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LEGAL RULING 2006 - 01 **April 28, 2006**

SUBJECT: Apportionment Factor Treatment of Exempt Income

ISSUE

When a taxpayer receives income that is partially or completely excluded from the measure of the income or franchise tax, how should the activities related to that income be reflected for apportionment factor purposes?

FACTS

Situation 1: Corporation A is an exempt organization that is ordinarily not subject to the income or franchise tax. However, Corporation A also has a division that engages in activities that give rise to unrelated business taxable income which must be reported on an income or franchise tax return. Corporation A conducts activities that generate exempt and taxable income in California as well as other states. The taxpayer has property, payroll and sales attributable to both the exempt and taxable activities in the following amounts:

PAYROLL

Payroll Everywhere

Related to taxable activity	Related to nontaxable activity	Total
$200	$800	$1000

Payroll in California

Related to taxable activity	Related to nontaxable activity	Total
$20	$200	$220

PROPERTY

Property Everywhere

Related to taxable activity	Related to nontaxable activity	Total
$100	$500	$600

Property in California

Related to taxable activity	Related to nontaxable activity	Total
$20	$100	$120

SALES

Sales Everywhere

Related to taxable activity	Related to nontaxable activity	Total
$400	$2000	$2400

Sales in California

Related to taxable activity	Related to nontaxable activity	Total
$100	$500	$600

Situation 2: Corporation A, with a commercial domicile in a state other than California, receives a $1000 dividend from its unitary affiliate, Corporation B. Corporation B is excluded from the combined report of Corporation A by virtue of a water's-edge election. Pursuant to California Revenue and Taxation Code section 25120[1], the dividend is included as business income in the combined report of Corporation A's water's-edge group; however, 75 percent of the dividend is eliminated from income by operation of section 24411. The taxpayer has an income producing activity readily identifiable with the receipt of the dividend.

LAW AND ANALYSIS

The income of multistate taxpayers is sourced to this state under the Uniform Division of Income for Tax Purposes Act (UDITPA) (§§25120 – 25139.) UDITPA classifies income into two mutually exclusive categories: "business income" and "nonbusiness income." Section 25120, subdivision (a), provides: "'Business income' means 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' means all income other than business income." (§ 25120, subd. (d).)

Business income is apportioned to California under an objective formula, described by one court as follows:

[1] All section references are to the Revenue and Taxation Code, and all references to regulations (hereinafter "Reg.") are to sections of Title 18 of the California Code of Regulations unless otherwise specifically noted.

> The California statutory apportionment formula takes into account three fractions. The first fraction, known as the "property factor," has a numerator of the average value of California real and tangible personal property and a denominator of all real and tangible personal property. (§ 25129.) The second fraction is the "payroll factor," which is the total amount of compensation paid by the taxpayer in California divided by the total compensation paid everywhere. (§ 25132.) The third fraction is the "sales factor," which is the total sales in California divided by the "total sales of the taxpayer everywhere during the income year." (§ 25134.) Each fraction has a numerator representing the amount attributable to California and a denominator representing the worldwide amount.

(*Citicorp North America v. Franchise Tax Bd.* (2000) 83 Cal.App.4th 1403, 1412 , cert. den. (2001) 533 U.S. 963.)

Nonbusiness income is allocated to a specific state or states; it is not apportioned. (§§ 25123-25137.)

In his article describing the operation of the UDITPA approach, William Pierce, the principal drafter of UDITPA, explained that:

> [T]he uniform act assumes that the existing state legislation has defined the base of the tax and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense.

(Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Tax Magazine 747 (Oct. 1957).)

After net income (as defined by state law) has been computed, UDITPA then determines what portion of that net income is allocable to a specific state or states as nonbusiness income, and what portion is business income subject to apportionment. Once business income has been determined, UDITPA apportions it using only those activities that gave rise to the income (the tax base) that is being apportioned. Thus, the components of the payroll, property, and sales factors only reflect the activities that produced the business income subject to apportionment. Property, payroll, and sales related to activities that did not give rise to business income subject to apportionment are not included in the apportionment formula.

