

ALABAMA DEPARTMENT OF REVENUE
ADMINISTRATIVE CODE
CHAPTER 810-27
MULTISTATE TAX COMPACT
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810-27-1-4-.01 Multistate Tax Compact Regulation Definitions.

(1) *Scope.* These Regulations are intended to set forth rules concerning the application of the apportionment and allocation provisions of Article IV ("Division of Income") of Section 40-27-1, Code of Alabama 1975, titled "Multistate Tax Compact". The apportionment rules set forth in these regulations are applicable to any taxpayer having business income, regardless of whether or not it has nonbusiness income, and the allocation rules set forth in these regulations are applicable to any taxpayer having nonbusiness income, regardless of whether or not it has business income.

(a) The only exceptions to the allocation and apportionment rules contained in these regulations are those set forth in Regulation 810-27-1-4-.18 pursuant to the authority of Section 40-27-1, Code of Alabama 1975, Article IV.18.

(b) These regulations are not intended to modify existing rules concerning jurisdictional standards.

(c) The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.

(2) *Business and Nonbusiness Income Defined.* Section 40-27-1, Article IV.1.(a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Section 40-27-1, Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

(a) Nonbusiness income means all income other than business income.

(b) The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or non-business income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (See Regulation 810-27-1-4-.01(c) for more specific examples of the classification of income as business or nonbusiness income.)

(3) *Business and Nonbusiness Income: Application of Definitions.* The following are rules and examples for determining whether particular income is business or nonbusiness income.

(a) *Rents and Royalties from real and tangible personal property.* Rental and royalty income from real and tangible property is business income if the property with respect to which the income was received is used in the taxpayer's trade or business or incidental thereto and therefore is includable in the property factor under Regulation 810-27-1-4-.10.

1. EXAMPLE: The taxpayer operates a multistate car rental business. The income from car rentals is business income.

2. EXAMPLE: 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 business income.

3. EXAMPLE: 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 taxpayer manages and leases the remaining two floors to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

4. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and hires an unrelated property management company to manage and lease the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

5. EXAMPLE: 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 taxpayer hires an unrelated property management company to manage and lease the remaining 18 floors 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. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

6. EXAMPLE: 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 business income and the gain on the sale

of the plant is business income.

7. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

8. EXAMPLE: The corporation is engaged in extracting natural resources. The corporation owns and operates or leases and operates mines or wells which are located in several states. For various reasons, the corporation ceases actual operation of the properties and leases or subleases mineral rights to others. Royalties are paid to the corporation by the operators based on units extracted and the royalty income is business income.

9. EXAMPLE: The corporation is engaged in lumber and related wood products business in various states. The corporation owns or leases timberlands which are used as raw materials for its lumber business. Some of the land is unsuitable and the corporation leases or subleases mineral rights to other parties. Royalties are paid to the corporation based on units extracted and the royalty income is business income.

10. EXAMPLE: The corporation acquires undeveloped land for future expansion of its multistate manufacturing business. The expansion plans are later discarded and mineral rights under the land are leased to others. The corporation receives royalties based on units extracted and the royalty income is nonbusiness income.

(b) *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 business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. See Regulation 810-27-1-4-.10.

1. EXAMPLE: In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

2. EXAMPLE: 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 business income.

3. EXAMPLE: 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 business income.

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

5. EXAMPLE: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

(c) *Interest.* Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

1. EXAMPLE: 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 business income.

2. EXAMPLE: The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is business income.

3. EXAMPLE: 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 moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

4. EXAMPLE: 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 business income.

5. EXAMPLE: 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 business income.

6. EXAMPLE: In January, the taxpayer sold all of the stock of a subsidiary not involved in the same trade or business of the taxpayer 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 interest income is nonbusiness income.

(d) *Dividends.* Dividends are business income where the stock, with respect to which the dividends are received, arises out of or was acquired in the regular course of the taxpayer's trade or business operations, or where the purpose of acquiring and holding the stock is related to, or incidental to, such trade or business operations.

1. EXAMPLE: 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 business income.

2. EXAMPLE: 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 business income.

3. EXAMPLE: The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist 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 the manufacturing business. The dividends are business income.

4. EXAMPLE: 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 business income.

5. EXAMPLE: 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 business income.

(e) *Patent and copyright royalties.* Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring or holding the patent or copyright is related to or incidental to such trade or business operations.

1. EXAMPLE: 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 business income.

2. EXAMPLE: The taxpayer is engaged in the music publishing 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 business. Any royalties received on these copyrights are business income.

(4) *Proration of Deductions.* In most cases, an allowable deduction of a taxpayer will be applicable to only the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases, an allowable deduction may be applicable to business income or several items of nonbusiness income. In such cases, the deduction shall be prorated among those items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable. Any allowable deduction that is applicable both to business and nonbusiness income of the taxpayer shall be prorated to each class of income in determining income subject to tax as provided below:

(a) *Interest Expense.* Interest expense shall be prorated to nonbusiness assets by multiplying total interest expense by the ratio of average cost of the nonbusiness assets to the average cost of the total assets. If any assets were acquired with stock of the taxpayer corporation, the value of such assets to the extent attributed to the taxpayer's stock shall be excluded from the computations.

(b) *Other Expenses.* Other type expenses applicable both to business and nonbusiness income shall be prorated in such a manner as to equitably assign such expenses to business or nonbusiness categories, as appropriate.

(c) *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.

(d) *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.

(5) Effective Date of Changes. The additions and deletions in this regulation shall be effective for the tax years beginning after December 31, 1996.

Author: Joe Garrett

Authority: §§ 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975

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810-27-1-4-.02 Application of Apportionment and Allocation.

(1) *Definitions.*

(a) 1. For all taxable years ending before January 1, 1997, "taxpayer" means any corporation, Subchapter K entity, firm, association, governmental unit or agency or person acting as a business entity in more than one state.

2. For all taxable years beginning after December 31, 1996, Ataxpayer \cong means any corporation, Subchapter K entity, firm, association, governmental unit or agency or other person acting as a business entity in more than one state, but does not include any individual.

(b) "Apportionment" refers to the division of net income between jurisdictions by the use of a formula containing apportionment factors.

(c) "Allocation" refers to the assignment of net income to a particular jurisdiction.

(d) "Business activity" refers to the transactions and activity occurring in the regular course of a trade or business of a taxpayer. Income from business activity includes business and nonbusiness income.

(e) "Purely personal services by an individual" refers to services rendered by a natural person either as an employee or which are personal services not involving the employment of capital other than a de minimis amount.

(f) "Employee" means (A) any officer of a corporation, or (B) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if included by an employer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act.

(g) "Personal services" refers to any activity for a taxable year which are generally recognized and accepted as rendering services of a personal character. Fields of activities generally recognized and accepted as rendering services of a personal character are, but not limited to, health (the provision of medical services by physicians, nurses, dentists, and other similar health-care professionals), law, engineering (including surveying and mapping), architecture, accounting, actuarial science, performing arts (the provision of services by actors, actresses, singers, musicians, entertainers, athletes, and similar artists), and consulting (the provision of advice and counsel).

(2) *Application of Article IV.*

(a) *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 section 40-27-1, Articles IV.9 to IV.17.

(b) Reserved.

(c) *Allocation.* Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with section 40-27-1, Articles IV.4 to IV.8.

(d) *Persons to which Article IV does not apply.* Any taxpayer shall not allocate and apportion his net income as provided in Article IV if such taxpayer has income from a business activity as

1. a financial organization,
2. a public utility, or

3.(I) for all taxable years ending before January 1, 1997, the rendering of purely personal services by a resident individual. Purely personal services of a resident individual are involved in the performance of personal services in any field, only if more than 95 percent of the time spent by an individual is devoted to the performance of personal services. For purposes of determining whether this more than 95 percent test is satisfied, the performance of any activity incident to the actual performance of personal services is considered the performance of personal services. Activities incident to the performance of personal services include the supervision of employees engaged in directly providing personal services to clients, and the performance of administrative and support services incident to such activities.

(I) EXAMPLE: Taxpayer A, a resident individual of Alabama, is compensated for services as an employee which are rendered in Alabama and in State G. Taxpayer A is not permitted to allocate and apportion net income under Article IV. Relevant to this determination is the fact that the taxpayer is an employee.

(II) EXAMPLE: Same facts as (I) above except that Taxpayer A is treated as an independent contractor required, in order to render personal services, to purchase and use a vehicle, a computer, software, and office supplies. Taxpayer A is not permitted to allocate and apportion net income under Article IV. Relevant to this determination is the fact that the taxpayer is rendering services of a personal character involving the employment of a de minimis amount of capital for the required purchases

(III) EXAMPLE: Taxpayer D, a resident individual of Alabama, owns medical offices in Alabama and in State G with employees (receptionist, bookkeeper, nurse, etc.) in both offices and uses a significant amount of medical office equipment in providing medical care and lab tests. Taxpayer D is permitted to allocate and apportion net income under

Article IV. Relevant to this determination is the fact that the taxpayer's business activity is not purely personal since the taxpayer employs a significant amount capital in the production of revenue.

