

STAFF REQUEST FOR AUTHORIZATION TO PROCEED WITH THE ADOPTION
OF PROPOSED AMENDMENTS TO REGULATION
SECTIONS 25130 AND 25137(b)(1)

The proposed amendments (a copy of the regulations as proposed to be amended is attached) add language to these two regulations designed to address how to calculate the net annual rental rate of a taxpayer for property factor purposes for the use of the property of someone other than the taxpayer from which natural resources such as timber, oil, gas or hard minerals are extracted. The proposed amendments generally would codify current administrative practice, as set forth in Franchise Tax Board Legal Ruling 97-2, December 17, 1997. There are some differences, however, detailed below. Staff believes these differences provide greater certainty and clarity and notes that they were not objected to by any taxpayer during the comment period of the formal regulatory process.

The proposed amendments to the regulations cover additional types of relationships than those addressed by Legal Ruling 97-2. The proposed amendments also add amounts actually paid by the taxpayer for the right to enter the property to those amounts addressed by the Legal Ruling.

The regulatory amendments reflect the intent that subsection (C) would be the general rule for the extraction of natural resources. This language would allow taxpayers to rely on this general rule and avoid providing costly valuations in determining the amount to be used in the property factor in the above circumstances. Of course, pursuant to a Board of Equalization case, *Appeal of Fluor Corp.*, 95-SBE-016, December 12, 1995, if a taxpayer can demonstrate that the rule of (C) does not "fairly represent the extent of the taxpayer's business activity" in California, it can always request a variance from the rule under section 25137. A taxpayer would not be required to demonstrate that the amount paid was nominal under subsection (B).

The amendments also provide definitions of words and phrases used in the regulation. Language is also proposed to clarify the fact that the subsections under subsection (b)(1) are special rules for determining the net annual rental rate in certain situations.

A symposium was held prior to the proposed amendments being noticed. Comments by interested taxpayers made at the symposium were taken into account. The proposed amendments to Regulation Sections 25130 and 25137(b)(1) have been drafted and noticed for hearing. No one indicated that they would attend a hearing and so none was held. No comments were received with respect to the proposed amendments.¹ Accordingly, staff requests that pursuant to the authority granted by Section 19503 of the Revenue and Taxation Code, the Board authorize the Executive Officer of the Franchise Tax Board to take the necessary steps to adopt the

¹ At the Board meeting on September 17, 2003, Benjamin Miller reported the results of the symposium and the subsequent work with an interested member of the public, and informed the Board that the proposed amendments would be presented to the Board for approval after the public hearing required by the Administrative Procedure Act. In conformity with that representation, the proposed amendments are now being presented to the Board for approval.

proposed Regulation Sections 25130 and 25137(b)(1) as noticed in accordance with the provisions of the Administrative Procedure Act.

Section 25130 is amended to read:

§ 25130. Property Valuation.

(a) Property Factor. Valuation of Owned Property.

(1) Property owned by the taxpayer shall be valued at its original cost. As a general rule “original cost” is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. However, for taxable income years beginning on or after January 1, 1990, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes.

Example (A1): The taxpayer acquired a factory building in this state at a cost of \$500,000 and 18 months later expended \$100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar year basis. A depreciation deduction in the amount of \$22,000 was claimed on the building for its return for the current taxable year. The value of the building includible in the numerator and denominator of the property factor is \$600,000 as the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example (B2): During the current year, X Corporation merges into Y Corporation in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, X owns a factory which X built five years earlier at a cost of \$1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X’s hands at the time of the merger is \$900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y’s hands is the same as its basis in X’s, Y includes the property in Y’s property factor at X’s original cost, without adjustment for depreciation, i.e., \$1,000,000.

Example (C3): Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under Internal Revenue Code section 334(b)(2) (i.e., stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y’s cost of the assets is the purchase price of the X stock, prorated over the X assets.

If original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(2) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(3) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

(b) Property Factor. Valuation of Rented Property.

(1) 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 such property, less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See [Cal. Code Regs., tit. 18, § 25137, sub. \(a\)](#), for special rules where the use of such net annual rental rate produces a negative or clearly inaccurate value or where property is used by the taxpayer at no charge or rented at a nominal rental rate.)

Subrents are not deducted when the subrents 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 (A1): 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 (B2): 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, shops and the like. The rental of the two floors is incidental 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 (C3): 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~~ 18 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.

(2) "Annual rental rate" is the amount paid as rental for property for a 12-month period (i.e., the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month to month basis.

Example (A1): Taxpayer A, which ordinarily files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is \$2,500 a month. The rent for the tax period January 1 to April 30 is \$10,000. After the rent is annualized the net rent is \$30,000 (\$2,500 x 12).

Example (B2): Same facts as in Example (A1) except that the lease would have terminated on August 31. In this case the annualized net rent is \$20,000 (\$2,500 x 8).

(3) "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(A) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor \$1,000 per month as a base rental and at the end of the year pays the lessor 1 percent of its gross sales of \$400,000. The annual rent is \$16,000 (\$12,000 plus 1 percent of \$400,000 or \$4,000).

(B) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.

Example (A1): A taxpayer, pursuant to the terms of a lease, pays the lessor \$12,000 a year rent plus taxes in the amount of \$2,000 and interest on a mortgage in the amount of \$1,000. The annual rent is \$15,000.

Example (B2): A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was \$1,000 of which \$700 was for the use of storage space and \$300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is \$700.

