

Multistate Tax Commission
Allocation and Apportionment Regulations

Adopted February 21, 1973; as revised through July 29, 2010

(Applicable to Article IV of the Multistate Tax Compact and to the Uniform Division of Income for Tax Purposes Act.)

The Allocation and Apportionment Regulations were adopted by the Multistate Tax Commission on February 21, 1973.

Reg. IV.11.(a) and (b) were revised on July 14, 1988.
Reg. IV.18.(c).4. was added on August 8, 1997.
Reg. IV.2.(a).(5) was added on July 27, 2001.
Reg. IV.1.(a) and (c) were revised on August 1, 2003.
Reg. IV.2.(a).(4) was revised on August 1, 2003.
Reg. IV.10.(b) was revised on August 1, 2003.
Reg. IV.11.(b) was revised on August 1, 2003.
Reg. IV.13.(a) was revised on August 1, 2003.
Reg. IV.1.(b) was revised on January 15, 2004.
Reg. IV.17.(2) and (3) were revised on August 2, 2007.
Reg. IV.17.(4)(C) was added on August 2, 2007.
Reg. IV.18.(a) was revised on July 29, 2010.

Special Industry Rules have been adopted and added to these Regulations (and further amended, where noted) as follows:

Reg. IV.18.(d). Construction Contractors, July 10, 1980.
Reg. IV.18.(e). Airlines, July 14, 1983.
Reg. IV.18.(f). Railroads, July 16, 1981.
Reg. IV.18.(g). Trucking Companies, July 11, 1986; amended July 27,
1989.
Reg. IV.18.(h). Television and Radio Broadcasting, August 31, 1990;
amended April 25, 1996.
Reg. IV.18.(i). Telecommunications and Ancillary Services, July 31, 2008.
Reg. IV.18.(j). Publishing, July 30, 1993.

The Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions was adopted November 17, 1994.

They are subject to adoption by each member state in accordance with its own laws and procedures.

The numerical references of the regulations are to Article IV of the Multistate Tax Compact and its subsections.

Prologue. These Regulations are intended to set forth rules concerning the application of the apportionment and allocation provisions of Article IV of the Multistate

Tax Compact. The apportionment rules set forth in these Regulations are applicable to any taxpayer having apportionable income, regardless of whether or not it has non-apportionable income, and the allocation rules set forth in these Regulations are applicable to any taxpayer having non-apportionable income, regardless of whether or not it has apportionable income.

The only exceptions to these allocation and apportionment rules contained in these Regulations are those set forth in Regulation IV.18 pursuant to the authority of Article IV.18 of the Compact.

These Regulations are not intended to modify existing rules concerning jurisdictional standards.

•• **Reg. IV.1.(a). Apportionable and Non-apportionable Income Defined.**

(1) **Apportionment and Allocation.** Article IV.1(a) and (e) require that every item of income be classified either as apportionable income or non-apportionable income. Income for purposes of classification as apportionable or non-apportionable includes gains and losses. Apportionable income is apportioned among jurisdictions by use of a formula. Non-apportionable income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as apportionable income if it falls within the definition of apportionable income. An item of income is non-apportionable income only if it does not meet the definitional requirements for being classified as apportionable income.

(2) **Apportionable Income.** Apportionable income means all income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state, including:

(A) income arising from transactions and activity in the regular course of the taxpayer's trade or business; and

(B) income arising from tangible and intangible property if the acquisition, management, employment, development or disposition of the property is or was related to the operation of the taxpayer's trade or business; and

(C) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, income derived from accounts receivable, operating income, non-operating income, *etc.*, is of no aid in determining whether income is apportionable or non-apportionable income.

(3) "Trade or business", as used in the definition of apportionable income and in the application of that definition means the unitary business of the taxpayer, part of which is conducted within [this State].

(4) **Transactional Test.** Apportionable income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

(A) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within [this State], the resulting income of the transaction or activity is apportionable income for [this State]. Income may be apportionable income even though the actual transaction or activity that gives rise to the income does not occur in [this State].

(B) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services which are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of apportionable income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.

(5) **Functional test.** Apportionable income also includes income from tangible and intangible property, if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business. "Property" includes any direct or indirect interest in, control over, or use of real property, tangible personal property and intangible property by the taxpayer.

Property that is "related to the operation of the trade or business" refers to property that is or was used to contribute to the production of apportionable income directly or indirectly, without regard to the materiality of the contribution.

Property that is held merely for investment purposes is not related to the operation of the trade or business.

"Acquisition, management, employment, development or disposition" refers to a taxpayer's activities in acquiring property, exercising control and dominion over property and disposing of property, including dispositions by sale, lease or license. Income arising from the disposition or other utilization of property which was acquired or developed in the course of the taxpayer's trade or business constitutes apportionable income, even if the property was not directly employed the operation of the taxpayer's trade or business.