The California Court of Appeal has affirmed this principle. In *Chase Brass and Copper Company Inc. v. Franchise Tax Board* (1977) 70 Cal.App.3d 457, the court held that because intercompany sales are eliminated from the tax base and are not included in the net income subject to apportionment, those sales should be excluded from the sales factor as well. The court stated:

> As to the sales factor, the record indicates that the Board excluded sales from one member of the unitary group to another, as no net income is realized as a result of the internal sales. Thus, the sales factor only included sales to outside purchasers. Chase argues that the sales factor as so computed erroneously distorts Kennecott's sales outside of California. These contentions ignore the fact that while *gross sales* are used to compute the sales factor, only *net income* is subject to the franchise tax. Since no net income is produced by the internal sales, it was not required that they be included in the computation. [Emphasis in the original]

(*Id.* at 473)

Similarly, the Franchise Tax Board has ruled that the activities of an entity exempt from the franchise tax should not be included in the combined report and should not be subject to UDITPA's apportionment provisions. In Legal Ruling 385, March 28, 1975, the Franchise Tax Board ruled that insurance companies, which are constitutionally exempt from the franchise tax, should not be included in a combined report with entities that are otherwise factually unitary with the insurance company. The ruling stated in part:

> A corporate insurer expressly exempted from these taxes by the California Constitution is not a "taxpayer" as defined in Section 23037. Accordingly, the Section 25101 limitation to a "taxpayer" bars the inclusion in a combined report of the income *and formula factors* of any corporate insurer operating in California, irrespective of the fact that it may have extensive intercorporate business connections with its affiliates conducting the unitary business. (Emphasis added.)

Legal Ruling 385 is an illustration of the principle, in the context of a combined report, that only entities subject to the Corporation Franchise or Income Tax should have their income and factors included in the combined report. Since the insurance company's income is exempt from the income or franchise tax, its factors as well as its income should be excluded from the combined report of the unitary group.

UDITPA itself does not specifically provide rules for the principles set forth above, but the regulations under UDITPA provide an illustration of the need to accomplish such a division of activities in its treatment of nonbusiness income. Because nonbusiness income is allocated, and not apportioned,[2] the activities that give rise to nonbusiness

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[2] Reg. section 25121, subsection (a)(2), provides that the word "apportionment" refers "to the division of business income between states by the use of a formula containing apportionment factors." Nonbusiness income is not addressed in the definition of "apportionment" and is addressed in Reg. section 25121, subsection (a)(3), which

income are similarly excluded from the apportionment formula. Thus, the payroll, property, and sales factors used in the apportionment of business income do not include activities related to the production of nonbusiness income. (See Reg. § 25129 subs. (a), second paragraph; Reg. § 25132 subs. (a)(2), second paragraph; Reg. §25134 subs. (a)(1).) Only activities that give rise to business income are included in the apportionment formula. This is appropriate because the nonbusiness activities are not related to the business income being apportioned. These same principles apply to the exclusion from the apportionment formula of activities that produce income not included in the tax base. In both cases, the activities are unrelated to the business income being apportioned.

The above analysis does not rely on a determination that the apportionment formula would unfairly reflect the activities of the business if the excluded amounts (nonbusiness or otherwise) were to be included.[3] Rather the exclusion is the result of the basic function of the UDITPA formula, which seeks to assign net business income solely on the basis of those activities that gave rise to such income. The activities that gave rise to the excluded income amounts are simply irrelevant in the UDITPA approach. This would be equally true for all activities that do not result in net business income, regardless of whether it is because the activity results in income that is nonbusiness in character or results in income that is excluded by operation of a statute.[4]

Other states have adopted this position in administrative decisions. The Revenue Department of the State of North Carolina has held: "Since exempt income is not apportioned, it is not included in the apportionment formula used to divide apportionable income, just as nonbusiness income is not included in the apportionment formula because it is not apportioned, but rather allocated."[5] Similarly, the Illinois Department of Revenue has held that partially exempted items of income, namely a portion of dividends exempted from taxation because they were paid by entities outside of the

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provides that nonbusiness income is assigned to a particular state (or states) through "allocation."

[3] This ruling expresses no opinion as to whether such an argument would have merit, as it falls outside the scope of this ruling.

[4] This analysis would apply regardless of whether the statute uses the term "exempted," "excluded," "deducted, "not recognized," etc. The conclusion is based upon the fact that these income amounts are related to activities excluded from net income subject to apportionment, not the language used in the statute to reach this conclusion. Therefore, factor amounts related to exclusions or exemptions from gross income as a result of the application of various provisions of the Internal Revenue Code, i.e. sections 351, 721, etc., would likewise be excluded from the apportionment formula to the extent the income is not included in income subject to apportionment.

