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7700 SPECIAL FORMULAS AND INDUSTRIES WITH UNIQUE APPORTIONMENT PROBLEMS

In cases where the standard apportionment provisions will not fairly represent the extent of the taxpayer's business activities within the state, R&TC § 25137 permits a departure from the standard formula. Such a departure may be,

- Separate accounting,
- The exclusion of one or more of the factors,
- The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state, or
- The employment of any other method which will result in fair apportionment and allocation of the taxpayer's income to this state.

Special procedures have been established in the regulations for certain industries and types of transactions where the FTB has determined that the standard apportionment formula will not produce apportionment that fairly represents the extent of the taxpayer's California business activities. The special formulas are contained in CCR § 25137-2 through CCR § 25137-15 and CCR § 25101. If the facts dictate that a special formula be applied to a taxpayer that is considered to be standard apportionment for that taxpayer.

There are additional industries and types of transactions that present unique apportionment problems, but for which specific solutions are not set forth in the special formulas at CCR § 25137-2 through CCR § 25137-15. In those situations, the party seeking to deviate from standard apportionment (either FTB or the taxpayer) must submit a R&TC § 25137 petition and follow guidance at CCR § 25137.

7701 APPLICATION OF CCR SECTION 25137 IN GENERAL

R&TC § 25137 permits a departure from the standard allocation and apportionment provisions only in cases where the standard formula gives rise to apportionment that does not fairly represent the extent of the taxpayer's activities in California. CCR § 25137 recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, and provide special apportionment procedures for those situations. In the *Appeal of Fluor Corporation*, 95-SBE-009., August 31, 1995, the SBE clarified the role of the special formulas provided by the regulations:

| General Rules | Unless... | In Which Case.. | | | |
|---|---|---|---|---|---|
| Both the taxpayer and FTB are required to use the standard apportionment and allocation rules under UDITP A | The party seeking to deviate from the standard formula establishes by clear and convincing evidence that the standard formula does not fairly represent the extent of the taxpayer's activities in the state. | The formula may be modified to reflect a method that is reasonable. | | | |
| <i>or</i> | | | Unless... | In Which Case... | |
| The taxpayer's situation satisfies the conditions and circumstances provided for in Regulations §25137 – 25137-11 and §25101. | | | Both the taxpayer and FTB are required to use the method prescribed by the regulations. | The party seeking to deviate from the regulations establishes by clear and convincing evidence that the method in the regulations does not fairly represent the extent of the taxpayer's activities in the state. | The formula may be modified to reflect a method (including the standard UDITP A formula) which is reasonable. |

The significance of the SBE's holding in *Fluor* was that as long as the taxpayer's circumstances satisfied the terms and conditions provided in CCR § 25137, neither the taxpayer nor the FTB had to prove distortion in order to apply the special formula prescribed by the regulations. Prior to the *Fluor* decision, the SBE's decision in *Appeal of Triangle Publications, Inc.* 84-SBE-096, June 27, 1984, had stated that the FTB could not apply the apportionment procedures specified in CCR § 25137(c)(1)(A) without first establishing that the standard formula would not result in fair apportionment because of the taxpayer's exceptional circumstances. To the extent that the opinion in *Triangle Publications* conflicts with the decision expressed in *Fluor*, the *Triangle Publications* decision was overruled.

The *Fluor* decision also recognized that even if a taxpayer meets the terms and conditions for applying a special formula prescribed by CCR § 25137, situations may arise where application of the special formula will not fairly represent the taxpayer's activities within the state. Therefore, either the taxpayer or the FTB may deviate from the method prescribed by the regulations if it can establish distortion.

CCR § 25137(b) and CCR § 25137(c) provide special apportionment rules to correct specific property and sales factor problems CCR § 25137-3 through CCR § 25137-15 provide apportionment rules for certain industries and types of transactions. In addition, CCR § 25101 provides apportionment rules for the sea transportation business. The partnership guidance is discussed at MATM 7705 and long-term contracts at MATM 7710. After that, special formulas are discussed at MATM 7715 through MATM 7760. The department has identified several other industries that present unique apportionment problems, and has developed apportionment procedures to deal with those situations.

R&TC § 25137 provides that a taxpayer may petition for the Franchise Tax Board to allow a departure from the standard formula. To grant relief under R&TC § 25137, the problem identified by the taxpayer must be a result of the apportionment and allocation provisions set forth in R&TC § 25120 - R&TC § 25139. R&TC § 25137 does not operate as a cure for other alleged inequities created by other provisions of the Revenue and Taxation Code. (*Appeal of CTI Holdings*, 96-SBE-003. Feb. 22, 1996.) See Legal Ruling 2019-XX for recent guidance on proper subject matter for a R&TC § 25137 petition.

Each taxpayer and each year will be evaluated on its own unique set of facts and circumstances to determine if a R&TC § 25137 issue exists. Any time a taxpayer, or you, seek to deviate from the standard allocation and apportionment rules established by R&TC § 25120 through R&TC § 25137, and the regulations adopted pursuant thereto, a potential R&TC § 25137 issue exists.

To ensure consistent treatment of similarly situated taxpayers, all audit staff recommendations regarding the use of R&TC § 25137 are to be forwarded to the Multistate Audit Specialist. The Multistate Audit Specialist will review the file to ensure

that the issue is factually developed. The Multistate Audit Specialist will route the file with his/her recommendation to the Multistate Tax Bureau of the Legal Division.

The Multistate Tax Bureau of the Legal Division will be responsible for reviewing the petition, coordinating staff's recommendation, and coordinating the petition meeting which taxpayer's now may attend to present their position. The taxpayer has the right to request the three member FTB review the petition if the petition is denied at the staff level. The Multistate Tax Bureau is responsible for submitting the appropriate information to the three member FTB if a taxpayer has requested review of a denial of a petition. .

Distortion

The apportionment formula is a method for approximating a taxpayer's California source income. Because methods of apportioning income are just an approximation, such methods will not be considered to be distortive just because another method may produce a slightly better result. In order for the standard apportionment formula, or a modified formula described in CCR § 25137, to be set aside, it must be shown to produce an unreasonable result. There are no bright-line tests for determining whether distortion is present, so determinations of distortion must be based on the unique facts and circumstances of each case. You should consider whether changes in the apportionment factors are significant in relation to the overall factor. It is also helpful to look beyond the numbers and consider whether the purpose for the individual apportionment factors is being met. Look to the following cases for guidance.

In *The Appeal of Pacific Telephone and Telegraph Company*, 78-SBE-028, May 4, 1978, several of the companies in the unitary group maintained pools of working capital which were invested in short-term securities. The largest of these pools was located in New York. Because of the turnover of the securities, *gross receipts* from the investments averaged 36 percent of the total gross receipts from all unitary activities, but the *income* generated by the investments was less than 2 percent of total unitary business income. Arguing that the standard formula resulted in unreasonable apportionment of income from the taxpayer's communications business, FTB sought to deviate from the standard formula by including the net income (rather than the gross receipts) from the investment activities in the sales factor.

The SBE allowed FTB's modification to the formula. It concluded that the standard UDITPA provisions did not fairly represent the extent of the taxpayer's business activities within the state as evidenced by the fact that an incidental part of the business caused 11 percent of The Bell System's entire unitary business activities to be attributed to New York.

In *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989, the taxpayer conducted a securities trading business. Its California activities consisted primarily of brokerage sales in which the taxpayer earned commission income from the buying and selling of securities for customers. The taxpayer also traded in securities as

a principal or underwriter, purchasing securities for its own account and remarketing them. Unlike the commission income, the gross receipts from the principal and underwriting transactions included the underlying cost of the security. Most of these transactions were conducted in New York, so were reflected only in the denominator of the sales factor.

The FTB's position was that the principal and underwriting transactions were virtually identical to the brokerage transactions, and that applying the standard formula to those transactions would have the effect of overweighting the sales in the denominator and underweighting sales in the numerator. Reasoning that both types of transactions should reflect similar weight in the formula, FTB adjusted the sales factor to use gross profits (rather than gross receipts) to reflect the principal and underwriting transactions. The SBE did not agree that the two types of transactions were identical, and held that FTB had not met the burden of proving that the statutory apportionment provisions did not fairly reflect the business activity in this state.

Of importance in this case is the SBE's finding that distortion in one factor does not necessarily result in unfair reflection of the business activity within the state; the other two factors may mitigate the distortive effect of the third. Whether the apportionment formula produces an unreasonable result will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination. However, per the 2006 *Microsoft Corporation v. Franchise Tax Board* case (see below), it is not up to the petitioner to prove there are no offsetting distortions in the other factors. Rather, the non-petitioning party must prove offsetting distortions in other factors. (*Microsoft, supra*, footnote 22.) In the *Merrill Lynch* case, the deviations from the standard formula proposed by the FTB revised the overall apportionment percentage from 3.4323 to 5.8637 in the year of the largest difference. The percentage difference for the appeal years was a 23% to 36% average increase in the apportionment formula. The SBE held that this difference was much too slight to justify application of R&TC § 25137.

The differences in fact patterns may have led to the contrasting results in the *Pacific Telephone* and *Merrill Lynch* decisions. In *Pacific Telephone*, the treasury activities were only an incidental part of the business, yet if the standard formula were applied, the receipts from those activities would have significantly affected the apportionment of income from the primary business activity. In *Merrill Lynch*, the underwriting transactions constituted one of the taxpayer's two primary activities, and could therefore be expected to significantly affect the overall apportionment. FTB was not able to demonstrate why the apportionment results in *Merrill Lynch* were not reasonable. However, after the *General Mills v. Franchise Tax Board* cases (*General Mills v. Franchise Tax Board* (2009) 172 Cal.App.4th 1535, *General Mills I* and *General Mills v. Franchise Tax Board* (2012) 208 Cal.App.4th 1290, *General Mills II*), it is no longer dispositive whether an activity is integral/primary or ancillary to the main line business as in *General Mills*, while the hedging was found to be integral, including the receipts from hedging was also found to be distortive. As a result, both integral and ancillary activities can give rise to distortion when the receipts are included in the sales factor.

In *Microsoft Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 750, the Court held that the inclusion of Microsoft's treasury function receipts in the sales factor denominator was distortive and upheld the Franchise Tax Board's use of an alternative formula which removed the receipts and included only net income from the treasury function in the sales factor denominator. In its opinion, the Court noted the Court of Appeal's policy argument that a systematic exclusion of these receipts may be preferable. The Court also cited numerous examples where states have amended UDITPA to achieve this result.

In *General Motors Corporation v. Franchise Tax Board* (2006) 39 Cal 4th 773, the California Supreme Court considered the nature of the particular investments, in that case repurchase agreements, and held that the proceeds from loans would be subject to different treatment for sales factor purposes.

January 1, 2007

For taxable years beginning on or after January 1, 2007, interest and dividends from intangible assets held in connection with the treasury function, along with gross receipts and overall net gains from the maturity, redemption, sale, and exchange or other disposition of such intangible assets, will be excluded from the numerator and denominator of the sales factor. (CCR § 25137(c).) So this will no longer be an issue.

January 1, 2011

For taxable years beginning on or after January 1, 2011, there is a definition of gross receipts that excludes revenue from many categories of activities including treasury, hedging, inventory exchanges, etc. at R&TC section 25120(f)(2). Also, generally the definition of gross receipts is tied to the federal definition of gross income as of January 1, 2011 so that if a transaction would give rise to income for federal purposes, the full amount received would be gross receipts for California purposes.

7705 PARTNERSHIP INCOME

The rules for apportionment and allocation of partnership income are found in CCR § 25137-1. (See MATM 3086.) In general, if a member of a combined reporting group is a partner in a partnership, and the partnership's activities are unitary with the activities of the combined reporting group under established standards (disregarding the ownership requirement), then the taxpayer's distributive share of the partnership's trade or business income and factors are combined with the taxpayer's trade or business income and factors, constituting a single trade or business. (CCR § 25137-1(a).)

Example

Corporation A's distributive share of income and factors in partnership P is 20%. Corporation A manufactures toys which are sold in the seven western states by partnership P. Corporation A's business income for the year was \$1,000,000 and partnership P's business income for the same year was \$800,000. The business income of Corporation A is \$1,160,000 (\$1,000,000 plus 20% of \$800,000 (\$160,000)) to be apportioned using combined factors.

When the activities of the partnership and the taxpayer do not constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's trade or business is treated as a separate trade or business of the taxpayer. In such a case the taxpayer is engaged in two trades or businesses. (CCR § 25137-1(a).)

Example

Corporation A's distributive share of income in partnership P is 20%. Corporation A manufactures and sells toys in the seven western states. Partnership P operates farms within and without this state. Corporation A's income for the year is \$1,000,000 and partnership P's income is \$800,000 for the same year. Corporation A is engaged in two trades or businesses, and is required to apportion its income of \$1,000,000 from its own operations to this state on the basis of a three factor apportionment formula. Partnership P would attribute part of its business income or \$800,000 to this state on the basis of its own three factor apportionment formula. Accordingly, Corporation A would report 20% of the partnership income apportioned to this state plus a portion of its income from its toy manufacturing business.

Distributive items of nonbusiness income are reported in the same manner as other nonbusiness income derived from other activities of the taxpayer. R&TC sections 25123-25127

7710 LONG-TERM CONTRACTS

CCR § 25137-2 sets forth the rules for apportioning income from long-term contracts. Rules for partnerships engaged in long-term contracts are found in CCR § 25137-1(h). At the time the regulation was written, taxpayers were allowed to elect either the percentage of completion method or the completed contract method for reporting the income from the contract. Since that time, the rules for long-term contracts have been substantially revised, and the completed contract method has been substantially phased out. Although the regulation will still apply with respect to contracts using the percentage of completion method, the application of the regulation provisions concerning the completed contract method will become much more limited.

The first step in dealing with the issue of long-term contracts is to determine which set of rules applies to the contracts. For contracts entered into on or before February 28, 1986, taxpayers were allowed to elect either the percentage of completion method or the completed contract method. Under the percentage of completion method, gross income from a long-term contract was reported annually according to the percentage of the contract that was completed during that year. The taxpayer was allowed to compute the appropriate percentage based upon either the percentage of total estimated contract costs incurred, or the percentage of total estimated work performed. If the completed contract method were used, the net profit from the entire job would be reported in the year in which the contract was completed and accepted.

