

Request for Authorization to Proceed with Discussion Draft of Proposed  
Amendments to Existing Regulations  
Relating to Business and Non-Business Income and the  
Determination of a Unitary Business

Proposed Cal. Code of Regs., Sections 25120(a)-(c) (Business and Nonbusiness  
Income Defined), 25121(a) (Definitions), 25129(b) (Property Factor: Property  
Used for the Production of Business Income), and 25130(b) (Property Factor:  
Valuation of Rented Property)

Staff requests permission to proceed with a discussion draft of proposed changes to the existing regulations at California Code of Regulations, title 18, section 25120, subsections (a), (b) and (c); section 25121, subsection (a); section 25129, subsection (b); and section 25130, subsection (b). These proposed changes would incorporate the August 1, 2003, changes to the Multistate Tax Commission's (MTC) model regulation concerning the characterization of business and non-business income, and the January 15, 2004, changes to the MTC model regulation concerning the determination of a unitary business. The MTC model regulation amendments are attached.

California's business income regulations, in effect since 1973, are modeled after the MTC business income regulation that was originally promulgated in that same year. The proposed amendments to the existing regulation would clarify, expand and update the definition of business income. In the interests of uniformity, California should conform its business income regulation to the MTC amendments.

The proposed amendments reflect several important decisions of the U.S. Supreme Court, the California Supreme Court, the Courts of Appeal and the State Board of Equalization (SBE) that have occurred since 1973. Topics contained in the proposed amendments include: the existence of both a transactional and functional test for business income (consistent with the landmark 2001 decision of the California Supreme Court in *Hoechst Celanese v. FTB*, 25 Cal.4<sup>th</sup> 508 (2001)); definitions for the key terms -- "trade or business" and "to contribute materially" -- and also for the terms "property", "acquisition", "management", "disposition", and "integral part" in the context of an explanation of the functional test; and a more direct recognition of the concept of conversion of property from an asset held for the production of business income to an asset that produces non-business income. The proposed amendments also reflect several important decisions of the courts in regards to the determination of a unitary business. Topics reflected in the proposed amendments include: the constitutional requirement for a unitary business; description and illustration of the concepts of functional integration, centralization of management, and economies of scale; and factual indicators of a unitary business. Notably, the proposed amendments also fully incorporate California Revenue and Taxation Code section 25105's definition of a "commonly controlled group" for purposes of determining the existence of unity of ownership. There are also several proposed amendments to the examples contained in the existing California and MTC business income regulations intended to improve illustrations of how the regulatory concepts should be applied.

Some of the proposed amendments may be controversial. Eliminated is the presumption in the current California regulation that all income is business income unless clearly classifiable as business income; added is the proposition that income derived from transactions made in liquidation or the winding up of business is considered business income if the property was used in business operations—a topic that is the subject of current California litigation. The constitutional limitations upon the states' application of the unitary business principle is equally applied to the taxpayer's application of the same principle. Finally, the concept of strong centralized management as a factual indicator of unity is limited to circumstances where managers make substantially all of the operational decisions of the business.

Draft language of the proposed amendments to the existing regulation sections is attached. Under the full symposium process, the attached discussion draft of the proposed amendments to the existing regulation sections will be placed on the department's website, a potential symposium date will be announced, public comment will be invited on the proposed amendments to the existing regulation sections, and a symposium will be held if there is public interest or comment. A report on the symposium will then be made to the Board, along with specific recommendations as to whether the Board should authorize staff to proceed with the formal regulatory process.

Section 25120 is amended to read:

**NOTE: MTC amendments that are already contained in Rev. & Tax Code section 25105 (defining "commonly controlled group") are in double-strike through. MTC additions are in double-underscore.**

§ 25120. Definition of "Business" and "Nonbusiness Income".

(a). ~~Business and Nonbusiness Income Defined. Section 25120 defines "business income" as 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. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Sections 25120 to 25139 inclusive, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.~~

~~Nonbusiness income means all income other than business income.~~

(1) Apportionment and Allocation. Revenue and Taxation Code section 25120, subdivisions (a) and (d), require that every item of income be classified either as business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.

(2) Business Income. Business income means income of any type or class, and from any activity, that meets the relationship described either in subsections (a)(4), the "transactional test", or (a)(5), the "functional test". The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, 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. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation 25120(c) for more specific examples of the classification of income as business or nonbusiness income; see Regulation 25120(b) for further explanation of what constitutes a trade or business.)