(ii) For all taxable years beginning after December 31, 1996, Article IV does not apply to an individual.

(e) *Public utility election.* If a taxpayer has income from business activity as a public utility which is not permitted to allocate and apportion net income pursuant to (2)(d) 2. above but derives more than 50 percent of income from business activities otherwise subject to this regulation, the taxpayer may elect, with a timely filed original return, to allocate and apportion the entire net income as provided for in Article IV of § 40-27-1.

1. If a taxpayer engaged in multistate business does not elect the reporting option available in (e) above or is not eligible to make the election then the taxpayer shall use separate (direct) accounting to determine income earned in this state.

(3) *Consistency and Uniformity in Reporting.*

(a) *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 business income or nonbusiness income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(b) *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 the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as business or nonbusiness income, the taxpayer shall disclose in the return to this state the nature and extent of the variance.

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Authority: §§ 40-2A-7(a)(5), 40-27-1, and 40-18-57, Code of Alabama 1975

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810-27-1-4-.03 Taxable in Another State.

(a) *Taxable in Another State: In General.* Under section 40-27-1, Article IV.2, the taxpayer is subject to the allocation and apportionment provisions of section 40-27-1, Article IV, if it has income from business activity that is taxable both within and without this state. Income from business activity includes business or nonbusiness income. Thus, if a taxpayer has nonbusiness income taxable by one state and business income taxable by another state, the taxpayer shall be taxable in another state within the meaning of section 40-27-1, 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 section 40-27-1, 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.

(b) *Taxable in Another State: When a Corporation is Subject to a Tax Under Section 40-27-1, Article IV.3(1).*

(1) A taxpayer is "subject to" one of the taxes specified in section 40-27-1, Article IV.3(1) if it carries on business activities in a state. Any taxpayer which asserts that it is subject to one of the taxes specified in section 40-27-1, Article IV.3(1) in another state shall furnish to the Commissioner of this state upon his/her request evidence to support that assertion. The Commissioner 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 section 40-27-1, 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 section 40-27-1, Article IV.3(1) and is therefore not "taxable in another state".

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 section 40-27-1, 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 section 40-27-1, Article IV.3(1) in another state.

(i) EXAMPLE: 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.

(ii) EXAMPLE: 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.

(iii) EXAMPLE: 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.

(iv) 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 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.

(c) *Taxable in Another State:* When a State has Jurisdiction to Subject a Taxpayer to a Net Income Tax. The second test, that of section 40-27-1, Article IV.3(2), applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax 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 section

40-27-1, 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.

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Authority: §§ 40-2A-7(a)(5) and 40-18-57
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810-27-1-4-.09 Apportionment Formula.

All business income of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in section 40-27-1, Article IV.9. The elements of the apportionment formula are the property factor (see Regulation 810-27-1-4-.10.), the payroll factor (see Regulation 810-27-1-4-.13.) and the sales factor (see Regulation 810-27-1-4-.15.) of the trade or business of the taxpayer. For taxpayers with a business interest in an unincorporated entity (e.g., partnership, unincorporated joint-venture, limited liability company taxed as a partnership, etc.), the elements of the apportionment formula shall include the pro rata share of the unincorporated entity's factor data. If any factor is not utilized in the production of business income, it shall be eliminated and the denominator reduced accordingly. The taxpayer may request, or the Commissioner may require, the use of a replacement factor in lieu of the eliminated factor where appropriate. See regulation 810-27-1-4-.18.

(i) EXAMPLE: Corporation C has a 20% distributive share of Partnership P's income which is included in C's apportionable business income. There are no transactions between C and P. Using the regulations for computing the elements of the apportionment formula, C has its own apportionment factor data as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property	550,000	600,000
Payroll	1,800,000	2,000,000
Sales 1,500,000	7,000,000	

Using the regulations for computing the elements of the apportionment formula at the partnership level, C's 20% share of P's apportionment factor data is as follows :

	<u>Alabama</u>	<u>Everywhere</u>
Property (20% of 100,000)	20,000	(20% of 275,000) 55,000
Payroll (20% of 50,000)	10,000	(20% of 125,000) 25,000
Sales (20% of 75,000)	15,000	(20% of 350,000) 70,000

C must compute its apportionment formula as follows:

	<u>Alabama</u>	<u>Everywhere</u>
Property (550,000+20,000)	570,000	(600,000+55,000) 655,000
Payroll (1,800,000+10,000)	1,810,000	(2,000,000+25,000) 2,025,000
Sales (1,500,000+15,000)	1,515,000	(7,000,000+70,000) 7,070,000

Property	(570,000) 655,000)	87.0229%
Payroll	(1,810,000) 2,025,000)	89.3827%
Sales	(1,515,000) 7,070,000)	<u>21.4286%</u>
Sum of Factor Percentages	197.8342%	
Divide by Number of Factors Used	<u>) 3</u>	
Apportionment Factor Average Percentage	<u>65.9447%</u>	

(ii) EXAMPLE: Assume same facts as in (i) except that C owns a building costing \$100,000 that is rented to P for \$12,000 per year. C must include the original cost of the building (\$100,000) in its property factor. Therefore, no portion of the value of P's rented property will be reflected in the property factor of C. C would eliminate intercompany rents (20% of \$12,000 is \$2,400) to the extent of its partnership interest from the net annual rental rate.

(iii) EXAMPLE: Assume same facts as in (ii) except that P owns the building at the same original cost and rents it to C. C will include \$20,000 (20% of \$100,000) in its property factor because of its interest in P. In addition, C must include its rental expense in its property factor in order to give weight to the rented building used in C's operations. C would eliminate intercompany rental expense of \$2,400 (20% of \$12,000) from its rent expense in its property factor before applying the multiplier of eight. Thus, the value of the building which is to be included in C's property factor is \$96,800 (\$20,000 plus \$76,800 [8 x \$9,600 (\$12,000 less \$2,400)]).

(iv) EXAMPLE: Same facts as in (i) except that C sells \$30,000 to P. In the computation of the sales factor of C, \$6,000 (20% of C's \$30,000 sales to P) will be eliminated. Thus, the amount of sales which is to be included in C's sales factor is \$7,064,000 (\$7,000,000 plus partnership sales of \$70,000 less eliminated sales of \$6,000).

(v) EXAMPLE: Same facts as in (i) except that P sells \$60,000 to C. In the computation of C's sales factor, \$12,000 (20% of P's \$60,000 sales to C) will be eliminated. Thus, the amount of sales which is to be included in C's sales factor is \$7,058,000 (\$7,000,000 plus partnership sales of \$70,000 less eliminated sales of \$12,000).

Author: Peter M. Petrillo, Jr.

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810-27-1-4-.10 Property Factor.

(a) *Property Factor: In General.* The property factor of the apportionment formula shall include all real and tangible personal property owned or used during the tax period to produce business income. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property used in connection with the production of business income but does not include coin or currency. Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used in connection with both the production of business and nonbusiness income shall be included in the factor only to the extent that the property was used in connection with the production of business income. 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 810-27-1-4-.12.

(b) *Property Factor: Property Used for the Production of Business 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 for the production of business income. 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 inventorable goods in process) shall be excluded from the factor until such property is actually used for the production of business income. If the property is partially used for the production of business income while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the production of business income shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale.

(i) EXAMPLE: 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.

(ii) EXAMPLE: Same as above except that the property was rented until the plant was sold. The rental income is business income and the plant is included in the property factor until the plant is sold.

(iii) EXAMPLE: Taxpayer closed its manufacturing plant and leased the building under a five-year lease. The plant is included in the property factor until the commencement of the lease.

(iv) EXAMPLE: The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into three small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property

is removed from the property factor on the date on which the remodeling of Store A commenced.

(v) EXAMPLE: The plant was sold shortly after it was put up for sale. Cases will vary as to the lapse of time until there is a sale. If a closed plant remains unsold for five years after it is put up for sale, it is to be removed from the property factor.

(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 the Multistate Tax 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.

(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.

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810-27-1-4-.11 Property Factor: Valuation.

(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 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. See § 40-18-6 and regulations thereunder for basis determination rules.

(i) *EXAMPLE:* 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.

(ii) *EXAMPLE:* 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.

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

If 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.

(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 810-27-1-4-.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 business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income. Accordingly there is no reduction in its value.

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

(ii) EXAMPLE: The taxpayer rents a 5-story office building primarily for use in its multistate business, uses three floors for its offices and subleases two floors to various other businesses and persons such as professional people and shops. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

(iii) EXAMPLE: 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. Since the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

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

(i) EXAMPLE: 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 ($\$2,500 \times 12$).

(ii) EXAMPLE: 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.

(i) EXAMPLE: 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.

(ii) EXAMPLE: 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.

(5) *Leasehold improvements.* 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.