For contracts entered into after February 28, 1986, IRC § 460 was amended to provide that (1) under the percentage of completion method, the appropriate percentage must be computed by comparing the construction costs incurred over the total estimated construction costs (the computation based upon percentage of work performed was no longer allowed); and (2) any contracts not accounted for under the percentage of completion method must use the "percentage-of-completion-capitalized-cost method." Percentage-of-completion-capitalized-cost was a hybrid method, which allowed the taxpayer to account for 60 percent of the net income from a contract under their normal method (such as the completed contract method) and the remaining 40 percent of the contract under the percentage of completion method.

In addition, any portion of a contract that was accounted for using the percentage of completion method would be subject to a "lookback" rule. The lookback provision under IRC § 460 is applied at the completion of the contract, and requires the taxpayer to compute the amount of tax that should have been reported in each year on the percentage-of-completion portion of the contract based upon the actual costs incurred each year in relation to the total actual contract costs. To the extent the recomputed income differs from the income that was reported based upon estimated construction costs, interest adjustments must be made. The taxpayer will be subject to interest on underreported amounts and will receive interest on overreported amounts.

California conformed to these federal changes for taxable years beginning on or after January 1, 1987 (R&TC § 24673.2).

Subsequent revisions to federal law were made to adjust the percentage of the contract required to be reported using the percentage of completion method from 40 percent to 70 percent for contracts entered into after October 13, 1987; to 90 percent for contracts entered into after June 20, 1988. Most long-term contracts executed after July 10, 1989 must be fully accounted for under the percentage of completion method, although certain exceptions are made for small construction contracts and residential construction contracts. California incorporated these changes for taxable years beginning on or after January 1, 1990. For California purposes, contracts outstanding on January 1, 1990 would become subject to the federal rules in effect as of the date that the contract was entered into. The conformity provisions provide that adjustments to correct any overreporting or underreporting of income resulting from the change in

the method of reporting the contracts must be made in the year that the contract is completed.

The regulation does not reflect the federal changes, which California conformed to for taxable years beginning on or after January 1, 1987 nor does the regulation reflect subsequent revisions to federal law, which California conformed to for taxable years beginning on or after January 1, 1990.

The percentage of completion method is generally required for book purposes. Therefore, adjustments on Schedule M-1 will be present if the taxpayer is using any other method for federal purposes. If the federal method has not been followed for California purposes, state adjustments will be present. Since more than one method may have been used during the transitional period, it may be necessary to analyze the taxpayer's workpapers to determine whether the appropriate method has been used based upon the date of each contract. Once you are satisfied that the income has been correctly reported, the apportionment factors may be reviewed.

Property Factor

Costs in Excess of Progress Billings: Capitalized costs of construction are only included in the property factor to the extent that they exceed progress billings accrued (or received for cash basis taxpayers) under the contract. The excess of construction costs over the progress billings reflects the taxpayer's net investment or equity interest in the contract. If progress billings exceed construction costs, they will not be reflected in the factor because they will reflect a liability rather than an investment. Each contract must be treated separately; excess costs on one contract may not be offset against excess billings on another contract.

Example: The taxpayer's costs attributable to the contract are \$1,000,000 at the end of the first year. The client has been billed for \$600,000. The net difference of \$400,000 should be included in the property factor. The excess costs may not be netted against other contracts with billings in excess of costs. A continuation of this example illustrating the treatment of excess costs in the second year of this contract may be found in CCR § 25137-2(d)(4)(A).

Some contracts, such as cost-plus-fixed-fee government contracts, provide that title to property on hand and future purchases passes to the government when the first progress payment is made. Despite the legal title being vested in the government, the taxpayer has an equitable interest in the property to the extent of its net investment. The excess costs will therefore still be included in the property factor.

Costs in excess of progress billings will generally be disclosed in the financial statements either in footnote form or as a separate line item on the balance sheet.

Rents: CCR § 25137-2(d)(4)(B) provides that 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 the rent expense may be included in the construction costs.

Payroll Factor

Compensation paid to employees is includable in the payroll factor even though such compensation may be included in costs of construction that are otherwise not reflected in the factor. Compensation paid to employees engaged in performing services at a construction site is attributed to the state in which the services are performed. This is the case even though the taxpayer will report such compensation to the state where the employees' base of operations is located for unemployment tax purposes (CCR § 25137-2(d)(5).)

Sales Factor

Under the percentage of completion method, the sales factor for each year will include the portion of the gross contract price that corresponds to the percentage of the entire contract that was completed during that year. For example, if the taxpayer completes 30 percent of a project during the year, and the project had a bid price of \$9,000,000, then the gross receipts includable in the sales factor will be \$2,700,000. Progress billings are not considered under this method. (CCR § 25137-2(d)(6)(B).)

If the completed contract method is used, the sales factor will include the portion of the progress billings that were accrued or received during the taxable year. (CCR § 25137-2(d)(6)(C).) The sales factor will therefore reflect the revenue from the contract during the years in which the contract is being performed. This is in contrast to the income from the contract, which will not be recognized until the contract is completed.

Gross receipts derived from the performance of a contract will be attributed to this state if the construction project is located in this state. If the project is located partly within and partly outside the state, the gross receipts will be allocated to this state based on the ratio of construction costs incurred within the state during the taxable year over the total costs for the project. (CCR § 25137-2(d)(6)(A).)

Application of Apportionment Formula

Except as indicated above with respect to the composition of the apportionment factors, no special apportionment computations are necessary for the percentage of completion method. To the extent that the completed contract method is used however, a special formula is described in CCR § 25137-2(e).

Under the completed contract method, recognition of income from the contract is deferred until the year in which the contract is completed. On the other hand, the factors representing the business activities that generated that income will have been reflected in earlier years. In order to achieve proper matching between the income and the factors, the formula operates as follows:

Business income from sources other than completed contracts is apportioned in accordance with the apportionment percentage for the taxable year. For each contract completed during the year, the portion of the gross receipts attributable to each year of the contract, based on the percentage of costs incurred in each year, will be determined. The gross receipts for each year will then be netted with the costs incurred during that same year to derive the contract income or loss attributable to each year of the contract. The contract income or loss for each year will be multiplied by the apportionment percentage for that year. The products are totaled, and the resulting income or loss will be the amount of business income from the contract derived from sources within the state.

The Regulation contains several examples of these computations and audit schedules for these calculations are available on PASS.

The use of the completed contract formula was approved by the SBE in the *Appeal of Donald M. Drake Company*, 77-SBE-012, February 3, 1977. Subsequently, in the *Appeal of J.F. Shea*, 90-SBE-009, September 12, 1990, the SBE refused to allow application of the formula in a situation where the early years of a contract pre-dated the acquisition of two subsidiaries, resulting in no completed contract income attributable to those years being apportioned to the subsidiaries. The precedential value of the *J.F. Shea* decision is limited to the specific facts present in that case.

The calculations for apportioning income from contracts using the completed contract method can be very time-consuming if multiple contracts are involved. Before adjustments are pursued in this area, you should carefully consider the tax implications. Any approximation of tax potential needs to take into account the fact that the completed contract method may only be allowable for a portion of the contract under the percentage-of-completion-capitalized-cost rules. In general, if all contracts are completed within the same time frame (i.e., two years), additional tax will most likely result from application of the special formula if:

- The aggregate of completed contracts is a loss and the apportionment factor is larger in the year being tested than in earlier years;

or

- The aggregate of completed contracts is a gain and the apportionment factor is smaller in the year being tested than in earlier years.

If the taxpayer has a few significant contracts, which run much longer than the other contracts, a quick look at the apportionment factors from the earlier years of those contracts will help place the overall tax impact in better perspective.

If the test check reveals that the tax potential of placing a taxpayer on this formula does not warrant the audit time, the decision to forego this issue should be explained in the

audit narrative. If application of the formula will result in a refund, and a substantial amount of work would be required to apply the special formula, the taxpayer should be notified in writing and given the opportunity to complete the work. If the taxpayer does not wish to do the work, the audit should be closed and the returns accepted as filed.

If the test shows a material amount of additional tax, the special formula will need to be applied. The information that will be needed to make the adjustments is:

- The contracts completed in each year under audit.
- The profit or loss on each contract.
- The total direct costs of each contract and the year(s) in which they were incurred.
- The apportionment factor for each year involved.

Use of the Schedule M-1 or M-3, if applicable, as a starting point is generally useful in obtaining supporting data for the above items. Commonly, the taxpayer will have a schedule showing work-in-progress at the end of the year, which will tie to the Schedule M-1 or M-3. This schedule can be compared to the end of the year for the prior period and any missing contract numbers will be contracts that have been completed in the current year. After identifying the contract numbers, the profit or loss can be determined and a supplemental schedule showing the direct costs by year should be easily obtained. In many cases, the work-in-progress schedule will show all the data that is needed.

The apportionment factors used for each year should reflect the proper method of reporting. For example, if the taxpayer used separate reporting in earlier years and a combined report was proper, the earlier years' apportionment factor will need to be recomputed on a combined basis even if the statute is closed. No income adjustment, of course, would be made on closed years. FTB's basis for recomputing income and factors from closed years in the context of NOL carryovers is discussed in MATM 8000.

7715 FRANCHISORS

The term "business of franchising" means a trade or business which includes the granting of a license by the taxpayer (franchisor) or a trademark, trade name or service mark, to market or use a product or service under such trademark, trade name or service mark in accordance with methods and procedures prescribed by the taxpayer.

CCR § 25137-3 provides the following special rules for the allocation and apportionment of income of franchisors. However, this special apportionment method applies only in narrow circumstances. The default rule for franchisors is application of general apportionment rules at R&TC §§ 25128 through 25127 as set forth at CCR § 25137-3(b). Only in certain narrow circumstances is the special formula applied.

Payroll Factor

Franchisors will typically employ personnel whose duties include regularly traveling to the franchisees' locations to provide administrative or advisory services. Under the normal payroll factor rules, the compensation paid to employees would be assigned to the one state in which their base of operations was located (MATM 7370). In accordance with CCR § 25137-3(b)(1), compensation paid to these specific employees who travel to franchisee locations for administrative or advisory services will be assigned to the numerator of the payroll factor on the basis of the following ratio:

Time spent performing administrative and
advisory services at franchisee locations in
California
Over
Time spent performing such services
everywhere

Sales Factor

Even after market-based sourcing rules come into effect, the sourcing rules for franchisors still use this special regulation at CCR § 25137-3 for sales factor assignment of receipts (CCR § 25136-2(g)(3)). Generally, franchisees pay fees to franchisors for providing various services. The regulation provides that fees received for (1) national and regional advertising placed by the franchisor; (2) administrative or advisory services; or (3) site investigation, selection and acquisition of a place of business for a franchisee must be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in the state of the franchisee, the receipts are attributed to the state in which the principal office of the employee performing the services is located. If the services are performed by an independent contractor rather than by an employee of the taxpayer, the receipts must be attributed to the state of the taxpayer's commercial domicile.

Fees or royalties received for the use of the franchisor's trademark, trade name, or the right to market a product or service must be attributed to the state in which the franchisee's place of business is located. If the taxpayer is not taxable in such state, the receipts must be attributed to the state of the taxpayer's commercial domicile.

7720 BANKS AND FINANCIAL CORPORATIONS

The unique rules developed to deal with the allocation and apportionment of income from banks and financial corporations are covered in detail in the Bank and Financial

Handbook. You should refer to that manual if you are auditing taxpayers in this industry. Further, refer to CCR sections 25137-4.1, 25137-4.2, and 25137-10.

7725 COMMERCIAL FISHING

"Business of commercial fishing" means a trade or business which uses a ship or ships in the taking of fish or the bringing of fish ashore for financial or pecuniary gain or profit. (CCR § 25137-5(a).)

CCR § 25137-5 prescribes the formula for apportioning the business income for commercial fishing boats operating within and outside California waters. The property, payroll, and sales factors attributable to boat fishing activity in California are determined by a "port day ratio." A ratio of California port days to total port days is applied to the total ship property, payroll and revenue for each fishing boat to determine the California portion. This formula only applies to boat activity. Land-based activities such as dockside facilities and equipment, and dockside payroll are assigned to the numerators of the factors under the normal apportionment rules.

Definitions

When auditing a commercial fishing corporation, you need to have a working knowledge of the terms pertaining to this industry. CCR § 25137-5(a) provides the definitions of the terms used in the formula for apportioning the business income for commercial fishing boats.

A port day is defined as a day or part of a day spent in port or on the seas while the vessel is in operation. A port day begins when a ship enters an area within which a state has jurisdiction to tax or asserts jurisdiction over fishing, which is within three miles. Likewise, a port day will end when the boat leaves that jurisdiction or goes out of operation.

The definition of a state includes a foreign country. (R&TC § 25120(f).) Thus, when a boat is on the high seas and not in the territorial waters of any state or foreign country, that time is not counted in the computation of port days. Jurisdictional limits vary by state and country. Countries like Mexico and some Central and South American countries assert a 200-mile limit and claim fishing jurisdiction in that area. Thus, tuna boats which begin and end their voyages in California, but which fish off the coast of Mexico will include time spent in both California and Mexico jurisdictions for the port days computation. Some larger tuna boats that fish in the Eastern Pacific may be subject to California jurisdiction at the beginning and end of their voyages. Port days would be counted while in California waters and while fishing within possession island jurisdiction, but not while en-route.

A boat is considered to be in operation when engaged in pre-voyage and post-voyage activities as well as when it is searching for fish, fishing, or transporting fish. Pre-voyage and post voyage activities include activities such as loading, unloading, refueling, provisioning the ship, and minor ship repairs. A boat that has been out of operation will begin being in operation for a voyage when it is manned with a full crew and the vessel is ready for a fishing voyage. It ends being in operation after a voyage when the vessel is unloaded and cleaned, including the preparation of the fish wells to a fish-carrying condition.

A boat is not in operation when it is out of service. Out-of-service time includes, but is not limited to, time while a ship is idle between voyages, time for repairs in shipyards (including dry docking), and time during which a boat is seized by a foreign government and held under restraint pending disposition of charges alleging violation of such government's law. A boat is also out of service when it is involuntarily waiting to unload. Out-of-service time is not included in the port days.

The denominators of the apportionment factors are computed under the normal apportionment rules. The numerators are computed as follows:

Property Factor

The port day ratio for each boat is applied to the cost of the boat and its equipment to derive the portion attributable to the California numerator. Land-based property, such as dockside buildings and equipment, is assigned to California under normal property factor rules.

Payroll Factor

The port day ratio for each boat is applied to compensation paid to the boat's personnel and fishermen to determine the amount attributable to the California numerator. The payroll of land-based employees is assigned under the normal rules.

Sales Factor

The port day ratio for each boat is applied to receipts from the sale of fish to determine the amount includable in the California numerator. Other gross receipts are assigned to California using the normal rules.

