tax exemption or the income of franchise tax credit, Sales & Use Tax Code §6902.2 allows taxpayers to file a claim for refund with the Board of Equalization for the sales and use tax paid. The refund is an amount equal to the income or franchise tax credit that would have been allowed to offset the current year tax liability. The refund may be claimed on or after the date the taxpayer would have been able to claim the credit on the income or franchise tax return.

Generally, a “qualified taxpayer” is allowed a manufacturers’ investment credit (MIC) equal to 6% of the “qualified costs” paid or incurred for “qualified property” that is placed in service in California. Qualified taxpayer, qualified costs and qualified property are the three requirements for claiming the MIC. All three must be met for the taxpayer to claim the credit. Each of the MIC qualification requirements is discussed below.

A "qualified taxpayer" for purposes of the MIC is any taxpayer that is engaged in an activity described in Division D (Manufacturing) of the Standard Industrial Classification (SIC) Manual, 1987 edition (SIC Code 2011- SIC Code 3999). A taxpayer with multiple business activities that are treated as "establishments" under the SIC Manual will be a qualified taxpayer if any one of its activities falls within SIC Code 2011- SIC Code 3999. In addition, for taxable years beginning on or after January 1, 1998, the definition of “qualified taxpayer” is expanded to include any taxpayer engaged in activities related to computer programming services or computer software design, SIC Code 7371 - SIC Code 7373.

The FTB Form 3535 instructions (included in the California Package X) contain a condensed listing of manufacturing activities, which are classified under SIC Code 2011- SIC Code 3999. The SIC Manual describes and uses “establishments” to classify business activities into the various SIC codes. Examples of whether an activity constitutes an “establishment” can be found in CCR §23649-3. See the SIC Manual for a complete listing and the rules for determining classification of the SIC codes. The SIC Manual is available at http://www.osha.gov/cgi-bin/sic/sicser5.

Note: AB 1040 (Ch. 605, Stats 1997) included language stating the legislature’s intent to replace the references in §23649 from the SIC Manual to the new North American Industry Classification System (NAICS) Manual. The NAICS is being used for the Principal Business Activity Code Chart found in the California and federal tax booklets. This system replaces the use of the SIC for purposes of

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business classification. However, until R&TC §23649 is amended, the SIC Manual will continue to be used for purposes of the MIC.

"Qualified property" refers to new or used IRC §1245(a) tangible personal property or off-the-shelf computer software upon which sales or use tax has been paid. Tangible personal property eligible for the MIC is generally considered to mean any tangible property except land and improvements, such as buildings, other inherently permanent structures, and their structural components. The determination of whether property is considered an inherently permanent structure is made in accordance with the provisions of IRC §1245(a), which describe an “inherently permanent structure” as one, which is affixed permanently and is incapable of being moved without significant damage. Because only tangible personal property qualifies for the credit, CCR §23649-5(b)(2) interprets the IRC §1245(a) requirement to mean that only property described in IRC §1245(a)(3)(A) qualifies for the MIC. One exception to the regulation’s general application of the statutory IRC §1245(a) tangible personal property requirement applies to taxpayers engaged in a line of business classified under SIC Code 2911, Petroleum Refining. For this SIC code, qualified property also includes other tangible property that is defined in IRC §1245(a)(3)(B), such as outdoor permanent industrial structures. This property must be primarily used in petroleum refining for the production of “reformulated gasoline” or “oxygenated gasoline.”

Another exception to the general IRC §1245(a) tangible personal property requirement is for special purpose buildings and foundations. Even though they are not IRC §1245(a) tangible personal property, special purpose buildings and foundations may also be considered qualified property, but only for taxpayers that are engaged in manufacturing activities that fall within certain SIC codes (generally related to computer or office equipment; electronic components; biotech or biopharmaceutical activities; space satellites and communications satellites and equipment; or semiconductor equipment). Rules regarding this exception are discussed in R&TC §23649(d)(3) and CCR §23649-5(c).

Specifically excluded from the definition of qualified property is furniture, equipment used for warehousing or extraction purposes, inventory, or property used in administration, general management or marketing.

To be qualified property, at least 50% of the property's use must be in an activity that involves manufacturing, processing, refining, fabricating, recycling, research and development, or pollution control; or the maintenance, repairing, measuring or testing of any other qualified property. The business activity must fall within SIC Codes 2011-3999. Definitions of qualified activities are in CCR §23649-2. Also, examples of when property is treated as being primarily used in a qualified activity are in CCR §23649-5. For guidance on determining whether cement mixers for ready-mixed concrete are qualified property, see Legal Ruling 2001-4.

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For taxable years beginning on or after January 1, 1998, qualified property also includes property consisting of computers and computer peripheral equipment (as defined in IRC §168(i)(2)(B)) used primarily by a qualified taxpayer to develop or manufacture prepackaged software or custom software. Qualified property for taxpayers involved in computer businesses described in SIC Codes 7371 - 7373 does not include any IRC §1245(a)(3)(A) tangible personal property other than computers and computer peripheral equipment (e.g., shrink-wrap machines, fork lifts, etc.). (R&TC § 23649(d)(2) as amended by AB 2798, Ch. 323, Stats. 1998.)

In general, the term "qualified costs" includes any capitalized costs paid or incurred by a qualified taxpayer for the construction, reconstruction or acquisition of qualified property on or after January 1, 1994. The costs must be properly includable in the taxpayer's depreciable basis of the property. Except for capitalized labor costs, qualified costs are an amount upon which California sales and use tax has been paid (directly or indirectly). For guidance on the use of California State Board of Equalization (SBE) sales and use tax audit results, see FTB Notice 2001-6. Examples of these requirements are in CCR §23649-4(a) - (c).

Capitalized labor costs for the construction or modification of qualified property may also qualify for the MIC, provided they meet the definition of “direct” labor costs under the federal uniform capitalization (UNICAP) rules. The UNICAP rules are in IRC §263A and the regulations thereunder. Examples of the capitalized labor cost requirements are in CCR §23649-4(d).

Note: For more guidance on the treatment of capitalized labor, see FTB Notice 2002-1, MIC Alternative Computation of Capitalized Direct Labor Costs Under Third-Party Contracts, Legal Ruling 2000-1, MIC Capitalized Costs Under Third-Party Contracts, and Legal Ruling 98-1, MIC Capitalized Costs of Labor For Engineering and Design.

A qualified taxpayer who leases qualified property may claim the MIC so long as the lessor paid California sales or use tax when it acquired the property. The lessor may not claim the MIC. The normal "qualified cost" rules do not apply to lessees. Instead, under an operating (or true) lease, the lessee may generally claim the MIC based upon the purchase price amount on which the lessor paid sales or use tax, plus any capitalized labor costs related to the lessor's construction or modification of the property. If the property is later re-leased to another lessee, the second lessee's qualified costs must be reduced by the costs used to compute the prior lessee's MIC. The general requirement that qualified costs must be chargeable to the qualified taxpayer’s capital account does not apply to a lessee’s rental payments under an operating (or true) lease arrangement.

In the case of an operating (or true) lease, the lessor must provide the lessee with a written statement within 45 days after the close of the lessee’s taxable year, containing the amount of the lessor’s qualified costs (i.e., the amount of such cost upon which the lessor has paid California sales or use tax).

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If the lease is a finance (or capital) lease for sales and use tax purposes, then the rules applicable to an acquisition will generally apply in calculating the qualified costs of the lessee. These general rules are subject to a few exceptions and refinements depending upon the type of lease and how the transaction is structured. For more information regarding leased property, see R&TC §23649(f) and CCR §23649-6.

The MIC is claimed on FTB Form 3535, Manufacturers' Investment Credit. The taxpayer is required to complete and attach this form to the return. The FTB Form 3535 contains information such as the description of the property, the qualifying activity, the primary use SIC code, whether or not the property is leased, the date placed in service, the sales or use tax paid, the property cost, any included capitalized direct labor costs, etc.

The first year the MIC may be taken is the qualified taxpayer's first taxable year beginning on or after January 1, 1995. In addition to costs actually paid or incurred during that first taxable year beginning on or after January 1, 1995, qualified costs paid or incurred on or after January 1, 1994, may also be claimed in that first credit year. For example, assume a taxpayer with a June 30 year-end. The first taxable year this taxpayer can claim the MIC is its year ended June 30, 1996, the first year beginning after January 1, 1995. To determine its credit, the taxpayer may include all qualified costs incurred from January 1, 1994, through June 30, 1996. For qualified taxpayers engaged in those lines of business under SIC Codes 7371 - 7373, substitute "the first taxable year beginning on or after January 1, 1998," for "January 1, 1994." Rules with respect to costs incurred pursuant to binding contracts in existence prior to January 1, 1994, are covered in CCR §23649-4(e).

The total cost of property eligible for the credit must be reduced by the amount of sales or use tax paid on the property. However, unlike many credits, the basis of qualified property for which the MIC is claimed is not required to be reduced by the amount of the credit.

There is no annual limit on the MIC. However, the amount of the credit that a taxpayer can use may be limited. The credit may not reduce the minimum franchise tax imposed on corporations and certain other entities. The MIC may not reduce the built-in gains tax or the excess net passive income tax imposed on some S corporations; or the limited liability company (LLC) gross receipts fee. Also, the credit may not reduce alternative minimum tax, but may reduce the "regular" California tax below the tentative minimum tax. If a taxpayer takes a Los Angeles Revitalization Zone Credit (R&TC §23612.6) with respect to the same qualified property, the taxpayer cannot take the MIC for that same item.

Generally, the credit can be carried forward for eight years. Small businesses, defined in R&TC §23649(e)(10), can carry the credit forward for ten years. The length of the credit carryover period for a credit generated by a pass-through entity (S corporation, partnership, LLC taxed as a partnership, etc.) is determined at the entity level. For more information regarding the MIC carryforward provisions, see CCR §23649-9.

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If the property upon which the credit is claimed is disposed of within one year or less from the date the property was first placed in service in California, the credit must be recaptured pursuant to R&TC §23649(g). Disposition includes removal of the property from California, use of the property primarily in a nonqualified activity, and transfer or sale of the property to an unrelated party, defined by IRC §267, IRC §318 or IRC §707. For more information regarding the recapture provisions, see CCR §23649-8.

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NOTE: ((* * *)) = Indicates confidential and/or proprietary information that has been deleted.

Reviewed: September 2003

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9130 RECYCLING EQUIPMENT CREDIT (R&TC §23612.5)

A credit is allowed for those taxpayers that purchase and use equipment to manufacture finished products out of waste materials. The credit is allowed for equipment purchased and placed in service in 1989 through 1993. The credit is equal to 40% of the equipment's cost. The total credit is limited to $625,000 per facility.

The taxpayer must receive a certification from the California Integrated Waste Management Board that the equipment purchase and use is qualified. Property previously certified will not qualify a second time. The auditor should request a copy of the certification. The statute specifically states that if the certification is not provided to FTB the credit may be disallowed.

The basis of the recycling equipment must be reduced by the amount of credit allowed.

This credit may be carried forward until exhausted. However, the credit may not reduce tax below the tentative minimum tax.

Reviewed: December 2002

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9140 RESEARCH EXPENSES CREDIT (R&TC §23609)

IRC §41 provides for a federal research tax credit equal to 20% of the amount by which a taxpayer's qualified research expenditures for a taxable year exceeded its base amount for that year, or for basic research payments. California allows a similar credit against tax for the amounts paid or incurred for research conducted in California. Generally, the credit is allowed in accordance with IRC §41, modified for California by R&TC §23609. There are several other federal and state differences, as well as several law changes that have been made periodically. Therefore, the auditor should be familiar with the California provisions for the year under audit. The research credit for both existing companies and "start-up" companies is claimed on FTB Form 3523.

California's credit for increasing research activities came into existence under R&TC §23609 for corporations in 1988. Taxpayer's may claim the credit for fiscal years beginning in 1987, but only for qualified research expenses paid or incurred on or after January 1, 1988.

For taxable years beginning on or after January 1, 2000, the California credit is 15% of the excess of qualified research expenses for the taxable year over the base period research expense amount, plus 24% of the basic research payments for corporations. The California research credit rates have changed frequently in recent years. See the table below for rates for the year(s) you are auditing.

Corporations may elect to reduce the regular credit to avoid having to make a state adjustment to income for the amount of the credit. According to IRC §280C(c) & R&TC §24440, deductions claimed for research activities must be reduced by the amount of the current year's research credit. However, if the taxpayer makes a timely election, by the due date for filing the return including extensions, to take the reduced credit, then the state adjustment to income is not required. If the taxpayer does not elect the reduced credit, they must add-back the amount of the credit created for the year, regardless of how much of it is actually used to reduce the current year tax liability. Be aware that taxpayers may have a different election for state and federal purposes and they can change the election from year to year, but the election is <u>irrevocable</u>. If the taxpayer does not elect the reduced credit for federal purposes, there should also be a state adjustment to eliminate the IRC §280C(c) add-back.

For taxable years beginning on or after January 1, 1997, corporations may elect to use the "Alternative Incremental Credit" rather than the regular credit. The alternative incremental credit allows a smaller 3-tiered fixed-base percentage and a reduced 3-tiered credit rate. To use the alternative incremental credit, the taxpayer must make an election for any taxable year beginning on or after January 1, 1997 and cannot change to the regular method unless they receive consent from FTB to revoke the election.

If a material credit is being claimed, the auditor should, at the very minimum, determine if the research is conducted in California and verify that the computation is mathematically correct.

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Auditors should ensure that California sales and expenses were used in the computation of the base period percentage. If the IRS is auditing or has audited the same expenses, our audit activity should be limited to verifying that the expenses were incurred in California.

California did not conform to the federal fixed-base period computation until January 1, 1993. For years prior to 1993, California used a three-year moving average to compute the base amount. If needed, refer to the prior law and forms for those years.