(c) *Property Factor: Under Completed Contract Method of Accounting.*

(1) Taxpayers using the completed contract method of accounting shall assign the values of property owned and utilized in the performance of such contracts to this state in the ratio of gross receipts from contracts completed in this state during the tax period to gross receipts from all completed contracts during the tax period. Such property not utilized in the performance of the completed contracts shall be assigned as otherwise

provided in this regulation.

(2) For property rented and utilized in the performance of completed contracts, such property shall be valued at eight (8) times the rental rate for the completed contract period.

Author: Peter M. Petrillo, Jr.

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810-27-1-4-.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 Commissioner 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:

$$\$120,000 \div 12 = \$10,000$$

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. 810-27-1-4-.11(b).

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810-27-1-4-.13 Payroll Factor .

(a) *Payroll Factor: In General.*

(1) The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation in the production of business income, and the denominator of which is the total compensation paid for the production of business income everywhere 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 payroll factor includes only compensation which is attributable to the business income subject to apportionment. The compensation of any employee on account of activities which are connected with the production of nonbusiness income shall be excluded from the factor.

(i) EXAMPLE: 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.

(ii) EXAMPLE: The taxpayer owns various securities from which nonbusiness income is derived. 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.

(3) The term "compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the federal Internal Revenue Code. In the case of employees not subject to the federal Internal Revenue Code, e.g., those employed in foreign countries, the determination of whether such benefits or services would constitute income to the employees shall be made as though such employees were subject to the federal Internal Revenue Code.

(4) The term "employee" means (A) any officer of a corporation, or (B) any individual who, under the usual common-law rules applicable in determining the

employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if he is included by the taxpayer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act; except that, since certain individuals are included within the term "employees" in the Federal Insurance Contributions Act who would not be employees under the usual common-law rules, it may be established that a person who is included as an employee for purposes of the Federal Insurance Contributions Act is not an employee for purposes of this regulation.

(5) *Year to year consistency.* In filing returns with this state, if the taxpayer departs from or modifies the treatment of compensation paid used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(6) *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 the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the treatment of compensation paid, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

(b) *Payroll Factor: Denominator.* The denominator of the payroll factor is the total compensation paid for the production of business income everywhere during the tax period. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is exempt 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 exempt 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.

(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 in the production of business income. The tests in section 40-27-1, 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 810-27-1-4-.13(a) to 810-27-1-4-.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.

(d) *Payroll Factor: Under the Completed Contract Method of Accounting* For taxpayers utilizing the completed contract method of accounting, the payroll factor shall include all payroll costs attributed to the contracts completed during the tax period. Payroll costs not directly attributed to the completed contract projects, such as administrative salaries, shall be reported as otherwise provided in this regulation.

Author: Peter M. Petrillo, Jr.

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810-27-1-4-.14 Payroll Factor: Compensation Paid in this State.

(a) 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.

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810-27-1-4-.15 Sales Factor.

(a) *Sales Factor: In General.*

(1) Section 40-27-1, Article IV.1(g) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under paragraphs (5) through (8) of section 40-27-1, Article IV. Thus, for the purposes of the sales factor of the apportionment formula, the term "sales" means generally all gross receipts derived by the taxpayer from transactions and activity in the course of its regular trade or business operations which produce business income within the meaning of paragraph (1)(a) of section 40-27-1, Article IV. The following are rules for determining "sales" in various situations:

(A) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" 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, "sales" 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, "sales" 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 renting real or tangible property, "sales" includes the gross receipts from the rental, lease, or licensing the use of the property.

(E) In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.

(F) If a taxpayer derives receipts from the sale of equipment used in its business, those receipts constitute sales. For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.

(2) *Exceptions.* In some cases certain gross receipts should be disregarded in determining the sales 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 810-27-1-4-.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 sales 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.

(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 the Multistate Tax 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.

(b) *Sales Factor: Denominator.* The denominator of the sales factor shall include the total gross receipts from sales, except receipts excluded under Regulation 810-27-1-4-.18(c).

(c) *Sales Factor: Numerator.* The numerator of the sales factor shall include gross receipts from sales attributable to this state. All interest income, service charge, 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.

(d) *Sales Factor: Under the Completed Contract Method of Accounting.* For taxpayers utilizing the completed contract method of reporting income, the receipts from such contracts completed during the tax period shall be included in the sales factor. Other receipts not directly attributable to the completed contracts shall be included in the sales factor as otherwise provided in this regulation.

Author: Peter M. Petrillo, Jr.
Authority: 40-2A-7(a)(5) and 40-18-57
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810-27-1-4-.16 Sales Factor: Tangible Personal Property.

(a) *Sales 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 810-27-1-4-.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 property will be deemed to have been shipped from this state and the sale is attributed to 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 merchandise is deemed to have been shipped from State B to the purchaser in State A and the sale is in State B. If the taxpayer is not taxable in State B, the merchandise is deemed to have been shipped from this state by the taxpayer to the purchaser in State A and the sale is in this state.

(b) *Sales Factor: Sales of Tangible Personal Property to United States Government in this State.*

(1) 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.

(i) EXAMPLE: 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.

(ii) EXAMPLE: 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.

(2) When the United States Government is the purchaser of property which remains in the possession of the taxpayer in this state for further processing under another contract, or for other reasons, "shipment" is deemed to be made at the time of acceptance by the United States Government.

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810-27-1-4-.17 Sales Factor: Sales Other Than Sales of Tangible Personal Property.

(a) *In General.* Section 40-27-1, Article IV.17 provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section, gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

(b) *Income Producing Activity: Defined.* The term "income producing activity" means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

(1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

(2) The sale, rental, leasing, licensing or other use of real property.

(3) The rental, leasing, licensing or other use of tangible personal property.

(4) The sale, licensing or other use of intangible personal property.

(c) *Income Producing Activity: Business Situs.* The income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is the commercial domicile of the taxpayer unless the property has acquired a "business situs" elsewhere. "Business situs" is I. the place at which intangible personal property is employed as capital; or II. the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property. This rule shall not apply to the performance of construction contracts.

EXAMPLE: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters pledges bonds in this state as security for the payment of taxes incurred or to be incurred in connection with its business activities in this state. The property has a business situs in this state; therefore, interest income derived from such bonds is attributable to this state.

(d) *Costs of Performance: Defined.* The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in

accordance with accepted conditions or practices in the trade or business of the taxpayer.

(e) *Application.*

(1) *In General.* Receipts (other than from sales of tangible personal property) which do not constitute a principal source of business income and which such receipts are included in the denominator of the receipts factor are in this state if:

(A) the income producing activity is performed wholly within this state; or

(B) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

(i) *EXAMPLE:* The taxpayer is engaged in the heavy construction business in which it uses cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term rentals of the equipment when not needed on any project. The taxpayer rented some of the equipment to A for three weeks. The equipment was used by A for two weeks in this state and one week in State X. The taxpayer's direct costs in connection with the equipment during the rental period was \$500 each week. Accordingly, the greater proportion of such costs was incurred in this state. All of the rental receipts are business income and for purposes of the sales factor are included in the numerator for this state.

(ii) *EXAMPLE:* Taxpayer, whose commercial domicile is in this state, manufactures and sells industrial chemicals. Taxpayer owns 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 which constitute a relatively minor amount of its income. The royalties are business income and for purposes of the sales factor are included in the numerator for the state of the taxpayer's commercial domicile.

(2) *Special Rules.* The following are special rules for determining when receipts from the income producing activities described below which constitute a principal source of business income are in this state:

(A) Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

(B) Gross receipts from the rental, lease, or licensing the use of or other use of tangible personal property are in this state if the property is located in this state during the entire period of rental, lease, license or other use. If the property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during that period.

EXAMPLE: Taxpayer is the owner of 10 railroad cars. During the year, the total of the days during which each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{(10 \times 50) = 500}{3650} \times \text{Total Receipts} = \text{Receipts Attributable to this State}$$

(C) Gross receipts for the performance of personal services are attributable to this state to the extent that such services are performed in this state. If services are performed partly within and partly without this state, the gross receipts from the performance of such services shall be attributable to this state based upon the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

(i) EXAMPLE: Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

(ii) EXAMPLE: The taxpayer, a public opinion survey corporation, conducted a poll by means of its employees in State X and in this state for the sum of \$9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man hours were expended in this state. The receipts attributable to this state are \$3,000.

$$\frac{200 \text{ man hours}}{600 \text{ man hours}} \times \$9,000 = \$3,000$$

(D) Gross receipts from intangible personal property shall be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere for the tax period.

(E) The provisions of this paragraph shall apply to sales other than sales of tangible personal property to the United States Government.

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810-27-1-4-.18 Special Rules.

(1) *Special Rules: In General.* Section 40-27-1, Article IV.18 provides that, if the allocation and apportionment provisions of Section 40-27-1, Article IV do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Commissioner may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any one or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(e) Section 40-27-1, Article IV.18, permits a departure from the allocation and apportionment provisions of Section 40-27-1, Article IV, only in limited and specific cases. Section 40-27-1, Article IV.18, may be invoked only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results under the apportionment and allocation provisions contained in Section 40-27-1, Article IV.

