

Section 25137-2 is amended to read:

Section 25137-2 ~~Construction Contractors.~~ -- Apportionment of Income, Long-Term ~~Construction Contracts.~~

(a) *In General.* When a taxpayer elects to use the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts, as provided by Revenue and Taxation Code section 24673.2, and has income from sources both within and without this state, the amount of business income derived from sources within this state, including income from such long-term contracts, shall be determined pursuant to these regulations. In such cases, the first step is to determine which portion of the taxpayer's income constitutes "business income" and "nonbusiness income" under ~~Section~~Revenue and Taxation Code section 25120 ~~of the Bank and Corporation Tax Law~~ and the regulations thereunder. Nonbusiness income is directly allocated to specific states pursuant to the provisions of ~~Section~~Revenue and Taxation Code sections 25124 to 25127, ~~inclusive of the law~~. The business income of the taxpayer is divided between or among the states in which the business is conducted pursuant to the property, payroll, and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state, plus (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax.

(b) *Business and Nonbusiness Income.* For definitions, rules and examples for determining business and nonbusiness income see California Code of Regulations, title 18, section 25120.

(c) *Methods of Accounting and Year of Inclusion.* For general rules of accounting, definitions and methods of accounting for long-term contracts, see ~~Section~~Revenue and Taxation Code sections 24651 and 24673.2 and the regulations thereunder, relating to accounting methods and long-term contracts.

(d) *Apportionment of Business Income.*

(1) *In General.* Under Revenue and Taxation Code section 25128 ~~B~~business income is apportioned to this state by a three or four factor formula consisting of a property factor, a payroll factor and a single or double weighted sales factor, regardless of the method of accounting for long-term contracts elected by the taxpayer. In general, Revenue and Taxation Code section 25128 provided for the use of a three-factor formula by all apportioning taxpayers for years beginning prior to January 1, 1993. For years beginning on or after January 1, 1993, that section requires most taxpayers to use a four-factor formula; however, for taxpayers in specified types of businesses, the three-factor formula continues to apply. The total of the property, payroll and sales percentages is divided by three or four, depending on whether a three or four factor formula is required, to determine the apportionment percentage. The apportionment percentage is then applied to business income to determine the amount apportioned to this state.

(2) *Percentage of Completion Method.* ~~Under this method of accounting for long-term contracts, the amount to be included each year as business income from each contract, is the~~

amount by which the gross contract price which corresponds to the percentage of the entire contract which has been completed during the income years exceeds all expenditures made during the income year in connection with the contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract.

Example:

A taxpayer using the percentage of completion method of accounting for long term contracts, entered into a long term contract to build a ship for \$9,000,000. The contract allowed three years for completion, and as of the end of the second income year the taxpayer's books of account, kept on the accrual method, disclosed the following:

	<u>Receipts</u>	<u>Expenditures</u>
End of 1st income year	\$2,500,000	\$2,400,000
End of 2nd income year	4,500,000	4,100,000
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	\$7,000,000	\$6,500,000

In computing the above expenditures, consideration was given to material and supplies on hand at the beginning and end of each income year.

It was estimated that the contract was 30% completed at the end of the first income year and 80% completed at the end of the second income year. The amount to be included as business income for the first income year is \$300,000 (30% of \$9,000,000 equals \$2,700,000 less expenditures of \$2,400,000). The amount to be included as business income for the second income year is \$400,000 (50% of \$9,000,000 equals \$4,500,000 less expenditures of \$4,100,000).

The specific rules for determining the amount of income to be included in business income when the percentage of completion method of long-term contract accounting is used are found in Treasury Regulations section 1.451-3(c). In general, those rules provide that the amount of income from each contract to be included each year is determined by determining the percentage of the total contract completed during the taxable year and applying that percentage to the total contract price, and then subtracting from the resulting amount the total expenditures made during the taxable year in connection with the contract.

(3) Completed Contract Method. The specific rules for determining the amount of income to be included in business income when the completed contract method of long-term contract accounting is used are found in Treasury Regulations section 1.451-3(d). In general, Under this method of accounting business income derived from long-term contracts is reported for the income taxable year in which the contract is finally completed and accepted. Therefore, a special computation that apportions the income using the apportionment percentages for the years in which the contract was performed is required to compute the amount of business income attributable to this state from each completed contract. (See subsection (e) of this regulation.) Thus, all receipts and expenditures applicable to such contracts whether completed or not as of the end of the income year are excluded from business income derived from other sources, as for example, short term contracts, interest, rents, royalties, etc., which is apportioned by the regular three factor formula of property, payroll and sales. Business income from all other activities not related to long term contracts subject to the completed contract method of accounting is then apportioned to this state using the regular three or four factor apportionment formula provided by Revenue and Taxation Code section 25128. The apportionment percentages used for apportioning the income from other activities (income not attributable to completed long term contracts) is computed as provided in subsections (4), (5) and (6) of this regulation for each of the taxable years in which such other income is recognized.