This table shows the recent changes in research credit rates:

TAX YEARS BEGINNING	QUALIFIED RESEARCH	BASIC RESEARCH	ALTERNATIVE INCREMENTAL
1987-1996	8%	12%	N/A
1997	11%	24%	1.65%, 2.20%, 2.75%
1998	11%	24%	1.32%, 1.76%, 2.20%
1999	12%	24%	1.32%, 1.76%, 2.20%
2000 and later	15%	24%	1.49%, 1.98%, 2.48%

QUALIFIED RESEARCH EXPENSES:

A review of the costs included in the qualified research expense should be considered. The taxpayer must have incurred the costs while conducting research in California for a qualified activity. Qualified research expense equals the sum of in-house research expenses and contract research expenses (IRC §41(b)(1)). In-house research expenses include compensation, supplies, and amounts paid to another person for the right to use computers in the conduct of qualified research.

IN-HOUSE RESEARCH EXPENSES –

COMPENSATION
For purposes of computing this credit, compensation must be directly related to the research activities and paid by the taxpayer (IRC §41(b)(2)). This may include direct supervision, direct support or direct performance of qualified research. An allocation of the purchasing or receiving departments' wages does not qualify because they are indirect costs. Items, which are considered compensation for purposes of determining the credit, include, but are not limited to, salaries, wages and taxable income from non-qualifying stock plans or disqualifying dispositions of incentive stock options (see *Apple Computer v. IRS*, 98 TC 232; and *Sun Microsystems, Inc., et al.,* TC Memo 1995-69, 69 CCH TCM 1884). Deferred compensation and fringe benefits (such as health benefits) are not qualifying

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expenditures. Information to make the above determinations may be found in employees' W-2 records, job descriptions, duty statements, employee evaluations etc.

SUPPLIES
Supplies include all tangible property that is consumed directly by the research activity or that goes into the prototype. The supplies must be used in conducting qualified research. Supplies mean any tangible property, other than land or improvements to land, and property of a character subject to the allowance for depreciation (IRC §41(b)(2)). In some cases, the costs attributable to the construction of molds and other special tooling may not be deductible as research and experimental expenditures under IRC §174 because the costs are for the component material and labor associated with the manufacturing of products sold by the taxpayer to its customers.

Examples of supplies that qualify are those used by a laboratory scientist in experimentation, those used by a laboratory assistant in entering research data into a computer, and those used by a machinist in the fabrication of a part for an experimental model. (See Treas. Regulation 1.41 for more examples.)
Generally, utilities (phone and electricity), small tools, and allocations of the total shipping cost are not qualifying supply expenses. Contract expenses in the cost of supplies are not permissible qualifying supply expenses.

CONTRACT RESEARCH EXPENSES:

Contract research means 65% of amounts paid to any person (excluding taxpayer's employees) to perform qualified research (IRC §41(b)(3)) (For taxable years beginning on or after January 1, 1997, 75% of amounts paid to a qualified research consortium qualify). The outside consultant must perform the research in California. The auditor may review the taxpayer's vendor files and vendor contracts to determine if the expense qualifies.

QUALIFIED RESEARCH DEFINED:

Under IRC §41(d)(1) the following four tests must be met for R&D expenditures to be considered qualified research expenses:

- The expenditures must qualify for a deduction under IRC §174,
- The expenditures must have been made to discover information that is technological in nature,
- The purpose of the research is intended to be useful in the development of a new or improved business component of the taxpayer, and
- Substantially all of the activities constitute elements of a process of experimentation that relates to a new or improved function, performance, or reliability or quality.

INTERNAL-USE SOFTWARE

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Software prepared by the taxpayer for its own internal use qualifies for the credit if it is used in an activity which constitutes qualified research or is used in a production process developed through activities constituting qualified research (IRC §41(d)(4)). Other software created for internal use is not eligible for the credit unless it meets the four tests for qualified research (outlined above) plus the following three tests:

- The software must be innovative,
- Its development must involve significant economic risk, and
- It cannot be commercially available for use by the taxpayer.

There are two significant federal court cases concerning qualified activities with regard to internally developed software that the auditors should be aware of:

- *United Stationers, Inc. v. U.S.*, 82 AFTR 2d 98-7488, 12/24/1998 - Credit was disallowed based on lack of technological nature and no experimentation process.

- *Norwest Corp., et al. v. Commissioner*, 110 T.C. No. 34, 6/29/1998 - Seven of eight internally developed software projects were not considered qualified because the sampled projects involved a "cookbook" approach to development that did not involve technical risk. This case includes a review of the seven tests discussed above.

GROSS RECEIPTS FOR CALIFORNIA PURPOSES:

R&TC §23609(h)(4) defines the term gross receipts for the purpose of computing the California research credit for taxable years beginning on or after January 1, 1993. When computing the fixed-base percentage and average annual gross receipts for California credit purposes, only California gross receipts are used in the computation. California gross receipts should include receipts, minus returns and allowances, from the sale of real, tangible, or intangible property held for sale to customers in the ordinary course of the taxpayer's trade or business that is delivered or shipped to a purchaser in California. This includes sales to the U.S. government, which are delivered in California. Throwback sales and receipts from services, rents, operating leases and interest are *excluded* from the computation.

MEMBERS OF A CONTROLLED GROUP:

California conforms to the federal rules for assigning this credit among members of a controlled group (IRC §41(f)). To determine the amount of the credit, all members of the same controlled group of corporations are treated as a single taxpayer. (The regulations define controlled group by reference to ownership of more than 50% of the total voting stock (IRC §41(f)(5), IRC §1563(a), Treas. Reg. 1.41-6(a)(3) and 1.52-1(b)-(g)). Nonunitary affiliates may be part of a controlled group.)

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First, the total R&D credit of the controlled group is determined and then allocated to the members that had an increase in research expenditures over the base amount. Treas. Reg. 1.41-6(a)(4) provides general examples for allocating the credit. However, for further details regarding how the allocation works refer to Proposed Treas. Reg. 1.41-8 (dated 1/4/2000), which also includes the proper method for allocating the credit. (Note: On 12/27/2000, T.D. 8930 redesignated the aggregation regulation to Treas.Reg. 1.41-6. Prior to that, the aggregation regulation, adopted by T.D. 8251, 5/16/1989, was numbered 1.41-8. This is not to be confused with the proposed aggregation regulation, which happens to also be numbered as Proposed Treas. Reg. 1.41-8.) Treas. Reg. 1.41-6(c) provides rules for members of a controlled group with different accounting periods. Treas. Reg. 1.41-6(d) provides rules for members during the taxable year in more than one group. Treas. Reg. 1.41-6(e) provides rules for intra-group transactions such as in house expenses, contract research expenses, lease payments and payments for supplies.

Note: For tax years beginning on or after January 1, 1990, a different method of allocating the credit to members of a controlled group was used whereby the credit was allocated to the members based on their proportionate share of research expenses. This method, which has been referred to as the "Expenditure Method," was determined to be incorrect. Proposed Regulation §1.41-8 (issued January 4, 2000) clarified the correct method, and referred to it as the "Incremental Method." Under the "Incremental Method" the group research credit is allocated to each member based on the ratio that the member's increase in its qualified research expenses over its base amount bears to the sum of each member's increase in qualified research expenses over the its base amounts.

Taxpayers were allowed to compute the credit using either method for taxable years ending prior to January 4, 2000. For taxable years ending on or after January 4, 2000, the taxpayer must follow the incremental method as prescribed in the proposed federal regulation. According to the proposed regulation, this method can also be imposed in prior years if deemed necessary. *

ALTERNATIVE MINIMUM TAX:

The credit cannot be used to reduce AMT. However, for taxable years beginning on or after January 1, 1989, R&TC §23036 was revised to allow the research credit to reduce the regular tax below the tentative minimum tax. If the credit is not used in the current year, it may be carried over to subsequent years until it is exhausted.

TERMINATION DATE:

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R&TC §23609 does not provide a termination date for the California research credit. However, be aware that IRC §41 incorporates a termination date, which changes often. Also, note that the federal credit has a lapse period. No federal credit is allowed for expenses incurred between June 30, 1995 and July 1, 1996. This may explain why the federal credit in those years may be smaller than the California credit.

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Reviewed: May 2003

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9150 RIDESHARING TAX CREDIT (R&TC §23605)

For years 1989 - 1995 employers may be allowed credits for participating in specific rideshare activities by purchasing and/or leasing vehicles used in an employer sponsored ridesharing program and/or subsidizing public transit passes for their employees.

The credit is allowed instead of any deduction the employer may otherwise claim, such as ordinary and necessary business expenses under IRC §162. Since there is not a comparable federal credit, this may result in a state adjustment. (See MATM 6058)

The credit may not reduce tax below the tentative minimum tax. However, the credit may be carried forward until exhausted.

For rideshare vehicles the credit is equal to 20% (30% if the employer has less than 200 employees) of the purchase cost or 15% (30% if less than 200 employees) of the cost for leasing qualified vehicles. The basis of any ridesharing vehicle must be reduced by the amount of the corresponding credit. If the vehicle is not used for ridesharing or is disposed of within three years, the prorata portion of the unused credit will be added back to the taxpayer's tax liability. The basis would then be increased by an equal amount included in the tax liability.

The taxpayer is required to maintain a log of the vehicle's use. At the minimum, the log must contain the dates and times driven, the mileage of each trip, and the purpose of each trip. The auditor should review the log to verify that the vehicle was used within the provisions of R&TC §23605. Additionally, the auditor should request the vehicle's owners manual and registration to verify the vehicle's weight and fuel efficiency meets the specified requirements of R&TC §23605.

The credit for subsidizing public transit is equal to the following:

- 10% of the cost if the employer provides free parking,
- 20% of the cost if subsidized parking is provided, or
- 40% of the cost if the employer does not provide free or subsidized parking.

Reviewed: December 2002

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9160 SOLAR ENERGY TAX CREDIT (R&TC §23601 - R&TC §23601.5)

Since 1976, California has allowed some type of solar energy credit. The solar energy credit and carryovers have been considerably revised over the years. Specifically, the definitions and requirements of a solar energy system changed dramatically for years 1990 through 1994. Therefore, the auditor should refer to R&TC §23601 through R&TC §23601.5 when examining a solar credit. This section discusses primarily the provisions of the solar energy credit since 1987.

In general, a credit is allowed for a portion of the cost of a solar energy system installed on premises used for commercial purposes. The premises must be located in California and owned by the taxpayer during the taxable year. If a taxpayer leases the solar energy system it may qualify for a credit. For more information on leases refer to the above Bank and Corporation Law sections.

The solar energy credit is allowed to reduce tax below the tentative minimum tax. If the credit is not used in the current year it may be carried forward until the credit is exhausted.

If the credit is material The California Energy Resources Conservation and Development Commission (CEC) should complete the audit and determination of the solar energy system's eligibility. It is current audit policy that the auditor requests an evaluation from the CEC at the start of the audit.

If a material credit exists, the auditor should inform the taxpayer that an examination by the CEC is necessary. To avoid disclosure, the auditor should give the taxpayer a letter, on the program office's letterhead, to forward to the CEC. This letter should contain the following information:

Addressed to:
California Energy Commission
1516 Ninth Street
Sacramento, CA 95814

- A request for a detailed evaluation of the credit
- The taxpayer's name.
- The taxable years questioned.
- The amount of the credit claimed.

The auditor should instruct the taxpayer to forward the letter to the CEC. The taxpayer is responsible for resolving the issue with the CEC and for forwarding the CECs final determination to the auditor.

There are a few areas that the auditor can review without CEC involvement. Listed below are the most common audit areas:

There is no provision in the statute for a credit for solar energy systems installed during 1989.

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The solar energy system must be installed in California.

The cost of the solar energy system must be reduced by any grants provided by any public entity for the system.

The allowable percentage for computing the credit has changed from year to year.

- 1987 is 12%
- 1988 is 10%
- 1989 has no provision for a credit
- 1990 - 1994 is 10%

The basis of the solar energy system must be reduced by the amount of the credit allowed and any public grants received.

The required useful life of a solar energy system has changed throughout the years. Information on this area can be found in the depreciation schedules. The useful life requirement is as follows:

- 1987 - 1988 useful life is three years or more
- 1989 has no provision for a solar energy credit
- 1990 - 1994 useful life is five years or more

For systems installed in 1990 and after, each owner's share of the credit is computed in proportion to its ownership interest in the premise. In the case of a partnership, the credit may be divided per a written partnership agreement. (The partnership provision applies to 1987 and 1988 as well.)

Reviewed: December 2002

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MULTISTATE AUDIT TECHNIQUE MANUAL (MATM) EXHIBITS

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C	LEXIS-NEXIS Libraries & Files
D.1	IRS Form 940
D.2	IRS Form 940 Instructions
E.1	IRS Form 941
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J.1	Foreign Country Accounting Practices
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K	Sample Statement Confirming Preliminary Unitary Facts

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LEXIS-NEXIS Libraries & Files

Return to MATM Exhibits Page

The Lexis-Nexis Service contains a vast amount of data. A key to using the Service effectively is knowing what sources to use to find information. The following is a list of Service Sources commonly used by Multistate Auditors.
Company and Financial Information (CMPNY)

The COMPNY Group File combines all of the major sources of company profiles, except Investext(R). The file includes profiles of companies and company executives, annual reports and other SEC filings, bankruptcy reports, merger and acquisition transactions, earnings reports. The file covers all US public companies, more than 200,000 private US companies, and many thousands of other companies around the world.
COMBINED CORPORATION AND LIMITED PARTNERSHIP FILINGS (ALLSOS)
File comprised of corporate and limited partnership information from 45 states.

Information contained in these documents include:

- Corporation and Limited Partnership names, numbers and status

- Names and addresses of registered agents

- Dates of Incorporation or Qualification

News (ALLNWS)

Contains English language, full-text news sources that part of the Lexis-Nexis Service.
Nationwide US and Canadian Public and Private Company Information (B-Find)
The B-FIND file is a nationwide group file directory of over 11 million US and Canadian Public and Private Companies. It was compiled from city and state directories, interactive customer files, government sources, school files and trade publications. In addition, selected segments of this file are enhanced and verified by Standard and Poor's, a major provider of business and financial information.
CA Deed Transfers, Tax Assessor Records and Mortgage Records - Selected Counties (CAOWN)
The CAOWN is a group file of California tax assessor property record information, deed transfer and mortgage records. Assessor data is collected primarily from tax assessors' offices and deed transfer and mortgage data primarily from county recorders' offices.
Although individual records may vary in content, most documents include the following:
- owner, buyer and/or seller name(s)

- property and/or mailing address

- sale price

- assessor parcel number

- property use

Counties may vary for Tax Assessor Property, Deed Transfer and Mortgage Records.