(f) In the case of certain industries, the foregoing regulations in respect to the apportionment formula do not set forth appropriate procedures for determining the apportionment factors. Nothing in Section 40-27-1, Article IV.18, or in this Regulation 810-27-1-4-.18 shall preclude the Commissioner from establishing appropriate procedures under Section 40-27-1, Article IV.10 to 17, inclusive, for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly.

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

(a) If the subrents taken into account in determining the net annual rental rate under Regulation 810-27-1-4-.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 Commissioner or requested by the taxpayer.

1. 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.

(b) 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.

(3) *Special Rules: Sales Factor.* The following special rules are established in respect to the sales factor of the apportionment formula:

(a) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

(b) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture, business automobiles, etc.

(4) *Special Regulation: Construction Contractors.* The following special rules are established in respect to the apportionment of income of long-term construction contractors:

(a) *In General.* When a taxpayer elects to use the percentage of completion method of accounting, or the completed contract method of accounting for long-term contracts (construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted), and has income from sources both within and without this state from a trade or business, the amount of business income derived from such long-term contracts from sources within this state shall be determined pursuant to this regulation. In such cases, the first step is to determine which portion of the taxpayer's income constitutes "business income" and which portion constitutes "nonbusiness income" under Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01 thereunder. Nonbusiness income is directly allocated to specific states pursuant to the provisions of Section 40-27-1, Article IV.5 to 8, inclusive. Business income is apportioned among the states in which the business is conducted pursuant to the property, payroll, and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state and (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax by this state.

(b) *Business and Nonbusiness Income.* For definitions, rules and examples for determining business and nonbusiness income, see Regulation 810-27-1-4-.01.

(c) *Methods of Accounting and Year of Inclusion.* For general rules of accounting, definitions and methods of accounting for long-term construction contracts see the provisions of Section 40-18-13 and the regulations thereunder.

(d) *Apportionment of Business Income.*

1. *In General.* All business income is apportioned to this state by use of the apportionment formula set forth in section 40-27-1, Article IV.9 and Regulation 810-27-1-4-.09 regardless of the method of accounting for long-term contracts elected by the taxpayer. The apportionment percentage is then applied to business income to determine the amount apportioned to this state.

2. *Percentage of Completion Method.* Under this method of accounting for long-term contracts, the amount to be included each year as business income from each contract is the amount by which the gross contract price which corresponds to the percentage of the entire contract which has been completed during the income year exceeds all expenditures made during the income year in connection with the contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each such contract.

EXAMPLE: A taxpayer using the percentage of completion method of accounting for long-term contracts, entered into a long-term contract to build a structure for \$9,000,000. The contract allowed three years for completion and, as of the end of the second income year, the taxpayer's books of account, kept on the accrual method, disclosed the following:

	Receipts	Expenditures
End of 1st income year	\$2,500,000	\$2,400,000
End of 2nd income year	<u>4,500,000</u>	<u>4,100,000</u>
Totals	<u>\$7,000,000</u>	<u>\$6,500,000</u>

In computing the above expenditures, consideration was given to material and supplies on hand at the beginning and end of each income year. It was estimated that the contract was 30% completed at the end of the first income year and 80% completed at the end of the second income year. The amount to be included as business income for the first income year is \$300,000 (30% of \$9,000,000 or \$2,700,000 less expenditures of \$2,400,000 equals \$300,000). The amount to be included as business income for the second income year is \$400,000 (50% of \$9,000,000 or \$4,500,000 less expenditures of \$4,100,000 equals \$400,000).

3. *Completed Contract Method.* Under this method of accounting business income derived from long-term contracts is reported for the income year in which the contract is finally completed and accepted. Therefore, a special computation is required to compute the amount of business income attributable to this state from each completed

contract (see paragraph (4)(e) of this regulation). Thus, all receipts and expenditures applicable to such contracts whether complete or incomplete as of the end of the income year are excluded from business income derived from other sources, as for example, short-term contracts, interest, rents, royalties, etc., which is apportioned by the regular three-factor formula of property, payroll and sales.

4. *Property Factor.* In general the numerator and denominator of the property factor shall be determined as set forth in Section 40-27-1, Article IV.10 to 12, inclusive, and Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12. However, the following special rules are also applicable:

(i) The average value of the taxpayer's cost (including materials and labor) of construction in progress, to the extent that such costs exceed progress billings (accrued or received, depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The value of any such construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

EXAMPLE 1: Taxpayer commenced a long-term construction project in this state as of the beginning of a given year. By the end of its second year, its equity in the costs of production to be reflected in the numerator and denominator of its property factor for such year is computed as follows:

	1st Year		2nd Year	
	Beginning	Ending	Beginning	Ending
Construction Costs	0	\$1,000,000		
Progress Billings		<u>600,000</u>		
Balance 12/31 - (1/1)		<u>\$ 400,000</u>	<u>\$ 400,000</u>	
Construction Costs: Total from beginning of Project				
\$5,000,000				
Progress billings: Total from beginning of Project				
<u>4,000,000</u>				
Balance 12/31				
1,000,000				
Balance beginning of Year				
<u>400,000</u>				
Total				
<u>\$1,400,000</u>				
Average (□) - Value used in property factor				<u>\$ 700,000</u>

Note: It may be necessary to use monthly averages if yearly averages do not properly reflect the average value of the taxpayer's equity; see Section 40-27-1, Article IV.12 and Regulation 810-27-1-4-.12.

EXAMPLE 2: Same facts as in EXAMPLE 1, except that progress billings exceeded construction costs. No value for the taxpayer's equity in the construction project is shown in the property factor.

(ii) Rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though such rental expense may be capitalized into the cost of construction.

(iii) The property factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though under the completed contract method of accounting, business income is computed separately (see paragraph (4)(e) of this regulation).

5. *Payroll Factor.* In general the numerator and denominator of the payroll factor shall be determined as set forth in Section 40-27-1, Articles IV.13 and IV.14 and Regulations 810-27-1-4-.13 and 810-27-1-4-.14. However, the following special rules are also applicable:

(i) Compensation paid employees which is attributable to a particular construction project is included in the payroll factor even though capitalized into the cost of construction.

(ii) Compensation paid employees who in the aggregate perform most of their services in a state to which their employer does not report them for unemployment tax purposes, shall nevertheless be attributed to the state in which the services are performed.

EXAMPLE: A taxpayer engaged in a long-term contract in state X sends several key employees to that state to supervise the project. The taxpayer, for unemployment tax purposes, reports these employees to state Y where the main office is maintained and where the employees reside. For payroll factor purposes and in accordance with Section 40-27-1, Article IV.14 and Regulation 810-27-1-4-.14 thereunder, the compensation is assigned to the numerator of state X.

(iii) The payroll factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately (see paragraph (4)(e) of this regulation).

(iv) *Sales Factor.* In general, the numerator and denominator of the sales factor shall be determined as set forth in Section 40-27-1, Article IV.15 to 17, inclusive, and Regulations 810-27-1-4-.15, 810-27-1-4-.16, and 810-27-1-4-.17. However, the following special rules are also applicable:

(i) Gross receipts derived from the performance of a contract are attributable to this state if the construction project is located in this state. If the construction project is located partly within and partly without this state, the gross receipts attributable to this state are based upon the ratio which construction costs for the project in this state incurred during the income year bear to the total of construction costs for the entire project during the income year, or upon any other method, such as engineering cost estimates, which will provide a reasonable apportionment.

EXAMPLE 1: A construction project was undertaken in this state by a calendar year taxpayer which had elected one of the long-term contract methods of accounting. The following gross receipts (progress billings) were derived from the contract during the three income years that the contract was in progress.

	<i>1st Year</i>	<i>2nd Year</i>	<i>3rd Year</i>
Gross Receipts	<u>\$1,000,000</u>	<u>\$4,000,000</u>	<u>\$3,000,000</u>

The gross receipts to be reflected in both the numerator and denominator of the sales factor for each of the three years are the amounts shown.

EXAMPLE 2: A taxpayer contracts to build a dam on a river at a point which lies half within this state and half within state X. During the taxpayer's first income year, construction costs in this state were \$2,000,000. Total construction costs for the project during the income year were \$3,000,000. Gross receipts (progress billings) for the year were \$2,400,000. Accordingly, gross receipts of \$1,600,000 ($\$2,000,000/\$3,000,000 \times \$2,400,000$) are included in the numerator of the sales factor.

(II) If the percentage of completion method is used, the sales factor includes only that portion of the gross contract price which corresponds to the percentage of the entire contract which was completed during the income year.

EXAMPLE 3: A taxpayer which had elected the percentage of completion method of accounting entered into a long-term construction contract. At the end of its current income year (the second since starting the project), it estimated that the project was 30% completed. The bid price for the project was \$9,000,000 and it had received \$2,500,000 from progress billings as of the end of its current income year. The amount of gross receipts to be included in the sales factor for the current income year is \$2,700,000 (30% of \$9,000,000), regardless of whether the taxpayer uses the accrual method or the cash method of accounting for receipts and disbursements.