(3) Terms Used in Definition of Business Income and in Application of Definition. As used in the definition of business income and/or in the application of the definition,

(A) “Trade or business” means the unitary business of the taxpayer, part of which is conducted within this State.

(B) “To contribute materially” includes, without limitation, “to be used operationally in the taxpayer’s trade or business.” Whether property materially contributes is not determined by reference to the property’s value or percentage of use. If an item of property materially contributes to the taxpayer’s trade or business, the attributes, rights or components of that property are also operationally used in that business. However, property that is held for mere financial betterment is not operationally used in the taxpayer’s trade or business.

(4) Transactional Test. Business income includes income arising from transactions and activity in the regular course of the taxpayer’s trade or business.

(A) If the transaction or activity is in the regular course of the taxpayer’s trade or business, part of which trade or business is conducted within this State, the resulting income of the transaction or activity is business income for this State. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in this State.

(B) For a transaction or activity to be in the regular course of the taxpayer’s trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer’s mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of business income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(5) Functional test. Business income also 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. “Property” includes any interest in, control over, or use in property (whether the interest is held directly, beneficially, by contract, or otherwise) that materially contributes to the production of business income. “Acquisition” refers to the act of obtaining an interest in property. “Management” refers to the oversight, direction, or control (directly or by delegation) of the property for the use or benefit of the trade or business. “Disposition” refers to the act, or the power, to relinquish or transfer an interest in or control over property to another, in whole or in part. “Integral part” refers to property that constituted a part of the composite whole of the trade or business, each part of which gave value to every other part, in a manner which materially contributed to the production of business income.

(A) Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within this State. Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time (generally, five years is sufficient) or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

(B) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations. (Property that has been converted to nonbusiness use (see subsection (a)(5)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.) Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, constitutes business income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(C) Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.

(D) If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, then income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in this State.

(E) If with respect to an item of property a taxpayer (i) takes a deduction from business income that is apportioned to this State or (ii) includes the original cost in the property factor, it is presumed that the item or property is or was integral to the taxpayer's trade or business operations. No presumption arises from the absence of any of these actions.

(F) Application of the functional test is generally unaffected by the form of the property (e.g., tangible or intangible property, real or personal property). Income arising from an

intangible interest, as, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. (Property that has been converted to nonbusiness use (see subsection (a)(5)(A)) has lost its character as a business asset and is not subject to the rule of the preceding sentence.) Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

(6) Relationship of transactional and functional tests to U.S. Constitution. The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income as business income that has no rational relationship with the taxing State. The protection against extra-territorial state taxation afforded by these Clauses is often described as the "unitary business principle." The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in this State. The unitary business that is conducted in this State includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same trade or business that is being conducted within this State. Determination of the scope of the unitary business being conducted in this State is without regard to extent to which this State requires or permits combined reporting.

(7) Nonbusiness income. Nonbusiness income means all income other than business income.

~~(b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.~~

~~EXAMPLE:~~

~~The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing tobacco products. The third division produces and distributed motion pictures for theaters and television. Each division operates independently; there is no strong central management. Each division operates in this state as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate "trades of businesses." Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this state is determined by applying an appropriate apportionment formula to the business income of~~

each business.

The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business 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. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(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 which 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.~~

(b) Principles for Determining the Existence of a Unitary Business.

(1) Unitary Business Principle.

(A) *The Concept of a Unitary Business.* A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this State is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to

this state using an apportionment percentage provided by Revenue and Taxation Code section 25128.

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

(B) *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (b)(1)(A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

(C) *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(D) *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single business entity or among a commonly controlled group of business entities. The scope of what is included in a commonly controlled group of business entities is set forth in subsection (4), below, which in turn references Revenue and Taxation Code section 25105.

(2) Determination of a Unitary Business

(A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, (1980) 445 U.S. 425: functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. **[RESERVED: MTC reserves this space for future discussion concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.]** Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and

not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.

(B) *Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.*

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

a. *Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.*

b. *Common Marketing.* The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)

c. *Transfer or Pooling of Technical Information or Intellectual Property.* Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.

d. *Common Distribution System.* Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking,

and/or transportation are controlled through a common network provides evidence of functional integration.

e. *Common Purchasing.* Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.

f. *Common or Intercompany Financing.* Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)

2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

a. *Facts Providing Evidence of Centralization of Management.* Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.

b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.

3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.

a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.

b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) *Indicators of a Unitary Business.*

(A) *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.

(B) *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary 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 business's executive offices.

(C) *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly

independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

(4) Commonly Controlled Group of Business Entities.