Federal and State Case Law (MEGA)

The complete combination of Federal and State caselaw provides all available caselaw in one stop. It includes U.S. Supreme Court, U.S. Court of Appeals, Federal District Courts and State Caselaw for all 50 States plus the District of Columbia, Puerto Rico, Virgin Islands and other U.S. territories. Also included are specialty courts such as Military Appeals, Customs, Patents, Tax, Trade, Commerce, Veteran Appeals and Bankruptcy. Refer to the guide document for specific courts to obtain coverage and currentness information

Federal and State Cases - 9th Circuit (9MEGA)

The Ninth Circuit combination of Federal and State caselaw provides all available caselaw for jurisdictions relating to the Ninth Circuit. It includes U.S. Supreme Court, U.S. Court of Appeals for the Ninth Circuit, as well as the Federal District Courts, Bankruptcy Courts and State Courts for Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington. Additionally, the District Courts for Guam and the Northern Mariana Islands are included.

CA Federal and State Case Law (CAMEGA)

The California combination of Federal and State case law provides all available case law for jurisdictions relating to California.

The Federal case law includes the U.S. Supreme Court, U.S. Courts of Appeal for the Ninth Circuit, as well as the U.S. District Court and Bankruptcy Courts for the State of California.

The State case law includes the Supreme Court of California (since 1850) and the California Courts of Appeal. Also included are officially reported cases of the Appellate Department of the Superior Courts.

CA Bill Tracking and Full-Text Bills (CABILL)

California bill tracking and bill text from the current session.

CA Cases, Administrative Decisions, and Attorney General Opinions (CACASE)

California caselaw decided by the California Supreme Court, California Courts of Appeal, Opinions from the California Board of Equalization and Franchise Tax, California Department of Corporations, California Public Utilities Commission, California Water Resource Control Board, and Office of the California Attorney General.

CA Board of Equalization and Franchise Tax Board Decisions (CATAX)

Tax related materials issued by the California State Board of Equalization, and the Franchise Tax Board, including promulgated and proposed rules and regulations, bulletins opinion, and orders, legal rulings and FTB notices.

Form **940**

Department of the Treasury
Internal Revenue Service (99)

Employer's Annual Federal Unemployment (FUTA) Tax Return

▶ **See separate instructions for information on completing this return.**

OMB No. 1545-0028

1998

T	
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Name (as distinguished from trade name) — Calendar year

Trade name, if any

Address and ZIP code — Employer identification number

A Are you required to pay unemployment contributions to only one state? (If "No," skip questions B and C.) . ☐ **Yes** ☐ **No**

B Did you pay all state unemployment contributions by February 1, 1999? ((1) If you deposited your total FUTA tax when due, check "Yes" if you paid all state unemployment contributions by February 10. (2) If a 0% experience rate is granted, check "Yes." (3) If "No," skip question C.) . . . . . ☐ **Yes** ☐ **No**

C Were all wages that were taxable for FUTA tax also taxable for your state's unemployment tax? . . . . . ☐ **Yes** ☐ **No**

If you answered "No" to any of these questions, you must file Form 940. If you answered "Yes" to all the questions, you may file Form 940-EZ, which is a simplified version of Form 940. (Successor employers see **Special credit for successor employers** on page 3 of the instructions.) You can get Form 940-EZ by calling 1-800-TAX-FORM (1-800-829-3676) or from the IRS's Internet Web Site at **www.irs.ustreas.gov.**

If you will not have to file returns in the future, check here, and complete and sign the return . . . . . ▶ ☐
If this is an Amended Return, check here . . . . . ▶ ☐

Part I Computation of Taxable Wages

1	Total payments (including payments shown on lines 2 and 3) during the calendar year for services of employees		**1**	
2	Exempt payments. (Explain all exempt payments, attaching additional sheets if necessary.) ▶	**2**		
3	Payments for services of more than $7,000. Enter only amounts over the first $7,000 paid to each employee. Do not include any exempt payments from line 2. The $7,000 amount is the Federal wage base. Your state wage base may be different. **Do not use your state wage limitation** .	**3**		
4	Total exempt payments (add lines 2 and 3)		**4**	
5	**Total taxable wages** (subtract line 4 from line 1) . . . . . ▶		**5**	

Be sure to complete both sides of this return, and sign in the space provided on the back.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 11234O Form **940** (1998)

DETACH HERE

Form **940-V**

Department of the Treasury
Internal Revenue Service

Form 940 Payment Voucher

Use this voucher only when making a payment with your return.

OMB No. 1545-0028

1998

Complete boxes 1, 2, 3, and 4. Do not send cash, and do not staple your payment to this voucher. Make your check or money order payable to the "United States Treasury". Be sure to enter your employer identification number, "Form 940", and "1998" on your payment.

1 Enter the amount of the payment you are making

▶ $.

2 Enter the first four letters of your last name (business name if partnership or corporation)

3 Enter your employer identification number

Instructions for Box 2

—Individuals (sole proprietors, trusts, and estates)—Enter the first four letters of your last name.

—Corporations and partnerships—Enter the first four characters of your business name (omit "The" if followed by more than one word).

4 Enter your business name (individual name for sole proprietors)

Enter your address

Enter your city, state, and ZIP code

1998

Department of the Treasury
Internal Revenue Service

Instructions for Form 940

Employer's Annual Federal Unemployment (FUTA) Tax Return

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Items To Note

New worksheet for computing the Part II, line 6 credit if state contributions were paid late. Filers who made contributions to their state unemployment fund after the due date for filing Form 940 should complete the new worksheet provided in the instructions for line 6 on page 5 to compute the allowable credit. **Do not** report such contributions in Part II, line 3, column (i) or on line 3b. Any credit allowed for such state contributions will appear on line 6.

Electronic deposit requirement. If your total deposits of social security, Medicare, railroad retirement, and withheld income taxes were more than $50,000 in 1997, you must make electronic deposits for **all** depository tax liabilities (including FUTA tax) that occur after 1998 using the Electronic Federal Tax Payment System (EFTPS). However, if you were first required to use EFTPS on or after July 1, 1997, no penalties for failure to use EFTPS will be imposed for tax liabilities that occur prior to July 1, 1999. To enroll in EFTPS, call 1-800-945-8400 or 1-800-555-4477. For general information about EFTPS, call 1-800-829-1040.

Preprinted EIN relocated. To ensure privacy, we have relocated the employer identification number on preprinted forms to an area above the envelope window.

State unemployment information. Employers must contact their state unemployment tax offices to receive their state reporting number, state experience rate, and details about their state unemployment tax obligations.

Purpose of Form

Use this form to report your annual Federal Unemployment Tax Act (FUTA) tax. FUTA tax, together with state unemployment systems, provides for payments of unemployment compensation to workers who have lost their jobs. Most employers pay both Federal and state unemployment taxes. Only the employer pays FUTA tax. Do not collect or deduct it from your employees' wages. The tax applies to the first $7,000 you pay each employee in a year. The $7,000 amount is the Federal wage base. Your state wage base may be different.

Form 940-EZ, Employer's Annual Federal Unemployment (FUTA) Tax Return, is a simpler version of Form 940. You may use it instead of Form 940 to report your annual FUTA tax if—

1. You paid unemployment contributions to only one state,

2. You paid all state unemployment contributions by February 1, 1999 (February 10 if you deposited all FUTA tax when due), and

3. All wages that were taxable for FUTA tax were also taxable for your state's unemployment tax. If, for example, you paid wages to corporate officers (these wages are taxable for FUTA tax) in a state that exempts these wages from its unemployment tax, you cannot use Form 940-EZ. **Note:** *A successor employer claiming a credit for state unemployment contributions paid by the prior employer must file Form 940.*

For details, get Form 940-EZ. **Do not file Form 940 if you have already filed Form 940-EZ for 1998.** However, see **Amended returns** on page 4.

When To File

File Form 940 for 1998 by February 1, 1999. However, if you deposited all FUTA tax when due, you may file on or before February 10, 1999. Your return will be considered timely filed if it is properly addressed and mailed First Class or sent by an IRS designated delivery service by the due date. See **Circular E (Pub. 15),** Employer's Tax Guide, for a list of designated delivery services.

Caution: *Private delivery services cannot deliver items to P.O. boxes.*

Who Must File

Except as noted below, you must file if Test 1 **or** Test 2 applies.

Test 1. You paid wages of $1,500 or more in any calendar quarter in 1997 or 1998.

Test 2. You had one or more employees for at least some part of a day in any 20 or more different weeks in 1997 or 20 or more different weeks in 1998.

Count all regular, temporary, and part-time employees. A partnership should not count its partners. If there is a change in ownership or other transfer of business during the year, each employer who meets Test 1 or 2 must file. **Do not** report wages paid by the prior (or subsequent) employer.

Household employers. File a FUTA tax return **ONLY** if you paid total cash wages of $1,000 or more (for all household employees) in any calendar quarter in 1997 or 1998 for household work in a private home, local college club, or local chapter of a college fraternity or sorority. Individuals, estates, and trusts that owe FUTA tax for **household work** in a private home, in most cases, must

file **Schedule H (Form 1040),** Household Employment Taxes, instead of Form 940 or 940-EZ. See the instructions for Schedule H (Form 1040).

In some cases, such as when you employ both household employees and other employees, you may have the option to report social security, Medicare, and withheld Federal income taxes for your household employee(s) on **Form 941,** Employer's Quarterly Federal Tax Return, or **Form 943,** Employer's Annual Tax Return for Agricultural Employees, instead of on Schedule H. If you reported your household employee's wages on Form 941 or 943, you must use Form 940 or 940-EZ to report FUTA tax.

Agricultural employers. File a FUTA tax return if either 1 **or** 2 below applies:

1. You paid cash wages of $20,000 or more to farmworkers during any calendar quarter in 1997 or 1998 or

2. You employed 10 or more farmworkers during at least some part of a day (whether or not at the same time) during any 20 or more different weeks in 1997 or 20 or more different weeks in 1998.

Count wages paid to aliens admitted on a temporary basis to the United States to perform farmwork, also known as workers with “H-2(A)” visas, to see if you meet either 1 or 2. However, wages paid to H-2(A) visa workers are not subject to FUTA tax.

Nonprofit organizations. Religious, educational, charitable, etc., organizations described in section 501(c)(3) and exempt from tax under section 501(a) are not subject to FUTA tax and are not required to file.

State and local government employees. Wages paid to state or local government employees are not subject to FUTA tax.

Where To File

In the list below, find the location where your legal residence, principal place of business, office, or agency is located. Send your return to the **Internal Revenue Service** at the address listed for your location. No street address is needed.

Note: *Where you file depends on whether or not you are including a payment.*

Florida, Georgia, South Carolina

Return without payment:
Atlanta, GA 39901-0046

Return with payment:
P.O. Box 105887
Atlanta, GA 30348-5887

New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)

Return without payment:
Holtsville, NY 00501-0046

Return with payment:
P.O. Box 1365
Newark, NJ 07101-1365

New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

Return without payment:
Andover, MA 05501-0046

Return with payment:
P.O. Box 371307
Pittsburgh, PA 15250-7307

Illinois, Iowa, Minnesota, Missouri, Wisconsin

Return without payment:
Kansas City, MO 64999-0046

Return with payment:
P.O. Box 970010
St. Louis, MO 63197-0010

Delaware, District of Columbia, Maryland, Pennsylvania, Puerto Rico, Virginia, U.S. Virgin Islands

Return without payment:
Philadelphia, PA 19255-0046

Return with payment:
P.O. Box 8726
Philadelphia, PA 19162-8726

Indiana, Kentucky, Michigan, Ohio, West Virginia

Return without payment:
Cincinnati, OH 45999-0046

Return with payment:
P.O. Box 6977
Chicago, IL 60680-6977

Kansas, New Mexico, Oklahoma, Texas

Return without payment:
Austin, TX 73301-0046

Return with payment:
P.O. Box 970017
St. Louis, MO 63197-0017

Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming

Return without payment:
Ogden, UT 84201-0046

Return with payment:
P.O. Box 7024
San Francisco, CA 94120-7024

California (all other counties), Hawaii

Return without payment:
Fresno, CA 93888-0046

Return with payment:
P.O. Box 60378
Los Angeles, CA 90060-0378

Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee

Return without payment:
Memphis, TN 37501-0046

Return with payment:
P.O. Box 1210
Charlotte, NC 28201-1210

If the location of your legal residence or principal place of business is not listed above

All Returns:
Philadelphia, PA 19255-0046

Magnetic Media Reporting

You may file Form 940 using magnetic media. See Rev. Proc. 96-18, 1996-1 C.B. 637, for the procedures and **Pub. 1314** for the tape specifications.

Penalties and Interest

Avoid penalties and interest by making tax deposits when due, filing a correct return, and paying all taxes when due. There are penalties for late deposits and late filing unless you can show reasonable cause. If you file late, attach an explanation to the return. There are also penalties for willful failure to pay tax, keep records, make returns, and for filing false or fraudulent returns. Get Circular E (Pub. 15), for more information on penalties.

Not Liable for FUTA Tax

If you receive Form 940 and are not liable for FUTA tax for 1998, write “Not Liable” across the front of the form, sign the return, and return it to the IRS.

Credit for Contributions Paid to a State Fund

You get a credit for amounts you pay to a state (including the District of Columbia, Puerto Rico, and the U.S. Virgin Islands) unemployment fund by February 1, 1999 (or February 10, 1999, if that is your Form 940 due date). Your FUTA tax will be higher if you do not pay the state contributions timely. See the line 6 instructions on page 5 if you did not pay state contributions by the due date of Form 940.

"Contributions" are payments that a state requires an employer to make to its unemployment fund for the payment of unemployment benefits. However, contributions do not include:

- Any payments deducted or deductible from your employees' pay.
- Penalties, interest, or special administrative taxes not included in the contribution rate the state assigned to you.
- Voluntary contributions paid to get a lower assigned rate.

You may receive an additional credit if you have a state experience rate lower than 5.4% (.054). This applies even if your rate is different during the year. This **additional** credit is equal to the difference between actual payments and the amount you would have been required to pay at 5.4%.