(III) If the completed contract method of accounting is used, the sales factor includes the portion of the gross receipts (progress billings) received or accrued, whichever is applicable, during the income year attributable to each contract.

EXAMPLE 4: A taxpayer which had elected the completed contract method of accounting entered into a long-term construction contract. By the end of its current income year (the second since starting the project), it had billed and had accrued on its books a total of \$5,000,000 of which \$2,000,000 had accrued in the first year in which the contract was undertaken and \$3,000,000 had accrued in the current (second) year. The amount of gross receipts to be included in the sales factor for the current income year is \$3,000,000.

EXAMPLE 5: Same facts as in EXAMPLE 4 except that the taxpayer keeps its books on the cash basis and, as of the end of its current income year, had received only \$2,500,000

of the \$3,000,000 billed during the current year. The amount of gross receipts to be included in the sales factor for the current income year is \$2,500,000.

(IV) The sales factor, except as noted above in paragraphs (4)(d)5.(iv)(II) and (4)(d)5.(iv)(III) of this regulation, is computed in the same manner, regardless of which long-term method of accounting the taxpayer has elected, and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately.

(V) *Apportionment Percentage.* The apportionment formula is set forth in section 40-27-1, Article IV.9 and Regulation 810-27-1-4-.09. The apportionment percentage is then applied to business income to establish the amount apportioned to this state.

(e) *Completed Contract Method - Special Computation.* The completed contract method of accounting requires that the reporting of income (or loss) be deferred until the year in which the construction project is completed or accepted. Accordingly, a separate computation is made for each such contract completed during the income year, regardless of whether the project is located within or without this state, in order to determine the amount of income which is attributable to sources within this state. The amount of income from each contract completed during the income year apportioned to this state plus other business income apportioned to this state by the regular three-factor formula such as interest income, rents, royalties, income from short-term contracts, etc. plus all nonbusiness income allocated to this state is the measure of tax for the income year.

(f) The amount of income (or loss) from each contract which is derived from sources within this state using the completed contract method of accounting is computed as follows:

1. In the income year in which the contract is completed, the income (or loss) therefrom is determined.

2. The income (or loss) determined at paragraph (4)(f)1. is apportioned to this state by the following method:

(i) A fraction is determined for each year during which the contract was in progress. The numerator is the amount of construction costs paid or accrued in each year during which the contract was in progress and the denominator is the total of all such construction costs for the project.

(ii) Each percentage determined in paragraph (4)(f)2.(i) above is multiplied by the apportionment formula percentage for that particular year as determined in paragraph (4)(d)5.(iv)(V) of this regulation above.

(iii) The percentages determined at paragraph (4) (f)2.(ii) for each year during

which the contract was in progress are totaled. The amount of total income (or loss) from the contract determined at paragraph (4)(f)1. of this regulation is multiplied by the total percentage. The resulting income (or loss) is the amount of business from such contract derived from sources within this state.

EXAMPLE 1: A taxpayer using the completed contract method of accounting for long-term contracts is engaged in three long-term contracts; Contract L in this state, Contract M in state X and Contract N in state Y. In addition, it has other business income (less expenses) during the income year 1972 from interests, rents and short-term contracts amounting to \$500,000, and nonbusiness income allocable to this state of \$8,000. During 1972, it completed Contract M in state X at a profit of \$900,000. Contracts L and N in this state and state Y, respectively, were not completed during the income year. The apportionment percentages of the taxpayer as determined in (paragraph (4)(d)5.(iv)(V) of this regulation and the percentages of contracts costs as determined in paragraph (4)(f)2. above for each year during which Contract M in state X was in progress as follows:

	1970	1971	1972
Apportionment percentages	30.0%	20.0%	40.0%
Percentages of Construction Costs of Contract M			
each year to total construction costs - (100%)	20.0%	50.0%	30.0%

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	\$ <u>500,000</u>
Apportion 40% to this state	\$ 200,000
Add: Income from Contract M*	\$ <u>252,000</u>
Total business income derived from sources within this state	452,000
Add: Nonbusiness income allocated to this state	<u>8,000</u>
Net income subject to tax in this state	\$ <u>460,000</u>

* Income from Contract M apportioned to this state:

	1970	1971	1972	Total
Apportionment percentage	30.0%	20.0%	40.0%	
Percent of Construction Costs	<u>20.0%</u>	<u>50.0%</u>	<u>30.0%</u>	<u>100.0%</u>
Product	<u>6.0%</u>	<u>10.0%</u>	<u>12.0%</u>	<u>28.0%</u>

28.0% of \$900,000 = \$252,000

EXAMPLE 2: Same facts as in EXAMPLE 1 except that Contract L was started in 1972 in this state, the first year in which the taxpayer was subject to tax in this state. Contract L in this state and Contract N in state Y are incomplete in 1972.

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	\$ <u>500,000</u>
Apportion 40% to this state	\$ 200,000
Add: Income from Contract M*	<u>108,000</u>
Total business income derived from sources	

within this state	\$ 308,000
Add: Nonbusiness income allocated to this state	<u>8,000</u>
Net income subject to tax in this state	\$ <u>316,000</u>

* Income from Contract M apportioned to this state:

	1970	1971	1972	Total
Apportionment percentage	0.0%	0.0%	40.0%	
Percent of Construction Costs	<u>20.0%</u>	<u>50.0%</u>	<u>30.0%</u>	<u>100.0%</u>
Product	<u>0.0%</u>	<u>0.0%</u>	<u>12.0%</u>	<u>12.0%</u>

12.0% of \$900,000 = \$108,000.

Note: Only 12% is used to determine the income derived from sources within this state since the corporation was not subject to tax in this state prior to 1972.

EXAMPLE 3: Same facts as in example 1 except that the figures relate to Contract L in this state and 1972 is the first year the corporation was taxable in another state (see Section 40-27-1, Articles IV.2 and IV.3 and Regulations 810-27-1-4-.02(b)(1) and 810-27-1-4-.03. Contracts M and N in states X and Y were started in 1972 and are incomplete.

The corporation's net income subject to tax in this state for 1972 is computed as follows:

Business Income	\$ <u>500,000</u>
Apportion 40% to this state	\$ 200,000
Add: Income from Contract L*	\$ <u>738,000</u>
Total business income derived from sources within this state	\$ 938,000
Add: Nonbusiness income allocated to this state	<u>8,000</u>
Net income subject to tax in this state	\$ <u>946,000</u>

* Income from Contract L apportioned to this state:

	1970	1971	1972	Total
Apportionment percentage	100.0%	100.0%	40.0%	
Percentage of Construction Costs	<u>20.0%</u>	<u>50.0%</u>	<u>30.0%</u>	<u>100.0%</u>
Product	<u>20.0%</u>	<u>50.0%</u>	<u>12.0%</u>	<u>82.0%</u>

82.0% of \$900,000 = \$738,000.

(f) *Computation for Year of Withdrawal, Dissolution or Cessation of Business - Completed Contract Method.* Use of the completed contract method of accounting for long-term contracts requires that income derived from sources within this state from incomplete contracts in progress outside this state on the date of withdrawal, dissolution or cessation of business in this state be included in the measure of tax for the taxable year during which the corporation withdraws, dissolves or ceases doing business in this state.

(g) The amount of income (or loss) from each such contract to be apportioned to this state by the apportionment method set forth in paragraph (4)(f)2. of this regulation shall be determined as if the percentage of completion method of accounting were used for all such

contracts on the date of withdrawal, dissolution or cessation of business. The amount of business income (or loss) for each such contract shall be the amount by which the gross contract price from each such contract which corresponds to the percentage of the entire contract which has been completed from the commencement thereof to the date of withdrawal, dissolution or cessation of business exceeds all expenditures made during such period in connection with each such contract. In so doing, one must take into account the material and supplies on hand at the beginning and end of the income year for use in each such contract.

EXAMPLE: A construction contractor qualified to do business in this state had elected the completed contract method of accounting for long-term contracts. It was engaged in two long-term contracts. Contract L in this state was started in 1971 and completed at a profit of \$900,000 on 12/16/73. The taxpayer withdrew on 12/31/73. Contract M in state X was started in 1972 and was incomplete on 12/31/73. The apportionment percentages of the taxpayer, as determined at paragraph (4)(d) of this regulation, and percentages of construction costs, as determined in paragraph (4)(f)2. of this regulation, for each year during which Contract M in state X was in progress are as follows:

	1971	1972	1973	Total
Apportionment percentages	30.0%	20.0%	40.0%	
Percentages of Construction Costs:				
Contract L, this state	20.0%	50.0%	30.0%	100.0%
Contract M, state X	0.0%	10.0%	25.0%	35.0%

The corporation had other business income (net of expenses) of \$500,000 during 1972 and \$300,000 during 1973. The gross contract price of Contract M (state X) was \$1,000,000, and it was estimated to be 35% completed on 12/31/73. Total expenditures to date for Contract M (state X) were \$300,000 for the period ended 12/31/73.