(A) Separate corporations can be part of a unitary business only if they are members of a commonly controlled group as defined by Revenue and Taxation Code section 25105.

~~(B) A "commonly controlled group" means any of the following:~~

- ~~1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if—~~
  - ~~a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,~~
  - ~~b. — Stock cumulatively possessing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph a, or one or more other corporations that satisfy the conditions of this subparagraph.~~
- ~~2. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.~~
- ~~3. Any two or more corporations that constitute stapled entities.~~
  - ~~a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.~~
  - ~~b. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.~~
- ~~4. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph 1 of subsection (E) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.~~

~~(C) 1. If, in the application of subsection (B), a corporation is a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated~~

~~as a member of only the commonly controlled group (or part thereof) with respect to which it has a unitary business relationship. If the corporation has a unitary business relationship with more than one of those groups, it shall elect to be treated as a member of only one of the commonly controlled groups with respect to which it has a unitary business relationship. This election shall remain in effect until the unitary business relationship between the corporation and the rest of the members of its elected commonly controlled group is discontinued, or unless revoked with the approval of the [state tax agency].~~

~~2. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (B) are not met, except as follows:~~

~~a. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subsection (B) are again met immediately after the sale, exchange, or disposition.~~

~~b. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subsection B are again met within a period not to exceed two years.~~

~~(D) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph 4 of subsection (B) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subsection, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.~~

~~(E) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.~~

~~1. An individual constructively owns stock that is owned by any of the following:~~

~~a. His or her spouse.~~

~~b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.~~

~~c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.~~

~~2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder~~

~~owning stock that represents more than 50 percent of the voting power of the corporation.~~

3. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), if more than 50% of the stock possessing voting power of a corporation is, in the aggregate, owned by or for the benefit of members of the same family, stock owned by that corporation shall be treated as constructively owned by members of that family in the same ratio as the proportion of their respective ownership of stock possessing voting power in that corporation to all of such stock of that corporation.

~~4. Except as otherwise provided, stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.~~

5. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

6. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), stock held by a limited partnership is constructively owned by a limited partner to the extent of the limited partner's capital interest in the limited partnership.

~~(F) For purposes of the definition of a commonly controlled group, each of the following shall apply:~~

~~1. "Corporation" means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation (including but not limited to a limited liability company) pursuant to [insert your State statute].~~

~~2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.~~

~~3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.~~

~~4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.~~

~~5. "Stock possessing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:~~

~~a. For one year or less.~~

~~b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.~~

6. In the case of an entity treated as a corporation under paragraph 1 of subsection (F), "stock possessing voting power" refers to an instrument, contract, or similar document demonstrating an ownership interest in that entity that confers power in the owner to cast a vote in the selection of the management of that entity.

7. In the general application of this section, if an entity may elect to be treated as a partnership or as a corporation under the laws of this state (or under Section 7701 of the Internal Revenue Code), and elects to be treated as a partnership, that entity shall be treated as a general partnership. If, however, contractual agreements, member agreements, or other restrictions limit the power of some or all of the members to participate in the vote of stock possessing voting power owned by that entity (similar to the restrictions of limited partners in a limited partnership), the [state tax agency] may permit or require that entity to be treated as a limited partnership.

~~(G) The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:~~

~~1. Prescribe terms and conditions relating to the election described by subsection (C), and the revocation thereof.~~

~~2. Disregard transfers of voting power not described by paragraph 5 of subsection (F).~~

~~3. Treat entities not described by paragraph 2 of subsection (F) as a person.~~

~~4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.~~

~~5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.~~

~~6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.~~

7. Treat limited partners as constructive owners of stock possessing voting power held by the limited partnership, in proportion to their interest in the partnership.

(c) *Business and Nonbusiness Income; Application of Definitions.* The following ~~are rules and examples for~~ applies the foregoing principles for purposes of determining whether particular income is business or nonbusiness income. (The examples used throughout these regulations are illustrative only and ~~do not purport to set forth all pertinent facts~~ and are limited to the facts they contain.)

(1) Rents from real and tangible personal property: Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includible in the property factor under Regulations 25129 to 25131 inclusive.

EXAMPLE (A):

The taxpayer operates a multistate car rental business. The income from car rentals is business income.

EXAMPLE (B):

The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipments are not needed on any particular projects. The rental income is business income.

EXAMPLE (C):

The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with this trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are held for future use in the trade or business, and are leased to tenants on a short-term basis in the meantime.~~are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business.~~ The rental income is business income.