Income from the disposition or other utilization of property which has been withdrawn from use in the taxpayer's trade or business and is instead held solely for unrelated investment purposes is not apportionable. Property that was related to the operation of the taxpayer's trade or business is not considered converted to investment purposes merely because it is placed for sale, but any property which has been withdrawn from use in the

taxpayer's trade or business for five years or more is presumed to be held for investment purposes.

Example (i): Taxpayer purchases a chain of 100 retail stores for the purpose of merging those store operations with its existing business. Five of the retail stores are redundant under the taxpayer's business plan and are sold six months after acquisition. Even though the five stores were never integrated into the taxpayer's trade or business, the income is apportionable because the property's acquisition was related to the taxpayer's trade or business.

Example (ii): Taxpayer is in the business of developing adhesives for industrial and construction uses. In the course of its business, it accidentally creates a weak but non-toxic adhesive and patents the formula, awaiting future applications. Another manufacturer uses the formula to create temporary body tattoos. Taxpayer wins a patent infringement suit against the other manufacturer. The entire damages award, including interest and punitive damages, constitutes apportionable income.

Example (iii): Taxpayer is engaged in the oil refining business and maintains a cash reserve for buying and selling oil on the spot market as conditions warrant. The reserve is held in overnight "repurchase agreement" accounts of U.S. treasuries with a local bank. The interest on those amounts is apportionable business income because the reserves are necessary for the taxpayer's business operations. Over time, the cash in the reserve account grows to the point that it exceeds any reasonably expected requirement for acquisition of oil or other short-term capital needs and is held pending subsequent business investment opportunities. The interest received on the excess amount is non-apportionable income.

Example (iv): A manufacturer decides to sell one of its redundant factories to a real estate developer and transfers the ownership of the factory to a special purpose subsidiary, SaleCo (Taxpayer) immediately prior to its sale to the real estate developer. The parties elect to treat the sale as a disposition of assets under IRC 338(h)(10), resulting in Taxpayer recognizing a capital gain on the sale. The capital gain is apportionable income. Note: although the gain is apportionable, application of the standard apportionment formula in Section 17 may not fairly reflect the taxpayer's business presence in any state, necessitating resort to equitable apportionment pursuant to Section 18.

(A) Under the functional test, income from the disposition or other utilization of property is apportionable if the property is or was related to the operation of the taxpayer's trade or business. This is true even though the transaction or activity from which the income is derived did not occur in the regular course of the taxpayer's trade or business.

(B) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving

Comment [SHL1]: Note to Uniformity Committee. There is no explicit authorization for the five year rule in the model statute. However,, the work group is of the view that the proposed rule is reasonable and consistent with the statutory definition of apportionable income. As the five year rule only creates a presumption of non apportionable income, the rule should pass constitutional muster.

property, including transactions made in liquidation or the winding-up of business, is apportionable income, if the property is or was related to the taxpayer's trade or business. Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business, constitutes apportionable income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

(C) Under the functional test, income from intangible property is apportionable income when the intangible property serves an operational function as opposed to solely an investment function.

(D) If the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business, then income from that property is apportionable income even though the actual transaction or activity involving the property that gives rise to the income does not occur in [this State].

(E) Examples.

Example (i): A manufacturer purchases raw materials to be incorporated into the product it offers for sale. The nature of the raw materials is such that the purchase price is subject to extreme price volatility. In order to protect itself from extreme price increases (or decreases), the manufacturer enters into future contracts pursuant to which the manufacturer can either purchase a set amount of the raw materials for a fixed price, within a specified time period, or resell the future contracts. Any gain on the sale of the future contracts would be considered apportionable income, regardless of whether the contracts were either made or resold in [this State].

Example (ii): A national retailer produces substantial revenue related to the operation of its trade or business. It invests a large portion of the revenue in fixed income securities which are divided into three categories; (a) short-term securities held pending use of the funds in the taxpayer's trade or business; (b) short-term securities held pending acquisition of other companies or favorable developments in the long-term money market, and (c) long-term securities held as an investment. Interest income on the short-term securities held pending use of the funds in the taxpayer's trade or business (a) is apportionable because the funds represent working capital necessary to the operations of the taxpayer's trade or business. Interest income derived from the other investment securities ((b) and (c)) is not apportionable as those securities were not held in furtherance of the taxpayer's trade or business.

(F) If with respect to an item of property a taxpayer (i) takes a deduction from income that is apportioned to [this State] or (ii) includes the original cost in the property factor, it is presumed that the item or property is or was related to the operation of the taxpayer's trade or business. No presumption arises from the

absence of any of these actions.

(G) Application of the functional test is generally unaffected by the form of the property (*e.g.*, tangible or intangible property, real or personal property). Income arising from an intangible interest, as, for example, corporate stock or other intangible interest in an entity or a group of assets, is apportionable income when the intangible itself or the property underlying or associated with the intangible is or was related to the operation of the taxpayer's trade or business. Thus, while apportionment of income derived from transactions involving intangible property may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, *i.e.*, the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function.