Local fishing boats generally do not have significant issues in this area because their operations generally will be contained within California's three-mile limit or in waters not subject to a jurisdiction. Such boats would have a port day ratio of 100 percent to California.

The main audit problems identified in this area deal with long-range tuna clippers that sail from San Diego and San Pedro to fish off Mexico and Central America for yellow fin tuna. San Diego boats may also travel to the Eastern Pacific Ocean area to fish.

Typical tuna voyages involve preparing the boat for sailing, traveling to the fishing areas, searching for fish, catching fish, storing the fish in refrigerated holds, and returning to port. The fish is sold to canneries in San Diego, San Pedro, Samoa and other locations. Refueling of the boat sometimes takes place at foreign ports. As long as adequate catches are being made, a voyage will usually last as long as it takes to fill the holds (anywhere from a week to two or three months). If fishing is good, a boat may return to port, sell its fish, and immediately depart on another voyage. When fishing is not good or when it is off-season for tuna, the boat lies at dock idle, and is out of operation.

To develop port day information, examine the ship's logs and other ship records to know when, where, and for how long a boat is in a jurisdiction area. These records will also show the time spent out of service and the time spent in areas of the ocean not under any fishing jurisdiction. Total port days will only include time that the boat is in operation and under a jurisdiction. Dry dock, idle time, and extended repair time are not counted in port days. Once the port day ratio has been developed for each boat, you need only examine the taxpayer's general ledger summaries or other records to determine each boat's revenue, property, and payroll factor amounts. These amounts are usually segregated by each boat. If not, ask the taxpayer to provide such segregation.

7730 FOREIGN COUNTRY OPERATIONS

The rules for determining income and factors from foreign country operations are set forth in CCR § 25106.5-10. For discussion of how particular items of income or factors should be treated by foreign corporations, refer to the sections of this manual, which cover those income or factor issues. (MATM 7155 and MATM 7355)

7735 AIR TRANSPORTATION COMPANIES

Due to the mobile nature of the air transportation industry, it is generally difficult to isolate and properly measure the level of California activity in comparison to the level of activity everywhere. The department looks to R&TC § 25101.3 to calculate the property factor and to CCR § 25137-7, to calculate payroll and sales factors. Each section provides its own formula for each factor. The rules for determining the apportionment factors for the air transport industry have generally been derived from, and are parallel to the State Board of Equalization's property tax allocation laws and guidelines.

The formula found in R&TC § 25101.3 compares business activity for certificated aircraft in California to the business activity of certificated aircraft everywhere. The

Payroll Factor

In determining the numerator of the payroll factor, compensation paid to flight personnel must be attributed to this state based upon the ratio that air and ground time spent in performing services in this state bears to the total air and ground time spent in performing services everywhere by model of aircraft. Air time (block to block) by model of aircraft determined for the income years must be used in computing flight personnel compensation attributable to this state. Ground time of flight personnel must include the time required by such personnel to perform preflight and post-flight activities pursuant to current employer-employee union contracts and includes time on the ground at intermediate stops on scheduled and nonscheduled flights for loading or unloading of passengers, freight, mail or other nonemergency purposes. Air and ground time of flight personnel utilized for training purposes to maintain proficiency must also be included for purposes of the payroll factor. (CCR § 25137-7(b)(2).)

Sales Factor

In determining the numerator of the sales factor, revenue from hauling passengers, freight, mail and excess baggage is attributed to this state based upon:

- The ratio which the air time of the taxpayer's aircraft spent in this state bears to the total air time (block to block) of such aircraft everywhere, by model of aircraft as defined in subsection (e), weighted at 80 percent; and
- The ratio of arrivals and departures in this state to total arrivals and departures everywhere by model of aircraft weighted at 20 percent. Air time and arrivals and departures (excluding time and arrivals and departures for flight training purposes) by model of aircraft, as defined in CCR § 25137-7(e), are used in computing revenue attributable to this state derived from hauling passengers, freight, mail, and excess baggage.

If records of actual revenue by model of aircraft are not maintained, the total revenue must be divided into passenger and freight (which must include express, excess baggage and mail) revenue and allocated to aircraft model on the ratio of the revenue passenger ton-miles and revenue freight (which includes express, excess baggage and mail) ton-miles of such model, respectively. Refer to CCR § 25137-7(b)(3)(B) for the above expressed as a formula.

Computation of Time Factor and Arrivals and Departures Factor

- The property and sales of the apportionment formula are based upon a time factor and an arrivals and departures factor. The payroll factor for flight personnel is based solely upon time. The statistics to be used in computing the time and arrivals and departures factors must be the annual statistics of the taxpayer or statistics for representative periods.

- Annual statistics for the taxpayer's income year, if available, should be used in determining the property, payroll and revenue factors of the apportionment formula. All other rules prescribed for property tax purposes for determining air and ground time and arrivals and departures will be applicable except as otherwise provided.
- If annual statistics are not available, statistics for representative periods can be used provided that permission to do so has been granted to the taxpayer by the Franchise Tax Board. In the event annual statistics are subsequently maintained on a regular basis, the taxpayer can use annual statistics in lieu of statistics from representative periods.

The representative periods to be used in computing the property, payroll and sales factors must consist of the representative periods designated by the State Board of Equalization for the current property tax assessment year and the immediately preceding or succeeding property tax assessment year, as provided for, unless the Franchise Tax Board determines that alternative periods should be designated as representative periods in order to fairly reflect the taxpayer's activities within California.

The statistical data developed for representative periods designated by the State Board of Equalization for property tax purposes can be used in computing the percentage of the time factor and the arrivals and departures factor. The time factor and arrivals and departures factor must be computed separately for each model of aircraft enumerated in subsection (b).

The term "current property tax assessment year" is the property tax assessment year for which the State Board of Equalization designates the representative period which falls within the taxpayer's current income year for California franchise tax purposes. In the case of a taxable year ending on February 28, it must be the property tax assessment year for which the State Board of Equalization designates the representative period, the major part of which falls within the taxpayer's current income year for California franchise tax purposes.

For example, if the State Board of Equalization designates February 23 through March 1 of the current calendar year as the representative period for the next property tax assessment year (beginning July 1, next), the "current property tax assessment year" is the property tax assessment year beginning July 1, next with respect to the income year ended February 28 of the current calendar year.

(2) Time Factor.

(A) Scheduled Carriers, Scheduled and Nonscheduled Air Taxis.

(i) Scheduled Operations, Scheduled Carriers, Scheduled and Nonscheduled Air Taxis.

(I) The representative period must consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the succeeding property tax assessment year unless the taxpayer's income year for California franchise tax purposes ends on or after February 28.

(II) If the taxpayer's fiscal year for California franchise tax purposes ends on or after February 28, the representative period must consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the preceding property tax assessment year.

(ii) Nonscheduled Operations, Scheduled Carriers and Scheduled Air Taxis.

(I) The representative period must consist of the representative periods designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the preceding property tax assessment year unless the taxpayer's income year for California franchise tax purposes ends on or after July 31.

(II) Taxpayers whose taxable year ends on or after July 31 should contact the Franchise Tax Board for instructions as to the representative period to be used.

(B) Supplemental Carriers. The representative period must be the same as stated in subsection (d)(2)(A)(ii).

(3) Arrivals and Departures Factor.

(A) Scheduled Carriers, Scheduled and Nonscheduled Air Taxis.

(i) Carriers Reporting Departures to Civil Aeronautics Board or Department of Transportation.

(I) The representative period must consist of the representative period designated by the State Board of Equalization for (1) the current property tax assessment year and (2) the succeeding property tax assessment year unless the taxpayer's current income year ends on or after February 28.

(II) In the case of taxpayers whose income year ends on or after February 28, the representative period must consist of the representative period designated by the State Board of Equalization for (1) the current property tax assessment year, and (2) the preceding property tax assessment year.

(ii) Air Taxis Not Reporting Departures to Civil Aeronautics Board or Department of Transportation.

(I) The representative period for scheduled operations of air taxis and operations of nonscheduled air taxis is the same as stated in subsection (d)(2)(A)(i).

(II) The representative period for nonscheduled operations of scheduled air taxis is the same as stated in subsection (d)(2)(A)(ii).

(B) Supplemental Carriers.

(i) Carriers Reporting Departures to Civil Aeronautics Board or Department of Transportation. The representative period must be the same as stated in subsection (d)(3)(A)(i).

(ii) Carriers Not Reporting Departures to Civil Aeronautics Board or Department of Transportation. The representative period must be the same as stated in subsection (d)(2)(A)(ii).

(e) A "model" of aircraft is defined as all aircraft that can be assigned to a group utilizing the following rules:

(1) All aircraft are grouped with other aircraft of the same manufacturer model, as determined by the manufacturer's designation system.

(2) If a taxpayer operates more than one series of an aircraft model, all series of that aircraft model are assigned to a single model group based on the aircraft manufacturer's designation system.

(3) If a taxpayer operates an aircraft that is part of an aircraft model series or version that is designated by the aircraft manufacturer for freight transportation, this aircraft is assigned to a model group separate from the group of aircraft of the same model that the aircraft manufacturer designates for passenger transportation.

(4) If a taxpayer operates an aircraft that can be configured either for freight transportation or passenger transportation, the aircraft is assigned to a group based on the aircraft model and the aircraft configuration.

Examples of Aircraft Model Groupings for Illustrative Purposes:

1. Boeing 737 model grouping includes series 737-300, 737-500 and 737-700.
2. Boeing 767 model grouping includes series 767-300 and 767-300ER.
3. Cessna 208 model grouping includes series Cessna 208A and Cessna 208B.
4. The Airbus S.A.S. aircraft designation system assigns aircraft models by families. The A310 family includes models A300 and A310. The A320 family includes models A318, A319, A320 and A321.
5. Airbus A300F4-600R, a freight aircraft, is assigned to a separate group from Airbus A300-600, a passenger aircraft.

6. Boeing MD-11F, a freight aircraft, is assigned to a separate group from Boeing MD-11, a passenger or freight aircraft, if the Boeing MD-11 is configured as a passenger aircraft. The Boeing MD-11F and Boeing MD-11 are assigned to the same model group if the Boeing MD-11 is configured for freight transportation.

Airlines file numerous reports with the Civil Aeronautics Board (CAB) or Department of Transportation that should contain the necessary data to compute the elements of the special formula. You should ask the taxpayer to identify the reports that it is required to file, and request copies of relevant reports to verify the apportionment factor. If the annual statistics necessary for computing the formula are not available, the Regulation contains procedures for using statistics from a "representative period."

Exempt Income

When dealing with corporations involved in air transportation, you need to be aware of R&TC § 24320 that exempts income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States. Also, Legal Ruling 2006-01 provides guidance regarding how activities related to the production of exempt income should be reflected for apportionment factor purposes.

Federal law contains a similar exemption under IRC § 883; however, there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50 percent of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. You should verify that the taxpayer qualifies for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries which are known to grant equivalent exemptions for various types of international shipping or aircraft income is contained in Revenue Ruling 97-31, I.R.B. 1997-32, 4, July 22, 1997. Since treaty provisions are subject to change, however, the full text of the relevant documents should be consulted if this is a material issue.

Air Express Companies

Overnight air express companies generally operate by receiving packages at points of origin around the country, shipping those packages to a central hub location for sorting by the various destinations, and then delivering the packages to the end destinations. The fee for this service is generally a flat rate rather than a rate based upon mileage. Application of the Air Transportation rules under CCR § 25137-7 may not result in fair

apportionment of income for this industry because it assigns sales to "bridge" states (the states the aircraft fly over, but do not land in) that do not reflect the market for the air express companies. For example, if a package is being shipped from Sacramento to Los Angeles, the air express company may route it through Houston for sorting. The Air Transportation rules would assign sales to each of the states between Texas and California. Since the customer is only contracting for shipment of the package within California, the sales should logically be assigned only within this state. The air express company's activities in Houston and en route would be taken into account in the property and payroll factors.

If you determine that an air express company's use of the CCR § 25137-7 Air Transportation rules results in distortion, then a modification to those rules may be made under the authority of R&TC § 25137. A modification that might be appropriate for curing distortion in a typical air express company situation would be to calculate the sales factor by assigning 50 percent of the revenues from air express companies to the point of origin and 50 percent to the point of destination. The property and payroll factors for such air express companies may generally continue to be determined in accordance with the provisions of CCR § 25137-7.

7740 FILM PRODUCERS AND TELEVISION NETWORKS

CCR § 25137-8.1 applies to motion picture and television film producers, producers of television commercials, and to television networks. The regulation will also apply under certain circumstances to independent television stations operating collectively or as network affiliates. This regulation applies to taxable years beginning on and after January 1, 1982. This regulation was amended operative April 25, 2012 resulting in CCR § 25137-8.2.

Definitions

When auditing this industry, it's important to have a working knowledge of the terms pertaining to this industry. Refer to CCR § 25137-8.2(b).

Property Factor

- RENTED STUDIOS

If studios are rented, the net annual rental rate must include only the amount of the basic or flat rental charge by the studio for the use of a stage and other permanent equipment such as sound recording equipment. Additional equipment that is not covered in the studio's basic rental charge or that is rented from other sources must also be included providing that it is used for one week or longer (even though it may be rented on a day-to-day basis). In the case of a lump sum rental payment covering more

than one taxable year, the payment must be assigned ratably over the rental period (CCR § 25137-8.2(c)(1)(A)(i).)

- VALUE OF FILMS

Films are deemed to be tangible personal property pursuant to CCR § 25137-8.2(b)(4). The value of a film is the original cost of producing the film as determined for federal income tax purposes, prior to any adjustments for federal credits, which have not been claimed for state purposes, and will include talent salaries.

Films of a topical nature, including news, current events programs, sporting events, interview shows, etc., generally have no lasting value, and are expensed for California purposes at the time of production. Such films must be included in the property factor at their original cost for one year beginning with the release date (the "release date" is defined as the date when it is first telecast or exhibited to the primary audience for which it was created). If the value of such films is material to the property factor, it may be necessary to calculate a monthly average (see MATM 7125) of the film values in order to more accurately reflect the 12-month inclusion.

All other films are included in the property factor at their original cost for twelve years beginning with the release date.

After the initial one-year or twelve-year period has elapsed, any films for which income has been received during the taxable year must be aggregated and treated as a single film property. Such property will be valued at eight times the aggregate gross receipts generated by those films during the year, but may not be valued at an amount greater than the total original cost of the aggregated film property.

The value of films will be assigned to the numerator in accordance with the ratio of the total California receipts from those films over the total of such receipts everywhere. The film receipts are determined for this purpose in the same manner as they are determined for sales factor purposes (see below).

