Instructions for Schedule R

Apportionment and Allocation of Income

General Information

This schedule is used by all taxpayers who are required to apportion business income. Special instructions apply to individuals, partnerships and limited liability companies (LLCs). See General Information B, Individuals, and General Information C, Partnerships and Limited Liability Companies, for more information.

Unless stated otherwise, the term "corporation" as used in these instructions and schedules includes "banks." See Cal. Code Regs., tit. 18 section 23038(a)(1) for more information.

For taxable years beginning on or after January 1, 2011:

- Any apportioning trade or business, other than an apportioning trade or business under Revenue and Taxation Code (R&TC) Section 25128(b), may make an irrevocable annual election on an original timely filed return to apportion California business income using the single-sales factor formula. To make the single-sales factor formula election, complete Schedule R-1, on Side 3 of Schedule R, Part B, Alternate Method – Single-Sales Factor Formula. Be sure to check the "Yes" box at the top of Schedule R-1.
- R&TC Section 25136(b) requires a taxpayer to assign sales, other than sales of tangible personal property, based on market rather than costs of performance when a single-sales factor formula election has been made. See Cal. Code Regs., tit. 18 section 25136-2 for more information.
- R&TC Section 25135(b) adopts the Finnigan rule in assigning sales from tangible personal property.
- R&TC Section 25120 was amended to add the definition of gross receipts.

For more information regarding the items listed above, see General Information G, Sales Factor; General Information H, Computation of Apportionment Percentage; or go to **ftb.ca.gov** and search for **law changes**.

For taxable years beginning on or after January 1, 2011, a taxpayer is "doing business" if it actively engages in any transaction for the purpose of financial or pecuniary gain or profit in California or if **any** of the following conditions is satisfied:

- The taxpayer is organized or commercially domiciled in California.
- The sales, as defined in R&TC Section 25120(e) or (f), of the taxpayer in California, including sales by the taxpayer's agents and independent contractors, exceed the lesser of $509,500 or 25% of the taxpayer's total sales.
- The real property and tangible personal property of the taxpayer in California exceed the lesser of $50,950 or 25% of the taxpayer's total real property and tangible personal property.
- The amount paid in California by the taxpayer for compensation, as defined in R&TC Section 25120(c), exceeds the lesser of $50,950 or 25% of the total compensation paid by the taxpayer.

In determining the amount of the taxpayer's sales, property, and payroll for doing business purposes, include the taxpayer's pro rata share of amounts from partnerships and S corporations. For more information, refer to R&TC Section 23101 or go to **ftb.ca.gov** and search for **law changes**.

R&TC Section 24410 was repealed and re-enacted to allow a "Dividends Received Deduction" of qualified dividends received from an insurer subsidiary. The deduction is allowed whether or not the insurer is engaged in business in California, if at the time of each payment at least 80% of each class of stock of the insurer was owned by the corporation receiving the dividend. For taxable years beginning on or after January 1, 2004, and **before** January 1, 2008, an 80% deduction is allowed for qualified dividends. For taxable years beginning on or **after** January 1, 2008, the deduction is increased to 85%. A portion of the dividends may not qualify if the insurer subsidiary paying the dividend is overcapitalized for the purpose of the dividends received deduction. Get Schedule H (100), Dividend Income Deduction; Schedule H (100W), Dividend Income Deduction – Water's Edge Filers; or Schedule B/C/D/H (100S) instructions for more information.

For taxable years beginning on or after January 1, 2008, dividend elimination is allowed regardless of whether the payer/payee are taxpayer members of the California combined unitary group return, or whether the payer/payee had previously filed California tax returns, as long as the payer/payee filed as members of a comparable unitary business outside of this state when the earnings and profits from which the dividends were paid arose.

In addition, dividend elimination is allowed for dividends paid from a member of a combined unitary group to a newly formed member of the combined unitary group if the recipient corporation has been a member of the combined unitary group from its formation to its receipt of the dividends. Earnings and profits earned before becoming a member of the unitary group do not qualify for elimination. See R&TC Section 25106 for more information.

In *Farmer Bros. Co.* vs. *Franchise Tax Board* (2003) 108 Cal App 4th, 134 Cal Rptr. 2nd 390, the California Court of Appeal found R&TC Section 24402 to be unconstitutional. A statute that is held to be unconstitutional is invalid and unenforceable. Therefore, R&TC Section 24402 deduction is not available.

A Apportionment and Allocation

Apportioning Trade or Business – An apportioning trade or business is a distinct trade or business that is required to apportion its business income because it is derived from sources within and outside California. For more information, refer to R&TC Sections 25101, 25110, 25120, and Cal. Code Regs., tit. 18 sections 25128.5.

Apportionment – Generally refers to the division of business income among states by the use of an apportionment formula.

Allocation – Generally refers to the assignment of nonbusiness income to a particular state.

When a corporation's income is from sources both within and outside California, the portion of the corporation's total net income that has its source in California is determined using R&TC Sections 25120 through 25141 and the applicable regulations, which generally conform to the Uniform Division of Income for Tax Purposes Act. The first step is to determine which portion of the corporation's net income is "business income" and which portion is "nonbusiness income."