(6) Relationship of transactional and functional tests to U.S. Constitution. The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income that has no rational relationship with the taxing state. The protection against extra-territorial state taxation afforded by these Clauses is often described as the “unitary business principle.” The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in [this State]. The unitary business that is conducted in [this State] includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same trade or business that is being conducted within [this State]. Determination of the scope of the unitary business being conducted in [this State] is without regard to extent to which [this State] requires or permits combined reporting.

(7) **Non-apportionable income.** Non-apportionable income means all income other than apportionable income.

••• **Reg. IV.1.(b). Principles for Determining the Existence of a Unitary Business.**

(1) Unitary Business Principle.

(A) *The Concept of a Unitary Business.* A unitary business is a single economic enterprise that is made up either of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to an entity located in this state that comes from being part of a unitary business conducted both within and without this state is what provides the constitutional due process “definite link and minimum connection” necessary for this state to apportion

apportionable income of the unitary business, even if that income arises in part from activities conducted outside the state. The apportionable income of the unitary business is then apportioned to this state using an apportionment percentage provided by [^{insert your state statute}].

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

- (B) *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this state, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

- (C) *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the apportionable income attributable to each separate unitary business as well as its non-apportionable income, which is specifically allocated. The apportionable income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

- (D) *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single entity or among a commonly controlled group of entities. The scope of what is included in a commonly controlled group of entities is set forth in Section V below.

(2) Determination of a Unitary Business

- (A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. ~~[RESERVED: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.]~~ Facts suggesting the presence of the factors mentioned above should

Comment [SHL2]: The workgroup recommends that this reservation be eliminated. The Commission has never promulgated the passive holding company regulation. Furthermore, the issue that gave rise to this concern (unitary holding company affiliates that hold debt) is now largely moot as most states have conceded the issue.

be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.

(B) Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.
 - a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales, because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.
 - b. *Common Marketing.* The sharing of common marketing features among entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the entities' products, services, or intangibles are distributed or sold to a common customer, when the entities use a common trade name or other common identification, or when the entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)
 - c. *Transfer or Pooling of Technical Information or Intellectual Property.* Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide

evidence of functional integration when the matter transferred is significant to the businesses' operations.

- d. *Common Distribution System.* Use of a common distribution system by the entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.
 - e. *Common Purchasing.* Common purchasing of substantial quantities of products, services, or intangibles from the same source by the entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.
 - f. *Common or Intercompany Financing.* Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more entities for the benefit of another entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)
2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single entity to another division within an entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.
- a. *Facts Providing Evidence of Centralization of Management.* Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are

common directors.

- b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.
3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.
 - a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.
 - b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. An entity that secures savings in the performance of corporate administrative services due to its affiliation with other entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) Indicators of a Unitary Business.

- (A) *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.
- (B) *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's

executive offices.

(C) *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

(4) Commonly Controlled Group of Entities.

(A) Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.

(B) A "commonly controlled group" means any of the following:

1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if--
 - a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,
 - b. Stock cumulatively possessing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more corporations described in subparagraph a, or one or more other corporations that satisfy the conditions of this subparagraph.
2. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.
3. Any two or more corporations that constitute stapled entities.
 - a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.
 - b. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or

interests are also transferred or required to be transferred.

4. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph 1 of subsection (E)) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.
- (C) 1. If, in the application of subsection (B), a corporation is a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only the commonly controlled group (or part thereof) with respect to which it has a unitary business relationship. If the corporation has a unitary business relationship with more than one of those groups, it shall elect to be treated as a member of only one of the commonly controlled groups with respect to which it has a unitary business relationship. This election shall remain in effect until the unitary business relationship between the corporation and the rest of the members of its elected commonly controlled group is discontinued, or unless revoked with the approval of the [state tax agency].
2. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (B) are not met, except as follows:
 - a. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subsection (B) are again met immediately after the sale, exchange, or disposition.
 - b. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subsection B are again met within a period not to exceed two years.
- (D) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph 4 of subsection (B) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subsection, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.
- (E) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.
1. An individual constructively owns stock that is owned by any of the following:
 - a. His or her spouse.

- b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.
 - c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.
2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.
 3. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), if more than 50% of the stock possessing voting power of a corporation is, in the aggregate, owned by or for the benefit of members of the same family, stock owned by that corporation shall be treated as constructively owned by members of that family in the same ratio as the proportion of their respective ownership of stock possessing voting power in that corporation to all of such stock of that corporation.
 4. Except as otherwise provided, stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.
 5. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.
 6. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), stock held by a limited partnership is constructively owned by a limited partner to the extent of the limited partner's capital interest in the limited partnership.
- (F) For purposes of the definition of a commonly controlled group, each of the following shall apply:
1. "Corporation" means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation (including but not limited to a limited liability company) pursuant to ^[insert your State statute].
 2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.