(4) Property Factor. In general the numerator and denominator of the property factor shall be determined as set forth in Sections Revenue and Taxation Code sections 25129, 25130 and 25131 and the regulations thereunder. However, the following special rules are also applicable

when either the completed contract or percentage of completion method of long term contract accounting is used:

(A) The average value of the taxpayer's cost (including materials and labor) of work construction in progress, to the extent such costs exceed progress billings (accrued or received depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The value of any such construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

Example 1:

Taxpayer commenced building a ship a long term construction project in this state under a long-term contract as of the beginning of a given year. By the end of its second income taxable year its equity in the costs of production to be reflected in the numerator and denominator of its property factor for such year is computed as follows:

	1st Year		2nd Year	
	Beginning	Ending	Beginning	Ending
Construction ProjectCosts	0	\$1,000,000		
Progress billings		600,000		
Balance 12/31--(1/1)		\$ 400,000	\$400,000	
<u>Total Construction project</u> <u>Costs Total from</u> beginning of project				\$5,000,000
<u>Total P</u> progress billings <u>Total from beginning of</u> project				4,000,000
Balance 12/31				1,000,000
Balance at beginning of year				400,000
Total				\$1,400,000
Average (1/2)--Value (*) used in property factor				\$ 700,000

(*) It may be necessary to use monthly averages if yearly averages do not properly reflect the average value of the taxpayer's equity; see Section Revenue and Taxation Code section 25131 and the regulations thereunder.

Example 2:

Same facts as in Example 1, except that progress billings exceeded ~~construction~~project costs. No value for the taxpayer's equity in the ~~construction~~project is shown in the property factor.

(B) Rent paid for the use of equipment directly attributable to a particular ~~construction~~project is included in the property factor at eight times the net annual rental rate even though such rental expense may be included in the cost of the project.

(C) The property factor is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each ~~income~~taxable year even though under the completed contract method of accounting, business income is computed separately (sSee subsection (e) of this regulation).

(5) *Payroll Factor.* In general the numerator and denominator of the payroll factor shall be determined as set forth in Sections Revenue and Taxation Code sections 25132 and 25133 and the regulations thereunder. However, the following special rules are also applicable when either the completed contract or percentage of completion method of long term contract accounting is used:

(A) Compensation paid employees which is attributable to a particular ~~construction~~project is included in the payroll factor even though included in the cost of ~~construction~~the project.

(B) Compensation paid to employees engaged in performing services at a ~~construction~~project site are attributed to the state in which the services are performed. Compensation paid all other employees is governed by Section Revenue and Taxation Code section 25133.

Example:

A taxpayer engaged in a long-term contract in state X assigns several key employees to that state to supervise the project. The taxpayer, for unemployment tax purposes, reports these employees to state Y where the main office is maintained and where the employees reside. For payroll factor purposes, such compensation is assigned to the numerator of state X.

(C) The payroll factor is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each ~~income~~metaxable year even though under the completed contract method of accounting, business income is computed separately (sSee subsection (e) of this regulation).

(6) *Sales Factor.* In general the numerator and denominator of the sales factor shall be determined as set forth in Sections Revenue and Taxation Code sections 25134, 25135 and 25136

and the regulations thereunder. However, the following special rules are also applicable:

(A) Gross receipts derived from the performance of a contract are attributable to this state if the ~~construction~~ project is located in this state. If the ~~construction~~ project is located partly within and partly without this state, the gross receipts attributable to this state are based upon the ratio which ~~construction~~ costs for the project in this state incurred during the ~~income~~taxable year bears to the total of such ~~construction~~ costs for the entire project during the ~~income~~taxable year or any other method, such as engineering cost estimates, which will provide a reasonable apportionment.

Example 1:

A ~~construction~~ ship building project was undertaken in this state by a calendar year taxpayer, which had elected one of the long-term contract methods of accounting. The following gross receipts (~~progress billings~~) were derived from the contract during the three ~~income~~taxable years the contract was in progress.

	1st Year	2nd Year	3 rd Year
Gross Receipts	\$1,000,000	\$4,000,000	\$3,000,000

The gross receipts to be reflected in both the numerator and denominator of the sales factor for each of the three years are the amounts shown.