Nonbusiness income is allocated to specific states as provided in R&TC Sections 25123 through 25127 and the applicable regulations. Business income is apportioned to the states in which the business is conducted. This apportionment is based on: (1) property, payroll and sales factors, if using the three-factor formula (which includes the single-weighted or double-weighted sales factor), or (2) the sales factor only if electing the single-sales factor formula. See R&TC Sections 25128 and 25128.5 for information regarding three-factor or single-sales factor formulas, R&TC Sections 25128 through 25141 for apportionment rules, and the regulations supporting these code sections. The corporation's California source net income is the sum (or net) of the business income apportioned to California, income from a trade or business conducted totally in California, plus the nonbusiness income items directly allocated to California.

California Source Income – includes income earned within the state, resulting from property owned or business conducted in California.

Business Income – is defined by Cal. Code Regs., tit. 18 section 25120(a) as income arising from transactions and activities in the regular course of the corporation's trade or business. Business income includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the corporation's regular trade or business operations. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activities that are the elements of a particular trade or business. In general, all transactions and activities of the corporation that are dependent on or contribute to the operations of the corporation's economic enterprise as a whole give rise to business income.

The California Supreme Court held that the definition of business income contains both a transactional test and a functional test and includes income from the sale of a business asset or right, even if the income is derived from an extraordinary event (*Hoechst Celanese Corp.* vs. *Franchise Tax Board*, (2001) 25 Cal. 4th 508).

Example 1 – Corporation Y owns 30% of Corporation X. Corporation Y makes substantial purchases from Corporation X for use in its unitary business operations and, except for the ownership percentage, would be considered unitary with Corporation X's business operations. A dividend from Corporation X paid to Corporation Y is business income.

Example 2 – Corporation A operates a multistate chain of men's clothing stores. Corporation A purchases a five-story office building primarily for use in connection with its principal business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. It leases the remaining two floors to others. The rental of the two floors is incidental to the operation of Corporation A's business. The rental income is business income.

Example 3 – Corporation B is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, Corporation B obtained patents on some of its products. Corporation B licensed the production of the chemicals in foreign countries. In return, Corporation B receives royalties. The royalties received by Corporation B are business income.

Example 4 – In conducting its multistate manufacturing business, Corporation C systematically sells and replaces automobiles,

machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example 5 – Corporation D is engaged in a multistate manufacturing and selling business. Corporation D usually has working capital that it regularly invests in interest bearing securities. The interest income is business income.

Nonbusiness Income – means all income other than business income.

In accordance with R&TC Sections 25120 through 25141 inclusive, the income of the corporation is business income unless clearly classifiable as nonbusiness income. Nonbusiness income must be computed net of related expenses.

Example 6 – Corporation E operates a multistate chain of men's clothing stores. Corporation E invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the 18 floors is not incidental to, but rather is separate from, the operation of the trade or business of Corporation E. The net rental income is nonbusiness income of the clothing store business.

Example 7 – Corporation F operates a multistate chain of grocery stores. An office building that had been used as the corporate headquarters did not provide adequate space. A new and larger building, located elsewhere, was acquired for use as the new headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, the building was sold at a gain (loss). The gain (loss) on the sale is nonbusiness income and the rental income received during the lease period is nonbusiness income.

The following special rules apply to gain or loss from the sale by a corporation of a nonbusiness partnership interest:

- If 50% or less of the value of the partnership's assets at the time of sale consist of intangibles, divide the original cost of tangible property in California owned by the partnership at the time of the sale by the original cost of all tangible personal property owned by the partnership at the time of the sale. Multiply this ratio by the gain or loss to find the California amount.
- If more than 50% of the value of the partnership's assets at the time of sale consist of intangibles, multiply the gain or loss by the sales factor of the partnership for its first full taxable period immediately preceding the taxable period during which the partnership interest was sold to find the California amount.

B Individuals

Nonresidents and resident individuals eligible for the other state tax credit who have income or loss from a trade or business activity conducted within and outside California must apportion their income in accordance with the provisions of R&TC Sections 25120 through 25141 (see Cal. Code Regs., tit. 18 section 17951-4). Items of income or loss that would be treated as nonbusiness income under those sections if earned by a corporation should be sourced using the normal sourcing rules that apply to individuals under R&TC Sections 17951 through 17955, and reported on the appropriate line of Schedule CA (540), California Adjustments – Residents, or Schedule CA (540NR), California Adjustments – Nonresidents or Part-Year Residents. Individuals complete only Schedule R-1, R-2, and lines 17, 18a, and 18b on Schedule R. Enter on line 17 the total income from the trade or business after any adjustment for federal and state differences, see Schedule CA (540). Nonresidents or part-year residents should enter the amount from line 18b on Schedule CA (540NR), line 12 or line 17, column E. In completing these schedules, the term "corporation" **should be** read as "apportioning business activity."

If an apportioning trade or business is (1) operating as a sole proprietorship owned by a nonresident individual or (2) operating as a single-member disregarded LLC owned by a nonresident individual and therefore treated as a sole proprietorship, the single-sales factor formula may be used to determine the California source income of the individual on Schedule R-1. For more information, see Cal. Code Regs., tit. 18 sections 17951-4 (c)(2) and 25128.5(c)(2)(A).