3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.
 4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.
 5. "Stock possessing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:
 - a. For one year or less.
 - b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.
 6. In the case of an entity treated as a corporation under paragraph 1 of subsection (F), "stock possessing voting power" refers to an instrument, contract, or similar document demonstrating an ownership interest in that entity that confers power in the owner to cast a vote in the selection of the management of that entity.
 7. In the general application of this section, if an entity may elect to be treated as a partnership or as a corporation under the laws of this state (or under Section 7701 of the Internal Revenue Code), and elects to be treated as a partnership, that entity shall be treated as a general partnership. If, however, contractual agreements, member agreements, or other restrictions limit the power of some or all of the members to participate in the vote of stock possessing voting power owned by that entity (similar to the restrictions of limited partners in a limited partnership), the [state tax agency] may permit or require that entity to be treated as a limited partnership.
- (G)The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:
1. Prescribe terms and conditions relating to the election described by subsection (C), and the revocation thereof.
 2. Disregard transfers of voting power not described by paragraph 5 of subsection (F).
 3. Treat entities not described by paragraph 2 of subsection (F) as a person.
 4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.

5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.
6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.
7. Treat limited partners as constructive owners of stock possessing voting power held by the limited partnership, in proportion to their interest in the partnership.

••• **Reg. IV.1.(c). Apportionable and Non-apportionable Income: Application of Definitions.** The following applies the foregoing principles for purposes of determining whether particular income is apportionable or non-apportionable income. The examples used throughout these regulations are illustrative only and are limited to the facts they contain.

(1) Rents from real and tangible personal property. Rental income from real and tangible property is apportionable income if the property with respect to which the rental income was received is or was used in the taxpayer's trade or business and therefore is includable in the property factor under Regulation IV.10.

Example (i): The taxpayer operates a multistate car rental business. The income from car rentals is apportionable income.

Example (ii): The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is apportionable income.

Example (iii): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The remaining two floors are held for future use in the trade or business and are leased to tenants on a short-term basis in the meantime. The rental income is apportionable income.

Example (iv): The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and leases the entire building to others. The net rental income is not apportionable income of the grocery store trade or business. Therefore, the net rental income is non-apportionable income.

Example (v): The taxpayer operates a multistate chain of men's clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate

headquarters. The remaining 18 floors are leased to others. The rental of the eighteen floors is not done in furtherance of but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not apportionable income of the clothing store trade or business. Therefore, the net rental income is non-apportionable income.

Example (vi): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(2) Gains or losses from sales of assets. Gain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes apportionable income if the property while owned by the taxpayer was related to the operation of the taxpayer's trade or business, or was otherwise properly included in the property factor of the taxpayer's trade or business.

Example (i): In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the trade or business. The gains or losses resulting from those sales constitute apportionable income.

Example (ii): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is apportionable income.

Example (iii): Same as (ii) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is apportionable income.

Example (iv): Same as (ii) except that the plant was rented while being held for sale. The rental income is apportionable income and the gain on the sale of the plant is apportionable income.

(3) Interest. Interest income is apportionable income where the intangible with respect to which the interest was received arose out of or was created in the regular course of the taxpayer's trade or business, or the purpose of acquiring and holding the intangible is related to the operation of the taxpayer's trade or business.

Example (i): The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are apportionable income.

Example (ii): The taxpayer conducts a multistate manufacturing business.

During the year the taxpayer receives a federal income tax refund pertaining to the taxpayer's trade or business and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is apportionable income.

Example (iii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The funds in those accounts earned interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations pertaining to the taxpayer's trade or business. The interest income is apportionable income.

Example (iv): The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is apportionable income.

Example (v): The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is apportionable income.

Example (vi): In January, the taxpayer sold all of the stock of a subsidiary for \$20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The funds are not pledged for use in the business. The interest income for the entire period between the receipt of the funds and their subsequent utilization or distribution to shareholders is non-apportionable income.

Comment [SHL3]: Following the last teleconference of the workgroup it was suggested changing "amounts" to "funds." It is the funds that are being pledged, not any particular amount in those funds.

(4) Dividends. Dividends are apportionable income where the stock with respect to which the dividends was received arose out of or was acquired in the regular course of the taxpayer's trade or business or where the acquiring and holding the stock is or was related to the operation of the taxpayer's trade or business, or contributes to the production of apportionable income of the trade or business.

Example (i): The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are apportionable income.

Example (ii): The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are apportionable income.

Example (iii): The taxpayer and several unrelated corporations own all of the stock of a corporation whose business consists solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing trade or business. The dividends are apportionable income.

Example (iv): The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are apportionable income.

Example (v): The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are apportionable income.

Example (vi): The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are non-apportionable income.

(5) Patent and copyright royalties. Patent and copyright royalties are apportionable income where the patent or copyright with respect to which the royalties were received arose out of or was created in the regular course of the taxpayer's trade or business or where the acquiring and holding the patent or copyright is or was related to the operation of the taxpayer's trade or business, or contributes to the production of apportionable income of the trade or business.