The measure of tax for the taxable year ended 12/31/73 is computed as follows:

	<i>Taxable Year 1973</i>	
	<i>Income Year 1972</i>	<i>Income Year 1973</i>
Business Income	\$500,000	300,000
Apportionment % to this state	<u>20%</u>	<u>40%</u>
Amount Apportioned to this state	100,000	120,000
Add: Income from contracts:		
L (this state) *		252,000
M (state X) **		<u>6,000</u>
Total business income derived from sources within this state	<u>\$100,000</u>	<u>\$378,000</u>

* Income from Contract L apportioned to this state:

	<i>1971</i>	<i>1972</i>	<i>1973</i>	<i>Total</i>
Apportionment percentage	30.0%	20.0%	40.0%	
Percentage of Construction Costs	<u>20.0%</u>	<u>50.0%</u>	<u>30.0%</u>	<u>100.0%</u>
Product	<u>6.0%</u>	<u>10.0%</u>	<u>12.0%</u>	<u>28.0%</u>

28.0% of \$900,000 = \$252,000.

** Income from Contract M apportioned to this state:

	<i>1971</i>	<i>1972</i>	<i>1973</i>	<i>Total</i>
Apportionment percentage	0.0%	20.0%	40.0%	
Percentage of Construction Costs	<u>0.0%</u>	<u>10.0%</u>	<u>25.0%</u>	<u>35.0%</u>
Product	<u>0.0%</u>	<u>2.0%</u>	<u>10.0%</u>	<u>12.0%</u>

12.0% of 50,000*** = \$6,000

*** Computation of apportionable income from Contract M based on percentage of completion method:

Total Contract Price	<u>\$1,000,000</u>
Estimated to be 35% completed	\$350,000
Less: total expenditures to date	<u>300,000</u>
Apportionable income	<u>\$ 50,000</u>

(5) *Special Rules: Railroads.* The following special rules are established in respect to railroads:

(a) *In General.* Where a railroad has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to this regulation. In such cases, the first step is to determine what portion of the railroad's income constitutes "business" income and which portion constitutes "nonbusiness" income under Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01 thereunder. Nonbusiness income is directly allocable to specific states pursuant to the provisions of Section 40-27-1, Article IV.5 to 8, inclusive. Business income is apportioned among the states in which the business is conducted pursuant to the property, payroll and sales apportionment factors set forth in this regulation. The sum of (1) the items of nonbusiness income directly allocated to this state and (2) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax by this state.

(b) *Business and Nonbusiness Income.* For definitions, rules and examples for determining business and nonbusiness income, see Regulation 810-27-1-4-.01.

(c) *Apportionment of Business Income.*

1. *In General.* The property factor shall be determined in accordance with Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12., the payroll factor in accordance with Regulation 810-27-1-4-.13., and the sales factor in accordance with Regulations 810-27-1-4-.14, 810-27-1-4-.15, 810-27-1-4-.16, and 810-27-1-4-.17, except as modified in this regulation.

2. *The Property Factor.*

(i) *Property Valuation.* Owned property shall be valued at its original cost and property rented from others shall be valued at eight (8) times the net annual rental rate in accordance with Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11. Railroad cars owned and operated by other railroads and temporarily used by the taxpayer in its business and for which a per diem or mileage charge is made are not included in the property factor as rented property. Railroad cars owned and operated by the taxpayer and temporarily used by other railroads in their business and for which a per diem charge is made by the taxpayer are included in the property factor of the taxpayer.

(ii) *General Definitions.* The following definitions are applicable to the numerator and denominator of the property factor:

(l) "Original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal income tax adjustments except for subsequent capital additions, improvements thereto or partial dispositions); or, if the property has no such basis, the valuation of such property for Interstate Commerce Commission purposes. If the

original cost of property is unascertainable under the foregoing valuation standards, the property is included in the property factor at its fair market value as of the date of acquisition by the taxpayer (Regulation 810-27-1-4-.11(a)).

(II) "Rent" does not include the per diem and mileage charges paid by the taxpayer for the temporary use of railroad cars owned or operated by another railroad.

(III) The "value" of owned real and tangible personal property shall mean its original cost. (See Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11(a).)

(IV) "Average value" of property means the amount determined by averaging the values at the beginning and ending of the income tax year, but the Department of Revenue may require the averaging of monthly values during the income year or such averaging as necessary to effect properly the average value of the railroad's property. (See Section 40-27-1, Article IV.12 and Regulation 810-27-1-4-.12.)

(V) The "value" of rented real and tangible personal property means the product of eight (8) times the net annual rental rate. (See Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11(b).)

(VI) "Net annual rental rate" means the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

(VII) "Property used during the income year" includes property which is available for use in the taxpayer's trade or business during the income year.

(VIII) A "locomotive-mile" is the movement of a locomotive (a self-propelled unit of equipment designed solely for moving other equipment) a distance of one mile under its own power.

(IX) A "car-mile" is a movement of a unit of car equipment a distance of one mile.

(iii) *The Denominator and Numerator of the Property Factor.* The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

(I) In determining the numerator of the property factor, all property except mobile or movable property such as passenger cars, freight cars, locomotives and freight containers which are located within and without this state during the income year shall be included in the numerator of the property factor in accordance with Section 40-27-1, Article IV.10 to 12, inclusive, and Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12.

(II) Mobile or movable property such as passenger cars, freight cars, locomotives

and freight containers which are located within and without this state during the income year shall be included in the numerator of the property factor in the ratio which "locomotive-miles" and "car-miles" in the state bear to the total everywhere.

3. *The Payroll Factor.* The denominator of the payroll factor is the total compensation paid everywhere by the taxpayer during the income year for the production of business income. (See Section 40-27-1, Articles IV.13 and IV.14 and Regulations 810-27-1-4-.13 and 810-27-1-4-.14.) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation. With respect to all personnel except enginemen and trainmen performing services on interstate trains, compensation paid to such employees shall be included in the numerator as provided in Section 40-27-1, Articles IV.13 and IV.14 and Regulations 810-27-1-4-.13 and 810-27-1-4-.14.

(i) With respect to enginemen and trainmen performing services on interstate trains, compensation paid to such employees shall be included in the numerator of the payroll factor in the ratio which their services performed in this state bear to their services performed everywhere. Compensation for services performed in this state should be deemed to be the compensation reported or required to be reported by such employees for determination of their income tax liability to this state.

4. *The Sales (Revenue) Factor.*

(i) *In General.* All revenue derived from transactions and activities in the regular course of the trade or business of the taxpayer which produces business income, except per diem and mileage charges which are collected by the taxpayer, is included in the denominator of the sales (revenue) factor. (See Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01.)

(I) The numerator of the sales (revenue) factor is the total revenue of the taxpayer in this state during the income year. The total revenue of the taxpayer in this state during the income year, other than revenue from hauling freight, passengers, mail and express, shall be attributable to this state in accordance with Section 40-27-1, Article IV.15 to 17, inclusive, and Regulations 810-27-1-4-.15, 810-27-1-4-.16, and 810-27-1-4-.17.

(ii) *Numerator of Sales (Revenue) Factor From Freight, Mail and Express.* The total revenue of the taxpayer in this state during the income year for the numerator of the sales (revenue) factor from hauling freight, mail and express shall be attributable to this state as follows:

(I) *Intrastate.* All receipts from shipments which both originate and terminate within this state; and

(II) *Multistate.* That portion of the receipts from each movement or shipment passing through, into, or out of this state is determined by the ratio which the miles traveled

by such movement or shipment in this state bear to the total miles traveled by such movement or shipment from point of origin to destination.

(iii) *Numerator of Sales (Revenue) Factor from Passengers.* The numerator of the sales (revenue) factor shall include:

(I) *Intrastate.* All receipts from the transportation of passengers (including mail and express handled in passenger service) which both originate and terminate within this state; and

(II) *Multistate.* That portion of the receipts from the transportation of interstate passengers (including mail and express handled in passenger service) determined by the ratio which revenue passenger miles in this state bear to the total everywhere.

(6) *Special Rules: Airlines.* The following special rules are established with respect to airlines:

(a) *In General.* Where an airline has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to Section 40-27-1, Article IV except as modified by this regulation.

(b) *Apportionment of Business Income.*

1. *General Definitions.* The following definitions are applicable to the terms used in the apportionment factor descriptions.

(i) "Value" of owned real and tangible personal property shall mean its original cost. (See Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11(a).)

(ii) "Cost of aircraft by type" means the average original cost or value of aircraft by type which are ready for flight.

(iii) "Original cost" means the initial federal tax basis of the property plus the value of capital improvements to such property, except that, for this purpose, it shall be assumed that Safe Harbor Leases are not true leases and do not affect the original initial federal tax basis of the property. (See Regulation 810-27-1-4-.11(a).)