The total credit allowable may not be more than 5.4% of the total taxable FUTA wages.

Special credit for successor employers. A successor employer is an employer who received a unit of another employer's trade or business or all or most of the property used in the trade or business of another employer. Immediately after the acquisition, the successor employer must employ one or more individuals who were employed by the previous owner.

You may be eligible for a credit based on the state unemployment contributions paid by the previous employer. You may claim these credits if you are a successor employer and acquired a business in 1998 from a previous employer who was not required to file Form 940 or 940-EZ for 1998. **If you are eligible to take this credit, you must file Form 940; you may not use Form 940-EZ.** See section 3302(e). Enter in Part II, line 3, columns (a) through (i) the information of the previous employer as if you paid the amounts.

Successor employers may be able to count the wages that the previous employer paid to their employees to meet the $7,000 wage base. See the instructions for Part I, line 3 on page 4.

Depositing FUTA Tax

When to deposit. Although Form 940 covers a calendar year, you may have to make deposits of the tax before filing the return. Generally, deposit FUTA tax quarterly but only when your liability exceeds $100. Determine your FUTA tax for each of the first three quarters by multiplying by .008 that part of the first $7,000 of each employee's annual wages you paid during the quarter. If any part of the amounts paid are exempt from state unemployment tax, you may be required to deposit an amount greater than that determined using the .008 rate. For example, in certain states, wages paid to corporate officers, certain payments of sick pay by unions, and certain fringe benefits, are exempt from state unemployment tax.

If your FUTA tax liability for any of the first three quarters of 1998 (plus any undeposited amount of $100 or less from any earlier quarter) is over $100, deposit it by the last day of the month after the end of the quarter. If it is $100 or less, carry it to the next quarter; a deposit is not required. If your liability for the fourth quarter (plus any undeposited amount from any earlier quarter) is over $100, deposit the entire amount by February 1, 1999. If it is $100 or less, you can either make a deposit or pay it with your Form 940 by February 1. (If you deposit it by February 1, you may file Form 940 by February 10, 1999.)

The deposit due dates are shown in the following chart:

If undeposited FUTA tax is over $100 on—	Deposit it by—
March 31	April 30
June 30	July 31
September 30	October 31
December 31	February 1

Note: *If any deposit due date shown falls on a Saturday, Sunday, or legal holiday, you may deposit on the next business day.*

How to deposit. If you are not required to use EFTPS (See **Electronic deposit requirement** on page 1), use **Form 8109,** Federal Tax Deposit Coupon, when you make each tax deposit. The IRS will send you a book of deposit coupons when you apply for an employer identification number (EIN). Follow the instructions in the coupon book. If you do not have coupons, see section 11 in Circular E (Pub. 15).

Make your deposits with an authorized financial institution (e.g., a commercial bank that is qualified to accept Federal tax deposits) or the Federal Reserve bank for your area. To avoid a possible penalty, do not mail deposits directly to the IRS. Records of your deposits will be sent to the IRS for crediting to your business accounts.

Specific Instructions

Employer's name, address, and employer identification number. Use the preaddressed Form 940 mailed to you. If you must use a form that is not preaddressed, type or print your name, trade name, address, and EIN on it. If you do not have an EIN, apply for one on **Form SS-4,** Application for Employer Identification Number. If you do not have your EIN by the time a return is due, write "Applied for" and the date you applied for the number.

Questions A through C. The answers to the questions will direct you to the correct form to file. If you answered "Yes" to all the questions, you may file Form 940-EZ, a simpler version of Form 940. If you answer "No" to any of the questions or you are a successor employer claiming a credit for state unemployment contributions paid by the prior employer, complete and file Form 940.

Final return. If you will not have to file returns in the future, check the box on the line below question C. Then

complete and sign the return. If you start paying FUTA wages again, file Form 940 or 940-EZ.

Amended returns. Use a new Form 940 to amend a previously filed Form 940. Check the Amended Return box above Part I. Enter all amounts that should have been on the original return, and sign the form. Attach an explanation of the reasons for the amended return. For example, you are filing to claim the 90% credit for contributions paid to your state unemployment fund after the due date of Form 940. File the amended return with the Internal Revenue Service Center where you filed the original return.

If you were required to file Form 940 but filed Form 940–EZ instead and you must correct an error, file the amended return on Form 940.

If you are filing an amended return after June 30 to claim contributions to your state's unemployment fund that you paid after the due date of Form 940, attach a copy of the certification from the state. This will expedite the processing of the amended return.

Part I — Computation of Taxable Wages

Line 1 — Total payments. Enter the total payments you made during the calendar year for services of employees, even if the payments are not taxable for FUTA tax. Include salaries, wages, commissions, fees, bonuses, vacation allowances, and amounts paid to temporary or part-time employees; the value of goods, lodging, food, clothing, and noncash fringe benefits; contributions to a 401(k) plan, payments to medical savings accounts (MSA), payments under adoption assistance programs, and contributions to SIMPLE retirement accounts (including elective salary reduction contributions); section 125 (cafeteria) plan benefits; and sick pay (including third party sick pay if liability transferred to employer). For details on sick pay, see **Pub. 15-A,** Employer's Supplemental Tax Guide. Include tips of $20 or more in a month reported to you by your employees. Also, include payments made by a previous employer if you are counting those payments for the $7,000 wage base as explained under ***Successor employer*** in the line 3 instructions below. Enter the amount before any deductions.

How you make the payments is not important to determine if they are wages. Thus, you may pay wages for piecework or as a percentage of profits. You may pay wages hourly, daily, weekly, monthly, or yearly. You may pay wages in cash or some other way, such as goods, lodging, food, or clothing. For items other than cash, use the fair market value when paid.

Line 2 — Exempt payments. The amounts reported on line 2 are exempt from FUTA tax. **Do not** enter payments over $7,000 for each employee. Enter such amounts on line 3. For FUTA purposes, “wages” and “employment” do not include every payment and every kind of service an employee may perform. In general, payments excluded from wages and payments for services excepted from employment are not subject to FUTA tax.

You may deduct exempt payments from total payments only if you explain them on line 2. Amounts that may be exempt from your state's unemployment tax, for example, corporate officers' wages, may not be exempt from FUTA tax.

Enter payments such as the following on line 2 if you included them in total payments on line 1:

1. Agricultural labor if you did not meet either 1 or 2 under **Agricultural employers** on page 2 and **all** payments to H-2(A) visa workers.

2. Benefit payments for sickness or injury under a workers' compensation law.

3. Household services if you did not pay total cash wages of $1,000 or more in any calendar quarter in 1997 or 1998.

4. Certain family employment. (See Cir. E (Pub. 15).)

5. Certain fishing activities. (See **Pub. 595,** Tax Highlights for Commercial Fishermen).

6. Noncash payments for farmwork or household services in a private home. Only cash wages to these workers are taxable.

7. Value of certain meals and lodging. (See Section 5 in Cir. E (Pub. 15).)

8. Cost of group-term life insurance.

9. Payments attributable to the employee's contributions to a sick-pay plan.

10. Employer contributions to a SIMPLE retirement account (other than elective salary reduction contributions).

11. Employer payments to a medical savings account (MSA).

12. Benefits excludable under a section 125 (cafeteria) plan.

13. Certain statutory employees. (See Pub. 15-A.)

14. Services performed by an inmate of a penal institution.

15. Any other exempt service or pay.

For more information, see **Special Rules for Various Types of Services and Payments** in Circular E (Pub. 15) or **How Do Employment Taxes Apply to Farmwork?** in **Circular A,** Agricultural Employer's Tax Guide (Pub. 51).

Line 3 — Payments for services of more than $7,000. Enter the total amounts over $7,000 you paid each employee. For example, if you have 10 employees and paid each $8,000 during the year, enter $80,000 on line 1 and $10,000 on line 3. **Only the first $7,000 paid to each employee is subject to FUTA tax. Do not use the state wage base for this entry. The state wage base may be different from the Federal wage base of $7,000. Do not include any exempt payments from line 2 in figuring the $7,000.**

Successor employer. If you acquired a business from an employer who was liable for FUTA tax, you may count the wages that employer paid to the employees who continue to work for you when you figure the $7,000 wage base. Include on line 3 the payments made by the previous employer that you included on line 1. If the first employer paid $7,000 or more to the employee, also include on line 3 all the wages you paid to that employee. If the first employer did not pay at least $7,000 to the employee, subtract what the first employer paid from $7,000. Then subtract that result from the wages you paid to the employee, and include any result on line 3. See section 3306(b)(1) and Regulations section 31.3306(b)(1)-1(b).

Line 5 — Total taxable wages. This is the total amount subject to FUTA tax. Use this amount in Part II to compute the gross FUTA tax and the maximum credit.

Part II — Tax Due or Refund

Line 1 — Gross FUTA tax. Multiply the total taxable wages in Part I, line 5, by .062. This is the maximum amount of FUTA tax.

Line 2 — Maximum credit. Multiply the total taxable wages in Part I, line 5, by .054. This is the maximum credit against FUTA tax for state contributions.

Line 3 — Computation of tentative credit. You must complete all applicable columns to receive any credit. Your state will provide an experience rate. If you have been assigned an experience rate of 0% or more, but less than 5.4%, for all or part of the year, use columns (a) through (i). If you have **not** been assigned any experience rate, use columns (a), (b), (c), and (i) only. If you have been assigned a rate of 5.4% or higher, use columns (a), (b), (c), (d), (e), and (i) only. If you were assigned an experience rate for only part of the year or the rate was changed during the year, complete a separate line for each rate period.

If you need additional lines, attach a separate statement with a similar format. Also, if you are a successor employer, see **Special credit for successor employers,** on page 3.

Column (a). Enter the two-letter abbreviation for the state(s) to which you were required to pay contributions (including the District of Columbia, Puerto Rico, and the U.S. Virgin Islands).

Column (b). Enter the state reporting number assigned to you when you registered as an employer with each state. Failure to enter the correct number may result in unnecessary correspondence.

Column (c). Enter the state taxable payroll on which you must pay state unemployment taxes for each state shown in column (a). If your experience rate is 0%, enter the wages that would have been subject to state unemployment tax if the 0% rate had not been granted.

Column (d). Enter the beginning and ending dates of the experience rate shown in column (e).

Column (e). Enter your state experience rate—the rate the state assigned to you for paying your state unemployment tax. This rate may change based on your "experience" with the state unemployment fund, for example, because of unemployment compensation paid to your former employees. If you do not know your experience rate, contact your state unemployment insurance service. The state experience rate can be stated as a percent or as a decimal.

Column (f). Multiply the amount in column (c) by .054.

Column (g). Multiply the amount in column (c) by the rate in column (e).

Column (h). Subtract column (g) from column (f). If zero or less, enter -0-. This additional credit is the difference between 5.4% and your state experience rate.

Column (i). Enter the contributions **actually paid** to the state unemployment fund **by the due date** for filing Form 940. **Do not** include amounts you are required to pay but have not paid by the due date (see **When To File** on page 1). If you are **filing Form 940 after the due date,** include only payments made by the return due date, and see the instructions and worksheet under line 6 below. If you are **claiming excess credits** as payments of state unemployment contributions, attach a copy of the letter from your state. **Do not** include any penalties, interest, or special administrative taxes (such as surcharges, employment and training taxes, excise tax, and assessments, which are generally listed as a separate item on the state's quarterly wage report) not included in the experience rate assigned to you.

Line 3a — Totals. Enter the totals of columns (c), (h), and (i).

Line 3b — Total tentative credit. Add line 3a, columns (h) and (i) only. As noted above, column (i) includes **only** payments to your state unemployment fund that you made by the due date for filing Form 940. Payments made after the due date are eligible for a reduced credit and will appear on line 6 as described below.

Line 6 — Credit. This is the credit allowable for your payments to state unemployment funds. If you made no late state contributions, enter the smaller of the amount in Part II, line 2 or line 3b. If you do not have to make payments to the state, enter zero on this line.

Note: *If any any state contributions were made after the Form 940 due date (see* **When To File** *on page 1), your credit for late contributions is limited to* **90%** *of the amount that would have been allowable as a credit if such contributions were paid on or before the Form 940 due date.*

Only taxpayers who made late contributions should complete the worksheet below.

Worksheet for Credit Computation if Any State Contributions Were Paid After the Due Date for Filing Form 940

A.	Enter the amount from Form 940, Part II, line 2	_____
B.	Enter the amount from Form 940, Part II, line 3b, if any.	_____
C.	Subtract line B from line A. If less than zero, enter -0-	_____
D.	Enter total contributions paid to the states **after** the Form 940 due date.	_____
E.	Enter the smaller of lines C or D . .	_____
F.	Multiply line E by .90 (90%) . . .	_____
G.	Add lines B and F	_____
H.	Enter the **smaller** of the amount on line G or A here, **and** on Form 940, Part II, line 6	_____

Example: You paid $1,500 of state contributions by the Form 940 due date and $1,000 after that date. Your maximum credit on Form 940, Part II, line 2 is $2,000; and your tentative credit on line 3b is $1,500. The maximum credit less the tentative credit is $500. If you had paid the $1,000 state contributions on time, you would have been allowed an additional amount of credit of only $500 not the full $1,000. Therefore, the credit for the late contributions is limited to 90% of $500. You complete the worksheet as shown on page 6.

A.	Enter the amount from Form 940, Part II, line 2	$2,000
B.	Enter the amount from Form 940, Part II, line 3b, if any.	1,500
C.	Subtract line B from line A. If less than zero, enter -0-	500
D.	Enter total contributions paid to the states **after** the Form 940 due date.	1,000
E.	Enter the smaller of lines C or D. .	500
F.	Multiply line E by .90 (90%) . . .	450
G.	Add lines B and F	1,950
H.	Enter the **smaller** of the amount on line G or A here, **and** on Form 940, Part II, line 6	1,950

Enter $1,950 from line H of the worksheet on Form 940, Part II, line 6. This is the allowable credit for your contributions to the state unemployment fund.

Line 9 — Balance due. Make your check or money order payable to the "United States Treasury". Write your EIN, "Form 940", and "1998" on your check or money order. Enter the amount of the payment in box 1 on Form 940-V at the bottom of Form 940. If the employer information is not preprinted on the payment voucher, enter the requested information. If the amount on line 9 is under $1, you do not have to pay it. On payments over $100, see **How to deposit** on page 3.