C Partnerships and Limited Liability Companies

Partnerships and LLCs that are classified as partnerships for tax purposes, with income or loss from a trade or business conducted within and outside California, must apportion business income in accordance with the provisions of R&TC Sections 25120 through 25141 (see Cal. Code Regs., tit. 18 section 17951-4).

If an apportioning trade or business conducted by a partner or member is **unitary** with the apportioning trade or business of the partnership or LLC, the partner's or member's distributable share of business income of the partnership is generally treated as business income of the partner. If using the three-factor formula, the partner or member must add its share of the partnership's or LLC's property, payroll, and sales from business activities conducted within and outside of California to the partner or member's own property, payroll, and sales to apportion the combined income. If electing the single-sales factor formula, the partner or member must add its share of the partnership's or LLC's sales from business activities conducted within and outside of California to the partner or member's own sales to apportion the combined income. This will be reflected on the partner's or member's own tax return. This rule does not apply to certain taxpayers described by Cal. Code Regs., tit. 18 section 17951-4(d)(4) and (5) subject to the personal income tax law. For more information, see Cal. Code Regs., tit. 18 section 17951-4(d)(4 and 5), and section 25137-1.

If the apportioning trade or business conducted by a partner or member is **not unitary** with the apportioning trade or business of the partnership or LLC, the partnership or LLC apportions its business income separately, using Schedules R, R-1, R-2, R-3, and R-4 only. An apportioning trade or business operating within a partnership or LLC that is **not unitary** with a partner may elect to use the single-sales factor formula on Schedule R-1 for the nonunitary partner's distributable share of income, (for more information, see Cal. Code Regs., tit. 18 section 25128.5(c)(1)). In completing these schedules **replace** the term "corporation" with "partnership" or "LLC."

If an apportioning trade or business operating as a partnership is owned by a nonresident individual, the partnership may elect to use the single-sales factor formula on Schedule R-1 to determine the California source income of the nonresident partner. For more information, see Cal. Code Regs., tit. 18 sections 17951-4(d)(1) and 25128.5(c)(2)(B).

For purposes of Schedule R-4, partnerships or LLCs should **not** allocate nonbusiness income from intangibles. The following special rules apply to such income.

Partnership or LLC items of nonbusiness income or loss are considered to be earned by the partner or member. If the partner is a corporation, that income is allocated according to the rules under R&TC Sections 25123 through 25127. Corporations should include such nonbusiness income (loss) on Schedule R, Side 1, on the appropriate line of lines 2-8, and, if applicable, lines 19-24. For individuals, such income is allocated under the rules applicable to individuals as if earned directly. The rules for determining business or nonbusiness classification are the same as those used for corporations, under Cal. Code Regs., tit. 18 section 25120(c).

For more information, see the instructions for Schedule K-1 (565), Partner's Share of Income, Deductions, Credits, etc., and Schedule K-1 (568), Member's Share of Income, Deductions, Credits, etc., included in the Form 565 and Form 568 Tax Booklets.

D Water's-Edge Filers

Corporations filing on a water's-edge basis that own controlled foreign corporations must complete form FTB 2416, Schedule of Included Controlled Foreign Corporations (CFC), included in the Form 100W Tax Booklet, and attach it to Form 100W, California Corporation Franchise or Income Tax Return — Water's-Edge Filers.

Water's-edge filers who are subject to the foreign investment interest offset must complete form FTB 2424, Water's-Edge Foreign Investment Interest Offset, included in the Form 100W Tax Booklet, and attach it to Form 100W or Form 100S. The foreign investment interest offset requires the application of interest expense to offset the foreign dividend deduction. In general, the calculation requires the identification of interest incurred for purposes of foreign investment using the ratio of unassigned foreign assets over unassigned total assets.

For more information regarding water's-edge reporting, get Form 100W Tax Booklet, and see Cal. Code Regs., tit. 18 section 25110.

E Property Factor

The property factor is a fraction. The numerator is the average value of real and tangible personal property owned or rented and used in California during the taxable year to produce business income. The denominator is the average value of **all** the corporation's real and tangible personal property owned or rented and used during the taxable year to produce business income. Property owned by the corporation that is in transit between states is considered to be located at its destination.

Property is included in the factor if it is actually used or is available for use or capable of being used during the taxable year. It remains in the property factor until its permanent withdrawal is established by an identifiable event such as its sale or conversion to the production of nonbusiness income. Property used in the production of nonbusiness income is excluded from the factor.

Property owned by the corporation is valued at its original cost. In general, "original cost" is the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the corporation. The original cost is adjusted by subsequent capital additions or improvements, special deductions, and partial disposition because of sale, exchange, abandonment, etc. Depreciation does not reduce original cost.

As a general rule, the average value of property owned by the corporation is computed by averaging the values at the beginning and ending of the taxable

year. The Franchise Tax Board (FTB) may require or allow monthly averaging if this method is required to properly reflect the average value of property for the taxable year.

Rented property is valued at eight times the net annual rental rate. The net annual rental rate for any item of rented property is the total annual rents paid for the property, less the aggregate annual subrental rates paid by subtenants if the subrents constitute nonbusiness income. Subrents are not deducted when the subrents constitute business income.