Example (i): The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are apportionable income.

Example (ii): The taxpayer is engaged in the music publishing trade or business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its trade or business. Any royalties received on these copyrights are apportionable income.

•• **Reg. IV.1(d). Proration of Deductions.** In most cases, an allowable deduction of a taxpayer will be applicable to only the apportionable income arising from a particular trade or business or to a particular item of non-apportionable income. In some cases, an

allowable deduction may be applicable to the apportionable incomes of more than one trade or business and to items of non-apportionable income. In such cases, the deduction shall be prorated among those trades or businesses and those items of non-apportionable income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

(1) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(2) State to state consistency. If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

••• **Reg. IV.2.(a). Definitions.**

(1) "Taxpayer" means [each state should insert the definition in Article II.3. or the definition in its own tax laws].

(2) "Apportionment" refers to the division of apportionable income between states by the use of a formula containing apportionment factors.

(3) "Allocation" refers to the assignment of non-apportionable income to a particular state.

(4) "Business activity" refers to the transactions and activities occurring in the regular course of a particular trade or business of a taxpayer and includes the acquisition, employment, development, management, or disposition of property that is or was related to the operation of the taxpayer's trade or business.

(5) "Gross receipts" are the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction which produces apportionable income, in which the income or loss is recognized (and, where foreign entities are included on a combined report, amounts which would be recognized if the relevant transactions or entities were in the United States) under the Internal Revenue Code. Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold.

[NOTE: States that maintain a list of nations that are considered tax shelters might consider additional language that would also include, in the definition of gross receipts, gross amounts realized by a taxpayer as a result of transactions which would produce apportionable income but for the fact that those transactions are sourced to a country that is included on the state's list of tax shelter nations].

Comment [SHL4]: Workgroup added foreign source income provision to address the fact that such income isn't generally reportable on a federal income tax return.

Comment [SHL5]: Following the last teleconference it was suggested that language to this effect be included. Oregon maintains such a list.

(6) "Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of Article IV, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded. Receipts, even if apportionable income, are presumed not to include such items as, for example:

- 1) damages and other amounts received as the result of litigation;
- 2) property acquired by an agent on behalf of another;
- 3) tax refunds and other tax benefit recoveries;
- 4) contributions to capital;
- 5) income from forgiveness of indebtedness;
- 6) amounts realized from exchanges of inventory that are not recognized by the Internal Revenue Code; or
- 7) Amounts realized as a result of factoring accounts receivable recorded on an accrual basis.

Comment [SHL6]: WORKGROUP CONCURS TO MODIFYING THE LIST. In addition, group should consider a similar list of receipts from the sale of assets that WOULD be included in the receipts factor. Also, this workgroup and the Section 17 workgroup should work together on this subsection (6) at it logically forms an intersection between the definition and the sourcing of such receipts.

In addition, receipts that are excluded from the receipts factor under provisions of Section 17 are also excluded from the definition of "receipts."

Exclusion of an item from the definition of "receipts" is not determinative of its character as apportionable or non-apportionable income. Nothing in this definition shall be construed to modify, impair or supersede any provision of Section IV.18.

••• **Reg. IV.2.(b)(1). Application of Article IV: Apportionment.** If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with Article IV.9. to IV.17.

••• **Reg. IV.2.(b)(2). Application of Article IV: Combined Report.** If a particular trade or business is carried on by a taxpayer and one or more affiliated corporations, nothing in Article IV or in these regulations shall preclude the use of a "combined report" whereby the entire apportionable income of such trade or business is apportioned in accordance with Article IV.9. to IV.17.

••• **Reg. IV.2.(b)(3). Application of Article IV: Allocation.** Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its non-apportionable income or loss within or without this state in accordance with Article IV.4. to IV.8.

••• **Reg. IV.2.(c). Consistency and Uniformity in Reporting.**

(1) **Year to year consistency.** In filing returns with this state, if the taxpayer departs from or modifies the manner in which income has been classified as apportionable income or non-apportionable income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification. [State should insert its requirements]

(2) State to state consistency. If the returns or reports filed by a taxpayer for all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as apportionable or non-apportionable income, the taxpayer shall disclose in its return to this state the nature and extent of the variance. [State should insert its requirements]

•• **Reg. IV.3.(a). Taxable in Another State: In General.** Under Article IV.2. the taxpayer is subject to the allocation and apportionment provisions of Article IV if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the taxpayer, by reason of such business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of Article IV.3.

(1) Applicable tests. A taxpayer is taxable within another state if it meets either one of two tests: (1) By reason of business activity in another state, the taxpayer is subject to one of the types of taxes specified in Article IV.3.(1), namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) By reason of such business activity, another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.

(2) Producing non-apportionable income. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of non-apportionable income or business activities relating to a separate trade or business.

