

§. 25128. Apportionment of Business Income.

- (a) In General. All business income of each apportioning trade or business of the taxpayer shall be apportioned to this state by use of the formula set forth in section 25128, section 25128.5, or section 25128.7 of the Revenue and Taxation Code, whichever is applicable.

Section 25128, subdivision (a), of the Revenue and Taxation Code, as in effect for taxable years beginning before January 1, 2013, provided that the apportionment formula is a fraction, the numerator of which is the property factor plus the payroll factor plus twice the sales factor, and the denominator of which is four. Section 25128, subdivision (b), of the Revenue and Taxation Code, however, provides exceptions to the rule in subdivision (a) of that section for taxpayers who derive more than 50 percent of their "gross business receipts" (as defined in section 25128, subdivision (d)(1), of the Revenue and Taxation Code) from conducting a qualified business activity (as defined in subdivisions (c) and (d)(2)-(5) of section 25128 of the Revenue and Taxation Code and these regulations thereunder). Such taxpayers must use an apportionment formula which is a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Section 25128.5 of the Revenue and Taxation Code applied to taxable years beginning on or after January 1, 2011 and before January 1, 2013. Section 25128.5, Revenue and Taxation Code, provided that any apportionable trade or business, other than that described in subdivision (b) of Section 25128, could have an irrevocable annual election on an original timely filed return to apportion its income to this state by multiplying its business income by the sales factor.

Section 25128.7 of the Revenue and Taxation Code applies to taxable years beginning on or after January 1, 2013. Section 25128.7, Revenue and Taxation Code, provides that an apportionable trade or business, other than that described in subdivision (b) of Section 25128, Revenue and Taxation Code, shall apportion its income to this state by multiplying its business income by the sales factor.

(b) Definitions.

- (1) The term "qualified business activity" is defined in subdivisions (c) and (d) of Revenue and Taxation Code section 25128. In general, for taxable years beginning before January 1, 2025, it means an agricultural business activity, an extractive business activity, a savings and loan activity, or a banking or financial business activity-, and for taxable years beginning on or after January 1, 2025, it means an agricultural business activity or an extractive business activity.
- (2) Except as otherwise provided under section 25128 of the Revenue and Taxation Code, the term "gross receipts" as used in this regulation means "sales" as defined in subdivision (e) of Revenue and Taxation Code section 25120 and in the regulations under section 25134 of the Revenue and Taxation Code.
- (3) The term "gross business receipts" is defined in subdivision (d)(1) of section 25128 of the Revenue and Taxation Code. Except as otherwise provided in that

subdivision, the term means gross receipts as defined in subsection (b)(2) of this regulation, whether or not the receipts are excluded from the sales factor by operation of section 25137 of the Revenue and Taxation Code.

- (c) Combined Reports. Section 25128, subdivision (d)(8), of the Revenue and Taxation Code generally provides that if the income and apportionment factors of two or more banks, savings associations, or corporations are required to be included in a combined report under section 25101 of the Revenue and Taxation Code, limited (if applicable), by a water's-edge election under section 25110 of the Revenue and Taxation Code, the more-than-50-percent gross business receipts test is determined with respect to the gross business receipts of the entire apportioning trade or business of the combined reporting group.

For taxable years beginning before January 1, 2011, if, after application of that test, the gross business receipts attributable to qualified business activity are not more than 50 percent of all gross business receipts of the group, then all members of the group must apportion their income using the double-weighted sales factor provided by subdivision (a) of section 25128 of the Revenue and Taxation Code, even if an individual member, considered alone, would have qualified for a single-weighted sales factor.

For taxable years beginning on or after January 1, 2011 and before January 1, 2013, if after application of that test the gross business receipts attributable to qualified business activity are not more than 50 percent of all gross business receipts of the group, then all members of the group must apportion their income using the double-weighted sales factor provided by subdivision (a) of section 25128 of the Revenue and Taxation Code unless the group made a timely annual irrevocable election pursuant to Section 25128.5, Revenue and Taxation Code. If an election were made, then all members of the group must apportion their income using the single sales factor apportionment formula.

For taxable years beginning on or after January 1, 2013, if, after application of that test, the gross business receipts attributable to qualified business activity are not more than 50 percent of all gross business receipts of the group, then all members of the group must apportion their income using the single sales factor apportionment formula pursuant to Section 25128.7, Revenue and Taxation Code.

Example: Corporation A is the parent of Corporations B and C. Corporations A and B are engaged in the manufacture and sale of ocean-going oil tankers and oil pipe, respectively. Corporation C owns a small oil refinery. Corporations A, B, and C are members of a unitary group required to file a combined report in California. The gross business receipts in all states for Corporations A and B are \$880 million and \$440 million, respectively. Under the provisions of section 25128 of the Revenue and Taxation Code and this regulation, none of those gross receipts are from a qualified business activity. Corporation C's gross business receipts from a qualified business activity (oil refining) in all states are \$320 million, and its other business receipts are \$80 million. The total gross business receipts of the combined group are \$1.720 billion, of which only 18.6 percent constitutes

gross business receipts from qualified business activity. The combined business income of the group is subject to apportionment using either a four-factor apportionment formula with a double-weighted sales factor or a single sales factor apportionment formula, whichever is applicable, despite the fact that more than 50 percent of Corporation C's gross business receipts is from an extractive trade or business.