F Payroll Factor

The payroll factor is a fraction. The numerator is the compensation paid in California during the taxable year to produce business income. The denominator is the total compensation paid during the taxable year to produce business income. Compensation connected with the production of nonbusiness income is excluded from the payroll factor.

The total amount "paid" to employees is determined on the basis of the corporation's accounting method. Under the accrual method, all compensation properly accrued is deemed to have been paid.

Regardless of the corporation's method of accounting, at the election of the corporation, compensation paid to employees may be included in the payroll factor by use of the cash method if the corporation is required to report the compensation under that method for unemployment compensation purposes.

Compensation – means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor, or any other person not properly classifiable as an employee, are excluded.

Compensation is paid in California if any of the following tests, applied sequentially, is met:

1. The employee's service is performed entirely within California.
2. The employee's service is performed both within and outside of California, but the service performed outside of California is incidental to the employee's service within California ("incidental" service means any service that is temporary or transitory in nature, or that is rendered in connection with an isolated transaction).
3. If the employee's service is performed both within and outside of California, the employee's compensation will be attributed to California if any of the following apply:
   - The employee's base of operations is in California.
   - 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 California.
   - The base of operations, or the place from which services are directed or controlled is not in any state that some part of the service is performed, but the employee's residence is in California.

Base of operations – is the place of a permanent nature from which the employee starts work and returns in order to receive instructions or communications from customers or other persons, to replenish stock or other materials, to repair equipment, or to perform any other functions necessary to the exercise of the trade or profession at some other point or points.

Individuals and partners engaged in the practice of a profession may be subject to special rules for determining the payroll factor. Sole proprietors and partners engaged in the practice of law, accounting, medicine, engineering, or any other profession involving personal services where capital is not a material income producing factor should refer to Cal. Code Regs., tit. 18 section 17951-4(g)-(i) for information regarding computation of the payroll factor.

G Sales Factor

For taxable years beginning on or after January 1, 2011, any apportioning trade or business, other than an apportioning trade or business under R&TC Section 25128(b), may make an irrevocable annual election on an original timely filed return to apportion California business income by multiplying the business income by the sales factor. For more information, see General Information H, Computation of Apportionment Percentage, R&TC Section 25128.5, or Cal. Code Regs., tit. 18 section 25128.5.

For taxable years beginning on or after January 1, 1993, the sales factor is double-weighted for most apportioning trades or businesses. **Exception**: any apportioning trade or business, under R&TC Section 25128(b), that derives more than 50% of its gross business receipts from conducting a "qualified business activity":

- Must use the standard method – three-factor formula (a single-weighted sales factor) to apportion all of its business income.
- **Cannot** elect the alternate method – single-sales factor formula for taxable years beginning on or after January 1, 2011.

For the purpose of the exception, **gross business receipts** means all gross receipts after eliminating any gross receipts from intercompany transactions between members of a combined group required to be included in a combined report under R&TC Section 25101 or, if applicable, limited by Section 25110, whether or not the receipts are excluded from the sales factor by operation of Section 25137.

The following activities are **"qualified business activities"** for purposes of this exception:

- Extractive or agricultural business activities are qualified business activities for all taxable years beginning on or after January 1, 1993. Extractive business activities are activities relating to the production, refining, or processing of oil, natural gas, or mineral ore. Agricultural business activities means activities relating to any stock, dairy, poultry, fruit, furbearing animal, truck farm, plantation, ranch, nursery, or range. Other activities may qualify. See R&TC Section 25128(d)(2) and Cal. Code Regs., tit.18 sections 25128, 25128-1, and 25128-2 for more information.
- Savings and loan activities are qualified business activities for taxable years beginning on or after January 1, 1994. A savings and loan activity means any activity performed by savings and loan associations or savings banks which have been chartered by federal or state law.
- Banking or financial business activities are qualified business activities for taxable years beginning on or after January 1, 1996. A banking or financial business activity means activities attributable to dealings in money or moneyed capital in substantial competition with the business of national banks.

Unitary corporations, partnerships, and LLCs must apply the more than 50% test to the business receipts of the entire group. If the entire group has more than 50% of its gross business receipts from one or more qualified activities, all members of the group are not eligible to elect the alternate method – single-sales factor formula and all members of the group must use the standard method – three-factor formula (a single-weighted sales factor). If the entire group has 50% or less of its gross business receipts from one or more qualified activities, all members of the group using the standard method must use a double-weighted sales factor or all taxpayer members of the group may elect the alternate method – single-sales factor formula.

The sales factor is a fraction. The numerator is the total gross receipts attributable to California which produced business income during the taxable year. The denominator is the total gross receipts derived during the taxable year from transactions and activities everywhere in the regular course of the corporation's trade or business.

For taxable years beginning on or after January 1, 2007, the sales factor excludes:

- Interest and dividends from intangible assets held in connection with a treasury function of the taxpayer's unitary business.
- Gross receipts and overall net gains from the maturity, redemption, sale, exchange or other disposition of intangible assets held in connection with a treasury function of a taxpayer's unitary business. This exclusion encompasses the use of futures contracts and options contracts to hedge foreign currency fluctuations.

See Cal. Code Regs., tit. 18 section 25137(c)(1)(D) for more information.