Line 10 — Overpayment. If the amount on line 10 is under $1, we will send a refund or apply it to your next return only on written request.

Part III — Record of Quarterly Federal Unemployment Tax Liability

Complete this part only if your FUTA tax on line 7 is over $100. To figure your FUTA tax liability for each quarter, multiply by .008 that part of the first $7,000 of each employee's annual wages you paid during the quarter. Enter the result in the space for that quarter. Your total liability ("Total for year") must equal your total tax shown in Part II, line 7.

Record your liability based on when you pay wages, not on when you deposit the FUTA tax. For example, if you pay wages on March 29, your FUTA tax liability on those wages is $200, and you deposit the $200 on April 30, you would record that $200 in the first quarter, not in the second.

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to figure and collect the right amount of tax. Chapter 23, Federal Unemployment Tax Act, of Subtitle C, Employment Taxes, of the Internal Revenue Code imposes a tax on employers with respect to employees. This form is used to determine the amount of the tax that you owe. Section 6011 requires you to provide the requested information if you are liable for FUTA tax under section 3301. Section 6109 requires you to provide your employer identification number (EIN).

Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you fail to provide this information in a timely manner, you may be subject to penalties and interest.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 11 hr., 29 min.; **Learning about the law or the form,** 1hr., 5 min.; **Preparing and sending the form to the IRS,** 1hr., 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the tax form to this office. Instead, see **Where To File** on page 2.

Part II Tax Due or Refund

1	Gross FUTA tax. Multiply the wages in Part I, line 5, by .062		1	
2	Maximum credit. Multiply the wages in Part I, line 5, by .054	2		

3 Computation of tentative credit (Note: *All taxpayers must complete the applicable columns.***)**

(a) Name of state	(b) State reporting number(s) as shown on employer's state contribution returns	(c) Taxable payroll (as defined in state act)	(d) State experience rate period From	(d) State experience rate period To	(e) State experience rate	(f) Contributions if rate had been 5.4% (col. (c) x .054)	(g) Contributions payable at experience rate (col. (c) x col. (e))	(h) Additional credit (col. (f) minus col.(g)). If 0 or less, enter -0-.	(i) Contributions paid to state by 940 due date
3a	Totals ▶								

3b	**Total tentative credit** (add line 3a, columns (h) and (i) only—for late payments also see the instructions for Part II, line 6 ▶		
4			
5			
6	**Credit:** Enter the smaller of the amount in Part II, line 2 or line 3b; or amount from the worksheet in the line 6 instructions	6	
7	**Total FUTA tax** (subtract line 6 from line 1). If the result is over $100, also complete Part III	7	
8	Total FUTA tax deposited for the year, including any overpayment applied from a prior year	8	
9	**Balance due** (subtract line 8 from line 7). Pay to the "United States Treasury". If you owe more than $100, see "Depositing FUTA Tax" on page 3 of the instructions ▶	9	
10	**Overpayment** (subtract line 7 from line 8). Check if it is to be: ☐ **Applied to next return or** ☐ **Refunded** ▶	10	

Part III Record of Quarterly Federal Unemployment Tax Liability *(Do not include state liability.)* Complete only if line 7 is over $100. See page 6 of the instructions.

Quarter	First (Jan. 1–Mar. 31)	Second (Apr. 1–June 30)	Third (July 1–Sept. 30)	Fourth (Oct. 1–Dec. 31)	Total for year
Liability for quarter					

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete, and that no part of any payment made to a state unemployment fund claimed as a credit was, or is to be, deducted from the payments to employees.

Signature ▶ **Title (Owner, etc.) ▶** **Date ▶**

Form **941**
(Rev. January 1999)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

▶ **See separate instructions for information on completing this return.**

Please type or print.

OMB No. 1545-0029

Enter state code for state in which deposits were made ONLY if different from state in address to the right ▶ ☐ (see page 2 of instructions).

Name (as distinguished from trade name) | Date quarter ended

Trade name, if any | Employer identification number

Address (number and street) | City, state, and ZIP code

T
FF
FD
FP
I
T

If address is different from prior return, check here ▶ ☐

IRS Use

1 1 1 1 1 1 1 1 1 1 2 3 3 3 3 3 3 3 3 4 4 4 5 5 5
6 7 8 8 8 8 8 8 8 8 9 9 9 9 9 10 10 10 10 10 10 10 10 10 10

If you do not have to file returns in the future, check here ▶ ☐ and enter date final wages paid ▶

If you are a seasonal employer, see **Seasonal employers** on page 1 of the instructions and check here ▶ ☐

1	Number of employees in the pay period that includes March 12th . ▶	**1**			
2	Total wages and tips, plus other compensation			**2**	
3	Total income tax withheld from wages, tips, and sick pay			**3**	
4	Adjustment of withheld income tax for preceding quarters of calendar year			**4**	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)			**5**	
6	Taxable social security wages	**6a**	× 12.4% (.124) =	**6b**	
	Taxable social security tips	**6c**	× 12.4% (.124) =	**6d**	
7	Taxable Medicare wages and tips	**7a**	× 2.9% (.029) =	**7b**	
8	Total social security and Medicare taxes (add lines 6b, 6d, and 7b). Check here if wages are not subject to social security and/or Medicare tax ▶ ☐			**8**	
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay $ _____ ± Fractions of Cents $ _____ ± Other $ _____ =			**9**	
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)			**10**	
11	**Total taxes** (add lines 5 and 10)			**11**	
12	Advance earned income credit (EIC) payments made to employees			**12**	
13	Net taxes (subtract line 12 from line 11). **If $1,000 or more, this must equal line 17, column (d) below (or line D of Schedule B (Form 941))**			**13**	
14	Total deposits for quarter, including overpayment applied from a prior quarter			**14**	
15	**Balance due** (subtract line 14 from line 13). See instructions			**15**	

16 **Overpayment.** If line 14 is more than line 13, enter excess here ▶ $ _____
and check if to be: ☐ Applied to next return **OR** ☐ Refunded.

- **All filers:** If line 13 is less than $1,000, you need not complete line 17 or Schedule B (Form 941).
- **Semiweekly schedule depositors:** Complete Schedule B (Form 941) and check here ▶ ☐
- **Monthly schedule depositors:** Complete line 17, columns (a) through (d), and check here ▶ ☐

17 **Monthly Summary of Federal Tax Liability.** Do not complete if you were a semiweekly schedule depositor.

(a) First month liability	**(b)** Second month liability	**(c)** Third month liability	**(d)** Total liability for quarter

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ | **Print Your Name and Title ▶** | **Date ▶**

Where to file. In the list below, find the state where your legal residence, principal place of business, office, or agency is located. Send your return to the **Internal Revenue Service** at the address listed for your location. No street address is needed. **Note:** *Where you file depends on whether or not you are including a payment.*

Florida, Georgia, South Carolina

Return without payment: Atlanta, GA 39901-0005

Return with payment: P.O. Box 105703, Atlanta, GA 30348-5703

New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)

Return without payment: Holtsville, NY 00501-0005

Return with payment: P.O. Box 416, Newark, NJ 07101-0416

New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

Return without payment: Andover, MA 05501-0005

Return with payment: P.O. Box 371493, Pittsburgh, PA 15250-7493

Illinois, Iowa, Minnesota, Missouri, Wisconsin

Return without payment: Kansas City, MO 64999-0005

Return with payment: P.O. Box 970007, St. Louis, MO 63197-0007

Delaware, District of Columbia, Maryland, Pennsylvania, Virginia

Return without payment: Philadelphia, PA 19255-0005

Return with payment: P.O. Box 8786, Philadelphia, PA 19162-8786

Indiana, Kentucky, Michigan, Ohio, West Virginia

Return without payment: Cincinnati, OH 45999-0005

Return with payment: P.O. Box 7329, Chicago, IL 60680-7329

Kansas, New Mexico, Oklahoma, Texas

Return without payment: Austin, TX 73301-0005

Return with payment: P.O. Box 970013, St. Louis, MO 63197-0013

Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming

Return without payment: Ogden, UT 84201-0005

Return with payment: P.O. Box 7922, San Francisco, CA 94120-7922

California (all other counties), Hawaii

Return without payment: Fresno, CA 93888-0005

Return with payment: P.O. Box 60407, Los Angeles, CA 90060-0407

Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee

Return without payment: Memphis, TN 37501-0005

Return with payment: P.O. Box 70503, Charlotte, NC 28272-0503

If you have no legal residence or principal place of business in any state

All returns: Philadelphia, PA 19255-0005

Privacy Act and Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. We need it to figure and collect the right amount of tax. Subtitle C, Employment Taxes, of the Internal Revenue Code imposes employment taxes on wages, including income tax withholding. This form is used to determine the amount of the taxes that you owe. Section 6011 requires you to provide the requested information if the tax is applicable to you. Section 6109 requires you to provide your employer identification number (EIN). Routine uses of this information include giving it to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. If you fail to provide this information in a timely manner, you may be subject to penalties and interest.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books and records relating to a form or instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

For Form 941:

Recordkeeping	11 hr., 44 min.
Learning about the law or the form	40 min.
Preparing the form	1 hr., 47 min.
Copying, assembling, and sending the form to the IRS	16 min.

For Form 941TeleFile:

Recordkeeping	5 hr., 1 min.
Learning about the law or the Tax Record	6 min.
Preparing the Tax Record	11 min.
TeleFile phone call	11 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the tax form to this address.

Form 941
Payment Voucher

Purpose of Form

Complete Form 941-V if you are making a payment with **Form 941,** Employer's Quarterly Federal Tax Return. We will use the completed voucher to credit your payment more promptly and accurately, and to improve our service to you.

If you have your return prepared by a third party and make a payment with that return, please provide this payment voucher to the return preparer.

Making Payments With Form 941

Make payments with Form 941 only if:

1. Your net taxes for the quarter (line 13 on Form 941) are less than $1,000 or

2. You are a monthly schedule depositor making a payment in accordance with the **accuracy of deposits** rule. (See section 11 of **Circular E,** Employer's Tax Guide, for details.) This amount may be $1,000 or more.

Otherwise, you must deposit the amount at an authorized financial institution or by electronic funds transfer. (See section 11 of Circular E for deposit instructions.) Do not use the Form 941-V payment voucher to make Federal tax deposits.

Caution: *If you pay amounts with Form 941 that should have been deposited, you may be subject to a penalty. See Circular E.*

Specific Instructions

Box 1—Amount paid. Enter the amount paid with Form 941.

Box 2. Enter the first four characters of your name as follows:

- **Individuals (sole proprietors, estates).** Use the first four letters of your last name (as shown in box 5).
- **Corporations.** Use the first four characters (letters or numbers) of your business name (as shown in box 5). Omit "The" if followed by more than one word.
- **Partnerships.** Use the first four characters of your trade name. If no trade name, enter the first four letters of the last name of the first listed partner.

Box 3—Employer identification number (EIN). If you do not have an EIN, apply for one on **Form SS-4,** Application for Employer Identification Number, and write "Applied for" and the date you applied in this entry space.

Box 4—Tax period. Darken the capsule identifying the quarter for which the payment is made. Darken only one capsule.

Box 5—Name and address. Enter your name and address as shown on Form 941.

- Make your check or money order payable to the United States Treasury. Be sure to enter your EIN, "Form 941," and the tax period on your check or money order. Do not send cash. Please do not staple this voucher or your payment to the return or to each other.
- Detach the completed voucher and send it with your payment and Form 941 to the address provided on the back of Form 941.

(Detach here)

Form 941-V

Department of the Treasury
Internal Revenue Service

Form 941 Payment Voucher

▶ Use this voucher when making a payment with your return.

OMB No. 1545-0029

1999

1 Enter the amount of the payment you are making	2 Enter the first four letters of your last name (business name if corporation or partnership)	3 Enter your employer identification number
▶ $.		

4 Tax period		5 Enter your business name (individual name if sole proprietor)
○ 1st Quarter	○ 3rd Quarter	Enter your address
○ 2nd Quarter	○ 4th Quarter	Enter your city, state, and ZIP code

For Privacy Act and Paperwork Reduction Act Notice, see back of Form 941.

Instructions for Form 941

(Revised January 1999)

Employer's Quarterly Federal Tax Return

Department of the Treasury
Internal Revenue Service

Section references are to the Internal Revenue Code unless otherwise noted.

Changes To Note

Social security wage base for 1999. Stop withholding social security tax after an employee reaches **$72,600** in taxable wages.

Threshold for deposit requirement increased from $500 to $1,000. Effective July 1, 1998, if your net taxes for the quarter (line 13) are less than **$1,000,** you are not required to make deposits for that quarter and may pay the taxes with Form 941.

General Instructions

Purpose of Form

Use Form 941 to report:

• Income tax you withheld from wages, including tips, supplemental unemployment compensation benefits, and third-party payments of sick pay.

• Social security and Medicare taxes.

Who Must File

Employers who withhold income tax on wages, or who must pay social security or Medicare tax, must file Form 941 each calendar quarter. After you file the first Form 941, you must file a return for each quarter, even if you have no taxes to report (but see the ***seasonal employer*** and ***final return*** information below). If you filed Form 941 on magnetic tape or by electronic or TeleFile methods, do not also file a paper Form 941.

Seasonal employers are not required to file for quarters when they regularly have no tax liability because they have paid no wages. To alert the IRS that you will not have to file a return for one or more quarters during the year, check the **Seasonal employer** box above line 1 on Form 941. The IRS will mail two Forms 941 to you once a year after March 1. The preprinted name and address information will not include the date the quarter ended. You must enter the date the quarter ended when you file the return. The IRS generally will not inquire about unfiled returns if at least one return showing tax due is filed each year. However, you must check the **Seasonal employer** box on each quarterly return you file. Otherwise, the IRS will expect a return to be filed for each quarter.

Exception. Employers of the following categories of workers do not usually file Form 941.

Household employees. See **Circular E,** Employer's Tax Guide, and **Pub. 926,** Household Employer's Tax Guide (Pub. 15).

Farm employees. See **Form 943,** Employer's Annual Tax Return for Agricultural Employees, and **Circular A,** Agricultural Employer's Tax Guide (Pub. 51).