- TANGIBLE PERSONAL PROPERTY OTHER THAN FILMS

If tangible personal property (other than films) is used within and outside the state during the year, the portion of its value included in the numerator must be in the same ratio which the number of days the property was located or used in this state bears to the total number of days such property was owned or rented during the taxable year.

Videocassettes and discs intended for home viewing are not considered films under CCR § 25137-8.2(b)(4). Such property must be included in the property factor at its inventory cost. CCR § 25137-8.2(b)(4)(B)

Payroll Factor

The payroll factor includes all compensation paid to employees during the taxable year, including talent salaries. Residual and profit participation payments also constitute compensation paid to employees. In many cases, actors or directors will be employees of personal service or "Alter Ego" corporations, and producers will contract with such corporations to provide the services of the actors or directors. The amounts paid to such corporations for those services, if substantial, will be included in the producer's payroll factor as if it were compensation paid directly to an employee.

Compensation of employees engaged in the production of a film on location must be attributed to the state where the services are or were performed. Compensation of all other employees is determined according to CCR § 25132 and CCR § 25133.

Sales Factor

The special rules applicable to the sales factor involve the assignment of gross receipts to the numerator.

- **Films**

The numerator of the sales factor includes gross receipts from films in release to theaters and television stations located in this state. Gross receipts from films in release to or by a television network for network telecast are attributed to this state in the ratio that the California audience for such network stations bears to the total audience everywhere. Although CCR § 25137-8.2(c)(3)(A)(ii) indicates that published rate card values are to be used to determine the audience, those rate card values are no longer published. Alternatives named in the Regulation for determining audiences are other published market surveys, or if not available, population data published by the U.S. Bureau of Census. The taxpayer may have internally generated audience information that may be used if it appears reasonable. Most independent radio and TV stations are not subject to this regulation since they operate in localized areas. Therefore, advertising revenues of those stations are assignable under the normal market-based sourcing rules of CCR § 25136-2 for taxable years beginning on or after January 1, 2013 or for those electing single-sales factor for taxable years beginning on or after January 1, 2011.

Gross receipts from films in release to subscription television telecasters must be attributed to this state in the ratio that the California subscribers bear to the total subscribers everywhere.

- **Video Cassettes and Discs**

Receipts from sales and rentals of videocassettes and discs are included in the sales factor in accordance with the normal rules for tangible personal property under CCR § 25135 for those sold in shrink wrap tangible form. For those downloaded or live streamed from the internet, see CCR § 25136-2.

7745 RAILROADS

The special rules for apportionment of railroad companies are found in CCR § 25137-9.

Railroad companies are broadly classified by the Surface Transportation Board (STB), which replaced the Interstate Commerce Commission for years after 1995, into three classes for reporting purposes:

- **Class I:**

As of 2011, this Class includes those having annual operating revenues of \$250,000,000 or more. For this class, STB Annual Report Form R-1 is required to be filed. Prior to 1996, this was filed with the ICC.

- **Class II:**

As of 2011, this Class includes those having annual operating revenues of \$20,000,000 or more. Prior to 1996, this class was required to file an Annual Report Form R-2 with the ICC.

- **Class III:**

As of 2001, this Class includes those having annual operating revenues of \$20,000,000 or less. Prior to 1996, this class was required to file an Annual Report Form R-3 with the ICC.

The Annual Reports filed with the ICC or SBT contain some of the data needed to compute the denominator of the special formula. You should request these reports as part of your examination. The California Public Utilities Commission (PUC) also requires an Annual Report (which is simply a copy of the R-1 or R-2, if applicable).

Definitions

When auditing this industry, it's important to have a working knowledge of terms used. Refer to CCR § 25137-9(1)(A) for definitions.

Property Factor

- **TEMPORARY RENTS**

It is common in the industry for the taxpayer to temporarily use railroad cars owned and operated by other railroads. The taxpayer will be charged a per diem or mileage charge for the use of those cars. Such payments are excluded from the definition of rents pursuant to CCR § 25137-9(a)(1)(A)(ii), and are not included in the property factor. Likewise, the taxpayer may receive per diem charges for equipment, which it owns but

temporarily rents, to other railroads. Although the property is temporarily rented out, the original cost of the property is included in the taxpayer's property factor.

- **MOBILE OR MOVABLE PROPERTY**

Mobile or movable property includes property such as passenger cars, freight cars, locomotives and freight containers that are located within and without this state during the taxable year. Locomotives must be included in the numerator of the property factor in the ratio which locomotive-miles in the state bear to total locomotive-miles. Other railroad cars must be included in the numerator in the ratio which car-miles in the state bear to the total car-miles everywhere.

The State Statistics filed with the PUC contain data regarding the mileage within California and total mileage. The R-1 filed with the SBT discloses the cost of locomotives and cars against which the ratio is applied.

Payroll Factor

CCR § 25137-9(a)(2) provides that compensation paid to enginemen and trainmen performing services on interstate trains must be included in the numerator of the payroll factor in the ratio which the compensation required to be reported to California for withholding tax purposes bears to the total compensation required to be reported to the IRS. (Under former 49 USC § 11504, now 49 USC § 11502, compensation of enginemen and trainmen is generally subject to income tax only in their state of residence.)

Sales Factor

- **REVENUE FROM TEMPORARY RENTS**

Per diem and mileage charges arising from the temporary use of the taxpayer's railroad cars by other railroads are excluded from the sales factor. This is consistent with the property factor rules that do not recognize such rentals.

- **REVENUE FROM HAULING FREIGHT, MAIL AND EXPRESS**

The portion of the revenue from hauling freight, mail and express that is attributable to this state includes:

All receipts from shipments which both originate and terminate within this state; and for shipments passing through, into, or out of this state, the portion of the revenues in the ratio that the miles traveled by such shipment in this state bears to the total miles from the point of origin of the shipment to the destination.

- **REVENUE FROM TRANSPORTATION OF PASSENGERS**

The portion of the revenue from transportation of passengers that is attributable to this state includes:

- All receipts from the transportation of passengers (including mail and express handled in passenger service) which both originate and terminate within this state; and
- That portion of the receipts from the transportation of interstate passengers (including mail and express handled in passenger service) determined by the ratio which miles traveled by such passengers on the taxpayer's lines within this state bear to the total miles traveled from point of origin to the destination.

7750 COMBINATION OF GENERAL AND FINANCIAL CORPORATIONS

Unitary businesses predominantly engaged in financial activities are subject to apportionment under the rules set forth in CCR section 25137-4.2 for taxable years beginning on or after January 1, 1996, and CCR section 25137-4.1 for income years beginning before January 1, 1996. Some unitary businesses, however, will contain one or more entities that are classified as financial corporations, but the predominant activity of the business as a whole will not be a financial activity. CCR section 25137-10, effective for taxable years beginning on or after January 1, 1989, provides special apportionment rules to properly reflect the income of these businesses. The provisions of CCR § 25137-10, as well as the apportionment procedures that were used prior to the effective date of the regulation, are covered in detail in the FTB Bank and Financial Handbook. You should refer to the regulation and to that handbook when examining a combined report that contains both general and financial corporations.

7755 TRUCKING COMPANIES

Effective for taxable years beginning on or after January 1, 1991, CCR § 25137-11 was enacted to provide the rules for apportioning income for trucking operations. A trucking company means a motor common carrier, a motor contract carrier, or an express carrier which primarily transports tangible personal property or others by motor vehicle for compensation.

The Regulation applies not only to trucking companies, but also to companies which are not predominantly trucking, but which do conduct some trucking activities. For such companies, the apportionment factors directly related to trucking activities (mobile property, payroll, and sales only) must be separately identified. For trucking activities that do not pertain to mobile property, payroll, and sales, the general apportionment

rules apply. For example, the employees at the headquarters of a trucking company do not move, and hence would follow the general payroll factor rules. Also, the headquarters building does not move, and would therefore follow the general property factor rules. To the extent that trucking companies also transport goods through methods other than by truck, the property and payroll attributable to such movement must be assigned to the numerator of the property and payroll factors in accordance with CCR § 25137-7 and CCR § § 25137-9 if air or rail transportation is involved or CCR sections 25129 and 25133 otherwise

Definitions

When auditing this industry, it's important to have a working knowledge of terms used. Refer to CCR § 25137-11(b).

Apportionment Factor

The trucking formula is based upon the interstate ratio. The ratio is computed by aggregating all units of mobile property operated by the taxpayer.

Example: A taxpayer has 10 units of mobile property, all of which operate in more than a single state during the year. One mobile property unit travels 40 miles within California and 60 miles outside the state for a total of 100 miles. The other nine units travel a total of 50 miles each, none of which is within this state. The interstate ratio assigned to California is:

$$40/(100 + (9 \times 50)) = 40/550 = 7.273\%$$

The interstate ratio will be applied to determine the amounts within California for (1) mobile property located in more than one state during the year, (2) compensation paid to personnel that operate and maintain mobile property for services performed in more than one state, and (3) receipts from shipments which originate in one state and terminate in another state.

Mobile property which is located solely within California during the taxable year, and compensation paid to personnel for operating or maintaining mobile property solely within this state are included 100 percent in the numerator of the property and payroll factors. Likewise, all receipts from any shipments that both originate and terminate within California are included 100 percent in the numerator. The interstate ratio is not applied to these wholly California items.

The taxpayer is required to maintain records necessary to identify mobile property which operates in more than a single state and to provide a by state breakdown of miles traveled.

De Minimis Rule

The regulation contains a de minimis standard which will not require apportionment to California if: (1) the taxpayer does not own any property in California other than mobile property which operates within and outside the state; (2) the taxpayer does not make any pick-ups or deliveries within the state; (3) the taxpayer does not travel more than 25,000 mobile property miles (provided total mobile property miles traveled within the state does not exceed 3 percent of total mobile property miles) within the state; (4) and the taxpayer does not make more than 12 trips into the state.

The regulation contains a requirement that the taxpayer maintain the records necessary to identify the mobile property, which operates in more than one state, and the miles traveled by such property in each state. Diesel tax reports filed with the Board of Equalization should also show mileage in and out of California. The taxpayer will have individual manifests, which can be checked on a test basis.

7757 PRINT MEDIA

The apportionment rules under CCR § 25137-12, effective for taxable years beginning on or after November 3, 1995, apply to taxpayers in the business of publishing, selling, licensing or distributing newspapers, magazines and other types of printed materials. Such taxpayers derive a large percentage of their revenues from the sale of advertising space, and the regulation clarifies the treatment of advertising revenues in the numerator of the sales factor.

Definitions

Print or printed material includes, without limitation, the physical embodiment or printed version or any thought or expression including, without limitation, a play, story, article, column or other literary, commercial, educational, artistic or other written or printed work. The determination of whether an item is or consists of print or printed material must be made without regard to its content. Printed material may take the form of a book, newspaper, magazine, periodical, trade journal or any other form of printed matter and may be contained on any medium or property.

Purchaser and subscriber means the individual, residence, business or other outlet which is the ultimate or final recipient of the print or printed material. Neither of such terms must mean or include a wholesaler or other distributor or print or printed material.

Apportionment

Gross receipts from the sale of printed materials delivered or shipped to a purchaser (or subscriber) within California is included in the numerator of the sales factor in accordance with the normal rules for sales of tangible personal property. Gross receipts derived from advertising or from the sale, rental or other use of customer lists is

attributed to California based upon the taxpayer's "circulation factor." The circulation factor must be established each year, and for each of the taxpayer's publications, and consists of the following ratio:

The publication's in-state circulation to purchasers and subscribers
Total circulation for that publication

The circulation should be determined by reference to rating statistics as reflected in sources such as Audit Bureau of Circulations. If no satisfactory sources are available, the circulation can be determined from the taxpayer's books and records.

If specific items of advertising can be shown to have been distributed only to a limited region within the total circulation area of the publication, then a regional or local geographic circulation factor should be used in lieu of the overall circulation factor for that publication.

If the purchaser or subscriber is the U.S. government or if the taxpayer is not taxable in a state, then a throwback rule applies. All gross receipts, including receipts from advertising and customer lists that would have been attributed to the other state by the circulation factor will be included in the sales factor numerator of this state if the printed materials were shipped from a place of storage or business in this state.

For taxable years prior to November 3, 1995, similar treatment was required under FTB Legal Ruling 367 (1973).

7760 SEA TRANSPORTATION ACTIVITIES

The apportionment rules for sea transportation activities are located in CCR § 25101(b). For purposes of the special formula, sea transportation means ocean vessels carrying cargo, freight, mail, passengers or similar items. Commercial fishing activities and vessels that are not engaged in sea transportation are not covered by this regulation, and are discussed in MATM 7725 and MATM 7815.

Apportionment Factor

The property, payroll, and sales factors related to vessels and their employees are determined in part under the concept known as "voyage days." A voyage day is defined as a day, or part of a day, that a ship is in operation for the purpose of transporting cargo, freight, mail, passengers, and the like. The days that a ship is in operation include all sailing days, even though a ship is returning empty or is en-route to a port of call to load passengers or cargo, all days in port while loading and unloading, and all days that the ship is laid up for ordinary repairs, refueling, or provisioning. Voyage days

do not include time a ship is out of service or during the time it is laid up for extended repairs, overhaul, modification, or is in dry dock.

A California voyage day includes all days from the time a vessel enters the California three-mile limit until it leaves that three-mile limit. Since it is unlikely that vessels of the size contemplated herein would remain continuously within the three-mile limit when sailing between California ports, a portion of the voyage may not be included in California voyage days.

The voyage day ratio is derived by dividing California voyage days by total voyage days. The ratio must be calculated separately for each ship. In calculating the apportionment factors, it is important to note that the voyage day ratio is only applied to property, payroll and sales related to the ocean vessels. Property, payroll and sales not connected with the ships, such as port restaurants, port facilities, land based offices, etc., are subject to the usual rules of factor assignment.

Property Factor

All property owned or rented by the taxpayer, including ships is subject to the normal rules for inclusion in the property factor. As to the numerator, the value of each ship is multiplied by that ship's voyage day ratio to determine the value to include in the numerator of the factor.

To the extent that bare boat charters, time charters and similar contracts constitute leases under established guidelines (see MATM 7137), the expense incurred for the charter is capitalized by eight in the denominator of the property factor. The voyage day ratio is applied to determine the portion of the capitalized value to include in the numerator. The owners of the ships that are leased under such contracts are receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the voyage day ratio is not applicable to those owners, and the rules described in MATM 7815 should be used. Taxpayers who charter ships under contracts that are determined to be service contracts do not include any value in the property factor.