Gross receipts means gross sales less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to these gross receipts. If federal and state excise taxes (including sales taxes) are passed on to the buyer or included in the selling price of the product, they must be included in gross receipts.

Sales means gross receipts from transactions in the regular course of an apportioning trade or business (see R&TC Section 25120(e) and (f)(1)).

For taxable years beginning on or after January 1, 2011, "gross receipts" means the gross amounts realized (the sum of money and the fair market value of other property or services received) on:

- The sale or exchange of property,
- The performance of services, or
- The use of property or capital (including rents, royalties, interest, and dividends) in a transaction that produces business income, in which the income, gain, or loss is recognized (or would be recognized if the transaction were in the United States) under the IRC.
- Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold.

Gross receipts, even if business income, shall **not** include the following items:

1. Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
2. The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
3. Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.
4. Damages and other amounts received as the result of litigation.
5. Property acquired by an agent on behalf of another.
6. Tax refunds and other tax benefit recoveries.
7. Pension reversions.

8. Contributions to capital (except for sales of securities by securities dealers).
9. Income from discharge of indebtedness.
10. Amounts realized from exchanges of inventory that are not recognized under the IRC.
11. Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. "Treasury function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business and includes the use of futures contracts and options contacts to hedge foreign currency fluctuations.
12. Amounts received from hedging transactions involving intangible assets.

See R&TC Section 25120(f) for more information.

The following are rules for determining "sales" in various situations, as set forth at Cal. Code Regs., tit. 18, section 25134(a)(1):

1. In the case of a corporation engaged in manufacturing and selling goods or products, "sales" includes all gross receipts from the sales of such goods or products held for sale to customers in the ordinary course of its trade or business. Goods or products also include other property of a kind that would properly be included in the inventory if on hand at the close of the taxable year.
2. In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "sales" includes the entire reimbursed cost, plus the fee.
3. In the case of a corporation engaged in providing services, such as the performance of equipment service contracts or research and development contracts, "sales" includes the gross receipts from the performance of such services, including fees, commissions, and similar items.
4. In the case of a corporation engaged in renting real or tangible property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.
5. In the case of a corporation engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.
6. In the case of a corporation that derives receipts from the sale of equipment used in its business, these receipts constitute "sales." For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

Gross receipts from sales of tangible personal property with a destination in California (except sales to the U. S. government) are attributable to California if the property is delivered or shipped to a purchaser within California regardless of the freight on board point or other conditions of sale.

For taxable years beginning before April 22, 1999 and for taxable years beginning on or after January 1, 2011:

1. Gross receipts from sales of tangible personal property (except sales to the U.S. Government) which are shipped from an office, store, warehouse, factory, or other place of storage within California are assigned to California unless a member of the seller's combined reporting group is taxable in the state of destination. If a member of the seller's combined reporting group is taxable in the state of destination, then the gross receipts from that sale are excluded from the California sales factor numerator.
2. The California sales of each corporation within a combined reporting group will be taken into account in the apportionment of business income to California, including amounts attributable to entities exempt from taxation in California such as entities protected by P.L. 86-272. See *Appeal of Finnigan Corporation,* Opn. on Pet. for Rehg., 88-SBE-022A (1/24/1990), and R&TC Section 25135(b).

For taxable years beginning on or after April 22, 1999 and before January 1, 2011:

1. Gross receipts from sales of tangible personal property (except sales to the U.S. Government) which are shipped from an office, store, warehouse, factory, or other place of storage within California are assigned to California unless the seller is taxable in the state of destination, even if another member of the seller's combined reporting group is taxable in the destination state. See Cal. Code Regs., tit. 18 section 25106.5(c)(7).
2. The California sales of those corporations within a combined reporting group that are taxable in California will be taken into account in the apportionment of business income to California. See *Appeal of Huffy Corporation*, 99-SBE-005 (4/22/99), and Cal. Code Regs., tit. 18 section 25106.5(c)(7)(B).

A corporation is taxable in the state of destination if it meets either one of the two following tests:

1. The corporation 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 because of its business activity in another state.
2. Another state has jurisdiction to tax net income, regardless of whether or not that state imposes such a tax on the corporation.

The first test applies only if a corporation carries on business activities in another state. However, the corporation is not taxable in another state if the corporation meets any of the following:

- Files and pays tax voluntarily, when not required to do so by the laws of that state.
- Pays a minimal fee for qualification, organization, or for the privilege of doing business in that state, but does not actually engage in business activities in that state.
- Engages in some activity, not sufficient to be taxed, and the minimum franchise tax bears no relation to the corporation's activities in that state.

The second test applies if the corporation's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. Jurisdiction to tax is not present if the state is prohibited from imposing the tax because of Public Law 86-272, 15 U.S.C. 381-385.

Any transportation of goods by vehicle is a form of shipment, whether the vehicle is owned by the seller, the purchaser, or a common carrier. If a seller transfers possession of goods to a purchaser at the purchaser's place of business in California, the sale is a California sale. However, if goods are transferred to the purchaser's employee or agent at some other location in California and the purchaser immediately transports the goods to another state, the sale is not a California sale. (See FTB Legal Ruling 95-3.)