Business reorganization or termination. If you sell or transfer your business, you and the new owner must each file a return for the quarter in which the transfer occurred. Each should report only the wages it paid. A change from one form of business to another, such as from sole proprietorship to partnership or corporation, is considered a transfer and requires a new employer identification number (EIN). See section 1 of Circular E. If a change occurs, please attach a statement to your return that shows: new owner's name (or new name of the business); whether the business is now a sole proprietorship, partnership, or corporation; kind of change (sale or transfer); and date of change.

When a business is merged or consolidated with another, the continuing firm must file the return for the quarter in which the change took place. The return should show all wages paid for that quarter. The other firm should file a final return.

Final return. *If you go out of business or stop paying wages, file a* ***final return.*** *Be sure to check the final return box and enter the date final wages were paid above line 1. See the* ***Instructions for Forms W-2 and W-3*** *for information on the earlier dates for the expedited furnishing and filing of Form W-2 when a final Form 941 is filed.*

Preparing the Form

The following will allow the IRS to process Form 941 faster and more accurately:

- Make dollar entries without the dollar sign and comma (0000.00).
- Enter negative amounts in parentheses.
- File the Form 941 that has your preprinted name and address.

When To File

File starting with the first quarter in which you are required to withhold income tax or pay wages subject to social security and Medicare taxes.

Quarter	Ending	Due Date
Jan.-Feb.-Mar.	March 31	April 30
Apr.-May-June	June 30	July 31
July-Aug.-Sept.	Sept. 30	Oct. 31
Oct.-Nov.-Dec.	Dec. 31	Jan. 31

If you made deposits on time in full payment of the taxes for a quarter, you have 10 more days after the above due date to file. Your return will be considered timely filed if it is properly addressed and mailed First-Class or sent by an IRS designated delivery service on or before the due date. See Circular E for more information on IRS designated delivery services. If the due date for filing a return falls on a Saturday, Sunday, or legal holiday, you may file the return on the next business day.

Where To File

See the back of Form 941 for the mailing address for your return.

Depositing Taxes

If your net taxes (line 13) are $1,000 or more for the quarter, you must deposit your tax liabilities at an authorized financial institution with **Form 8109,** Federal Tax Deposit Coupon, or by using the **Electronic Federal Tax Payment System (EFTPS).** See section 11 of Circular E for information and rules concerning Federal tax deposits.

Reconciliation of Forms 941 and W-3

Certain amounts reported on the four quarterly Forms 941 for 1999 should agree with the **Form W-2,** Wage and Tax Statement, totals reported on **Form W-3,** Transmittal of Wage and Tax Statements, or equivalent magnetic media reports filed with the Social Security Administration (SSA) (Form 6559). The amounts that should agree are income tax withholding, social security wages, social security tips, Medicare wages and tips, and the advance earned income credit. If the totals do not agree, the IRS will require you to explain any differences and correct any errors. For more information, see section 12 of Circular E.

Penalties and Interest

There are penalties for filing a return late and paying or depositing taxes late, unless there is reasonable cause. If you are late, please attach an explanation to your return. There are also penalties for failure to (1) furnish Forms W-2 to employees and file copies with the SSA or (2) deposit taxes when required. In addition, there are penalties for willful failure to file returns and pay taxes when due and for filing false returns or submitting bad checks. Interest is charged on taxes paid late at the rate set by law. See Circular E for additional information.

Caution: *A **trust fund recovery penalty** may apply if income, social security, and Medicare taxes that must be withheld are not withheld or are not paid. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply when these unpaid taxes cannot be immediately collected from the employer or business. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. See Circular E for more information.*

Ordering Forms and Publications

IRS forms and publications are available by calling 1–800–829–3676 or by accessing the IRS's Internet Web Site at **www.irs.ustreas.gov**. See Circular E for additional methods of obtaining forms and publications.

Forms W-4

Each quarter, send with Form 941 copies of any **Forms W-4,** Employee's Withholding Allowance Certificate, received during the quarter from employees claiming (1) more than 10 withholding allowances or (2) exemption from income tax withholding if their wages will normally be more than $200 a week. For details, see section 9 of Circular E.

Forms W-5

Each eligible employee wishing to receive any advance earned income credit (EIC) payments must give you a completed **Form W-5,** Earned Income Credit Advance Payment Certificate. The employer's requirement to notify certain employees about the EIC can be met by giving each eligible employee **Notice 797,** Possible Federal Tax Refund Due to the Earned Income Credit (EIC). See Circular E and **Pub. 596,** Earned Income Credit, for more information.

Employer Identification Number

If you do not have an EIN, apply for one on **Form SS-4,** Application for Employer Identification Number. Get this form from the IRS or the SSA. If you do not have an EIN by the time a return is due, write “Applied for” and the date you applied in the space shown for the number. Form SS-4 has information on how to apply for an EIN by mail or by telephone.

Note: *Always be sure the EIN on the form you file matches the EIN assigned to your business by the IRS. Do not show your personal social security number on forms calling for an EIN. Filing a Form 941 with an incorrect EIN or using another business' EIN may result in penalties and delays in processing your return.*

Preprinted Name and Address Information

If any of the preprinted name, EIN, or address information on Form 941 is not correct, cross it out and type or print the correct information.

Generally, preprinted address information on Form 941 is from IRS records. However, if you filed a change of address card with the United States Postal Service (USPS), that address information may be preprinted on your Form 941 and 941Telefile Tax Record. If the preprinted address is from the USPS, your IRS address of record will be changed when your return is filed and properly processed.

Specific Instructions

State Code

If you made your deposits in a state other than that shown in your address on Form 941, enter the state code for the state where you made deposits in the box provided in the upper left corner of the form. Use the Postal Service two-letter state abbreviation as the state code. Enter the code “MU” in the state code box if you deposit in more than one state. If you deposit in the same state as shown in your address, do not make an entry in this box.

Line 1—Number of employees

Enter the number of employees on your payroll during the pay period including March 12 (on the January-March calendar quarter return only). Do not include household employees, persons who received no pay during the pay period, pensioners, or members of the Armed Forces. An entry of 250 or more on line 1 indicates a need to file Forms W-2 on magnetic media. Call the SSA at 1–800–772–1213 for more information on magnetic media filing requirements.

Line 2—Total wages and tips, plus other compensation

Enter the total of all wages paid, tips reported, taxable fringe benefits provided, and other compensation paid to your employees, **even if you do not have to withhold income or social security and Medicare taxes on it.** Do not include supplemental unemployment

compensation benefits, even if you withheld income tax on them. Do not include contributions to employee plans that are excluded from the employee's wages (e.g., section 401(k) and 125 plans).

If you get timely notice from your insurance carrier concerning the amount of third-party sick pay it paid your employees, include the sick pay on line 2. If you are an insurance company, do not include sick pay you paid policyholders' employees here if you gave the policyholders timely notice of the payments. See **Pub. 15-A,** Employer's Supplemental Tax Guide, for details.

Line 3—Total income tax withheld

Enter the income tax you withheld on wages, tips, taxable fringe benefits, and supplemental unemployment compensation benefits. An insurance company should enter the income tax it withheld on third-party sick pay here.

Line 4—Adjustment of withheld income tax

Use line 4 to correct errors in income tax withheld from wages paid in earlier quarters of the ***same calendar year.*** You may not adjust or claim a refund or credit for any overpayment of income tax that you withheld or deducted from an employee in a prior year. This is because the employee uses the amount shown on Form W-2 as a credit when filing his or her income tax return. Because any amount shown on line 4 increases or decreases your tax liability, the adjustment must be taken into account on line 17, Monthly Summary of Federal Tax Liability, or on **Schedule B (Form 941),** Employer's Record of Federal Tax Liability. For details on how to report adjustments on the record of Federal tax liability, see the instructions for line 17 (on page 4) or the instructions for Schedule B (Form 941). Explain any adjustments on **Form 941c,** Supporting Statement To Correct Information, or an equivalent statement. See section 13 of Circular E.

Note: *Do not adjust income tax withholding for quarters in earlier years unless it is to correct an administrative error. An administrative error occurs if the amount you entered on Form 941 is not the amount you actually withheld. For example, if the total income tax actually withheld was incorrectly reported on Form 941 due to a mathematical or transposition error, this would be an administrative error. The administrative error adjustment corrects the amount reported on Form 941 to agree with the amount actually withheld from the employees.*

Line 5—Adjusted total of income tax withheld

Add line 4 to line 3 if you are reporting additional income tax withheld for an earlier quarter. Subtract line 4 from line 3 if you are reducing the amount of income tax withheld. If there is no entry on line 4, line 5 will be the same as line 3.

Line 6a—Taxable social security wages

Enter the total wages subject to social security taxes that you paid your employees during the quarter. Also include any sick pay and taxable fringe benefits subject to social security taxes. See section 5 of Circular E for information on types of wages subject to social security taxes. Enter the amount before deductions. Do not include tips on this line. Stop reporting an employee's wages (including tips) when they reach $72,600 for 1999. However, continue to withhold income tax for the whole year on wages and tips even when the social security wage base of $72,600 is reached. See the line 7a instructions for Medicare tax. **If none of the payments are subject to social security tax, check the box in line 8.**

Line 6c—Taxable social security tips

Enter all tips your employees reported during the quarter until tips and wages for an employee reach $72,600 in 1999. Do this even if you were not able to withhold the employee tax (6.2%). However, see the line 9 instructions.

An employee must report to you cash tips, including tips you paid the employee for charge customers, totaling $20 or more in a month by the 10th of the next month. The employee may use **Form 4070,** Employee's Report of Tips to Employer, or a written statement.

Do not include allocated tips on this line. Instead, report them on **Form 8027,** Employer's Annual Information Return of Tip Income and Allocated Tips. Allocated tips are not reportable on Form 941 and are not subject to withholding of income, social security, or Medicare taxes.

Line 7a—Taxable Medicare wages and tips

Report all wages and tips subject to Medicare tax. Also include any sick pay and taxable fringe benefits subject to Medicare tax. See section 5 of Circular E for information on types of wages subject to Medicare tax. There is no limit on the amount of wages subject to Medicare tax. **If none of the payments are subject to Medicare tax, check the box in line 8.**

Include all tips your employees reported during the quarter, even if you were not able to withhold the employee tax (1.45%). However, see the line 9 instructions below.

Line 9—Adjustment of social security and Medicare taxes

Current period adjustments. In certain cases, amounts reported as social security and Medicare taxes on lines 6b, 6d, and 7b must be adjusted to arrive at your correct tax liability. See section 13 of Circular E for information on the following:

- Adjustment for the uncollected employee share of social security and Medicare taxes on tips.
- Adjustment for the employee share of social security and Medicare taxes on group-term life insurance premiums paid for former employees.
- Adjustment for the employee share of social security and Medicare taxes withheld by a third-party sick pay payer.
- Fractions of cents adjustment.

Enter the adjustments for sick pay and fractions of cents in the appropriate line 9 entry spaces. Enter the amount of all other adjustments in the “Other” entry space, and enter the total of the three types of adjustments, including prior period adjustments (discussed on page 4), in the line 9 entry space to the right. Provide a supporting statement explaining any adjustments reported in the “Other” entry space.

Prior period adjustments. Use line 9 to correct errors in social security and Medicare taxes reported on an earlier return. If you report both an underpayment and an overpayment, show only the net difference.

Because any prior period adjustments shown on line 9 increase or decrease your tax liability, the adjustments must be taken into account on line 17, Monthly Summary of Federal Tax Liability, or on Schedule B (Form 941). For details on how to report adjustments on the record of

Federal tax liability, see the instructions for line 17 below or the instructions for Schedule B (Form 941).

Explain any prior period adjustments on Form 941c. **Do not** file Form 941c separately from Form 941. Form 941c is not an amended return but is a statement providing necessary information and certifications supporting the adjustments on lines 4 and/or 9 on Form 941. If you do not have a Form 941c, you may file an equivalent supporting statement with the return providing the required information about the adjustment(s). See section 13 of Circular E.

If you are adjusting an employee's social security or Medicare wages or tips for a prior year, you must file **Form W-2c,** Corrected Wage and Tax Statement, with **Form W-3c,** Transmittal of Corrected Wage and Tax Statements.

Line 10—Adjusted total of social security and Medicare taxes

Add line 9 to line 8 if line 9 is positive (e.g., the net adjustment increases your tax liability). Subtract line 9 from line 8 if line 9 is negative.

Line 12—Advance earned income credit (EIC) payments made to employees

Enter advance EIC payments made to employees. Your eligible employees may elect to receive part of the EIC as an advance payment. Eligible employees who have a qualifying child must give you a completed Form W-5 stating that they qualify for the EIC. Once the employee gives you a signed and completed Form W-5, you must make the advance EIC payments. Advance EIC payments are generally made from withheld income tax and employee and employer social security and Medicare taxes. See section 10 of Circular E and Pub. 596.

If the amount of your advance EIC payments exceeds your total taxes (line 11) for the quarter, you may claim a refund of the overpayment or elect to have the credit applied to your return for the next quarter. Provide a statement with your return identifying the amount of excess payment(s) and the pay period(s) in which it was paid. See section 10 of Circular E.

Line 15—Balance due

You do not have to pay if line 15 is under $1. Generally, you should have a balance due only if your net tax liability for the quarter (line 13) is less than $1,000. (However, see section 11 of Circular E regarding payments made under the ***accuracy of deposits rule***). If line 13 is $1,000 or more and you have deposited all taxes when due, the amount shown on line 15 (balance due) should be zero.

Caution: *If you fail to make deposits as required and instead pay the taxes with Form 941, you may be subject to a penalty.*

Line 16—Overpayment

If you deposited more than the correct amount for a quarter, you can have the overpayment refunded or applied to your next return by checking the appropriate box. If you do not check either box, your overpayment will be applied to your next return. The IRS may apply your overpayment to any past due tax account under your EIN. If line 16 is under $1, we will send a refund or apply it to your next return only on written request.

Line 17—Monthly Summary of Federal Tax Liability

Note: *This is a summary of your monthly tax liability,* ***not*** *a summary of deposits made. If line 13 is less than $1,000, do not complete line 17 or Schedule B (Form 941).*

Complete line 17 only if you were a monthly schedule depositor for the entire quarter (see section 11 of Circular E for details on the deposit rules). You are a monthly schedule depositor for the calendar year if the amount of your Form 941 taxes reported for the lookback period is not more than $50,000. The lookback period is the four consecutive quarters ending on June 30 of the prior year. For 1999, the lookback period begins July 1, 1997, and ends June 30, 1998.

