

INITIAL STATEMENT OF REASONS FOR THE AMENDMENT OF REGULATION  
SECTION 25128 AND THE ADOPTION OF REGULATIONS SECTIONS  
25128-1 AND 25128-2

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER  
CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO  
ADDRESS

~~When a corporate taxpayer has income from trade or business activity that is taxable both within and without this state, section 25121 of the Revenue and Taxation Code requires that the taxable portion of the business income from such activity be determined by means of an apportionment formula. Revenue and Taxation Code section 25128, as amended in 1993, 1994, 1996, and 1997, defines the applicable formulas. to require For most multijurisdictional corporations, to use a double-weighted sales factor in their income apportionment the applicable formula is a fraction whose numerator is the property factor plus the payroll factor plus twice the sales factor, and whose denominator is four. However, this section continued to require the use of a single-weighted sales factor by if the corporations deriving more than 50 percent of its their gross business receipts from one or more “qualified business activities,” the applicable formula is a fraction whose numerator is the property factor plus the payroll factor plus the sales factor, and whose denominator is three. The qualified business activities subject to the special three-factor formula are which include “agricultural business activity,” and “extractive business activity;” “savings and loan activity,” and “banking or financial business activity.”~~

Existing ~~¶~~ Regulation section 25128 was adopted prior to ~~the~~ 1993 and does not reflect current law.

SPECIFIC PURPOSE OF THE REGULATION

~~other recent amendments of Revenue and Taxation Code section 25128 and specifies the use of a three-factor apportionment formula.~~ The purpose of the proposed amendment to ~~¶~~ Regulation section 25128 and of the proposed adoption of new ~~¶~~ Regulations sections 25128-1 and 25128-2 is to bring the regulations into conformity with the 1993 and later amendments to section 25128 ~~of the code~~ of the Revenue and Taxation Code and to provide needed guidance ~~to taxpayers. In particular, the regulatory action being proposed is intended to provide guidance~~ regarding: (1) the activities which constitute agricultural and extractive business activities within the meaning of Revenue and Taxation Code section 25128, (2) the effects on the classification of such business activity if the taxpayer processes agricultural or extractive commodities into finished products, and (3) the way to compute gross business receipts from a taxpayer’s qualified and nonqualified business activities.

NECESSITY

Existing Regulation section 25128 needs to be amended to reflect current law regarding the general use of a double-weighted sales factor. In addition, the Franchise Tax Board needs to provide guidance to help taxpayers decide whether they are required to use a single-weighted sales factor instead of the generally applicable double-weighted factor.

#### TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In proposing these regulatory changes, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports, or documents, except for the following: Standard Industrial Classification Manual (1987); Modern Petroleum (2d ed.), by Bill D. Berger and Kenneth E. Anderson; and Petroleum Refining for the Nontechnical Person (2d ed.), by William L. Leffler.

#### ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

In accordance with Government Code section 11346.5(a)(12), the Franchise Tax Board has determined that no alternative considered by it would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed regulatory action. In addition, because the proposed regulatory action pertains to multijurisdictional corporate taxpayers, it will have only a minimal impact on small business and does not have any effect on private persons.

#### ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed regulatory action will not have a significant adverse impact on business. The proposed amendments to regulation 25128 contain general definitions and rules; proposed new regulation 25128-1 defines extractive business activity; and proposed new regulation 25128-2 defines agricultural business activity.

Amended regulation 25128 defines “gross business receipts” to mean “sales” as defined in other statutes and regulations related to income apportionment. The regulation also states that only sales to unrelated third parties will be used to determine whether the taxpayer obtains more than 50 percent of its gross business receipts from qualified business activities.

Revenue and Taxation Code section 25128, subdivision (d)(3), defines extractive business activity as “activities relating to the production, refining, or processing of oil, natural gas, or mineral ore.” Proposed regulation 25128-1 explains the meaning of the terms “production,” “refining,” and “processing.” The regulation defines “production” as

the location, extraction, and initial processing of oil, gas, or minerals, and it provides detailed examples of the specific activities that are included. The regulation defines “refining” as the separation, purification, or conversion of oil, gas, or minerals into valuable products in a refinery. The regulation lists examples of specific activities that constitute oil refining and other types of refining, and it also lists examples of products that are produced in oil refineries and in other refineries. “Processing” is defined as activities intended to create valuable products from oil, gas, or minerals that have not already been refined. The regulation provides that receipts from sales of services or from sales of products purchased from third parties are not gross business receipts from extractive business activity. Exceptions are allowed, however, for resales of products acquired from other taxpayers either as the result of exchanges of similar extractive products or because of a temporary interruption in the taxpayer’s normal supply of crude oil or refined products.

Proposed regulation section 25128-2 defines “agricultural business activity.” It states that this term applies only to taxpayers engaged in the business of farming, as that business is defined for federal income tax purposes, and includes only activities that are considered to be farming activities for federal tax purposes. The regulation contains a detailed list of qualifying activities and products. It also states that neither receipts from sales of services nor receipts from resales of products purchased from others are gross business receipts from agricultural business activity. An exception is made, however, for resales of agricultural products acquired in an exchange of such products. The regulation says that agricultural cooperatives are not engaged in “agricultural business activity,” and that patronage dividends received by a taxpayer are not receipts from qualified agricultural business activity.

These proposed regulations address a specific California problem. There is no federal law comparable to Revenue and Taxation Code section 25128, because apportionment of income between states is not necessary under federal law.