When examining the property factor of American shipping companies, you should verify that the cost basis of the ships has not been reduced by "capital construction fund" amounts—see below for an explanation of this issue.

Payroll Factor

The California payroll factor for ocean-going personnel is determined by applying the voyage day ratio to total payroll for such personnel. Land-based payroll is included in the California numerator using the regular payroll rules.

Sales Factor

The numerator of the sales factor is determined by multiplying the California voyage day ratio times the total revenue from transportation related receipts (receipts from cargo, passengers, freight, mail, and the like). All other receipts are assignable to the California numerator using the standard assignment rules.

The main problem encountered in this type of audit is determining the California voyage day ratio and segregating ocean-going property, payroll and sales from land-based factors. Each ship keeps a detailed log, which shows the exact location of the ship shown in hours, minutes, and seconds. California voyage days can be computed from the time each ship enters or leaves the three-mile limit. Taxpayers will probably use the logs to compute voyage days, and the data may be summarized on apportionment workpapers. The workpapers should be requested to help guide you through the information contained on the logs. The logs should also have detail on extended repair and drydock time that must be removed from both total and California voyage days. Be careful to ensure that only major repair and drydock time has been removed. Ordinary minor repair time, refueling, and provisioning time are not removed.

The taxpayer's general ledger summaries, revenue runs, property ledgers, payroll records, and other records will show the revenues, property, rent expense, and payroll for each vessel. Once this information is verified, the voyage day ratio for each vessel can be applied to determine the California portion. California property, payroll and revenue for nonocean-going or land-based items can be determined using techniques described in other parts of this manual.

Exempt Income

Under R&TC § 24320, income derived from the operation of aircraft or ships by a corporation organized under the laws of a foreign country may be exempt from taxation. In order to qualify for the exemption, the aircraft or ships must be registered or documented under the laws of the foreign country, and the income must be exempt from national income taxes by reason of a reciprocal treaty or agreement between the foreign country and the United States. Also, Legal Ruling 2006-01 provides guidance regarding how activities related to the production of exempt income should be reflected for apportionment factor purposes.

Federal law contains a similar exemption under IRC § 883; however, there are some federal/state differences. Although federal law does not contain the California requirement that the aircraft or ships be registered or documented under the laws of the foreign country, federal law does contain an additional requirement that at least 50 percent of the value of the foreign corporation be owned by residents of a foreign country meeting the requirements of the statute. You should verify that the taxpayers qualify for the state exemption. Because of the federal/state differences, some taxpayers will qualify for the federal exemption but not the California exemption.

A table summarizing the countries, which are known to grant equivalent exemptions for various types of international shipping or aircraft income, is contained in Revenue

Ruling 89-42, 1989-1 C.B. 234. Since treaty provisions are subject to change however, the full text of the relevant documents should be consulted if this is a material issue.

Merchant Marine Capital Construction Fund

American shipping companies are subsidized to an extent by the federal government. This subsidy involves the taxpayer placing funds in a special account for ship replacement. Under IRC § 7518, U.S. citizens that own or lease qualified vessels may establish tax-deferred reserve funds, called capital construction funds, under Section 607 of the Merchant Marine Act of 1936, for the replacement or addition of vessels. Generally, amounts deposited into a capital construction fund are deductible from taxable income, and earnings from the investment of amounts held in the fund are not taken into account. Withdrawals made for the acquisition, construction, or repair of a qualified vessel are "qualified withdrawals" and do not generate income. Nonqualified withdrawals generate income and are taxed in the year they are made.

For taxable years beginning before January 1, 1997, California did not conform to these rules, therefore a state adjustment reversing the capital construction fund deduction and restoring the related income should be made. Since the basis of vessels acquired or constructed through fund withdrawals is reduced for federal purposes by the nontaxable fund contributions, federal/state basis differences will also be present. This will create additional state adjustments for depreciation and gain or loss on the sale of the vessels. For property factor purposes, the cost of the property should not be reduced by the capital construction fund withdrawals.

For taxable years beginning after 1996, California incorporates and modifies IRC § 7518. California modifies IRC § 7518 to reflect California cross-references, the dividend deduction percentage requirements, and California's tax rate. California incorporates the federal provisions that allow United States citizens who own or lease qualified vessels to establish tax-deferred reserve funds, called capital construction funds, for the replacement or addition of vessels (R&TC § 24272.5).

7765 BUS TRANSPORTATION

The normal rules under CCR § 25129(d) for apportioning income from mobile property are based on time spent within and outside the state. Bus lines involved in interstate transportation of passengers and goods do not generate revenue based upon time within a state, but upon mileage traveled. Therefore, the standard formula may not result in a clear reflection of income for such taxpayers. Under the authority of R&TC § 25137, the department has developed modifications to the standard formula to reflect the special characteristics of this industry. The modifications are similar to the special rules authorized for railroads (MATM 7745) and trucking companies (MATM 7755).

You should apply the normal apportionment rules to property, payroll and sales not related to interstate busing. Property subject to the normal rules will include stationary assets such as terminals and offices, as well as intrastate buses, buses that do not cross state borders as part of their normal activity.

Interstate buses (buses which travel across state borders as part of their normal activity) will be included in the numerator of the property factor in the ratio which miles traveled in California bears to total miles traveled everywhere. The compensation paid to interstate drivers will also be assigned to California based upon that ratio.

Revenue is not generated when the bus is traveling empty. Therefore, the sales factor is calculated based only upon miles traveled while hauling passengers (revenue miles). Empty miles are excluded from the calculation. Revenue from interstate bus trips is assigned to the numerator of the sales factor in the ratio which revenue miles traveled in California bears to total revenue miles traveled everywhere.

Reports, which the bus lines are required to file with the Interstate Commerce Commission prior to 1996, should disclose total miles traveled. Diesel tax reports filed with the Board of Equalization and reports filed with the California Public Utilities Commission should identify mileage in and out of California.

7770 FREIGHT FORWARDING COMPANIES

Freight forwarding companies arrange for the shipment of goods by air, sea, rail or truck common carriers, and receive fees for their services. In addition, many forwarders will provide their customers with truck trailers that may be transported by independent highway haulers or rail piggyback services.

Provision of Trailers

To the extent that the freight forwarding companies provide their own trailers for transporting customer goods, their revenue is a function of the mileage traveled rather than time spent within and outside the state. The apportionment rules developed for the trucking, rail, sea or air transportation industries (whichever are applicable) should be applied to the property, payroll and sales related to this activity. Although freight forwarders will not generally fall within the definitions of truck, rail, sea or air transportation companies under the regulations, the general authority of R&TC § 25137 may be used to permit application of those rules to freight forwarders, however the party seeking to deviate from standard apportionment must present a R&TC § 25137 petition which will be addressed by the Multistate Tax Bureau R&TC § 25137 Committee.

Unlike trucking and rail companies that will have nexus in all states in which they operate, it is possible that a freight forwarding company's activities within a state may not be sufficient to establish nexus. In such cases, the mileage ratio calculated for freight forwarding companies should exclude miles traveled through states where nexus has not been established.

In *Appeal of John H. Grace Co.*, 80-SBE-115, October 28, 1980, the SBE held that nexus was not established in California when a corporation's only connection with the state was through railroad cars leased by the corporation to industrial companies who in turn arranged for railroad companies to transport their products in those cars. The railroad cars would occasionally pass into or through California. The SBE held that the presence of railroad cars in California, while under the control of the corporation's lessees' bailees, was "too attenuated to satisfy the statutory nexus requirement." As a practical matter, this type of fact pattern will probably not apply to freight forwarders because they make the transportation arrangements and are therefore not as far removed from the movements of their trailers. In order to determine whether a taxpayer has nexus in a particular state refer to the nexus requirements discussed in MATM 1100.

7780 MINING

Taxpayers who derive more than 50 percent of their gross business receipts from conducting an extractive business activity may be required to use a three-factor apportionment formula (no double-weighted sales). See MATM 7005.

Valuation of depletable or wasting assets in the property factor is an issue for the mining industry, and is discussed in MATM 7210. Federal/state depletion issues are covered in MATM 6080.

Payments that are made for leased mining rights are considered royalties or a similar form of economic interest in the property. For the limited purpose of CCR § 25137(b)(1)(B), royalty payments are treated as equivalent to rents and are included in the property factor as such (rent expense), reflecting an eight-multiple capitalization rate under CCR § 25130 (MATM 7138). To the extent that payments such as lease bonuses are capitalized, they are included in the factor as owned property. (See MATM 7795 for an explanation of lease acquisition costs or bonuses).

7785 PRINTERS

Whether to treat printing receipts as sales of tangible personal property or as receipts for personal services is a common problem that arises with taxpayers involved in the printing business.

Printers generally produce a product in accordance with the customer's specifications, and in many cases the customer will provide the paper used in the printing process. If the printer does not market the finished product for its own account, the issue is whether the printer is merely providing a fabrication service or is in fact selling a tangible personal product.

You must determine the nature of the printing receipts on a case-by-case basis taking into account the taxpayer's facts and circumstances. Paper makes up the highest component cost of the printing process. If the customer supplies the paper and the printer only supplies incidental materials, then the printer will usually be considered to have provided a service.

On the other hand, if the printer supplies the paper, then the determination becomes more difficult. Consider the extent of the activities performed by the printer, the manner in which the parties treated the transactions, request copies of the contracts, and the relative value of the paper and other components as compared to the finished product. An analysis of this issue is contained in *Wm. H. Wise & Co. v. Rand McNally & Co.*, (U.S. District Court S.D. N.Y. 1961) 195 Fed. Supp. 621.

7790 PROFESSIONAL SPORTS

Generally speaking, all the sports income of California-based professional sports teams will be apportioned to California and none of the sports income of non-California-based professional sports teams will be apportioned to California (R&TC § 25141). For exceptions to this rule in cases where other states or countries follow a different rule, see R&TC § 25141(d). Notwithstanding these provisions, the non-California based teams are still subject to the minimum franchise tax if they play within the state. These rules are only intended to operate as stated above, and should not be construed as an inference that the unitary concept is being modified or limited. R&TC § 25141 is effective for taxable years beginning on or after January 1, 1986. Prior to that date, apportionment rules for professional sports teams were contained in former CCR § 25137-10.

7795 OIL & GAS INDUSTRY

The oil and gas industry is one of the largest and most important segments of the U.S. economy. The importance of the petroleum industry to the economy of the United States has led Congress and California to pass specialized tax laws that are unique to the oil and gas industry. Petroleum industry accounting records have been adapted to the specialized nature of the industry. As a result, an efficient and effective audit of a return with oil and gas investments, transactions, or operations will require some specialized knowledge of the industry and the tax laws involving the industry. Although many of the basic auditing techniques ordinarily used when auditing income, expense items, state adjustments and apportionment factors will be essentially the same in auditing oil and gas operations, the specialized nature of the industry and its accounting records necessitates the use of additional audit techniques that are not common in other industries.

Overview of the Industry

The exploration, development, and production of oil and gas require enormous amounts of capital. To obtain the funds needed, companies sometimes join together and pool their resources to explore for oil. Large integrated oil companies, as well as small companies and individuals, participate in the exploration, development, and production phase of the oil and gas industry. Many times partnerships are formed to enable outside investors to invest in drilling ventures. The investors may have little knowledge of the oil and gas industry, but are willing to invest funds in risky drilling ventures because of favorable tax benefits and the possibility of large economic benefits.

Primarily because of the extremely large capital requirements, the transportation, refining, and marketing of oil and gas are phases of the industry that are dominated by the large integrated oil companies.

Specialized aspects of the oil and gas industry that are discussed separately in this manual are offshore drilling operations (MATM 7796) and pipeline companies (MATM 7797). Since many oil companies operate shipping lines to transport the oil, they may also be subject to the sea transportation rules discussed in MATM 7760.

State Adjustments

Although not apportionment issues per se, there are several state adjustments that are unique to the oil and gas industry and that deserve mention in this section. State adjustments for depletion, intangible drilling and development costs, and tertiary injectants will be present in most cases, and are discussed in MATM 6080, 6085 and 6086. Prior to 1987, state adjustments with respect to exploration expenses may also be necessary (former R&TC sections 24837, 24837.5).

A material issue for the oil and gas industry involves the deduction for foreign taxes. R&TC § 24345 generally allows a deduction for taxes paid or accrued during the taxable year, but an exception is made for taxes on or according to or measured by income or profits (see MATM 6100). Many oil-producing countries impose a tax, which is in part an

income tax, and in part a compulsory payment in exchange for a specific economic benefit. Such taxes are termed "dual capacity" taxes. Since dual capacity taxes consist of two distinct elements, those elements are separated under rules set forth in CCR § 24345-7(c) in order to determine the portion of the tax that is deductible.

In order for a taxpayer to deduct any portion of a dual capacity tax, the burden is upon the taxpayer to prove (1) that the imposition of the foreign tax is directly related to the receipt or future receipt of a specific economic benefit from the foreign country, and (2) the amount (if any) that is not an income tax. This may be accomplished if the taxpayer claiming a deduction establishes, based on all relevant facts and circumstances, the specific amount of the dual capacity tax that is not an income tax.

Alternatively, the Regulation provides for a safe harbor method. Under the safe harbor method, the taxpayer makes an election on its California return with respect to the foreign country, which asserted the tax upon an entity included in the combined report, and applies the safe harbor formula to determine the deductible portion of the tax. In very general terms, the safe harbor formula operates as follows:

Step 1

Some payments to foreign governments are calculated based upon the "posted" price of crude oil. Since the oil is sold at the market price, the posted price is not representative of realized income to the extent that it exceeds the market price. Therefore, the portion of the payments that are attributable to the differential between the posted price and market price cannot be considered "income" taxes.

The first step in the safe harbor formula is to reduce the actual payments to the foreign government by any payments attributable to a posted price differential (PPD). The method for computing the amount of PPD payments is explained in CCR § 24345-7(c)(5)(A).

$$\boxed{\begin{array}{c} \text{Payments to} \\ \text{Foreign} \\ \text{Government} \end{array}} - \boxed{\begin{array}{c} \text{Posted} \\ \text{Price} \\ \text{Differential} \end{array}} = \boxed{\begin{array}{c} \text{Non-PPD Payments} \end{array}}$$

Step 2

A reasonable amount of "income tax" is estimated by multiplying the taxpayer's income in the foreign country by 52 percent (55 percent for 1986 and prior).

$$\boxed{\begin{array}{c} \text{Income from} \\ \text{Activities in} \\ \text{Foreign Country} \end{array}} \times \boxed{52\%} = \boxed{\begin{array}{c} \text{Amount of Payment} \\ \text{Considered to be an} \\ \text{Income Tax} \end{array}}$$

Step 3

Any excess of the non-PPD payments over the portion of those payments that are considered to be income taxes (from Step 2) are added to the PPD payments (from Step 1). The result is the deductible portion of the dual capacity tax.

| | | | | |
|--|---|--|---|---|
| Non-PPD Payments | - | Amount of payment considered an Income Tax | = | Deductible Portion of Non-PPD Payments (not less than zero) |
| Deductible portion of Non-PPD payments | + | PPD Payments | = | Total Deduction Allowed for the Dual Capacity Tax |

§ 24345-7, and the auditor should refer to that regulation if issues arise in this area.