EXAMPLE (D):

The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not business income of the grocery store's trade or business. Therefore, the net rental income is nonbusiness income.

EXAMPLE (E):

The taxpayer operates a multistate chain of men's clothing stores. The taxpayer 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 eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Therefore the net rental income is nonbusiness income.

EXAMPLE (F):

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 (G):

The taxpayer operates a multistate chain of grocery stores. It owned an office building which 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.

(2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in or was otherwise included in the property factor of the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. (See Regulations 25129 to 25131, inclusive.)

EXAMPLE (A):

In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

EXAMPLE (B):

The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

EXAMPLE (C):

Same as (B) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

EXAMPLE (D):

Same as (B) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

EXAMPLE (E):

The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, the taxpayer acquired a

new and larger building elsewhere for its corporate headquarters. Because the taxpayer did not intend to reoccupy the old building, the taxpayer rented ~~The old building was rented~~ to an unrelated investment company under a five-year lease. Upon expiration of the lease, the taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

(3) Interest. Interest income is business income where the intangible with respect to which the interest was received ~~arises~~ arose out of or was created in the regular course of the taxpayer's trade or business operations or where the ~~purpose for~~ purpose for acquiring and holding the intangible is ~~related to or incidental to such~~ an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

EXAMPLE (A):

The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

EXAMPLE (B):

The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business income.

EXAMPLE (C):

The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The monies in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

EXAMPLE (D):

The taxpayer is engaged in a multistate money order and traveler's checks business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

EXAMPLE (E):

The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

EXAMPLE (F):

In January the taxpayer sold all the stock of a subsidiary for \$20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

(4) Dividends. Dividends are business income where the stock with respect to which the dividends ~~are~~was received ~~arises~~arose out of or was acquired in the regular course of the taxpayer's trade or business operations or where the ~~purpose for~~ acquiring and holding the stock is related to or incidental to such an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

EXAMPLE (A):

The taxpayer operates a multistate chain of stock brokerage houses. During the year the taxpayer receives dividends on stock it owns. The dividends are business income.

EXAMPLE (B):

The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the monies in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

EXAMPLE (C):

The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

EXAMPLE (D):

The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

EXAMPLE (E):

The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

EXAMPLE (F):

The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

(5) Patent and copyright royalties. Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received ~~arises~~arose out of or was created in the regular course of the taxpayer's trade or business operations or where the ~~purpose for acquiring and holding the patent or copyright is related to or incidental to such an~~ integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

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.

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 music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

EXAMPLE (C):

Same as Example (B), except that the acquired company also held the patent on a ~~type of phonograph needle~~ method of producing digital audio recordings. The taxpayer does not manufacture or sell ~~phonographs or phonograph equipment~~ digital audio recordings. Any royalties received on the patent would be nonbusiness income.

(d) Proration of Deductions. In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or

businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

Note: Authority cited: Section ~~26422~~19503, Revenue and Taxation Code.  
Reference: Section 25120, Revenue and Taxation Code.

Section 25121 is amended to read:

§ 25121(a). Definitions.

(1) "Taxpayer." The word "taxpayer" as used in these regulations is the same as defined in Revenue and Taxation Code section 23037 and the regulations thereunder.

(2) "Apportionment" refers to the division of business income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of nonbusiness income to a particular state.

(4) "Business activity" refers to the transactions and ~~activity~~activities occurring in the regular course of a particular trade or business of a taxpayer or to the acquisition, management, and disposition of property that constitute integral parts of the taxpayer's regular trade or business operations.

Note: Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 25121, Revenue and Taxation Code.

Section 25129 is amended to read:

§ 25129(b). Property Factor: Property Used for the Production of Business Income. Property shall be 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 trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is ~~held for sale~~no longer held for use in the trade or business.

*Example (A):* Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale one year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

*Example (B):* Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

*Example (C):* Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

*Example (D):* The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into three small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property is removed from the property factor on the date on which the remodeling of Store A commenced.

Note: Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 25129, Revenue and Taxation Code.

Section 25130 is amended to read:

§ 25130(b). Property Factor: Valuation of Rented Property.

(b) Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation section 25137(b) for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.) Subrents are not deducted when they constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

*Example (A):* The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

*Example (B):* The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses and persons such as professional people and shops. The rental of the two all five floors is ~~incidental~~ integral to the operation of the taxpayer's trade or business. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

*Example (C):* The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

Note: Authority cited: Section ~~26422~~19503, Revenue and Taxation Code.  
Reference: Section 25130, Revenue and Taxation Code.