•• **Reg. IV.3.(b).Taxable in Another State: When a Corporation Is "Subject to" a Tax under Article IV.3.(1).**

(1) A taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) if it carries on business activities in a state and the state imposes such a tax thereon. Any taxpayer which asserts that it is subject to one of the taxes specified in Article IV.3.(1) in another state shall furnish to the [tax administrator] of this state upon his/her request evidence to support that assertion. The [tax administrator] of this state may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in Article IV.3.(1) in the other state.

Voluntary tax payment. If the taxpayer voluntarily files and pays one or more of such taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization or for the privilege of doing business in that state, but

(A) does not actually engage in business activity in that state, or

(B) does actually engage in some business activity not sufficient for nexus and the

minimum tax bears no relationship to the taxpayer's business activity within such state, the taxpayer is not "subject to" one of the taxes specified within the meaning of Article IV.3.(1).

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the \$50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(2) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes enumerated in Article IV.3.(1) which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" one of the taxes specified in Article IV.3.(1) in another state.

Example (i): State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of \$50 and a maximum fee of \$500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not "taxable" in State A.

Example (ii): Same facts as Example (i) except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is "subject to" the net income tax of State A and is "taxable" in State A.

Example (iii): State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is "taxable" in State B.

Example (iv): State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax.

••• **Reg. IV.3.(c). Taxable in Another State: When a State Has Jurisdiction to Subject a Taxpayer to a Net Income Tax.** The second test, that of Article IV.3.(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-385. In the case of any "state" as defined in Article IV.1.(h), other than a state of the United States or political subdivision thereof, the determination of whether the "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that "state." If jurisdiction is otherwise present, that "state" is not considered as being without jurisdiction by reason of the provisions of a treaty between that "state" and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.

••• **Reg. IV.9. Apportionment Formula.** All apportionable income of each trade or business of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in Article IV.9. The elements of the apportionment formula are the property factor (see Regulation IV.10.), the payroll factor (see Regulation IV.13.) and the receipts factor (see Regulation IV.15.) of the trade or business of the taxpayer.

••• **Reg. IV.10.(a). Property Factor: In General.** The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of the trade or business. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency. Property used in connection with the production of non-apportionable income shall be excluded from the property factor. Property used both in the regular course of the taxpayer's trade or business and in the production of non-apportionable income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See Regulation IV.12.

••• **Reg. IV.10.(b). Property Factor: Property Used for the Production of Apportionable Income.** Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor. Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If

the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event that results in its conversion to the production of non-apportionable income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is no longer held for use in the trade or business.

Example (i): Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale one year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

Example (ii): Same as above except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

••• **Reg. IV.10.(c). Property Factor: Consistency in Reporting.**

(1) **Year to year consistency.** In filing returns with this state, if the taxpayer departs from or modifies the manner of valuing property or of excluding property from or including property in the property factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(2) **State to state consistency.** If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion of property from or the inclusion of property in the property factor, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

••• **Reg. IV.10.(d). Property Factor: Numerator.** The numerator of the property factor shall include the average value of the real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period in the regular course of the trade or business of the taxpayer. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment which are located within and without this state during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period. An automobile assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.

••• **Reg. IV.11.(a). Property Factor: Valuation of Owned Property.**

(1) Property owned by the taxpayer shall be valued at its original cost. As a general rule, "original cost" is deemed to be the basis of the property for federal income

tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. However, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes. [This last sentence was added on July 14, 1988.]

Example (i): The taxpayer acquired a factory building in this state at a cost of \$500,000 and, 18 months later, expended \$100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. Depreciation deduction in the amount of \$22,000 was claimed with respect to the building on the return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is \$600,000; the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example (ii): During the current taxable year, Corporation X merges into Corporation Y in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, Corporation X owns a factory which X built five years earlier at a cost of \$1,000,000. X has been depreciating the factory at the rate of two percent per year, and its basis in X's hands at the time of the merger is \$900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's hands, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e. \$1,000,000.

Example (iii): Corporation Y acquires the assets of Corporation X in a liquidation by which Y is entitled to use its stock cost as the basis of the X assets under Section 334(b)(2) of the 1954 Internal Revenue Code (i.e. stock possessing 80 percent control is purchased and liquidated within two years). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.

If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(2) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(3) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

••• **Reg. IV.11.(b). Property Factor: Valuation of Rented Property.**

(1) Multiplier and subrentals. Property rented by the taxpayer is valued at eight times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See Regulation IV.18.(b) for special rules when the use of such net annual rental rate produces a negative or clearly

inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.) Subrents are not deducted when they constitute apportionable income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

Example (i): The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are apportionable income, they are not deducted from rent paid by the taxpayer for the food market.

Example (ii): The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses on a short-term basis because it anticipates it will need those two floors for future expansion of its multistate business. The rental of all five floors is related to the operation of the taxpayer's trade or business. Since the subrents are apportionable income, they are not deducted from the rent paid by the taxpayer.