Property Factor Issues

LEASE ACQUISITION COSTS - The lease acquisition costs are costs incurred in connection with acquiring an oil and gas lease. The initial consideration paid by the lessee to the lessor known as a "bonus" does not represent rents and instead represents an economic interest in the property (Treas. Reg. § 1.612-3(a)(3).) These costs are capitalized as part of the cost of acquiring a lease (IRC section 178) and therefore should be included in the property factor.

OIL & GAS TANKERS - See MATM 7760, Sea Transportation Companies, for general rules.

ITEMS EXPENSED FOR TAX PURPOSES, CAPITALIZED FOR BOOK PURPOSES. As a general rule, items, which are expensed for tax purposes, are not includable in the property factor (see MATM 7120). Intangible drilling costs (IDCs) are capitalized for book purposes, but are usually expensed for tax purposes. Prior to 1990, auditors should ensure that IDCs have been excluded from the factor if they have been expensed on the return. For taxable years beginning on or after January 1, 1990 however, CCR § 25130(a)(1) was revised to include IDCs in the property factor regardless of whether they have been expensed or capitalized. The property factor inclusion is not limited to IDCs incurred after January 1, 1990, but applies to all IDCs that are still capitalized on the taxpayer's books, even though they may have been expensed for tax purposes in a prior year.

If you are unsure whether a cost associated with the development of a well is correctly classified as an IDC, it may be helpful to review the definition of IDCs provided in Treasury Regulation section 1.612-4, as well as federal Revenue Rulings and case law on the subject.

GEOLOGICAL AND GEOPHYSICAL COSTS - Geological and geophysical costs, which result in the acquisition or retention of oil properties, must be capitalized as part of the cost of these properties (Rev. Rul. 77-188, 1977-1 C.B. 76, and Rev. Rul. 83-105, 1983-2 C.B. 51). The average yearly value should be included in the cost value of the property and thus will be includable in the property factor.

In the event that the acquisition or retention of the oil properties does not occur, these costs are deductible as a loss under IRC § 165. Since the costs are no longer capitalized, they are not includable in the property factor.

DELAY RENTALS - Generally, oil and gas leases will require the development of an oil property within a set period of time, usually one year. In lieu of abandoning the project if development is not commenced within the contractual period, the lessee may pay the lessor a delay rental, which will extend the period for development. Delay rentals are considered carrying charges which may be expensed, or which the taxpayer may elect to capitalize under the provisions of IRC § 266 and R&TC § 24426 (Treas. Reg. § 1.612-3(c)(2)).

The general rule provides that the capitalized value of expenditures will be includable in the property factor, and no value will be included if the taxpayer has elected to expense the item (MATM 7120). However, if an analysis of the contract reveals that the delay rental is really in the nature of a rent (a payment for the ability to use the land), then the property factor should include eight times the annual rental rate (MATM 7130). Such an analysis need only be performed if the item is material.

ROYALTY PAYMENTS - A mineral lease contract provides that the lessee will make royalty payments to the lessor. The lessor (owner of the minerals) retains a royalty interest in the minerals and is entitled to receive a specific portion of the oil and gas produced or a specified portion of the value of such production. Historically, the typical royalty on oil and gas properties has been a one-eighth share. An amount representing royalties paid in connection with the extraction of natural resources generally is includable in the property factor of the lessee, so long as the property for which the royalty payments are made is actually used by the lessee/taxpayer. The amount to be included in the lessee's property factor is determined by multiplying the annual royalties paid times eight. [FTB Legal Ruling 97-2](#) provides that such royalties must be treated as equivalents to rental payments. Also, the State Board of Equalization in *Appeal of Proctor and Gamble* concluded that CCR section 25137(b)(1)(B) authorizes the capitalization of royalties in a case such as this.

Offshore Property - See MATM 7796.

Drilling Ships and Barges

Drilling ships and floating barges are included in the denominator of the property factor regardless of location. Vessels operating within the California jurisdictional limits (three miles) are included in both the numerator and the denominator. In the event that the operations of these vessels are conducted both within and outside of the California jurisdictional limits, the value of property to be included in the numerator will be computed on the basis of a modified port day formula (see MATM 7796).

The voyage day formula should not be used as these vessels are not used for sea transportation purposes.

OTHER PROPERTIES - Undeveloped properties, shale oil, tar sands, geothermal steam properties and non-producing leases are all generally included in the property factor as property available for use (see MATM 7140). For the SBE's analysis of this issue, see *Appeal of Richfield Oil Corporation*, 64-SBE-083, November 17, 1964; and *Appeal of Union Oil Co. of California*, 64-SBE-084, November 17, 1964.

Payroll Factor Issues

- PAYROLL ATTRIBUTABLE TO OFFSHORE PROPERTY - MATM 7796.
- OIL AND GAS TANKERS - See MATM 7760, Sea Transportation Activities.
- DRILLING SHIPS AND BARGES - See MATM 7796, Offshore Operations.

Sales Factor Issues

- Sales from Offshore Property - See MATM 7796.
- Royalty Income - Royalties received should be included in the sales factor and assigned to the state based on rules in place for your audit year.
- Exchange Transactions in Relation to Oil Transfers - To achieve efficient delivery, storage or processing of petroleum, gasoline or similar products, one company may trade its inventory for another company's inventory. Following are examples of such transactions:

Company A ships crude oil by oil tanker with its intended destination being Company A's Los Angeles refinery. At some point during the shipment, it is determined that the Los Angeles refinery facilities are full and the oil cannot be delivered for processing. Company B has a refinery that can handle the oil. Company A contracts for Company B to take the delivery and, in exchange, Company B will supply Company A's refinery with oil at a later date.

Company X has crude oil in Texas. Company Y has crude oil in California. Company Y, a dealer in crude, needs oil in Texas to fill a contract for delivery to a customer in that state. Arrangements are made with Company X to exchange its crude in Texas for Company Y's crude in California.

In both instances, there is an exchange of inventory for inventory. These transactions have the potential to distort the sales factor because the exchange does not reflect a true market for the product. If the value of the inventory is included in the sales factor as a result of the exchange, a double counting of sales will result when the replacement inventory is subsequently sold. If you determine that the inclusion of the exchange transactions in the sales factor is

distortive, the exchanges may be excluded under the authority of section 25137. See MATM 7701 for a discussion of when application of the standard formula will be deemed to be distortive.

Reciprocal agreements are sometimes entered into whereby Corporation A agrees to buy inventory from Corporation B at a specific location for a specified cash amount in exchange for an agreement by B to purchase inventory from A at a different location. Such arrangements are essentially exchange transactions, and should be given the same treatment as described above. Such transactions may or may not be identified as exchange transactions on the taxpayer's books of account or workpapers, and therefore may be difficult to identify. You may be able to determine whether such transactions exist by interviewing taxpayer personnel familiar with the overall operations of the integrated production process.

- Sales of Trading Companies or Brokers Oil companies may have subsidiaries which are trading companies or brokers. The function of these subsidiaries is to find buyers for the company product. They may either receive a commission or they may actually purchase and resell the product. When a combined report includes a trading company or broker that purchases and resells the product, you should consider the propriety of including the "gross receipts" in the sales factor. The trading company or broker will typically only have a few employees and minor facilities, and may have less than a one percent profit margin since it is effectively only taking a commission for finding a buyer for the product. The size of the receipts may therefore be disproportionate to the activity conducted. If you determine that the inclusion of the gross receipts in the sales factor is distortive, then an adjustment may be made under the authority of R&TC § 25137 to include only the gross profit. For guidance in resolving this issue, see *Appeal of Pacific Telephone and Telegraph Company*, 78-SBE-028, May 4, 1978; and *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989; also MATM 7701.
- Exclusion of Royalty Payments from the Sales Factor - Companies which pay royalties to a landholder or to the holder of an overriding royalty interest sometimes reduce their sales by an amount equal to the royalty payments. For example, if an oil producer has an \$800 receipt on which it owes a one-eighth royalty to the landholder and a one-eighth royalty to the holder of the overriding interest, it may record \$600 as sales, and record the remaining \$200 as payables. For purposes of administrative ease, the department will allow the sales to be reduced by the royalties for sales factor purposes so long as that treatment is used on a consistent basis. Since the statute requires the use of gross receipts however, that treatment should only be allowed when the amounts involved are not material.

7796 Offshore Drilling Contractors

Offshore drilling contractors and builders of oil platforms on the high seas operate in an area over which the U.S. Government has asserted exclusive jurisdiction. The states are prohibited from taxing activity within the federal jurisdiction, either directly or indirectly.

Through the enactment of the Submerged Land Act (43 U.S.C. 1301 et seq.) and the Outer Continental Shelf Lands Act of 1953 (67 Stat. 462, 43 U.S.C. 1331 et seq.), the U.S. Government's exclusive jurisdiction extends to the subsoil and sea bed of the outer continental shelf, and to all artificial islands and fixed structures erected thereon for the purpose of oil exploration, development, removal and transportation. These acts have been interpreted to also cover barges used for the exploration and drilling of the wells ([FTB Legal Ruling 396](#)). For California purposes, the federal jurisdiction covers the continental shelf beyond the three-mile limit.

All business income derived from activities on the Outer Continental Shelf is included in total business income subject to apportionment even though it cannot be assigned to any state. Therefore, property, payroll and sales attributable to offshore activities are included only in the denominators of the apportionment factors. By excluding Outer Continental Shelf factors from the numerators, income attributable to the Outer Continental Shelf will not be taxed by California because it is being assigned to a location outside the state. Similar inclusion of Outer Continental Shelf income in the unitary tax base has been approved by the U.S. Supreme Court in *Shell Oil Company v. Iowa Department of Revenue* (488 US 19, 102 L Ed 2d 186, 109 S Ct 278) as not amounting to extraterritorial taxation. California's apportionment rules detailing the treatment of offshore property, payroll and sales may be found in [FTB Legal Ruling 366](#).

Some have questioned the alleged inconsistency between the state's taxation of income earned through activities in the Outer Continental Shelf (OCS) and income earned through exempt activities. For example, cooperatives are taxable on nonmember income only. The department apportions the nonmember income using the apportionment factors that relate to the nonmember income. Member income and apportionment factors are not taken into account to apportion nonmember income.

The US Supreme Court held in *Shell Oil Company v. Iowa Department of Revenue*:

"In sum, the language, background, and history of the OCSLA leave no doubt that Congress was exclusively concerned with preventing the adjacent States from asserting, on the basis of territorial claims, jurisdiction to assess direct taxes on the OCS. We believe that Congress primarily intended to prohibit those direct taxes commonly imposed by States adjacent to offshore production sites: for example, severance and production taxes. See *Maryland vs. Louisiana* (451 US, at 753, n. 26) ("It is clear that a State has no valid interest in imposing a severance tax on federal OCS land"). This prohibition is a far cry from prohibiting a State from including income from OCS-derived oil and gas in a constitutionally permissible apportionment scheme."

The difference in treatment for apportionment purposes of income earned in the OCS and exempt income is justified based on the difference in law between an exemption from direct taxation and an exclusion from the tax base.

Property and payroll attributable to offshore activities may only be included in the numerators of the apportionment factors if they are located within three miles of the California coast.

Barges and similar vessels that are used in offshore drilling operations may travel from one offshore location to another. Property, payroll and sales attributable to these vessels should be assigned to the numerator based upon a modified version of the "port day" ratio. As described in MATM 7815 (and MATM 7725), the standard port day formula only takes into account time spent within the jurisdictional waters of a state or foreign country. This results in 100 percent of the income from the vessels being taxed to those jurisdictions. In order to accomplish the assignment of income to the federal waters on the Outer Continental Shelf, the denominator of the port day ratio must be modified to include time spent in those waters. Sales are also excluded from the numerator unless they take place within the three-mile limit. In order to determine whether the sales factor has been properly computed, it is important for the auditor to obtain an understanding of where the offshore drilling sites are located and how the oil is sold. The oil may either be pumped from these locations through pipelines to mainland refineries or placed directly in tankers for delivery to refineries. The sales may occur at the well site or at a mainland or refinery location. Once you have determined how the oil is sold, the usual rules for assignment of tangible personal property will apply. For example:

If the well site is within the California three-mile limit, then sales of oil at the well site are California sales. If the well site is outside the three-mile limit, the sales are excluded from the numerator.

If the oil or gas is pumped ashore to California from outside the three-mile limit for sale to a California customer, the sale is included in California's numerator. Oil in transit to a California location would also be considered California property includable in the numerator of the property factor (CCR § 25129(d)).

If the oil or gas is pumped ashore to California for storage and subsequent sale, the subsequent sale would be treated as a sale of tangible personal property shipped from California.

The taxpayer should have records identifying the locations of offshore drilling sites. The annual reports or SEC Forms 10-K might also have this information. Your primary concern should be to identify whether any of the offshore locations are within the three-mile limit off the California coast.

See MATM 7815 for rules regarding the property factor treatment of vessels that spend time both within Outer Continental Shelf areas and within the three-mile limit.

7797 Pipeline Companies

Property Factor

Determining the property to be included in the denominator of the property factor should pose no special problems beyond those encountered in a standard apportionment audit. Pipelines are included in the denominator at original cost, including any portions of the pipelines that run to offshore drilling platforms located outside the three-mile limit.

Interstate pipelines are included in the numerator as shown in the following calculation:

$$\begin{array}{r} \text{Pipeline Mils in California} \\ \text{Over} \\ \\ \text{Pipeline Miles} \\ \text{Everywhere} \end{array} \quad \times \quad \begin{array}{l} \text{Original Cost of} \\ \text{Pipeline} \end{array}$$

With respect to pipelines running from offshore oil platforms, pipeline miles that run within the three-mile limit are considered pipeline miles in California.

Sales Factor

Revenue derived from an interstate pipeline will be assigned to California based on a ratio of the barrel miles transported within California to the total barrel miles. If natural gas were transported through a pipeline, the means of measurement would be in cubic feet of gas.