[5] In the matter of: The denial of a refund of corporate income tax for tax years ended December 31, 1991, through December 31, 1993, by the *Secretary of Revenue of North Carolina v. [Taxpayer*], 97-985 (3/30/1998).

water's edge, should not be included in the sales factor of the apportionment formula to the extent the dividends were excluded from income.[6]

Once it is determined that activities giving rise to income not included in the income base should be excluded from the apportionment formula, it is necessary to address how this exclusion should be accomplished. In some cases, this will be straightforward. Factors related to income that is wholly exempt from tax simply will be removed from both the numerator and denominator of the formula. Income items that are proportionately exempted from tax will be proportionately removed from the formula. However, in some cases, a business may engage in activities that support the production of not only taxable business income, but also excluded income. In these cases it will be necessary to separate these activities into component parts, with one part included in the apportionment formula, and the other not included. As noted above, current regulations regarding the treatment of nonbusiness income provide guidance on how this should be accomplished. Thus, for example, Reg. section 25129 subs. (a), second paragraph, states:

> Property used both in the regular course of the taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case.

Accordingly, if property is used for both the production of taxable business income and income not included in the measure of the tax, the property factor for the apportionment of business income will reflect only that portion of the value of the property used in the production of taxable business income.

A similar principle applies to the assignment of expenses to business and nonbusiness income. Reg. section 25120, subsection (d), provides that where an activity gives rise to deductions that are attributable to both business and nonbusiness activities, the deductions shall be "pro rated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deductions among the classes of income to which it is applicable."

Similarly, section 24425 provides that "[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part" should be disallowed as a deduction. Thus, if a taxpayer engages in an activity that generates both taxable income and exempt income, section 24425 requires an appropriate assignment of expenses to the taxpayer's exempt income. Accordingly, an exempt organization with unrelated business taxable income will be able to deduct expenses that relate to that unrelated business taxable income,

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[6] *The Department of Revenue for the State of Illinois v. Karloff Labratories Inc.*, IT 99-5 (6/22/1999).

but it cannot deduct expenses that relate to the taxpayer's exempt activity. Section 24425 applies an approach similar to that provided in Reg. section 25120, subsection (d), to assign expenses to all classes of income not included in the measure of tax.

Just as these sections deny deductions allocable to income not included in the measure of the tax, the apportionment factors attributable to such income should also be removed from the apportionment formula. Therefore, if an activity generates both income included in the measure of tax and excluded income, only factors related to the production of the income subject to tax should be utilized to apportion that income, just as a division of expenses occurs in the context of the production of taxable and exempt income. (See *Appeal of Zenith National Insurance Co.*, 98-SBE-001, Jan. 8, 1998, dec. on rehg., 98-SBE-001-A, June 25, 1998; *Appeal of Mission Equities Corp.*, 75-SBE-002, Jan. 7, 1975.) For example, this may be accomplished for payroll factor purposes through a time ratio for the employees engaged in activities that generate exempt income as well as taxable income. The property factor can be bifurcated in a manner similar to that provided with respect to business and nonbusiness income, as described above. In the case of the sales factor this can be accomplished by eliminating sales from the sales factor to the extent they relate to exempt income not subject to apportionment.

HOLDING

Situation 1:

Because the taxpayer engages in activities that are both exempt and non-exempt, there must be a determination as to what activities of the taxpayer give rise to the income subject to tax. Those activities are the only activities that will be reflected in the tax base and the apportionment formula. Therefore, in this example, the payroll factor would be $20/$200 or 10%; the property factor would be $20/$100 or 20%; and the sales factor would be $100/$400 or 25%.

If there are activities that are undertaken for a dual purpose, the payroll and property associated with the activities should be divided into exempt and taxable portions. This may be accomplished through a time ratio or other reasonable means. The sales factor will reflect only those sales giving rise to income subject to tax.

Situation 2:

Because the dividend in issue is 75 percent excluded from the tax base, the denominator of the sales factor will only reflect $250 of the dividend, 25 percent of the total dividend amount. The remaining $750 will be excluded because it relates to an activity excluded from the tax base apportioned by UDITPA.

DRAFTING INFORMATION

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