Caution: *If you were a semiweekly schedule depositor during any part of the quarter,* ***do not*** *complete columns (a) through (d) of line 17. Instead, complete Schedule B (Form 941).*

Reporting adjustments on line 17. If the net adjustment during a month is negative (e.g., correcting an overreported liability in a prior period) and it exceeds the total liability for the month, do not enter a negative amount for the month. Instead, enter -0- for the month and carry over the unused portion of the adjustment to the next month. For example, Pine Co. discovered on February 6, 1999, that it overreported social security tax on a prior quarter return by $2,500. Its Form 941 taxes for the 1st quarter of 1999 were: January $2,000, February $2,000, March $2,000. Pine Co. should enter $2,000 in column (a), -0- in column (b), $1,500 in column (c), and the total, $3,500, in column (d). The prior period adjustment ($2,500) offsets the $2,000 liability for February and the excess $500 must be used to offset March liabilities. Since the error was not discovered until February, it does not affect January liabilities reported in column (a).

If excess negative adjustments are carried forward to the next quarter, do not show these excess adjustments on lines 4 or 9. Line 17, column (d), must equal line 13.

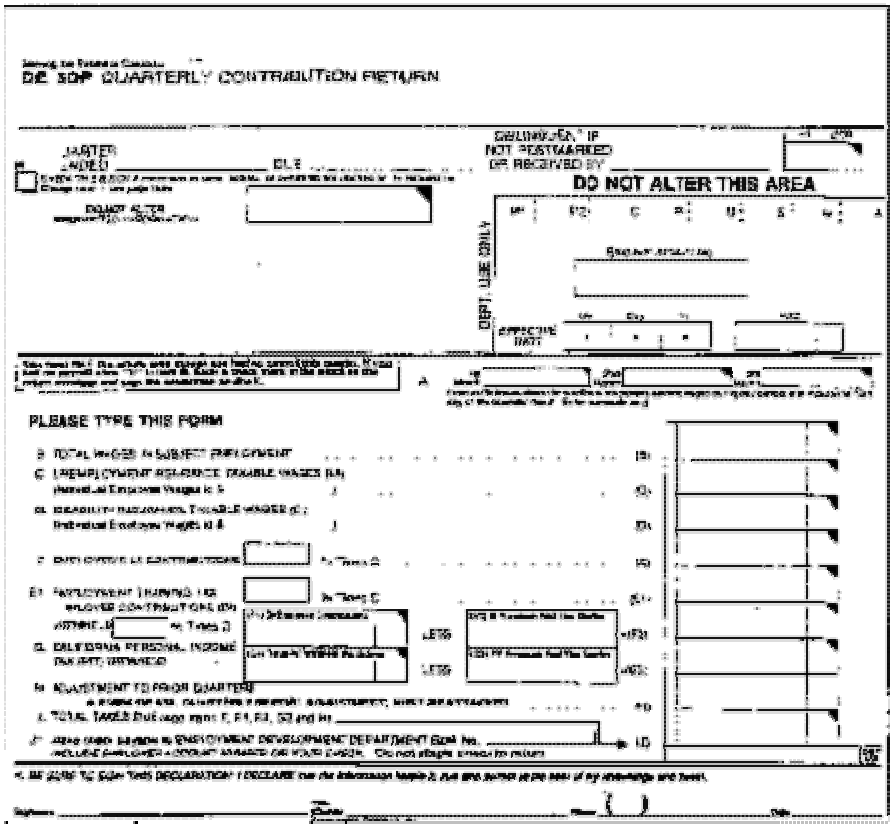
Who Must Sign

- **Sole proprietorship.** The individual owning the business.
- **Corporation.** The president, vice president, or other principal officer.
- **Partnership or unincorporated organization.** A responsible and duly authorized member or officer having knowledge of its affairs.
- **Trust or estate.** The fiduciary.

The return may also be signed by a duly authorized agent of the taxpayer if a valid power of attorney has been filed.

EDD DE 3

Return to MATM Exhibits Page



STATE OF CALIFORNIA
FRANCHISE TAX BOARD

DECLARATION TO SUPPORT CLAIM OF TAXABILITY IN OTHER STATES OF THE UNITED STATES

A taxpayer asserting that it is not subject to California Sales Factor assignment under Section 25135(b), because it is subject to one of the taxes specified in Section 25122 in a sales destination state, must provide substantiation of its claim of taxability as follows:

- By showing that returns have been filed and taxes due have been paid (other than minimum taxes), or
- By providing a statement explaining why no return has been filed, and incontrovertible evidence that its activities in the destination state cause nexus for the taxation of the taxpayer under the U.S. Constitution and exceed the activities protected by Public Law 86-272

A taxpayer wishing to show that its activities in a destination state exceed those protected by Public Law 86-272 should provide the information described below and any other data necessary to support the claim of taxability. If the Franchise Tax Board agrees that the described activities cause the taxpayer to be taxable and the activities are substantiated by objectively verifiable taxpayer records, the sales in question will be assigned to the destination state for apportionment purposes, and a copy of the taxpayer's submission may be furnished to the destination state as authorized by law.

DESTINATION STATE _____

_____
CORPORATION NAME (TAXPAYER)

_____ _____
CALIFORNIA CORPORATE NUMBER FEDERAL EMPLOYER IDENTIFICATION NUMBER

EXPLANATION FOR NOT FILING RETURN(S) WITH DESTINATION STATE:

_____

_____

_____

_____

GENERAL DESCRIPTION OF BUSINESS ACTIVITIES IN DESTINATION STATE:

_____

_____

_____

_____

_____

SPECIFIC ACTIVITY IN DESTINATION STATE _____

_____

Date of commencement of activity _____

Date of termination of activity (if applicable) _____

Description of property in destination state:

Inventory _____

_____

_____

_____

_____

Other Owned Property _____

_____

_____

_____

Rented Property _____

_____

_____

_____

Description of employees in destination state (location and general description of duties) _____

_____

_____

_____

Name and address of the taxpayer's agent for service of process in the destination state: _____

_____

_____

THE ABOVE INFORMATION SUBMITTED BY:

NAME: _____

TITLE: _____ TELEPHONE: _____

ADDRESS: _____

_____

Under penalty of perjury, I declare that the information furnished is to the best of my knowledge and belief, true, correct and complete.

SIGNATURE: _____ DATE: _____

INDIVIDUAL TO PROVIDE SUPPORTING DOCUMENTATION (if other than above):

NAME: _____ TELEPHONE: ( ) _____
AREA CODE

Japan Corp 0123456 **5/20/99**
Schedule of Revised Net Income **INT**
12/90 - 12/92

Schedule I

	Reference	IYE 12/90	IYE 12/91	IYE 12/92
Net Income After State Adjustments	Sch. I a	52,443,663	54,636,782	82,858,413
Nonbusiness Income and Losses:				
-		0	0	0
-		0	0	0
-		0	0	0
Total Nonbusiness Items:		0	0	0
Balance:		52,443,663	54,636,782	82,858,413
Add: Interest Offset		0	0	0
Unitary Business Income		52,443,663	54,636,782	82,858,413
Apportionment Percentage	Sch. II	0.2474%	0.2169%	0.2939%
Amount Apportioned to California		129,757	118,518	243,561
Nonbusiness Income or Loss Wholly Attributable To California:				
-		0	0	0
-		0	0	0
-		0	0	0
Total California Nonbusiness Items:		0	0	0
Balance:		129,757	118,518	243,561
Less: Interest Offset		0	0	0
Net Income Before Contributions Adj.		129,757	118,518	243,561
Contributions Adjustment		0	0	0
Net Income After Contributions Adj.		129,757	118,518	243,561
Net Operating Loss Carryover		0	0	0
Net Income for State Purposes		129,757	118,518	243,561
Tax Rate:		9.3%	9.3%	9.3%
Tax		12,067	11,022	22,651
Minimum Tax Corporations		0	0	0
Other Taxes		0	0	0
Less: Tax Credits		0	0	0
Net Tax		12,067	11,022	22,651
Alternative Minimum Tax	Sch. I f	0	0	0
Total Tax		12,067	11,022	22,651
Less: Previously Assessed		800	800	800
Additional Tax (Overpayment)		11,267	10,222	21,851
TOTAL				43,341

Japan Corp 0123456 **5/20/99**
State Adjustments to Income **INT**
12/90 - 12/92

Schedule I a

(In Yen)	Reference	IYE 12/90	IYE 12/91	IYE 12/92
Net Income Per Return:		5,497,250,000	5,899,250,000	7,615,750,000
Adjustments:				
Taxes Measured by Income	Sch. I b	876,500,000	958,000,000	1,156,500,000
Additions to Reserves	Sch. I c	2,783,500,000	2,171,000,000	3,612,750,000
Less: Actual Expenses allowed	Sch. I c	-1,567,000,000	-1,681,750,000	-1,874,750,000
-		0	0	0
-		0	0	0
Revised State Net Income (In Yen)		7,590,250,000	7,346,500,000	10,510,250,000
Conversion Rate (weighted average)		144.7315	134.4607	126.8459
Revised State Net Income (U.S. $)		52,443,663	54,636,782	82,858,413

Japan Corp 0123456
Revised Apportionment Formula
12/90 - 12/92

5/20/99
INT

Schedule II

	IYE 12/90		IYE 12/91		IYE 12/92	
	Amount	%	Amount	%	Amount	%
Property Factor (Sch. III)						
Total Property	96,338,530,000		106,761,307,000		118,902,943,000	
California Property	313,692,396		318,372,846		432,612,336	
%		0.3256%		0.2982%		0.3638%
Payroll Factor (Sch. IV)						
Total Payroll	17,652,944,000		20,220,780,000		22,210,021,000	
California Payroll	72,771,432		67,373,820		105,567,500	
%		0.4122%		0.3332%		0.4753%
Sales Factor (Sch. V)						
Total Sales	318,288,250,000		346,688,750,000		367,788,000,000	
California Sales	14,057,481		67,106,646		157,027,867	
%		0.0044%		0.0194%		0.0427%
Total %		0.7423%		0.6508%		0.8818%
Average % (To Sch. I)		0.2474%		0.2169%		0.2939%

Japan Corp. 0123456
Computation of Property Everywhere
12/90 - 12/92

5/20/99
INT
Schedule III
Pg. 1 of 2

Description (In Yen)	**Reference**	**IYE 12/89**	**IYE 12/90**	**IYE 12/91**	**IYE 12/92**
Everywhere Property					
Per Return (year end):		0	0	0	0
Adjustments (year end):					
Worldwide Property Per					
Consolidated Financial Stmts.:					
Inventory	w/p 9/1	9,471,000,000	9,581,750,000	9,761,500,000	9,749,750,000
Fixed Assets	w/p 9/1	63,000,500,000	70,895,250,000	78,139,250,000	85,204,250,000
-					
-					
Total End of Year		72,471,500,000	80,477,000,000	87,900,750,000	94,954,000,000
Total Beginning of Year			72,471,500,000	80,477,000,000	87,900,750,000
Total Beginning and Ending			152,948,500,000	168,377,750,000	182,854,750,000
Average Beginning and Ending			76,474,250,000	84,188,875,000	91,427,375,000
Adjustments: (average)					
-			0	0	0
-			0	0	0
Revised Owned Property			76,474,250,000	84,188,875,000	91,427,375,000
Rent Expense as Reported:			0	0	0
Adjustments:					
Worldwide Rent Expense	w/p 9/14		2,483,035,000	2,821,554,000	3,434,446,000
-			0	0	0
-			0	0	0
Rents Capitalized X 8			19,864,280,000	22,572,432,000	27,475,568,000
Property Everywhere (in Yen)	To Sch. II		96,338,530,000	106,761,307,000	118,902,943,000

5/20/99
INT
Schedule III
Pg. 2 of 2

Japan Corp. 0123456
California Property
12/90 - 12/92

Description	Reference	IYE 12/89	IYE 12/90	IYE 12/91	IYE 12/92
California Property at year end					
Per Return:		0	0	0	0
Adjustments (year end):					
Property acquired in 12/88	w/p 9/3	890,443	494,534	475,889	453,485
Average Conversion Rate		128.15	128.15	128.15	128.15
Stated in Yen		114,110,270	63,374,532	60,985,175	58,114,103
Property acquired in 12/89	w/p 9/4	556,871	128,674	99,643	97,564
Average Conversion Rate		137.96	137.96	137.96	137.96
Stated in Yen		76,825,923	17,751,865	13,746,748	13,459,929
Property acquired in 12/90	w/p 9/5		197,028	103,224	103,224
Average Conversion Rate			144.7315	144.7315	144.7315
Stated in Yen			28,516,158	14,939,764	14,939,764
Property acquired in 12/91	w/p 9/6			1,007,421	669,998
Average Conversion Rate				134.4607	134.4607
Stated in Yen				135,458,533	90,088,400
Property acquired in 12/92	w/p 9/7				1,350,811
Average Conversion Rate					126.8459
Stated in Yen					171,344,837
Total End of Year (in Yen)		190,936,194	109,642,555	225,130,221	347,947,034
Total Beginning of Year			190,936,194	109,642,555	225,130,221
Total Beginning and Ending			300,578,749	334,772,776	573,077,254
Average Beginning and Ending			150,289,374	167,386,388	286,538,627
Adjustments: (average)					
-			0	0	0
-			0	0	0
Revised Owned Property			150,289,374	167,386,388	286,538,627
Rent Expense as Reported:			0	0	0
Adjustments:					
US Corp Rents (in US $)	w/p 9/16		141,126	140,363	143,948
-			0	0	0
-			0	0	0
Rents Capitalized X 8			1,129,008	1,122,904	1,151,584
Conversion Rate (weighted average)			144.7315	134.4607	126.8459
Capitalized Rents (in Yen)			163,403,021	150,986,458	146,073,709
California Property (in Yen)	To Sch. II		313,692,396	318,372,846	432,612,336

Note: This example uses the weighted average conversion rate for the year in which the property was acquired. The Regulations call for the exchange rate as of the date of acquisition. If the difference is material and if the information necessary to perform the calculations is available, a more precise conversion may be done.