Example (iii): The taxpayer rents a 20-story office building and uses the lower two stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are non-apportionable income they are not included in the taxpayer's property factor.

(2) "Annual rental rate" is the amount paid as rental for property for a 12-month period (i.e., the amount of the annual rent). Where property is rented for less than a 12-month period, the rent paid for the actual period of rental shall constitute the "annual rental rate" for the tax period. However, where a taxpayer has rented property for a term of 12 or more months and the current tax period covers a period of less than 12 months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized. If the rental term is for less than 12 months, the rent shall not be annualized beyond its term. Rent shall not be annualized because of the uncertain duration when the rental term is on a month-to-month basis.

Example (i): Taxpayer A, which *ordinarily* files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with 5 years remaining is \$2,500 a month. The rent for the tax period January 1 to April 30 is \$10,000. After the rent is annualized the net rent is \$30,000 ($\$2,500 \times 12$).

Example (ii): Same facts as in *Example (i)* except that the lease would have terminated on August 31. In this case, the annualized rent is \$20,000 ($\$2,500 \times 8$).

(3) "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:

(A) Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor \$1,000 per month as a base rental and at the end of the year pays the lessor one percent of its gross sales of \$400,000. The annual rent is \$16,000 (\$12,000 plus one percent of \$400,000 or \$4,000).

(B) Any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and other items.

Example (i): A taxpayer, pursuant to the terms of a lease, pays the lessor \$12,000 a year rent plus taxes in the amount of \$2,000 and interest on a mortgage in the amount of \$1,000. The annual rent is \$15,000.

Example (ii): A taxpayer stores *part* of its inventory in a public warehouse. The total charge for the year was \$1,000 of which \$700 was for the use of storage space and \$300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is \$700.

(4) Exclusions. "Annual rent" does not include:

(A) Incidental day-to-day expenses such as hotel or motel accommodations, daily rental of automobiles, etc.; and

(B) Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.

(5) Leasehold improvements shall, for the purposes of the property factor, be treated as property owned by the taxpayer **regardless** of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

••• **Reg. IV.12. Property Factor: Averaging Property Values.** As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, the [tax administrator] may require or allow averaging by monthly values if that method of averaging is required

to properly reflect the average value of the taxpayer's property for the tax period.

Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or if property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

| | | | |
|----------|---------------|-----------|------------------|
| January | \$2,000 | July | \$15,000 |
| February | 2,000 | August | 17,000 |
| March | 3,000 | September | 23,000 |
| April | 3,500 | October | 25,000 |
| May | 4,500 | November | 13,000 |
| June | <u>10,000</u> | December | <u>2,000</u> |
| | \$25,000 | | \$95,000 |
| | | Total | <u>\$120,000</u> |

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\frac{\$120,000}{12} = \$10,000$$

Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of such property as set forth in Reg. IV.11.(b).

•• **Reg. IV.13.(a). Payroll Factor: In General.**

(1) The payroll factor of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

(2) The total amount "paid" to employees is determined upon the basis of the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes. The compensation of any employee on account of activities which are connected with the production of non-apportionable income shall be excluded from the factor.

Example (i): The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a

capital expenditure by the taxpayer. The amount of those wages is included in the payroll factor.

Example (ii): The taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.

••• **Reg. IV.13.(b). Payroll Factor: Denominator.** The denominator of the payroll factor is the total compensation paid everywhere during the tax period. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation, for example, by Public Law 86-272, is included in the denominator of the payroll factor.

Example: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In *addition* the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is immune from taxation under the provisions of Public Law 86-272. As to these latter employees, the compensation will be assigned to State C where their services are performed (i.e., included in the denominator but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C.

••• **Reg. IV.13.(c). Payroll Factor: Numerator.** The numerator of the payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The tests in Article IV.14. to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act. Accordingly, if compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report such compensation under that method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation purposes constitute compensation paid in this state except for compensation excluded under Regulation IV.13.(a). to IV.14. The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes.

••• **Reg. IV.14. Payroll Factor: Compensation Paid in This State.** Compensation is paid in this state if any one of the following tests, applied consecutively, are met:

(1) The employee's service is performed entirely within the state.

(2) The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state. The word "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

(3) If the employee's services are performed both within and without this state, the employee's compensation will be attributed to this state:

(A) if the employee's base of operations is in this state; or

(B) if there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or

(C) if the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this state.

The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points.

••• **Reg. IV.15.(a). Receipts Factor: In General.**

(1) Reg. IV.2.(a)(6). defines the term "receipts." The following are additional rules for determining "receipts" in various situations:

Comment [SHL7]: Should these be moved elsewhere, such as the definition of receipts?

(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "receipts" includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if the taxes are passed on to the buyer or included as part of the selling price of the product.

(B) In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, "receipts" includes the entire reimbursed cost plus the fee.