(4) "Annual Rent" does not include: [incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.](#)

~~(A) Incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.; and~~

~~(B) Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration, conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.~~

(5) Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor. [\(See Cal. Code Regs., tit. 18, § 25137, sub.\(b\)\(1\)\(C\).\)](#)

Note: Authority cited: Section [2642219503](#), Revenue and Taxation Code.
Reference: Section 25130, Revenue and Taxation Code.

Section 25137 is amended to read:

§ 25137. Other Apportionment Methods.

(a) **Special Rules. In General.** Section 25137 provides that if the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) Separate accounting;
- (2) The exclusion of any one or more of the factors;
- (3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section 25137 permits a departure from the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act only in limited and specific cases.

Section 25137 may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in these regulations.

In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics and so forth, the foregoing regulations in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. Nothing in Section 25137 or in the Regulation shall preclude the Franchise Tax Board from establishing appropriate procedures under Sections 25129 to 25136 inclusive, for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

(b) **Special Rules. Property Factor.**

(1) The following special rules [for determining the net annual rental rate as provided by California Code of Regulations, title 18, section 25130, subsection \(b\)](#), are established in respect to the property factor of the apportionment formula:

(A) **Subrents.** If the subrents taken into account in determining the net annual rental rate under Regulation 25130, subsection (b), produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the Franchise Tax Board or requested by the taxpayer.

In no case, however, shall such value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for such property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example: The taxpayer rents a 10-story building at an annual rental rate of \$1,000,000. Taxpayer occupies two stories and sublets eight stories for \$1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or \$200,000.

(B) Property of others in general. If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a "reasonable market rental rate" for such property.

(C) Natural resources. Without regard to whether the following property is also described in subsection (b)(1)(B), if a taxpayer enters upon property owned by others for the purpose of extracting natural resources such as timber, oil, gas or hard minerals, and irrespective of whether such entry or extraction is pursuant to an agreement between the holder of the interest in the property and the taxpayer (and also irrespective of whether such relationship is characterized as a *profit à prendre* or some other relationship), consideration actually paid by the taxpayer to the holder of the interest in the property that constitutes a sharing of current or future production or extraction of the timber, oil, gas or hard minerals from such property (irrespective of the method of payment or how such consideration is characterized, whether as a royalty, advance royalty, rental or otherwise) and consideration actually paid by the taxpayer for the right to enter the property and extract the timber, oil, gas or hard minerals (such as forest management fees, fire protection fees, reforestation or reclamation fees, road maintenance fees, etc.) for the taxable year at issue shall constitute the net annual rental rate. The net annual rental rate shall then be multiplied by eight (8) in accordance with Revenue and Taxation Code section 25130. Improvements shall not be included in the calculation of a net annual rental rate, but are separately accounted for. (See California Code of Regulations, title 18, section 25130, subsection (b)(5).)

Example: On December 31, 2000, a taxpayer engaged in the paper products business enters into a 50-year forest management agreement with a government entity to commence January 1, 2001, that allows it to extract 100,000 cords of timber per year from forests owned by that government entity. In exchange for the right to enter the government's land and extract timber, the taxpayer agrees to pay a royalty fee of \$10.00 per cord extracted, plus a \$10,000 per year access fee, \$10,000 fire protection fee for any fires caused by the taxpayer, and an additional reforestation fee of 10 percent of the royalty fee paid. The forest management agreement also requires the taxpayer to make \$1 million worth of improvements to an existing mill facility owned by the government entity. In taxable year 2001, the taxpayer extracts 50,000 cords and does not cause any fires to occur. It also makes the \$1 million in improvements to the existing mill facility. The taxpayer therefore pays the government entity the \$10,000 access fee, \$500,000 in royalty fees (\$10.00 per cord times 50,000 cords), and an additional \$50,000 for the reforestation fee (10 percent of the \$500,000 royalty fee). Under these facts, the taxpayer is entitled to claim \$560,000 as the net annual rental rate. The taxpayer reports \$4,480,000 (\$560,000 multiplied by 8) for property factor purposes for this property for taxable year 2001. In addition,

the taxpayer reports the \$1 million in improvements in the property factor as property owned by the taxpayer in accordance with California Code of Regulations, title 18, section 25130, subsection (b)(5), for taxable year 2001.

(D) Definitions. For purposes of subsection (b) the following definitions apply.

1. A "reasonable market rental rate" shall mean the rate at which a lessor is willing to lease and a lessee is willing to pay in an open and competitive marketplace for the property.

2. A "nominal rate" shall mean a token payment compared to a rental rate at which a lessor is willing to lease and a lessee is willing to pay in an open and competitive marketplace for the property.

3. "Agreement" shall mean contract, lease or similar arrangement for the use of property.

(c) Special Rules. Sales Factor.

(1) The following special rules are established in respect to the sales factor of the apportionment formula:

(A) Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial.

~~1.~~ For purposes of this subsection, a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole.

~~2.~~ For purposes of this subsection, a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.

(B) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, business automobiles, etc.

(C) Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the

numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation 25134, sub. (a)(1)(A)) and income from the sale, licensing or the use of intangible personal property (Regulation 25136, sub. (b)(4)).

Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest shall be excluded from the denominator of the sales factor.

(d) In cases deemed appropriate by the Franchise Tax Board it may elect to hear and decide petitions filed pursuant to Section 25137 instead of having this function performed by the staff. As a condition to having such petition considered by the Board, the petitioning taxpayer shall waive in writing the confidentiality provisions of Section 19542 with respect to such petition and to any other facts which may be deemed relevant in making a determination. Consideration of said petitions by the Board shall be in open session at a regularly scheduled meeting.

Note: Authority cited: Section [1950326422](#), Revenue and Taxation Code. |
Reference: Section 25137, Revenue and Taxation Code.