(iv) "Average value" of the property means the amount determined by averaging the values at the beginning and ending of the income year, but the Commissioner may require the averaging of monthly values during the income year if such averaging is necessary to reflect properly the average value of the airline's property. (See Section 40-27-1, Article IV.12 and Regulation 810-27-1-4-.12.)

(v) The "value" of rented real and tangible personal property means the product of eight (8) times the net annual rental rate. (See Section 40-27-1, Article IV.11 and

Regulation 810-27-1-4-.11(b).)

(vi) "Net annual rental rate" means the annual rental rate paid by the taxpayer.

(vii) "Property used during the income year" includes property which is available for use in the taxpayer's trade or business during the income year.

(viii) "Aircraft ready for flight" means aircraft owned or acquired through rental or lease (but not interchange) which are in the possession of the taxpayer and are available for service on the taxpayer routes.

(ix) "Revenue service" means the use of aircraft ready for flight for the production of revenue.

(x) "Transportation revenue" means revenue earned by transporting passengers, freight and mail as well as revenue earned from liquor sales, pet crate rentals, etc.

(xi) "Departures" means, for purposes of these regulations, all takeoffs, whether they be regularly scheduled or charter flights, that occur during revenue service.

2. *Property Factor.*

(i) *Property valuation.* Owned aircraft shall be valued at its original cost and rented aircraft shall be valued at eight (8) times the net annual rental rate in accordance with Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11. The use of the taxpayer's owned or rented aircraft in an interchange program with another air carrier will not constitute a rental of such aircraft by the airlines to the other participating airline. Such aircraft shall be accounted for in the property factor of the owner. Parts and other expendables, including parts for use in contract overhaul work, will be valued at cost.

(ii) *The denominator and numerator of the property factor.* The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year.

(l) In determining the numerator of the property factor, all property except aircraft ready for flight shall be included in the numerator of the property factor in accordance with Section 40-27-1, Article IV.10 to 12, inclusive. Aircraft ready for flight shall be included in the numerator of the property factor in the ratio calculated as follows:

l. Departures of aircraft from locations in this state weighted as to the cost and value of aircraft by type compared to total departures similarly weighted.

3. *The Payroll Factor.* The denominator of the payroll factor is the total

compensation paid everywhere by the taxpayer during the income year. (See Section 40-27-1, Articles IV.13 and IV.14.) The numerator of the payroll factor is the total amount paid in this state during the income year by the taxpayer for compensation. With respect to non-flight personnel, compensation paid to such employees shall be included in the numerator as provided in Section 40-27-1, Articles IV.13 and IV.14. With respect to flight personnel (the air crew aboard an aircraft assisting in the operations of the aircraft or the welfare of passengers while in the air), compensation paid to such employees shall be included in the ratio of departures of aircraft from locations in this state, weighted as to the cost and value of aircraft by type compared to total departures similarly weighted, multiplied by the total flight personnel compensation.

4. *Sales (Transportation Revenue) Factor.* The transportation revenue derived from transactions and activities in the regular course of the trade or business of the taxpayer and miscellaneous sales of merchandise, etc., are included in the denominator of the sales (transportation revenue) factor. (See Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01.) Passive income items such as interest, rental income, dividends, etc., will not be included in the denominator nor will the proceeds or net gains or losses from the sale of aircraft be included. The numerator of the sales (transportation revenue) factor is the total revenue of the taxpayer in this state during the income year. The total revenue of the taxpayer in this state during the income year is the result of the following calculation:

(i) The ratio of departures of aircraft in this state weighted as to the cost and value of aircraft by type, as compared to total departures similarly weighted multiplied by the total transportation revenue. The product of this calculation is to be added to any non-flight revenues directly attributable to this state.

(c) *Records.* The taxpayer must maintain the records necessary to arrive at departures by type of aircraft as used in these regulations. Such records are to be subject to review by the respective state taxing authorities or their agents.

(d) *Examples.* Examples of the manner in which the airline regulation would apply to specific fact situations:

EXAMPLE 1: Assume the following facts for an airline for a tax year:

1. It has ten 747s ready for flight and in revenue service at an average cost per unit of \$40,000,000 for nine of the aircraft. It rents the tenth 747 from another airline for \$9,000,000 per year. At eight times rents, the latter is valued at \$72,000,000 for apportionment purposes. The total 747 valuation is, therefore, \$432,000,000 for property factor denominator purposes.

2. It has twenty 727s ready for flight in revenue service at an average cost per unit of \$20,000,000. The total 727 valuation is, therefore, \$400,000,000 for property factor denominator purposes.

3. It has nonflight tangible property (n.t.p.) valued at an original cost of \$200,000,000.

4. It has the following annual payroll:

Flight personnel	\$ 60,000,000
Nonflight personnel (n.p.)	<u>40,000,000</u>
Total	<u>\$ 100,000,000</u>

5. From its operations, it has total receipts of \$50,000,000, business net income of \$1,000,000, and no nonbusiness income.

6. It has the following within Alabama:

a.	10% of its 747 flight departures (.10 x \$432,000,000)	\$43,200,000
b.	20% of its 727 flight departures (.20 x \$400,000,000)	\$80,000,000
c.	5% of its n.t.p. (.05 x \$200,000,000)	\$10,000,000
d.	15% of its n.p. payroll (.15 x \$40,000,000)	\$6,000,000

The airline's business income apportioned to Alabama would be determined as follows:

	<i>Within AL</i>	<i>Everywhere</i>	
<u>Property Factor:</u>			
747s (.10 x \$432,000,000)	43,200,000	432,000,000	
727s (.20 x \$400,000,000)	80,000,000	400,000,000	
n.t.p. (.05 x \$200,000,000)	<u>10,000,000</u>	<u>200,000,000</u>	
	<u>133,200,000</u>	<u>1,032,000,000</u>	12.9070%
<u>Sales Factor:</u>			
747s (.10 x \$432,000,000)	43,200,000	432,000,000	
727s (.20 x \$400,000,000)	<u>80,000,000</u>	<u>400,000,000</u>	
	<u>123,200,000</u>	<u>832,000,000</u>	14.8077%
<u>Payroll Factor:</u>			
Flight personnel (.148077 x 60,000,000)	8,884,620	60,000,000	
Nonflight personnel (n.p.)	<u>6,000,000</u>	<u>40,000,000</u>	
	<u>14,884,620</u>	<u>100,000,000</u>	<u>14.8846%</u>
<u>Total of factor ratios</u>			<u>42.5993%</u>

3

Alabama apportionment ratio		<u>14.1998%</u>
Business income	\$1,000,000	
Amount apportioned to Alabama (.141998 x \$1,000,000)	<u>\$ 141,998</u>	

EXAMPLE 2: Same facts except that paragraph 6 is changed to read:

6. It has the following within Alabama:

a.	6% of its 747 flight departures (.06 x \$432,000,000)	\$25,920,000
b.	31% of its 727 flight departures (.31 x \$400,000,000)	\$124,000,000

c.	3% of its n.t.p. (.03 x \$200,000,000)	\$6,000,000
d.	7% of its n.p. payroll (.07 x \$40,000,000)	\$2,800,000

The airline's business income apportioned to Alabama would be determined as follows:

	<i>Within AL</i>	<i>Everywhere</i>	
<u>Property Factor:</u>			
747s (.06 x \$432,000,000)	25,920,000	432,000,000	
727s (.31 x \$400,000,000)	124,000,000	400,000,000	
n.t.p. (.03 x \$200,000,000)	<u>6,000,000</u>	<u>200,000,000</u>	
	<u>155,920,000</u>	<u>1,032,000,000</u>	15.1085%
<u>Sales Factor:</u>			
747s (.06 x \$432,000,000)	25,920,000	432,000,000	
727s (.31 x \$400,000,000)	<u>124,000,000</u>	<u>400,000,000</u>	
	<u>149,920,000</u>	<u>832,000,000</u>	18.0192%
<u>Payroll Factor:</u>			
Flight personnel (.180192 x 60,000,000)	10,812,520	60,000,000	
Nonflight personnel (n.p.)	<u>2,800,000</u>	<u>40,000,000</u>	
	<u>13,611,520</u>	<u>100,000,000</u>	13.6115%
<u>Total of factor ratios</u>			46.7392%
			%
<u>3</u>			
Alabama apportionment ratio			<u>15.5797%</u>
Business income		<u>\$1,000,000</u>	
Amount apportionment to Alabama (.155797 x \$1,000,000)		<u>\$ 155,797</u>	

(7) *Special Rules: Trucking Companies.* The following special rules are established with respect to trucking companies:

(a) *In General.* As used in this regulation, the term "trucking company" means a motor common carrier, a motor contract carrier, or an express carrier which primarily transports tangible personal property of others by motor vehicle for compensation. Where a trucking company has income from sources both within and without this state, the amount of business income from sources within this state shall be determined pursuant to this regulation. In such cases, the first step is to determine what portion of the trucking company's income constitutes "business" income and what portion constitutes "nonbusiness" income under Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01 thereunder. Nonbusiness income is directly allocable to specific states pursuant to the provisions of Section 40-27-1, Article IV.5 to 8, inclusive. Business income is apportioned among the states in which the business is conducted and pursuant to the property, payroll, and sales apportionment factors set forth in this regulation. The sum of (i) the items of nonbusiness income directly allocated to this state and (ii) the amount of business income attributable to this state constitutes the amount of the taxpayer's entire net income which is subject to tax in this state.