Example 2:

A taxpayer contracts to build a dam on a river at a point, which lies half within this state and half within state X. During the taxpayer's first ~~income~~taxable year construction costs in this state were \$2,000,000. Total construction costs for the project during the ~~income~~taxable year were \$3,000,000. Gross receipts (~~progress billings~~) for the year were \$2,400,000. Accordingly, gross receipts of \$1,600,000 (~~\$2,000,000~~ $\frac{1,600,000}{2,400,000} = 66 \frac{2}{3}\%$ x \$2,400,000) are included in the numerator of the sales factor.

(B) If the percentage of completion method is used, the sales factor includes only that portion of the gross contract price, which corresponds to the percentage of the entire contract, which was completed during the ~~income~~taxable year.

Example:

A taxpayer which had elected the percentage of completion method of accounting entered into a long-term ~~construction~~ contract. At the end of its current taxable year (the first since starting the project) it estimated that the project was 30% completed. The bid price for the project was \$9,000,000 and it had received \$2,500,000 from progress billings as of the end of its current ~~income~~taxable year. The amount of gross receipts to be included in the sales factor for the current ~~income~~taxable year is \$2,700,000 (30% of \$9,000,000), regardless of whether the taxpayer uses the accrual method or the cash method for accounting for receipts and disbursements.

(C) If the completed contract method of accounting is used, the sales factor includes the portion of the gross receipts (~~progress billings~~) received or accrued, whichever is applicable, during the ~~income~~taxable year attributable to each contract.

Example 1:

A taxpayer which had elected the completed contract method of accounting entered into a long-term ~~construction~~ contract. By the end of its current ~~income~~taxable year (the second since starting the project) it had billed, and accrued on its books a total of \$5,000,000 of which \$2,000,000 had accrued in the first year the contract was undertaken, and \$3,000,000 had accrued in the current (second) year. The amount of gross receipts to be included in the sales factor for the current ~~income~~taxable year is \$3,000,000.

Example 2:

Same facts as in Example 1 except that the taxpayer keeps its books on the cash basis, and as of the end of its current ~~income~~taxable year had received only \$2,500,000 of the \$3,000,000 billed during the current year. The amount of gross receipts to be included in the sales factor for the current ~~income~~taxable year is \$2,500,000.

(D) The sales factor, except as noted above in subparagraphs (B) and (C) of this subsection (6), is computed in the same manner regardless of which long-term contract method of accounting the taxpayer has elected and is computed for each ~~income~~taxable year even though under the completed contract method of accounting, business income is computed separately.

(7) Apportionment Percentage. ~~The total of the property, payroll and sales percentages is divided by three to determine the apportionment percentage~~ apportionment percentage is determined under Revenue and Taxation Code section 25128 using the property, payroll and sales factors determined as provided under subsections (4), (5) and (6) above, except that when computing the fraction described in Revenue and Taxation Code section 25128, subdivision (a), for years beginning before January 1, 1993, the payroll factor, the property factor and the sales factor shall be weighted equally and the denominator of the fraction described in Revenue and Taxation Code section 25128, subdivision (a), shall be three. ~~The apportionment~~ That percentage is then applied to business income to establish the amount apportioned to California.

(e) Completed Contract Method--Special Computation. The completed contract method of accounting requires that the reporting of income (or loss) be deferred until the year the ~~construction~~ project is completed and accepted. Accordingly, a separate computation is made for each such contract completed during the ~~income~~taxable year, regardless of whether the project is located within or without this state, in order to determine the amount of income which is attributable to sources within this state. The amount of income from each contract completed during the ~~income~~taxable year apportioned to this state, plus other business income apportioned to this state by the ~~regular~~applicable three or four factor formula, ~~such as interest income, rents, royalties, income from short term contracts, etc.,~~ plus all nonbusiness income allocated to this state, is the measure of tax for the ~~income~~taxable year. The amount of income (or loss) from each contract, which is derived from sources within this state for which the completed contract method of accounting is used, is computed as follows:

(1) In the ~~income~~taxable year the contract is completed, the income (or loss) therefrom is determined.

(2) The income (or loss) determined ~~at~~under subsection (e)(1) is apportioned to this state by the following method:

(A) A fraction expressed as a percentage is determined for each taxable year the contract was in progress. The numerator of ~~which the fraction~~ is the amount of construction project costs paid or accrued each taxable year the contract was in progress and the denominator of which the fraction is the total of all such ~~construction~~-costs accrued or paid for the entire project.

(B) Each percentage determined in subsection (e)(2)(A) is multiplied by the apportionment formula percentage for that particular year as determined in ~~paragraph 7 of subsection (d)~~subsection (d)(7) of this regulation.