Gross receipts from sales of tangible personal property to the U.S. Government are attributable to California if the property is shipped from California even if the corporation is taxable in the state of destination. Only sales for which the U.S. Government makes direct payment to the seller, according to the terms of a contract, constitute sales to the U.S. Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the U.S. Government, do not constitute sales to the U.S. Government.

For taxable years beginning before January 1, 2011, and for taxable years beginning on or after January 1, 2011, for which R&TC Section 25128.5 is operative and no single-sales factor formula election has been made, sales, other than sales of tangible personal property, are assigned in this state if either of the following apply:

1. The income-producing activity is performed wholly within California.
2. The income-producing activity is performed within and outside California but the greater portion of this activity is performed within California based on costs of performance.

Taxpayers that elect the single-sales factor formula for apportioning income must assign receipts from sales, other than sales of tangible personal property, using the market assignment rule. For more information, see the Market Assignment information on the next page.

Income-producing activity – means the transactions and activity directly engaged in by the corporation in the regular course of its trade or business for the ultimate purpose of earning gains or profits. If the activities performed on behalf of the corporation are performed by entities that are in a unitary relationship with the corporation and are members of the same combined reporting group, the activities of the entity performing the services will be considered income-producing activities directly engaged in by the corporation. See FTB Legal Ruling 2006-2. "Income-producing activity" applies to each separate item of income. For taxable years beginning on or after January 1, 2008, "income-producing activity" **includes** transactions and activities performed on behalf of a corporation, such as those conducted by an independent contractor. For more information, see Cal. Code Regs., tit. 18, section 25136.

Cost of performance – means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with industry practices in the corporation's trade or business.

Special Rules. The following are special rules to determine if receipts from the income-producing activities are attributable to California:

1. Gross receipts from the rendering of personal services by employees or the use of tangible and intangible property by the corporation in performing a personal service are attributable to California to the extent that the personal services are performed within California. See FTB Legal Ruling 2005-1 for the definition of personal services for sales factor purposes.

   However, when personal services are performed within and outside California, the gross receipts are attributable to California as shown below. If services are related to any of the following:

   - Separate income producing activities – personal service gross receipts are measured by the ratio of time spent within California versus the time spent performing services everywhere.

   - A single item of income – all gross receipts if a greater portion of personal services are performed within California based on costs of performance.

Time spent in performing personal services includes the amount of time expended in the performance of a contract or other obligation that gives rise to the gross receipts.

Personal service not directly connected with the performance of the contract or other obligation (for example, time expended in negotiating the contract) is excluded from the computations.

2. Gross receipts from the sale, rental, leasing, licensing, or other use of real property are attributable to California if the real property is located within California.
3. Gross receipts from the rental, leasing, licensing, or other use of tangible personal property are attributable to California if the property is located within California.

   If tangible personal property is located within and outside of California during the rental, lease, or licensing period, gross receipts attributable to California are measured by the ratio which the time the property was physically present or was used within California bears to the total time or use of the property during the period.
4. Under certain fact patterns a taxpayer may, **with prior FTB approval**, exclude some gross receipts from the sales factor. A taxpayer must show that including the receipts in the sales factor would cause apportionment that does not fairly represent the taxpayer's California business activities and that its proposed alternative method of apportionment is reasonable. See Cal. Code Regs., tit. 18 section 25137 and FTB Notice 2004-5 for more information.

Market Assignment. Taxpayers that elect the single-sales factor formula for apportioning income must assign receipts from sales, other than sales of tangible personal property, using market assignment as set forth in R&TC Section 25136(b). According to this method, the sales are assigned as follows:

1. Sales from services are assigned to California to the extent that the purchaser of the service receives the benefit of the service in California.
2. Sales of intangible property are assigned to California to the extent that the intangible property is used in California. For marketable securities, the sales are in California if the customer is in California.
3. Sales from the sale, lease, rental, or licensing of real property are assigned to California if the real property is located in California.
4. Sales from the rental, lease, or licensing of tangible personal property are in California if the property is located in California.

See R&TC Section 25136(b) and Cal. Code Regs., tit. 18 section 25136-2, for more information.

H Computation of Apportionment Percentage

Corporations using the Standard Method – Three-Factor Formula. When computing the average apportionment percentage for Schedule R-1, Part A, line 5, divide the total percent on line 4 by the number of factors that have amounts in column (a). For most corporations, the denominator is four (property, payroll, and twice the sales factor). For agricultural, extractive, savings and loans, and banking and financial business activities, the denominator is three (property, payroll, and sales). Those factors with zero balances in the totals of both column (a) and column (b) will not be included in the fraction. For example, if the corporation has no payroll then the average apportionment percentage would be computed by entering 1/3 of line 4 instead of the standard 1/4.

Corporations electing the Alternate Method – Single-Sales Factor Formula. When computing the apportionment percentage for Schedule R-1, Part B, line 2, divide the total sales in column (b) by the total sales in column (a).

I Consistency in Reporting

Corporations that changed the way the following items were treated in prior year tax returns, must disclose the nature and extent of these changes on Schedule R-2, line 6. Disclose any changes to the following:

- Classification of income as business or nonbusiness income.
- Valuation of property or inclusion of property in the property factor.
- Determination of the amount of compensation paid that is used in the payroll factor.
- Inclusion of gross receipts in the sales factor.

