

Section 25130 is amended to read:

§ 25130. Property Valuation.

(a) Property Factor. Valuation of Owned Property.

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 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 income year on the calendar year basis. Depreciation deduction in the amount of \$22,000 was claimed on the building for its return for the current income 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 Corporation 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 § 334(b)(2) of the 1954 Internal Revenue Code (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~~<sup>18</sup> 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)...~~

~~(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.  
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