(C) The products determined at subsection (e)(2)(B) for each taxable year the contract was in progress are totaled. The amount of total income (or loss) from the contract determined under ~~at~~subsection (e)(1) is multiplied by the total percentage. The resulting income (or loss) is the amount of business income from such contract derived from sources within this state.

Example 1:

A taxpayer, not engaged in a "qualified business activity as defined in California Code of Regulations, title 18, section 25128(c), using the completed contract method of accounting for long-term contracts is engaged in three long-term contracts; Contract L in this state, Contract M in state X and Contract N in state Y. In addition, it has other business income (less expenses) during the income year ~~1972~~1992 from interest, rents and short-term contracts amounting to \$500,000, and nonbusiness income allocable to this state of \$8,000. During ~~1972~~1992 it completed Contract M in state X at a profit of \$900,000. Contracts L in this state and N in state Y were not completed during the income year. The apportionment percentages of the taxpayer as determined in ~~paragraph 7~~subsection (d)(7) ~~of subsection (d)~~ of this regulation and the percentages of contract costs as determined in ~~paragraph (2)~~subsection (e)(2) above for each year Contract M in state X was in progress are as follows:

	<u>1970</u> <u>1990</u>	<u>1971</u> <u>1991</u>	<u>1972</u> <u>1992</u>
Apportionment percentages for this state	30%	20%	40%
Percentage of <u>project construction</u> costs of Contract M each year to total Construction <u>project</u> costs— (100%)	20%	50%	30%

The corporation's net income subject to tax in this state for ~~1970~~1992 is computed as follows:

Business Income (excluding income from Contract M)	\$500,000
Apportion 40% to this state	\$200,000
Add: Income from Contract M *	\$252,000
Total business income derived from sources within this state	452,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	\$460,000

*Income from Contract M apportioned to this state:

	1970 <u>1990</u>	1971 <u>1991</u>	1972 <u>1992</u>	Total
Apportionment percentage for this state	30%	20%	40%	
Percent of construction <u>project</u> costs	20%	50%	30%	100%
Product	6.00%	10.00%	12.00%	28%
28% of \$900,000 = \$252,000				

Example 2:

Same facts as in Example 1 except that Contract L was started in ~~1972~~1992 in this state, the first year the taxpayer was subject to tax in this state. Contract L in this state and Contract N in state Y are incomplete in ~~1972~~1992.

The corporation's net income subject to tax in this state for ~~1972~~1992 is computed as follows:

Business Income (excluding income from Contract M)	\$500,000
Apportion 40% to this state	\$200,000
Add: Income from Contract M *	108,000
Total business income derived from sources within this state	\$308,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	\$316,000

* Income from Contract M apportioned to this state:

	1970 <u>1990</u>	1971 <u>1991</u>	1972 <u>1992</u>	Total
Apportionment percentage for this state	0%	0%	40%	
Percentage of construction <u>project</u> costs	20%	50%	30%	
Product	0	0	12.0%	12.0%

* 12% of \$900,000 = \$108,000

Note: ~~Only~~The percentage of 12% is used to determine the income derived from sources within this state ~~since~~reflects the fact that the corporation was not subject to tax in this state prior to ~~1972~~1992.

Example 3:

Same facts as in Example 1 except that the figures relate to Contract L in this state and ~~1972~~1992 is the first year the corporation was taxable in another state (see ~~Sections~~Revenue and Taxation Code sections 25121 and 25122 and the regulations thereunder). Contracts M and N in states X and Y were started in ~~1972~~1992 and are incomplete.

The corporation's net income subject to tax in this state for 1992 is computed as follows:

Business Income (excluding income from Contract L)	\$500,000
Apportion 40% to this state	\$200,000
Add: Income from Contract L *	738,000
Total business income derived from sources within this state	\$938,000
Add: Nonbusiness income allocated to this state	8,000
Net income subject to tax	\$946,000

* Income from Contract L apportioned to this state:

	<u>1970</u> <u>1990</u>	<u>1971</u> <u>1991</u>	<u>1972</u> <u>1992</u>	Total
Apportionment percentage for this state	100%	100%	40%	
Percentage of project <u>construction</u> costs	20%	50%	30%	100%
Product	20%	50%	12%	82%
82% of \$900,000 = \$738,000				

(f) *Dissolution, Withdrawal or Cessation of Business.* Except as noted in subsection (g) below, the income of a taxpayer which has elected either the percentage of completion or the completed contract method of accounting for long-term contracts and which ceases to do business, dissolves or withdraws from this state during a taxable year shall be computed in accordance with ~~Section~~Revenue and Taxation Code section 23151.1.