Keep in mind, if the taxpayer derives more than 50 percent of its gross business receipts from extractive business activity, the applicable formula is a 3-factor formula consisting of the sum of the property factor, the payroll factor, and the sales factor, divided by three.

Example: An interstate oil pipeline is 1,000 miles long and has one million barrels of crude oil transported through it during a taxable year. Those barrels of oil travel through 200 miles of the pipeline located within California. One-fifth (200/1000) of the revenue earned by the pipeline from the transportation of oil would be assigned to the numerator.

All revenue earned from a pipeline located entirely within California should be assigned to the numerator. The barrel miles traveled through wholly California pipelines should not be aggregated with the barrel miles of an interstate pipeline.

You should examine I.C.C. and P.U.C. reports to determine the number of barrels of oil or cubic feet of gas that travel through California and through the total length of the pipeline.

7800 BROKER DEALERS

Broker dealers present some unique apportionment problems as they engage in a variety of activities which give rise to several different revenue streams. In addition, some may qualify as a financial corporation which has special rules of assignment, and some may not qualify as a financial corporation and therefore must apply the general rules of assignment.

Financial or General Corporation

In general, broker dealers are typically found to be general corporations. However, one must go through the standard analysis to decide whether a broker dealer is a financial corporation or a general corporation. If the broker dealer is classified as a financial corporation (more than 50% of the broker dealer's gross income is generated from its principal trading activities that relate to the buying and selling of debt securities, i.e. Type 1 and Type 2 securities, on its own account as a principal, etc.) then such receipts are assigned to the sales factor using CCR § 25137-4.2. In addition, the broker dealer and its combined reporting group might be required to use the three-factor formula under R&TC § 25128(c) if the requirements within that section are met. See MATM XXX for steps in this analysis.

Commission Income

For all taxable years, buying and selling of stocks or bonds for a customer's account generates commission income. Even if a broker dealer is considered to be a financial corporation, receipts from commissions are not addressed within CCR § 25137-4.1 or CCR § 25137-4.2 as these are receipts from services, not from trading activities. The broker dealer never actually takes title to the stocks or bonds, but merely earns a fee for arranging the transaction. These are receipts from services assigned to the sales factor using CCR § 25136(c)(1) or (c)(2) depending on whether the customer is an individual or a business entity, for all apportioning trades or businesses for taxable years beginning on or after January 1, 2013, or for those electing single-sales factor apportionment, for taxable years beginning on or after January 1, 2011. For earlier years, R&TC § 25136 and CCR § 25136 require cost of performance method of assignment for receipts from services.

Interest, Dividends, Stocks

If the broker dealer is a financial corporation: interest, dividends and gains from trading and investment activities are assigned to the sales factor using CCR § 25137-4.2. If the broker dealer is not a financial corporation, for receipts from interest (other than margin interest), dividends, and gains on the sale of stocks (when the broker dealer is acting as a principal and selling on its own account), follow the rules set forth at CCR § 25136-2(e) (for taxable years beginning on or after January 1, 2013 or for those electing single-sales factor apportionment for taxable years beginning on or after January 1, 2011). These cascading rules vary depending on whether the customer is an individual or a business entity. For earlier years, cost of performance method of assignment of receipts is required under R&TC § 25136 and CCR § 25136.

Margin Interest

If the broker dealer is a financial corporation, margin interest is assigned to the sales factor using CCR § 25137-4.2. If the broker dealer is not a financial corporation, receipts from margin interest are assigned using R&TC § 25136 and CCR § 25136-2(d)(2)(A)2.c. for assigning interest for taxable years beginning on or after January 1, 2013, or for those electing single-sales factor apportionment, for taxable years beginning on or after January 1, 2011. For earlier years, R&TC § 25136 and CCR § 25136 require cost of performance method of assignment for receipts from services.

Commission vs. Gross Receipts

In addition to arranging transactions for a commission, many broker dealers will also engage in trades as a principal or underwriter. In such transactions, the taxpayer will purchase securities on its own account for resale. Although the net profit on the resale of the securities is comparable to the commission that would have been received from a brokerage transaction, the gross receipts from the resale will be much greater because they will include the cost of the underlying security. For cost of performance years (for taxable years beginning before January 1, 2011 for those electing single-sales factor, or before January 1, 2013 for those not electing single-sales factor), since most "dealer" transactions take place in the headquarters offices in New York, inclusion of the gross receipts in the denominator of the sales factor has the potential to skew the factor to divert income out of California. In the *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 89-SBE-017, June 2, 1989, the department attempted to correct this problem by requiring the taxpayer to use gross profits rather than gross receipts to reflect these transactions. The SBE did not allow that deviation from the standard formula, stating that FTB had not met its burden of proving that distortion existed. This case is described in more detail in MATM 7701. As a result of this decision, gross receipts from dealer sales are included in the sales factor unless it can be established by clear and convincing evidence that such inclusion would not fairly reflect the extent of the taxpayer's activities in California under R&TC § 25137, in which case an auditor generated petition is required.

Rent Expense in the Property Factor

If rent expenses incurred for ticker tape machines and display boards are material to the property factor, you should ensure that they have been included correctly. Generally, such rental expenses will include two elements. A portion of the payment will represent the rental for the machine itself, and this portion is properly capitalized by eight and included in the property factor. The other portion of the payment represents a charge from the particular exchange for the quotation information. This latter charge is a service, and should be excluded from the factor.

7805 TELECOMMUNICATIONS COMPANIES

A taxpayer in the business of providing telecommunications services, electronic information services, subscription television services, access to the internet, or any combination thereof poses unique apportionment issues which are not addressed under the general apportionment rules.

Definitions

Telecommunications means the electronic transmission of voice, data, image, and other information through the use of any medium such as wires, cables, electromagnetic waves, light waves, or any combination of those or similar media now in existence or that might be devised, but "telecommunications does not include the information content or any such transmission."

Telecommunications service means providing telecommunications (including services provided by telecommunication services resellers) for a charge and includes, but is not limited to, telephone services, telegraph service, paging service, personal communication services, mobile or cellular telephone services, but does not include "electronic information service," "internet access services" or "subscription television service."

Electronic information service means providing information or entertainment for a charge by means of telecommunications including through access to the internet.

Subscription television service means providing transmission of video programming, including single-event programs, to subscribers and includes any subscriber interaction for the selection of video programming or other program services. The term includes, but is not limited to, direct broadcast satellite service, cable television service, satellite master antenna television service, master antenna television service, multipoint distribution service, multichannel/multipoint distribution service, and any audio portion of a video program.

Private telecommunications service means a dedicated service that entitles the subscriber to the exclusive or priority use of a "communications channel" or group of "communications channels" from one or more locations.

Communications Satellites

Property Factor

Communications satellites located in space are included in the denominator of the property factor in accordance with the normal rules. If the satellite system is directly or indirectly connected to facilities located in California, then satellites will be included in the numerator based upon the ratio of the value of property in California (excluding satellites) to the value of total property everywhere (excluding satellites).

Sales Factor

For sales factor purposes, the revenues will be included in the numerator based upon the rules governing your audit year.

During cost of performance years (for all apportioning trades or businesses for taxable years beginning before January 1, 2011 for those not electing single-sales factor for taxable years beginning before January 1, 2013), the following California Court of Appeals decision contains the authority for using the income producing activity treatment, if applicable, as well as an example of a sales factor ratio that was considered to be a reasonable measure of the income producing activity.

In *Communications Satellite Corp. v. Franchise Tax Board*, (1984) 156 Cal.App.3d 726, the taxpayer was an operator and part owner of a global commercial communications satellite system. The satellites were in "synchronous" orbit so that they appeared to remain stationary over a fixed point on earth. They were positioned over the Atlantic, Pacific and Indian Oceans, and never passed over California. The system also included earth stations, one of which was located in California. Revenues were generated from the leasing of "half circuits" to communications common carriers. A half circuit is a two-way communications channel between a satellite and an earth station. When combined with another half circuit between the satellite and another earth station, this channel permitted communications to be transmitted between earth stations. The system operated as follows: (1) A communications signal destined for a foreign country or an offshore U.S. point is received at the California earth station from its place of origin in the U.S. through terrestrial facilities owned and operated by communications carriers; (2) The earth station transmits the signal to a satellite in orbit, which in turn transmits the signal to another earth station in a foreign country or an offshore U.S. point; (3) Likewise, communications from foreign countries are received via satellite by the California earth station and are then transmitted to their point of destination in the United States.

The taxpayer only included the California earth station in the numerator, and excluded the value of its interest in the satellite. On audit, FTB included a portion of the value of the taxpayer's interest in the satellite based on the ratio of the value of the taxpayer's interest in property on the ground in California over the value of the taxpayer's interest in property on the ground everywhere. The Court of Appeal agreed with the FTB's treatment, and concluded that there is "an invisible, but apparently continuous and very real connection between the earth station and the satellites. The earth station has a value only because this connection exists, and it is otherwise of no value." Because the taxpayer owned an interest in the satellites, and because the satellites functioned in California at and through the California earth station, the court held that they were tangible personal property owned and used in this state within the meaning of R&TC § 25129.

In addition to revenues from the leasing of half circuits, the taxpayer also reported its share of the income from the joint venture that owned the satellite system. The joint venture's revenues consisted of use charges paid by the participants. For numerator purposes, the taxpayer had only included a "ground percentage" of sales attributable to the California earth station. This formula resulted in revenues from the use of satellites being omitted from the numerator of any state. FTB revised the numerator computation to include a percentage of sales everywhere based upon the ratio between the number of half-circuits leased at the California earth station and the number of half circuits the taxpayer leased everywhere. Since the revenue from both the leasing of half circuits and from the share of joint venture income are intrinsically related to the function of the earth stations, the SBE upheld the FTB's calculation as reasonable.

For market-based sourcing years (for apportioning trades or businesses that elected the single-sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and for all apportioning trades or business for taxable year beginning on or after January 1, 2013), see CCR § 25136-2(c)(1)(C)1 for phone services to individuals. Receipts from sale of telecommunications services are assigned using a ratio of California net plant facilities over total net plant facilities used to provide the services.

International Transmission Cables

For market-based sourcing years (for apportioning trades or businesses that elected the single sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013 and for all apportioning trades or business for taxable year beginning on or after January 1, 2013), assignment of these receipts would follow CCR § 25136-2(c) and would be assigned to the location of where the benefit of the service is received.

For cost of performance years (for all apportioning trades or business for taxable years beginning before January 1, 2011 and for those not electing single-sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013) International transmission cables that cross the high seas are similar to satellites in that

they are located (at least in part) outside the jurisdiction of any country, but have value only because of their connection with land-based facilities. Therefore, the department's policy is to apply the "Comsat" method for assigning the value and revenue from such assets to the property and sales factors. Use of this method for the apportionment of non-jurisdictional communications satellites was approved by the California Court of Appeals in *Communications Satellite Corp. v. Franchise Tax Board*, (1984) 156 Cal.App.3d 726 (discussed above). As applied to transmission cables, the formula will operate as follows:

Property Factor

All property is included in the denominator of the property factor under normal valuation rules. Property and cable located within California's three-mile limit will be included 100 percent in the numerator. The portion of the cable that is located beyond the Outer Continental Shelf will be included in the numerator based upon the ratio of property factor values in California (excluding non-jurisdictional assets) to total property factor values everywhere (excluding non-jurisdictional assets).

Sales Factor

For sales factor purposes, the revenues will be included in the numerator based upon the rules in place according to the audit year involved. If using the income producing/cost of performance rule, you should obtain an understanding of how the income producing activity is conducted. Interviews with taxpayer personnel who are familiar with how the revenues are generated will usually be a good source for this information.

Telephone Companies

Other than the problems discussed above with respect to communications satellites and international transmission cables, telephone companies do not present any unique property or payroll factor issues. The difficulties that arise in apportioning income from this industry generally relate to the sales factor. The department's position for cost of performance years (for all apportioning trades or businesses for taxable years beginning before January 1, 2011 and for those not electing single-sales factor for taxable years beginning on or after January 1, 2011 and before January 1, 2013) is as follows:

- Revenues from intrastate calls (calls between two California points) will be included 100 percent in the numerator of the sales factor.
- Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call. The rationale for this position is that the operation of the facilities constitutes the income producing activity that generates the revenue. The value of the net plant facilities is the best measure of this activity. Since the "all or nothing" approach provided by the normal rules under R&TC § 25136 would not

reflect the fact that a market exists at both ends of the telephone call, this allocation is made under the general authority of R&TC § 25137 in order to fairly reflect the activities within the state.

When auditing a telephone company, you should request a copy of the reports required to be filed with the Federal Communications Commission (FCC). Such reports will contain information regarding plant values and revenues that will be useful for verifying the apportionment factors. Some blank FCC forms are available on the Internet at <http://www.fcc.gov>. You may scan the forms and instructions in order to determine the type of information that is reported and the titles of the forms or reports that you may want to request from the taxpayer.

Contributions in Aid of Construction

Contributions in aid of construction (CIACs) are amounts that are received by a utility company to encourage the provision of services to or for the benefit of the person making the contribution. An example of CIACs occurs when new housing developments are started. The utility companies servicing the area will collect a one-time fee from the developers or homeowners to fund construction of facilities to provide power to the new homes. If the ratepayers consume enough power to pay for the construction, then the fees will be refunded. If sufficient power is not consumed, the utility company will keep the fees.

R&TC § 24324 provides that CIACs are excluded from the gross income of regulated public utilities that provide electric energy, gas, water or sewerage disposal services. This exclusion does not extend to telephone companies. Cases have been noted, however, where telephone companies have attempted to exclude such income. If the return contains Schedule M-1 or M-3, if applicable, adjustments or state adjustments deducting net CIACs received, those adjustments should be reversed. Adjustments may also be necessary to allow additional depreciation if the taxpayer reduced the basis of its assets by the amount of the CIACs that it excluded from income -- former section 24554.

Pursuant to R&TC § 24325, CIACs made on or after January 1, 1992 will no longer be excluded from the income of any public utility.

7810 TIMBER

The problem unique to the timber industry is that of valuation of timber tracts in the property factor. CCR § 25130(a)(1) provides that owned property must be valued at its original cost, which is generally federal basis at the time of acquisition, adjusted by any capital improvements and partial dispositions. With respect to timber tracts, the costs are constantly changing as old trees are logged off and new growth takes place. To take

the changing value of the timber tracts into account in the property factor, the department interprets the cutting of timber as constituting a partial disposition of the timber property requiring a reduction to original cost basis by an amount equivalent to the depletion adjustment.