Japan Corp 0123456
Computation of Payroll Factor
12/90 - 12/92

5/20/99
INT

Schedule IV

Description	Reference	IYE 12/90	IYE 12/91	IYE 12/92
Computation of Total Payroll Everywhere				
Total Payroll Everywhere				
Per Return (In Yen)		17,652,944,000	20,220,780,000	22,210,021,000
Adjustments:				
-		0	0	0
-		0	0	0
-		0	0	0
-		0	0	0
Total Payroll Everywhere (in Yen)	To Sch. II	17,652,944,000	20,220,780,000	22,210,021,000
Computation of California Payroll				
California Payroll per Return (in U.S. $)		502,803	501,067	832,250
Adjustments:				
-		0	0	0
-		0	0	0
-		0	0	0
-		0	0	0
California Payroll (in U.S. $)		502,803	501,067	832,250
Conversion Rate (weighted average)		144.7315	134.4607	126.8459
Total California Payroll (in Yen)	To Sch. II	72,771,432	67,373,820	105,567,500

5/20/99
INT

Japan Corp 0123456
Computation of Sales Factor
12/90 - 12/92

Schedule V

Description	Reference	IYE 12/90	IYE 12/91	IYE 12/92
Computation of Total Sales Everywhere				
Total Sales Everywhere Per Worldwide				
Financial Statements (In Yen)	w/p 6/3	318,288,250,000	346,688,750,000	367,788,000,000
Adjustments:				
-		0	0	0
-		0	0	0
-		0	0	0
-		0	0	0
Total Sales Everywhere (in Yen)	To Sch. II	318,288,250,000	346,688,750,000	367,788,000,000
Computation of California Sales				
California Sales per Return (in U.S. $)		97,128	335,519	460,114
Adjustments:				
US Corp: Sales to Spain	w/p 11/2	0	163,561	476,879
US Corp: Sales to Thailand	w/p 11/2	0	0	300,949
-		0	0	0
-		0	0	0
California Sales (in U.S. $)		97,128	499,080	1,237,942
Conversion Rate (weighted average)		144.7315	134.4607	126.8459
Total California Sales (in Yen)	To Sch. II	14,057,481	67,106,646	157,027,867

FOREIGN COUNTRY ACCOUNTING PRACTICES

Return to MATM Exhibits Page

When auditing foreign-owned corporations, the financial statements will often be prepared using the accounting principles of a foreign country. These accounting principles may be significantly different from the generally accepted accounting principles (GAAP) used in the United States. In order to recognize issues and verify that foreign income is properly represented in the combined report, the auditor should become familiar with the basic accounting practices of the foreign parent's country.

There are several publications available that summarize the significant accounting principles of most major countries. A three-volume Matthew Bender "*World Accounting*" text covers the accounting principles of 20 countries. The AICPA publishes a series entitled "*The Accounting Profession in (particular country)*", and some of the "Big-6" accounting firms publish similar handbooks. Tax Management Inc (BNA) publishes a series of Foreign Income Portfolios entitled "*Business Operations in (particular country)*" which focus primarily on the foreign tax accounting treatment. Auditors should investigate which publications are available in their program office or at the public library in their area.

The table at the end of this exhibit summarizes some of the significant accounting practices for several foreign countries. The table is intended as a quick reference, but should not be a substitute for more in-depth research, particularly if a material issue is identified.

Foreign depreciation and inventory issues are discussed at MATM 6020 and MATM 6075. Some other common issues that auditors will encounter with respect to foreign accounting practices are as follows:

Asset Revaluation:

Many foreign countries permit some type of asset revaluation. This is most common with respect to investments, but also may occur for property, plant and equipment. In some cases, assets will be written-down when their market value falls below historical cost, and the unrealized losses will reduce net income. In other cases, the losses will be charged to a revaluation reserve until they are recognized. Some countries also allow asset values to be written-up to reflect price increases. The financial statements will usually disclose the current year and cumulative revaluation amounts. If depreciation or amortization was computed based upon the revalued amounts, those figures will often be disclosed as well.

The property factor should reflect historical cost rather than revalued amounts. If material, adjustments to net income should be made to back out unrealized revaluation gains and losses. Corresponding adjustments may need to be made for depreciation or amortization expense. When the revalued assets are disposed of, offsetting adjustments will be necessary to reflect the book/California tax basis difference that will exist.

In cases where the financial statement disclosure is very good or where the revaluation applies to a small number of very large assets, it may not be difficult to obtain the information necessary to make adjustments. In other cases, it may

be necessary to make reasonable approximations as permitted by Regulation §25106.5-3(e)(1) (see MATM 5145). For example, a foreign corporation with a large portfolio of securities may value the portfolio at lower of cost or market value at year end, and report the resulting unrealized loss in net income. If the loss is material, it should be reversed when determining worldwide combined income. When the securities are sold in later years, the California tax gain will be smaller than the book gain because of the difference in the basis of the securities. In a perfect world, the taxpayer would be able to trace the auditor's restoration of the write-down adjustments to the specific securities involved and correctly compute the California gain or loss. Realistically however, either the information needed to make this adjustment does not exist, or the effort and expense involved would be disproportionate to the potential tax at issue. A reasonable approximation might be to allow the restored write-downs to be amortized over a reasonable period of time, beginning with the year after the disallowance. A reasonable period of time will depend upon the facts and circumstances of the taxpayer. For some taxpayers, the average holding period of the written-down securities might be used. In other cases, an agreed upon period, such as five years, might be adequate.

Reserves:

The accounting principles of many countries (including the U.S.) utilize reserves. If large losses or expenditures are anticipated due to an future event such as a business restructuring or possible litigation damages, then the corporation may charge the unrealized loss against income in the current year and establish a reserve account. As the losses or expenditures are actually incurred, they will be charged against the reserve. In other cases, unrealized gains or losses (such as gains or losses from asset revaluations) will be run through a reserve account *instead* of being charged against income. When the gains or losses become recognized, they are backed out of the reserve account and charged to income. This type of reserve is intended to provide information to investors and does not result in the acceleration of unrealized losses.

Material reserves are usually disclosed in the financial statements (an exception is Germany, which only requires disclosure for certain limited types of contingencies). If the reserves represent unrealized losses that have been charged against income, then adjustments should be made to restore the losses. The taxpayer should be asked to provide documentation to establish when the losses were actually recognized so that offsetting adjustments can be made in subsequent years.

Unrealized Translation Gains/Losses:

Translation practices vary from country to country, but it is common for unrealized translation losses to be reported in net income. If the financial statements do not disclose the amounts of unrealized translation losses, the auditor should request the figures from the taxpayer.

Many countries use current exchange rates instead of historical rates to translate assets. Although this difference will not usually create a large tax effect, it could be material if significant changes in the exchange rates have occurred. California

translation rules are covered in MATM 5320.

Consolidation Practices:

Not all countries require all majority-owned subsidiaries to be included in the consolidated return. Therefore, the auditor can not necessarily assume that the foreign financial statements include the income of all unitary affiliates. The financial statements may disclose the non-consolidated subsidiaries. As a standard audit procedure, the auditor should identify which entities have been included, and conduct a search for other majority-owned affiliates. Lexis/Nexis, corporate directories, and articles in trade journals or other publications are often good sources for locating affiliates.

Subsidiaries Accounted for Under Equity Method:

For book purposes, a corporation's basis in a subsidiary's stock may be increased or decreased based on the subsidiary's earnings. For California tax purposes, the basis is generally the original cost plus contributed capital. This difference may create significant book/tax differences when the stock is sold. Some countries allow subsidiaries to be reported on an equity basis for financial statement presentation even if ownership is 50% or less. Any income attributable to these subsidiaries would be excluded from the combined report because of insufficient ownership. Furthermore, any dividends paid by the subsidiaries would be included in income for California even though the dividends may be eliminated from the financial statements. The auditor may have to request the consolidation workpapers or the pre-consolidation books of account to find the dividend amounts.

Country	Asset Valuation	Currency Translation	Consolidation Practices	Other Comments
Australia	Unrealized losses from investment writedowns included in income. Asset writedowns permitted but charged to reserve.	Current rate method or temporal rate method (end-of-year rates for monetary items, historical rates for nonmonetary items). Unrealized translation gains/losses reported in income.	All majority-owned subs included in consolidation.	
Canada	Unrealized losses from long & short term investment writedowns reported in income. For years beginning before 12/1/90, capital assets occasionally written up to appraised values.	Current rate method or temporal rate method (end-of-year rates for monetary items, historical rates for nonmonetary items). Unrealized translation gains/losses reported in income, but may be deferred and amortized if related to long-term monetary investments or liabilities.	Consolidated statements generally include majority-owned subs except for banks and life insurance companies. Entities are also excluded if their business operations are substantially different from operations of the rest of the group.	Stock investments accounted for using equity method if ownership exceeds 20%.
France	Investments in securities carried at lower of cost or market, unrealized losses reported on profit & loss statement as "other financial charges." Write-downs of property also permitted.	Unrealized translation gains deferred until they become realized, but unrealized losses flow through the profit & loss account.	Full integration of companies controlled over 50%. Companies controlled at least 20% but not over 50% reported using equity method. Joint ventures owned by several companies use proportional integration method.	All leases accounted for as operating leases, but notes to financial statements contain disclosures regarding capital leases.
Germany	Marketable securities carried at lower of cost or market. If further reduction in market value is expected within 2 years, the lower	No accounting standards for translating foreign currency financial statements. If foreign assets/liabilities are significant, a statement	Prior to 1990, only German companies required to be included in consolidated statements. As of 1/1/90, all majority-owned subs should	Financial statement disclosure very limited. For example, many countries permit reserves for contingencies or anticipated

Country	Asset Valuation	Currency Translation	Consolidation Practices	Other Comments
	value may be used. Long-term investments written down if decline in value expected to be permanent. Write-downs not disclosed.	regarding the translation is required in the notes. Unrealized foreign currency transaction gains related to short-term receivables and payables may be included in income, but generally are deferred. Unrealized losses reported currently.	generally be consolidated, but there are many exceptions. For example, subs may be excluded if the controlling company intends to dispose of the sub, or if inclusion would causes high costs or significant delay in obtaining information needed for the consol-idation. Exclusion required if the sub is in a signif-icantly different line of business from the rest of the group.	liabilities, but require that material reserves be disclosed in the financial statements. Germany also allows such reserves, but only requires disclosure for certain limited types of contingencies. Close inspection of notes to the financial statements and "management reports" (similar to U.S. annual reports) may provide some clues.
Japan	Marketable securities and long-term investments in equity securities may be written down to market, and the unrealized losses are reported in the income statement.	Short-term monetary assets/obligations translated at end-of-year exchange rates, other assets translated at historical rates. Unrealized gains/losses may be included in income.	Only significant subs (those whose sales or assets amount to at least 10% of the combined sales/assets of the group) are required to be consolidated. Investments in unconsolidated subs included under equity method.	Public companies generally prepare 2 separate sets of financial statements, one for distribution to shareholders, and a more detailed one to file with the Ministry of Finance.
Taiwan	Short-term investments are carried at lower of cost or market, and unrealized losses are reported in income. Real, tangible and intangible property may be stepped up in certain circumstances to reflect increasing price levels. The revaluation increment is	The weighted average exchange rate for the period is used to translate revenue and expense items. Assets and liabilities are translated using the current rate. Unrealized gains and losses are reported as an exchange adjustment to stockholder's equity.	Majority-owned subs should generally be consolidated. If inclusion is not proper because of a sub's business activities, the equity method of accounting for that subsidiary should be used. The equity method should be used for subs owned between 20% and 50%.	

Country	Asset Valuation	Currency Translation	Consolidation Practices	Other Comments
	credited to stockholder's equity instead of income. Writedowns of long-term equity investments are charged to stockholder's equity unless the decrease is permanent, in which case the loss is reported in income.			
United Kingdom	Tangible and intangible property and investments may be revalued. Unrealized losses from permanent declines in value are charged to the profit & loss account. Other unrealized gains/losses charged to a revaluation reserve.	Income statements of foreign subsidiaries translated at end-of-year rates.	All majority-owned subs generally included. Exceptions include immaterial subs, and subs whose activities are substantially different from the rest of the group.	Separate statutory requirements govern financial reporting in Great Britain (England, Scotland & Wales) and in Northern Ireland, but the requirements are virtually identical.

SAMPLE STATEMENT CONFIRMING PRELIMINARY UNITARY FACTS AND THE TAXPAYER'S AGREEMENT WITH THE PROPOSED AUDIT ADJUSTMENT

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Based upon the preliminary information described below, Corporations X and Y appear to be unitary for IYEs xx/xx - xx/xx. The taxpayer has indicated it is in agreement that Corporations X and Y are unitary, therefore it is not necessary to complete the unitary examination at this time.

By signing this statement, you are confirming that the facts described below are accurate with respect to IYEs xx/xx - xx/xx. You are also confirming your agreement to the unitary combination of Corporations X and Y for IYEs xx/xx - xx/xx.

If any of the facts or statements contained in this document are found by the Franchise Tax Board staff to be inaccurate, additional factual development necessary to complete the examination of this issue may be undertaken at that time. In addition, if the adjustment is protested or if a claim for refund is subsequently filed, the case will be returned to the field for complete factual development.

Preliminary Facts Regarding the Unitary Relationship Between Corporations X and Y:

[Auditor: List the facts or information that leads you to believe that the corporations would probably be found to be unitary. Include information obtained from discussions with the taxpayer, third party sources such as annual reports, and initial IDRs, as well as any facts developed in prior audit cycles which you believe to still be present in the current cycle. Since the tax personnel are unlikely to have personal knowledge of the operations, the statement should be signed by a principle officer of the corporation.]

Statement of Taxpayer:

I have personal knowledge that the facts listed above are accurate with respect to the income years ending xx/xx - xx/xx. I also agree with the conclusion that Corporations X and Y are unitary, and do not plan to protest that issue.

Authorized Signature: _____

Print Name, Title: _____

An individual's signature above shall be prima facie evidence that such individual is authorized to sign this statement on behalf of the taxpayer.