Disclose only inconsistencies in the valuation or assignment of items in the three factors that materially affect the apportionment percentage. On Schedule R-2, line 5, explain (with references to the laws or regulations of the other state) any inconsistencies in the determination of nonbusiness income and in the factors due to a difference in state laws or regulations. Show the amount of inconsistency on a state-by-state basis.

When a corporation sells tangible personal property that is shipped from California and assigned to a state in which the corporation does not file a tax return or report, the corporation must identify the state to which the property is shipped, report the total amount of sales assigned to that state, and furnish the facts that the corporation relied on in establishing jurisdiction to tax by that state.

J Computation of Interest Offset

The U. S. Supreme Court held California's interest offset provision (R&TC Section 24344(b)) to be unconstitutional in circumstances in which nonbusiness dividends or interest which are allocated outside of California exist within a unitary group (*Hunt-Wesson* vs. *Franchise Tax Board* (2000) 120 S.Ct. 1022). As provided in FTB Notice 2000-9, the statute continues to apply, for all corporations, to interest expense assigned to business interest income.

For taxable years beginning on or **after** February 22, 2000, that portion of the interest offset that assigns interest expense to nonbusiness interest and dividend income shall apply only to interest expense assignable to nonbusiness interest and dividend income allocated to California.

If no dividend or interest income is classified as nonbusiness income on Schedule R, line 2 and line 3, it is not necessary to complete Schedule R-5. Intercompany interest paid from one member of a combined reporting group to another is not included in the interest offset computation.

In any case in which the tax of a corporation is or has been determined in a combined report with another corporation, all dividends paid by one to another of such corporations are, to the extent dividends are paid out of the earnings and profits of the unitary business, eliminated from the income of the recipient and are not taken into account for interest offset purposes.

If a California domiciliary's income is subject to apportionment by formula, the corporation's interest expense deduction is limited to interest income subject to apportionment plus the amount, if any, that the balance of interest expense exceeds nonbusiness interest and nonbusiness dividend income of the California domiciliary.

Interest expense not deductible under the preceding paragraph is directly offset against nonbusiness interest and nonbusiness dividend income.

Use Schedule R-5 to make the interest expense computation. Enter on Schedule R, line 16 and line 26, the amount of interest offset from Schedule R-5, line 7 or line 16.

If supplemental Schedule Rs are required, the interest offset shall not be applied on more than one Schedule R.

K Income (Loss) from a Separate Trade or Business

If a corporation conducts two or more nonunitary businesses, the business income from each trade or business must be separately apportioned, see Cal. Code Regs., tit. 18 section 25120(b). Enter the **total** separately apportionable business income (loss) on Schedule R, Side 1, line 11 and **California** separate business income (loss) apportionments on Schedule R, Side 2, line 29. Attach a supplemental Schedule R for each separate business.

L Business Income (Loss) Deferred from Prior Years

This applies to certain installment sales (see FTB Legal Ruling 413), and certain long-term contracts (see Cal. Code Regs., tit. 18 section 25137-2). Enter the **total** deferred business income (loss) from prior years on Schedule R, Side 1, line 12 and **California** deferred business income (loss) from prior years' apportionments on Schedule R, Side 2, line 30.

M Capital Gain (Loss) Netting

California conforms to the federal provisions for netting gains and losses from involuntary conversions, Section 1231 assets, and capital assets. If the netting process results in net capital losses, the losses are not deductible in the current year, but may be carried over to subsequent years.

For corporations that are not in a combined reporting group, enter the capital gain on Schedule R, line 13 if the gain is not included on Schedule R, line 1a. Corporations filing a combined report should use Schedule R, line 13 to reverse the capital gain amounts and report the gain on Schedule R, line 32 as explained below.

For a combined reporting group only, the members' business gains and losses in each class (i.e., the classes are voluntary conversion, 1231 short-term capital, or long-term capital) are combined, and each taxpayer member determines its share of the business gain/loss items based on its apportionment percentage. Then, each taxpayer member applies the federal netting rules to its share of post-apportioned business gain/loss items and its California-source nonbusiness gain/loss items. Enter the total amount of the combined post-apportioned and allocated capital gain (loss) on Schedule R, line 32. If a net loss results for any taxpayer member, it may be carried forward for up to five years.

For more information regarding the application of the capital loss limitation in a combined report and the capital loss carryover, see Cal. Code Regs., tit. 18 section 25106.5-2 and get FTB Pub. 1061, Guidelines for Corporations Filing a Combined Report.

N Contributions Adjustment

There may be differences between the federal and California amount. In general under California law, corporations may deduct contributions only to the extent of the corporation's basis in the asset being contributed.

For taxable years beginning on or after January 1, 1996, the limit for the charitable contributions deduction increased to 10% of a corporation's California net income before deducting contributions, adjusted for the use of the apportionment formula and any nonbusiness income and losses. Contributions that exceed the 10% limit may be carried over for up to five taxable years.

For purposes of the charitable contribution limitation, net income is to be computed without regard to deductions for items included in Art. 2, Ch. 7, of the Corporation Tax Law (other than organizational expenses). Such adjustments should be included on Schedule R-6, line 3. Refer to R&TC Section 24358.