An understanding of the basic federal tax treatment versus California's treatment will help you to better understand the problem of valuation of timber tracts in the formula and the reasoning behind California's interpretation of original cost for determining the property factor.

Capital Expenditures

When timberland is purchased, an allocation of the purchase price is made between the land and the timber. The purchase price includes costs of timber cruising, appraisal, land survey, title search and insurance, recording fees, and legal services.

The land account includes the land itself, and depreciable and nondepreciable improvements. Depreciable land improvements include bridges, culverts, graveling, fences, fire towers, and other structures and improvements. Nondepreciable land improvements include earthwork betterments of a permanent character such as clearing, grading, and ditching of roads with an indeterminable life. Permanent roads for administration, fire access or logging are regarded as partly depreciable to the extent that the bridges, culverts, and graveling may be depreciated over their physical life. Temporary roads, which are abandoned after a logging operation has been completed, are usually expensed when cutting begins.

The timber account is divided into three categories: (1) timber for sale (merchantable timber); (2) young growth; and (3) deferred reforestation. The portion of the purchase price of a timber tract, which is attributed to the timber, is allocated to merchantable timber and young growth. These accounts will also include costs of timber cruising and other expenses directly associated with the timber purchase.

The deferred reforestation account is charged with costs of planting timber. These costs include expenditures for the preparation of the timber site for tree planting or seeding and for the cost of seedlings or tree seeds. Site preparation costs include expenditures for tree girdling, brush or stump removal, and the leveling and conditioning of land to facilitate planting. Other expenses capitalized in this account are tool expenses, depreciation of equipment used in planting and the cost of labor employed in tree planting or seeding.

As timber becomes merchantable, the young growth and deferred reforestation accounts are credited, and such amounts are then debited to the merchantable timber account for recovery through timber depletion.

The federal revenue rulings and case law that clarify the rules for capitalization of timber related costs are applicable for California purposes. To the extent that these

expenditures have been capitalized, they will be included in the property factor (net of depletion) as part of the cost of the timber tracts.

Timber Depletion

For taxable years beginning on or after January 1, 1987, California conforms to the federal rules for depletion of timber tracts (R&TC § 24831, Treas. Reg. § 1.611-3).

At the time timber tracts are purchased, the total quantity of merchantable timber acquired is determined and expressed in board feet, log scale, cords or other units. The quantity of timber is updated each year to (1) deduct the units of timber that were cut in prior years, (2) add the new units that have been acquired, transferred from new growth accounts or gained by growth, and (3) add or deduct any units necessary to correct the estimate of the number of units available in the account. For each year, the basis (total purchase cost and capitalized expenses, less prior year depletion) allocated to the merchantable timber is divided by the total unit quantity of such timber to determine the unit cost (depletion unit).

The number of units of timber cut during the year multiplied by the depletion unit for that timber account must be the amount of depletion allowable for the year. To establish the basis of the timber when it is sold, the depletion unit for the year in which the timber was cut will be multiplied by the quantity of timber sold.

In addition to the above rules for depletion, California law contains an election under R&TC § 24372.5 by which the taxpayer may amortize certain reforestation expenses over a period of 84 months or more. Although depletion due to the cutting of timber will reduce the value of the timber tracts in the property factor, no such reduction is made for R&TC § 24372.5 amortization. The reasoning behind this is that the reforestation amortization is based on time and does not relate to the sale or disposition of the property. Consequently, timber will normally be included in the property factor at its net post-depletion federal basis.

Election to Treat Cutting of Timber as a Sale

For taxable years beginning on or after January 1, 1987, California conformed to IRC § 631(a), which provides an election to treat the cutting of timber as a sale or exchange. In accordance with Treasury Regulation § 1.631-1(d)(4), the gain or loss must be given IRC § 1231 treatment (capital gain, ordinary loss) even though the timber might be an inventoriable asset for the taxpayer.

To qualify for the benefits of IRC § 631(a), the timber must be cut for sale or for use in the taxpayer's trade or business, and the taxpayer must have owned either the timber or a contract right to cut it for more than one year (six months for property acquired before January 1, 1988). Once the taxpayer makes an election to use IRC § 631(a), the election is binding with respect to all timber that the taxpayer owns or has a contract right to cut unless the Commissioner permits revocation of the election.

If IRC § 631(a) is elected, the tax effect is as follows:

- The cutting of timber is considered to be a sale or exchange of such timber in the taxable year in which it is cut. This provision is based upon the concept of a hypothetical sale of the timber by the taxpayer to itself at the time of cutting.
- Capital gain or loss is recognized in an amount equal to the difference between the adjusted basis for depletion of the timber and the fair market value of such timber as of the first day of the taxable year.
- The fair market value is thereafter considered to be the cost of the cut timber. For example, if the taxpayer is engaged in the manufacture of lumber or other wood products, the fair market value of the timber used to calculate gain at the time of cutting becomes the cost of the timber for purposes of determining the profit or loss upon sale of the lumber or wood product.

The following example will illustrate the application of the above points:

Example: At the start of the taxable year, the taxpayer owned timber with a cost basis of \$16,000 and a fair market value of \$40,000. During the taxable year, all of this timber was cut. The taxpayer therefore realized a capital gain of \$24,000 (\$40,000 less \$16,000). During the same year, the taxpayer sold all the cut timber for \$60,000. The total taxable income from the timber is \$20,000 of ordinary income (\$60,000 less \$40,000) and \$24,000 capital gain income. If no timber had been sold during the current year, the basis of the cut timber for future sales would have been \$40,000.

For taxable years beginning on or after January 1, 1987, California treatment will be the same as federal with respect to calculating income under an IRC § 631(a) election. Since this is effectively a deemed intercompany sale and does not reflect the true market for the timber, the deemed sale price from the cutting of timber should not be included in the sales factor. Although the fair market value of the cut timber at the time of the deemed sale is considered the cost of the cut timber "for all purposes for which such cost is a necessary factor," R&TC § 25137 may be used to reflect the original cost basis in the property factor (\$16,000 in the above example) in situations where the use of fair market value would be distortive.

Prior to 1987, California had no provisions similar to IRC § 631(a). If all the timber was sold in the year cut, no adjustments to income or factor items would be necessary. To the extent that cut timber was not sold, adjustments would be required to back out the IRC § 631(a) income and basis adjustments.

Example: Assume the same facts as in the previous example, but assume that the timber was cut prior to California's conformity with IRC § 631(a). If none of the timber was sold in the year in which it was cut, \$24,000 of income and sales would need to be removed from the amount reported for federal purposes. In addition, the inventory basis

of \$40,000 used for federal purposes would need to be reduced to \$16,000 for the California property factor.

The election of IRC § 631(a) for federal purposes should be apparent on Schedule M-1 or M-3, if applicable.

Timber Leases and Cutting Rights

Long-term cutting agreements exist in many forms, ranging from simple purchase-and-sale contracts to more complicated leases or cutting agreements for a term of years with right or license to the lessee to cut and remove the timber. Such agreements may extend to all the timber on the lands covered in the lease, to trees of certain size classes, or to timber yet to be grown if the agreement covers a sufficiently long period.

Most of the timber companies acquire federal cutting rights from the U.S. Forest Service. The Forest Service advertises the amount of timber to be cut and its fair market value for competitive bid. The stated fair market value of the timber includes an allowance for the cost of logging roads in the tract. The successful bidder is typically required to cut the timber within two years after the cutting contract is awarded. Since no payments are made until the logs are sold or delivered to the mill for cutting into lumber, timber companies are required to post a bond for payment of the bid price when the contract is awarded. The Forest Service cutting lease includes a price index escalation clause, which may increase or decrease the bid price of the timber. This adjustment is made at the time the timber is logged, and is based upon the then current price index for each timber classification.

With respect to the lessee, Treasury Regulation § 1.631-2(e) provides that payments for timber or timber cutting rights are a capital expenditure and must be treated as part of the lessee's depletable basis for such timber regardless of whether the payments are designated as rentals, royalties or bonuses. The rationale is that rental payments, taxes, fire protection assessments, and other similar payments to or in behalf of the landowner are payments for future growth and not for the use of land. However, there is a split of authority as to the propriety of this regulation (*Union Bag-Camp Paper Co. v. United States* (5th Cir.) 325 F.2d 730; *United States v. Regan* (9th Cir.) 410 F.2d 744.)

The inclusion in the property factor of timber acquired or to be acquired under a cutting contract depends upon the nature of the contract. If the contract provides for the purchase of timber for a lump sum, the contract price of such timber or trees will be included in the property factor. If, on the other hand, the purchase contract is the more typical "pay-as-cut" or "no stated value" contract where the seller is to be paid a stated amount per unit harvested and only for the units harvested, title is not deemed to pass until the trees are cut. (U.S. Forest Service and Bureau of Land Management contracts fall into this class.) Until the trees are cut and the exact purchase price can be determined, costs are generally excluded from the property factor. In *Appeal of The Proctor & Gamble Manufacturing Company*, 89-SBE-028, September 26, 1989, the SBE determined that inclusion of a value for the entire timberland was warranted. A

determination in this area will require an in-depth analysis of the nature of the agreement and the particular facts and circumstances of the case. For a detailed discussion of this issue, see MATM 7138.

7815 VESSELS SUCH AS TUG BOATS and BARGES

The regulations contain special formulas for commercial fishing boats (CCR § 25137-5, MATM 7725) and ships engaged in transporting cargo, freight, mail, passengers or similar items (CCR § 25101(b), MATM 7760). Other types of sea-going vessels that are not covered by those regulations are discussed in this section. Such vessels include tug boats that service large vessels that enter or leave a California port; dredges that are used in various harbors for repair work; service and repair boats for ocean oil platforms; research vessels used on the ocean for gathering scientific data; and various other types of vessels.

If a bareboat charter or similar charter is deemed to be a lease (see MATM 7137), then the owner of the ship is receiving income from a rental transaction rather than from the activity of sea transportation. Therefore, the sea transportation rules will not be applicable to that owner even though the ship may be chartered for use in sea transportation. The owner will include the ship in the numerator of the property factor in accordance with the rules described below.

The property, payroll and sales attributable to the ocean-going activities of these types of vessels are included in the numerators of the factors based upon a "port day" ratio. A ratio of California port days to total port days is applied to total property, payroll and sales for each vessel to determine the California portion. Additional detail with respect to calculating the port day ratio may be found in MATM 7725.

The use of the port day method is authorized under the general authority of R&TC § 25137, and was approved by the California Court of Appeals in *Luckenbach Steamship Co. v. Franchise Tax Board*, 219 Cal. App. 2d 710. The court explained that the port day method more clearly reflected the taxpayer's activities than the voyage day method (voyage days are used for sea transportation -- see MATM 7760). The voyage day formula operates as if income were attributable evenly to every location through which the vessel traveled. On the other hand, the port day formula recognizes that the greater part of the income producing activity of the vessels occurs at ports rather than at sea. The port day method attributes the income to the ports where the bulk of the income producing activity takes place rather than to the high seas.

In order to determine whether the port day formula will apply you must first gain an understanding of the types of activities performed by each of the taxpayer's vessels. For example, a tugboat, which guides large ships in and out of harbors is very localized. If the tug is located in a California port, then no activity is likely to be outside the three-

mile limit and 100 percent of the property, payroll and revenue related to the tug will be assigned to California.

Scientific ships do research in various ocean areas. If such a vessel is based in California and takes a trip for research in water not subject to any state or country's taxing jurisdiction, then all activity is assignable to California. If the vessel does research in waters subject to Mexico's jurisdiction, then time spent in California ports or within the California three-mile limit would be included in the numerator, and port days in both Mexico and California jurisdictions would be included in the denominator.

Vessels involved in offshore oil and gas operations (except for vessels used for transportation of oil which are subject to the voyage day formula -- MATM 7760) must use a modified version of the port days formula that includes time spent on the Outer Continental Shelf in the denominator. This issue is discussed in MATM 7796.

All the above-mentioned vessels should have logs that detail time, location, and activity of the vessels. In addition, taxpayer's apportionment workpapers, general ledger summaries, and property ledgers will aid you in determining the proper apportionment factors.

7820 Mutual Fund Service Provider

A mutual fund service provider derives income from the direct or indirect provision of management, distribution or administration services to or on behalf of a Regulated Investment Company(RIC) as defined in IRC § 851.

Definitions

In order to audit this industry, it's important to have a working knowledge of terms used. Following is a partial list of definitions. Refer to CCR § 25137-14(a) for a complete list.

“Administration services” include, but are not limited to, clerical, fund or shareholder accounting; participant record-keeping, transfer agency, bookkeeping, data processing, custodial, internal auditing, legal, and tax services performed for a regulated investment company. Services qualify as administration services only if the provider of such service or services during the taxable year also provides, or is affiliated with a person that provides, management or distribution services to the same regulated investment company during the same taxable year.

“Distribution services” include, but are not limited to, the services of advertising, servicing, marketing or selling shares of a regulated investment company. The services of advertising, servicing or marketing shares qualify as distribution services only when the service is performed by a person who is, or in the case of a closed-end company was, either engaged in the business of selling regulated investment company shares or

affiliated with a person that is engaged in the service of selling regulated investment company shares. In the case of an open-end company, such service of selling shares must be performed pursuant to a contract entered into pursuant to 15 United States Code, Section 80a-15(b), as amended.

“Management services” include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company or providing services related to the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to 15 United States Code, Section 80a-15(a), as amended, for a person who has entered into such a contract with the regulated investment company or for a person who is affiliated with a person who has entered into such a contract with a regulated investment company.

Apportionment

The general apportionment rules apply for mutual fund service providers except as provided in CCR § 25137-14. These are applicable for taxable years beginning on or after January 1, 2007.

Receipts from the direct or indirect provision of management, distribution or administrative services to or on behalf of a RIC are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate RIC for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the RIC's shareholders domiciled in the state at the beginning of and at the end of the RIC's taxable year, and denominator of which is the average of the number of the shares owned by the RIC's shareholders everywhere at the beginning of and at the end of the RIC's company's taxable year.

If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for RICs, these services will be assigned to this state if the domicile of the beneficial owner of the assets is located in this state.

If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a RIC with shareholders in this state, or that are providing asset management services directly or indirectly for beneficiaries who are domiciled in this state, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of the regulation will be included in the numerator of the sales factor in determining the unitary

group's business income apportioned to California, even though the specific entity that performed the services is not a taxpayer in California.

If the ratio calculated under the regulation assigns receipts to a state where no members of the mutual fund service provider's unitary group are taxable, these receipts will not be assigned to that state. Instead, these receipts will be assigned to the location of the income producing activity that gave rise to the receipts, as determined under R&TC § 25136.