(g) *Computation for Year of Withdrawal or Cessation of Business--Completed Contract Method.* Use of the completed contract method of accounting for long-term contracts requires that income derived from sources within this state from incomplete contracts in progress outside this state on the date of withdrawal or cessation of business in this state be included in the measure of tax for the taxable year during which the corporation withdraws or ceases doing business in this state.

(1) The amount of income (or loss) from each such contract to be apportioned to this state by the apportionment method set forth in subsection (e)(2) of this regulation shall be determined as if the percentage of completion method of accounting were used for all such contracts on the date of withdrawal or cessation of business as set forth in subsection (g)(2), below.

(2) The amount of business income (or loss) for each such contract shall be the amount by which the gross contract price from each such contract which corresponds to the percentage of the entire contract which has been completed from the commencement thereof to the date of withdrawal or cessation of business exceeds all expenditures made during such period in connection with each such contract. In so doing, ~~account must be taken of the materials and supplies on hand for use in such contract at the beginning and end of the income year such period must be added to expenditures for materials and supplies, and materials and supplies intended for use in such contract, on hand at the end of such period, and must be subtracted from such expenditures for use in each such contract.~~

Example:

A ~~construction~~ contractor qualified to do business in this state had elected the completed contract method of accounting for long-term contracts. It was engaged in two long-term contracts; Contract L in this state was started in ~~1971~~1991 and completed at a profit of \$900,000 on 12/16/~~79~~93. The taxpayer withdrew on 12/31/~~79~~93. Contract M in state X was started in ~~1972~~1992 and was incomplete on 12/31/~~79~~93.

The apportionment percentages of the taxpayer as determined at subsection (d) of this regulation, and percentages of ~~construction~~project costs as determined in subsection (e)(2) of this regulation, for each year for each contract are as follows:

	<u>1971</u> <u>1991</u>	<u>1972</u> <u>1992</u>	<u>1973</u> <u>1993</u>	Total
Apportionment percentage for this state	30%	20%	40%	
Percentage of construction <u>project</u> costs:				
Contract L, this state	20%	50%	30%	100%
Contract M, state X	0	10%	25%	35%

The corporation had other business income (net of expenses) of \$500,000 during ~~1972~~1992 and \$300,000 during ~~1973~~1993. The gross contract price of Contract M (state X) was \$1,000,000 and it was estimated to be 35% completed on 12/31/~~79~~93. Total expenditures to date for Contract M (state X) were \$300,000 for the period ended 12/31/~~79~~93.

The measure of tax for the ~~taxable~~income year ended 12/31/~~79~~93 (based upon measure of tax for income years ~~1972~~1992 and ~~1973~~1993) is computed as follows:

	<u>Taxable</u> <u>Income</u> Year <u>1973</u> <u>1993</u>	
	<u>Income</u> Year <u>1972</u> <u>1992</u>	<u>Income</u> Year <u>1973</u> <u>1993</u>
Business Income	\$500,000	\$300,000
Apportionment percentage for this state	20%	40%
Amount apportioned to this state	\$100,000	\$120,000

Add: Income from contracts:

*L (this state) 252,000
 **M (state X) 6,000

Total ~~h~~Business ~~i~~Income derived from sources within this state \$100,000 \$378,000

* Income from Contract L apportioned to this state:

	1971 1991	1972 1992	1973 1993	Total
Apportionment percentages	30%	20%	40%	
Percentage of construction project costs	20%	50%	30%	100%
Product	6.0%	10.0%	12.0%	28%
28% of \$900,000 = \$252,000				

** Income from Contract M apportioned to this state:

	1971 1991	1972 1992	1973 1993	Total
Apportionment percentages	0	20%	40%	
Percentage of construction project costs	0	10%	25%	35%
Product	0	2.0%	10.0%	12.0%
*** 12.0% of \$50,000 = \$6,000.				

***Computation of apportionable income from Contract M based on percentage of completion method:

Total Contract Price	\$1,000,000
Estimated to be 35% completed.....	\$350,000
Less: total expenditures to date	300,000
Apportionable income	\$50,000

(h) *Reporting of Partnership Income.* In the case of taxpayers that receive distributive shares of partnership income, see ~~Section~~California Code of Regulations, title 18, section 25137-1.

(i) This section is applicable to taxable years beginning on or after January 1, 2003.

Note: Authority cited: Section ~~26422~~19503, Revenue and Taxation Code.
 Reference: Section 25137, Revenue and Taxation Code.