Use Schedule R-6 to compute deductible contributions for state purposes. If the contributions deducted do not exceed the 10% limit, and no nonbusiness income is reported on Schedule R, it is not necessary to complete Schedule R-6.

O Combined Report

The unitary method of computing California income is required when two or more corporations are engaged in a unitary business, a portion of which is carried on in California. A tax return for each corporation subject to the Corporation Tax Law is required, unless Schedule R-7 is filed with the FTB. For more information, get FTB Pub. 1061 and see Cal. Code Regs., tit. 18 section 25106.5.

P Group Return Election

As a convenience for taxpayers, a group of unitary corporate taxpayers may elect to file a single group return. The election applies **only** to those members of a unitary group which are taxpayers (i.e., are themselves subject to the California income or franchise tax). **Do not** complete the Schedule R-7 for unitary groups that have only one California taxpayer. (See Cal. Code Regs., tit. 18 section 25106.5-11.)

The designated "key" corporation makes the election on behalf of itself and the electing taxpayer members by completing Schedule R-7 and attaching the schedule to the return. Schedule R-7 is effective only for the taxable year with which it is filed. In order to make a valid election, the key corporation's powers, rights, and privileges must not be suspended or forfeited. For the requirements that must be satisfied in order for a corporation to be deemed a "key corporation," see Cal. Code Regs., tit. 18 section 25106.5-11(b).

Attach the Schedule R behind the California tax return and prior to the supporting schedules.

The parent corporation of a unitary group should only be designated as the key corporation if it is qualified or incorporated in California, or if it is doing business in California. Combined returns are often filed with a parent corporation that is neither qualified nor doing business in California designated as the key corporation. This can result in an erroneous assessment of minimum tax to the parent corporation.

By filing a single group tax return and the completed Schedule R-7, each electing member indicates acceptance of all terms and conditions set forth in Schedule R-7. The single group return satisfies the requirement of each electing taxpayer member to file its own tax return (See Cal. Code Regs., tit. 18 section 25106.5-11). Failure to complete all of the items requested in this election may result in : 1) incorrect processing of the tax return; 2) electing member(s) Schedule R-7 election may be disallowed. If an electing member(s) Schedule R-7 election is disallowed, they must file a separate California return.

The tax liability of each taxpayer member of the unitary group is computed using the combined reporting rules provided in Cal. Code Regs., tit. 18 sections 25106.5 through 25106.5-10, and the instructions in FTB Pub. 1061. The tax liabilities of each of the electing taxpayer group members are then separately identified, aggregated, and reported on the group return.

Corporations That Cannot Elect to File a Group Return: Due to statutory filing requirements, California taxpayers may not be included in a group return unless all of the following apply:

1) The taxpayer's taxable year is the same as or wholly within the key corporation's taxable year.
2) The due date of the taxpayer's tax return for the taxable year is the same as the due date of the key corporation's tax return.

In addition, corporations may not file a group return if more than one unitary business is being conducted by any one taxpayer.

Example – If Division 1 of Corporation A is engaged in a unitary business with Corporation B and Division 2 of Corporation A is engaged in a separate unitary business with Corporation C (i.e., the business of A-B and A-C are not unitary with each other), a group return may not be filed by A, B, and C. Two separate combined report computations will be necessary to determine and apportion the income of each of the businesses A (Division 1)-B and A (Division 2)-C.

Tax Liability of Electing Members: Show the total tax liability for each electing corporation on Schedule R-7 in the "Total self-assessed tax" column.

The liability of each corporation included in the group return is the same as if each member of the group filed a separate return. Thus, it is necessary to determine each corporation's share of the combined report income apportioned to California using the method prescribed by Cal. Code Regs., tit. 18 section 25106.5. Each member then applies its own nonbusiness income or loss and its own net operating loss (if applicable) to that amount to arrive at the corporate taxpayer's net income (loss) for state purposes. In determining the member's tax liability, tax credits authorized by Chapter 3.5 of the Corporation Tax Law may be claimed only by the particular member that is eligible for the credit unless provided by statute to the contrary. Each member incorporated, qualified to do business, or doing business in California must pay at least the minimum franchise tax provided for in R&TC Sections 23153 and 23181. On a separate schedule, clearly show the computation of the tax liability for each member of the group. Get FTB Pub. 1061 for examples of the computational detail that should be provided.

Caution: 1) If the information on Schedule R-7, Part I, Section A, is not filled out completely, the electing member(s) Schedule R-7 election may be disallowed. If an electing member(s) Schedule R-7 election is disallowed, they must file a separate California return. 2) Failure to indicate each member's correct self-assessed tax liability may result in incorrect processing if separate assessments or refunds are required. (See FTB Legal Ruling 95-2.)

Payment of Tax: Any tax required to be paid with the single group return should normally be paid by the key corporation on behalf of its members, using the key corporation's California corporation number. In addition, if the group has made an election for the preceding taxable year, estimated taxes and payments with extension of time to file for the taxable year should be made by the key corporation on behalf of the members, using the key corporation's California corporation number.

If the corporation must pay its tax liability electronically, all payments must be remitted by electronic funds transfer (EFT) or Web Pay to avoid penalties. For information on who is required to make EFT payments, go to **ftb.ca.gov** and search for **eft**, or call 916.845.4025.