(d) Vertically Integrated Companies.

- (1) Section 25128, subdivision (b), of the Revenue and Taxation Code provides that a taxpayer must use a three-factor formula if it has more than 50 percent of its "gross business receipts" from conducting one or more qualified business activities. For purposes of this 50-percent test, subdivision (d)(1) of section 25128 of the Revenue and Taxation Code provides that gross business receipts do not include gross receipts from sales or other transactions (hereinafter referred to as intercompany sales) within an apportioning trade or business between members of a group of corporations whose income and apportionment factors are required to be included in a combined report under section 25101 of the Revenue and Taxation Code, limited, if applicable, by section 25110 of the Revenue and Taxation Code.
- (2) Because section 25128, subdivision (d)(1), of the Revenue and Taxation Code expressly excludes intercompany sales, only sales to parties outside the apportioning trade or business are considered in determining the numerator and denominator of the over-50-percent gross receipts test of Revenue and Taxation Code section 25128, subdivision (b), and only such gross receipts from sales to parties outside the apportioning trade or business are used to determine whether a receipt is from a qualified business activity. Therefore, in a vertically integrated operation, only the products sold to those outside of the apportioning trade or business will be considered in determining whether the apportioning trade or business is engaged in a qualified business activity.

Example 1: A parent company produces crude oil, a combined unitary subsidiary which is part of the apportioning trade or business refines some of the oil into gasoline, another combined unitary subsidiary makes petrochemicals from naphtha obtained from its unitary affiliate's refining operations, and another combined unitary subsidiary uses the petrochemicals to make plastics. The apportioning trade or business sells gasoline and plastics to third parties. Only the products sold to parties outside of the combined unitary group are considered in determining whether this group is engaged in a qualified business activity under section 25128 of the Revenue and Taxation Code. In this example, the only products sold to third parties are gasoline and plastics. Therefore, the intercompany sales of naphtha and petrochemicals are not considered in determining whether the group is engaged in a qualified business activity. Receipts from the sale of gasoline constitute gross business receipts from a qualified business activity (extractive business activity) under section 25128 of the Revenue and Taxation Code and the regulations thereunder. Receipts from the sale of plastics, however, are not gross business receipts from a qualified business activity. (See Regulation section

25128-1 for determining whether an activity is a qualified extractive business activity.)

Example 2: The business activity of an apportioning trade or business is the sale of soup to third parties. However, an entity in the combined apportioning trade or business grows vegetables, which it provides to other entities in the combined apportioning trade or business in order to make the soup. Only the activities which lead to receipts from sales to parties outside of the combined apportioning trade or business will be considered in determining whether the apportioning trade or business is engaged in an agricultural business activity. Because only the sale of soup results in gross business receipts as defined in this regulation, the sale of soup is considered to be the business activity of the apportioning trade or business. The making and sale of soup is not an agricultural business activity under the definition set forth in Revenue and Taxation Code section 25128, subdivision (d)(2), and these regulations because it does not directly involve the production of agricultural products; therefore, the apportioning trade or business does not qualify to use a single-weighted sales factor. The fact that other companies in the combined unitary group were engaged in agricultural production and provided commodities within the combined group to be made into the final product is not taken into account, because any agricultural receipts derived by these other companies are from intercompany sales as defined in subsection (d)(1) of this regulation and, therefore, are not from sales to parties outside the apportioning trade or business. (See Regulation section 25128-2 for determining whether an activity is a qualified agricultural business activity.)

Example 3: An apportioning trade or business operates a winery, which grows all of the grapes used in its wine. The business does not sell any grapes to third parties; all of its third party receipts come from the sale of wine. The winery does not qualify as an agricultural business activity because making and selling wine is not the direct production of an agricultural commodity. Only the product sold to third parties, wine, is considered in making this determination. (See Regulation section 25128-2 for determining whether an activity is a qualified agricultural business activity.)

Example 4: Company A and Company B are engaged in a unitary business. A makes a water's-edge election and, as a result, B is not included in A's combined report. A produces grapes which it sells to B. B in turn processes the grapes into wine and sells the wine to unrelated customers. A is engaged in a qualified business activity, and A's sales of grapes are considered to be gross business receipts from a qualified business activity because its sales are made to an entity outside of the combined apportioning trade or business of A. Sales by A and B are not intercompany sales because B is not part of A's combined report group. (See Regulation section 25128-2 for determining whether an activity is a qualified agricultural business activity.)

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

Reference: Section 25128, Revenue and Taxation Code.