(C) In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency or the performance of equipment service contracts or research and development contracts, "receipts" includes the gross receipts from the performance of such services, including fees, commissions, and similar items.

(D) In the case of a taxpayer engaged in the sale of equipment used in the taxpayer's trade or business, where the taxpayer disposes of the equipment under a regular replacement program, "receipts" includes the gross receipts from the sale of this

equipment. For example, a truck express company that owns a fleet of trucks and sells its trucks under a regular replacement program the gross receipts from the sale of the trucks would be included in “receipts.”

(E) In the case of a taxpayer with insubstantial amounts of gross receipts arising from sales in the ordinary course of business, such receipts may be excluded from the receipts factor unless their exclusion would materially affect the amount of income apportioned to this state.

(2) Exceptions. In some cases certain gross receipts should be disregarded in determining the receipts factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business. See Regulation IV.18.(c).

(3) Year to year consistency. In filing returns with this state, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the receipts factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification. [Each state should insert its own reporting requirement].

(4) State to state consistency. If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under Article IV of this Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose in its return to this state the nature and extent of the variance. [Each state should insert its own reporting requirement].

••• **Reg. IV.15.(b). Receipts Factor: Denominator.** The denominator of the receipts factor shall include the gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under these regulations.

••• **Reg. IV.15.(c). Receipts Factor: Numerator.** The numerator of the receipts factor shall include gross receipts attributable to this state and derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under these regulations. All interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of (1) the place where the accounting records are maintained or (2) the location of the contract or other evidence of indebtedness.

••• **Reg. IV.16.(a). Receipts Factor: Sales of Tangible Personal Property in This State.**

(1) Gross receipts from sales of tangible personal property (except sales to the United States Government; see Regulation IV.16.(b)) are in this state:

(A) if the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or

(B) if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.

(2) Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

Example: The taxpayer, with inventory in State A, sold \$100,000 of its products to a purchaser having branch stores in several states, including this state. The order for the purchase was placed by the purchaser's central purchasing department located in State B. \$25,000 of the purchase order was shipped directly to purchaser's branch store in this state. The branch store in this state is the purchaser within this state with respect to \$25,000 of the taxpayer's sales.

(3) Property is delivered or shipped to a purchaser within this state if the shipment terminates in this state, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this state at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products shipped to the purchaser's warehouse in this state constitute property delivered or shipped to a purchaser within this state.

(4) The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state.

Example: A taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this state pursuant to purchaser's instructions. The sale by the taxpayer is in this state.

(5) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in this state, the sales are in this state.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route, the produce is diverted to the purchaser's place of business in this state in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this state.

(6) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.

Example: The taxpayer has its head office and factory in State A. It

maintains a branch office and inventory in this state. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in this state for approval and are filled by shipment from the inventory in this state. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this state, the state from which the merchandise was shipped.

(7) If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

(A) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

(B) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this state.

Example: The taxpayer in this state sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this state.

••• **Reg. IV.16.(b). Receipts Factor: Sales of Tangible Personal Property to the United States Government in This State.** Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. For the purposes of this regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example (i): A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The sale is a sale to the United States Government.

Example (ii): The taxpayer, as a subcontractor to a prime contractor with the National Aeronautics and Space Administration, contracts to build a component of a rocket for \$1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government.

••• **Reg. IV.17. Receipts Factor: Sales Other Than Sales of Tangible Personal Property in This State**

Comment [SHL8]: Reserved for revised Reg.IV.17

•• **Reg. IV.18.(a). Special Rules: In General.** Article IV.18. provides that if the allocation and apportionment provisions of Article IV do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one or more of the factors;
- (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Article IV.18. permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where the apportionment and allocation provisions contained in Article IV produce incongruous results.

In the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the foregoing regulations in respect to the apportionment formula may not set forth appropriate procedures for determining the apportionment factors. Nothing in Article IV.18. or in this Regulation IV.18. shall preclude [the tax administrator] from establishing appropriate procedures under Article IV.10. to 17. for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

•• **Reg. IV.18.(b). Special Rules: Property Factor.** The following special rules are established in respect to the property factor of the apportionment formula:

- (1) If the subrents taken into account in determining the net annual rental rate under Regulation IV.11.(b) produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the [tax administrator] or requested by the taxpayer.

In no case, however, shall the value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for the property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example: The taxpayer rents a 10-story building at an annual rental rate of \$1,000,000. Taxpayer occupies two stories and sublets eight stories for

\$1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or \$200,000.

(2) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for the property.

•• **Reg. IV.18.(c). Special Rules: Receipts Factor.** The following special rules are established in respect to the receipts factor of the apportionment formula:

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Comment [SHL9]: We decided to drop all of 4. Instead, this appears to be the appropriate place for special applications of Section 18 for those receipts that are "quasi-functional" in nature but nevertheless comprise significant portions of the taxpayer's income. Also, receipts of a securities dealer should be addressed here.