(b) *Business and Nonbusiness Income.* For definitions, rules, and examples for determining business and nonbusiness income, see Regulation 810-27-1-4-.01.

(c) *Apportionment of Business Income*

1. *In General.* The property factor shall be determined in accordance with Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12, the payroll factor in accordance with Regulations 810-27-1-4-.13 and 810-27-1-4-.14, and the sales factor in accordance with Regulations 810-27-1-4-.15, 810-27-1-4-.16, and 810-27-1-4-.17, except as modified by this regulation.

2. *The Property Factor*

(i) *Property Valuation.* Owned property shall be valued at its original cost and property rented from others shall be valued at eight (8) times the net annual rental rate in accordance with Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11.

(ii) *General Definitions.* The following definitions are applicable to the numerator and denominator of the property factor, as well as other apportionment factor descriptions:

(I) "Average value" of property means the amount determined by averaging the values at the beginning and end of the income tax year, but the Department of Revenue may require the averaging of monthly values during the income year or such averaging as is necessary to reflect properly the average value of the trucking company's property. (See Section 40-27-1, Article IV.12 and Regulation 810-27-1-4-.12.)

(II) "Mobile property" means all motor vehicles, including trailers, engaged directly in the movement of tangible personal property.

(III) A "mobile property mile" is the movement of a unit of mobile property a distance of one mile whether loaded or unloaded.

(IV) "Original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal income tax adjustments, except for subsequent capital additions, improvements thereto, or partial dispositions); or, if the property has no such basis, the valuation of such property for Interstate Commerce Commission purposes. If the original cost of property is unascertainable under the foregoing valuation standards, the property is included in the property factor at its fair market value as of the date of acquisition by the taxpayer. (Regulation 810-27-1-4-.11(a).)

(V) "Property used during the course of the income year" includes property which is available for use in the taxpayer's trade or business during the income year.

(VI) The "value" of owned real and tangible personal property means its original cost. (See Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11(a).)

(VII) The "value" of rented real and tangible personal property means the product of

eight (8) times the net annual rental rate. (See Section 40-27-1, Article IV.11 and Regulation 810-27-1-4-.11(b).)

(iii) *The Denominator and Numerator of the Property Factor.* The denominator of the property factor shall be the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the income year. The numerator of the property factor shall be the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year. In the determination of the numerator of the property factor, all property, except mobile property as defined in this regulation, shall be included in the numerator of the property factor in accordance with Section 40-27-1, Article IV.10 to 12, inclusive, and Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12.

(I) Mobile property, as defined in this regulation, which is located solely within this state during the income year shall be included in the numerator of the property factor.

(II) Mobile property as defined in this regulation, which is located within and without this state during the income year shall be included in the numerator of the property factor in the ratio which mobile property miles in the state bear to the total mobile property miles.

3. *The Payroll Factor.* The denominator of the payroll factor is the compensation paid everywhere by the taxpayer during the income year for the production of business income. (See Section 40-27-1, Articles IV.13 and IV.14 and Regulations 810-27-1-4-.13 and 810-27-1-4-.14.) The numerator of the payroll factor is the total compensation paid in this state during the income year by the taxpayer. With respect to all personnel, except those performing services within and without this state, compensation paid to such employees shall be included in the numerator as provided in Section 40-27-1, Articles IV.13 and IV.14 and Regulations 810-27-1-4-.13 and 810-27-1-4-.14.

(i) With respect to personnel performing services within and without this state, compensation paid to such employees shall be included in the numerator of the payroll factor in the ratio which their services performed in this state bear to their services performed everywhere based on mobile property miles.

4. *The Sales (Revenue) Factor*

(i) *In General.* All revenue derived from transactions and activities in the regular course of the taxpayer's trade or business which produce business income shall be included in the denominator of the sales (revenue) factor. (See Section 40-27-1, Article IV.1 and Regulation 810-27-1-4-.01.)

(I) The numerator of the revenue factor is the total revenue of the taxpayer in this state during the income year. The total state revenue of the taxpayer, other than revenue from hauling freight, mail, and express, shall be attributable to this state in accordance with Section 40-27-1, Article IV.15 to 17, inclusive, and Regulations 810-27-1-4-.15,

810-27-1-4-.16, and 810-27-1-4-.17.

(ii) *Numerator of the Sales (Revenue) Factor From Freight, Mail, and Express.* The total revenue of the taxpayer attributable to this state during the income year from hauling freight, mail, and express shall be:

(I) *Intrastate.* All receipts from any shipment which both originates and terminates within this state; and,

(II) *Multistate.* That portion of the receipts from movements or shipments passing through, into, or out of this state as determined by the ratio which the mobile property miles traveled by such movements or shipments in this state bear to the total mobile property miles traveled by movements or shipments from points of origin to destination.

(d) *Records.* The taxpayer shall maintain the records necessary to identify mobile property and to enumerate by state the mobile property miles traveled by such mobile property as those terms are used in this regulation. Such records are subject to review by the Department of Revenue or its agents.

(e) *De Minimis Nexus Standard.* Notwithstanding any provision contained herein, this Regulation 810-27-1-4-.18 (7) shall not apply to require the apportionment of income to this state if the trucking company during the course of the income tax year neither:

1. owns nor rents any real or personal property in this state, except mobile property; nor
2. makes any pick-ups or deliveries within this state; nor
3. travels more than twenty-five thousand mobile property miles within this state; provided that the total mobile property miles traveled within this state during the income tax year do not exceed three percent of the total mobile property miles traveled in all states by the trucking company during that period; nor
4. makes more than twelve trips into this state.

(8) *Special Rules: Television and Radio Broadcasting.* The following special rules are established in respect to the apportionment of income from television and radio broadcasting by a broadcaster that is taxable both in this state and in one or more other states.

(a) *In General.* When a person in the business of broadcasting film or radio programming, whether through the public airwaves, by cable, direct or indirect satellite transmission or any other means of communication, either through a network (including owned and affiliated stations) or through an affiliated, unaffiliated or independent television or radio broadcasting station, has income from sources both within and without this state,

the amount of business income from sources within this state shall be determined pursuant to Section 40-27-1, Article IV, and the regulations issued thereunder by this state, except as modified by this regulation.

(b) Business and Nonbusiness Income. For definitions, regulations and examples for determining whether income shall be classified as "business" or "nonbusiness" income, see Regulation 810-27-1-4-.01.

(c) Definitions. The following definitions are applicable to the terms contained in this regulation, unless the context clearly requires otherwise.

1. "Film" or "film programming" means any and all performances, events or productions telecast, on television, including but not limited to news, sporting events, plays, stories or other literary, commercial, educational or artistic works, through the use of video tape, disc or any other type of format or medium.

(i) Each episode of a series of films produced for television shall constitute a separate "film" notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

2. "Outer-jurisdictional" property means certain types of tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in the business of telecasting or broadcasting, but which are not physically located in any particular state.

3. "Radio" or "radio programming" means any and all performances, events or productions broadcast, on radio, including but not limited to news, sporting events, plays, stories or other literary, commercial, educational or artistic works, through the use of an audio tape, disc or any other format or medium.

(i) Each episode of a series of radio programming produced for radio broadcast shall constitute a separate "radio programming" notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

4. "Release or in release

means the placing of film or radio programming into service. A film or radio program is placed into service when it is first broadcast to the primary audience for which the film was created. Thus, for example, a film is placed in service when it is first publicly telecast for entertainment, educational, commercial, artistic or other purpose. Each episode of a television or radio series is placed in service when it is first broadcast. A program is not placed in service merely because it is completed and therefore in a condition or state of readiness and availability for telecast or, merely because it is previewed to prospective sponsors or purchasers.

5. "Rent" shall include license fees or other payments or consideration provided in exchange for the broadcast or other use of television or radio programming.

6. A "subscriber" to a cable television system is the individual residence or other outlet which is the ultimate recipient of the transmission.

7. "Telecast" or "broadcast" (sometimes used interchangeably with respect to television) means the transmission of television or radio programming, respectively, by an electronic or other signal conducted by radiowaves or microwaves or by wires, lines, coaxial cables, wave guides, fiber optics, satellite transmissions directly or indirectly to viewers and listeners or by any other means of communications.

(d) Apportionment of Business Income.

1. In General. The property factor shall be determined in accordance with Regulations 810-27-1-4-.10, 810-27-1-4-.11, and 810-27-1-4-.12, the payroll factor in accordance with Regulations 810-27-1-4-.13 and 810-27-1-4-.14, and the sales factor in accordance with Regulations 810-27-1-4-.15, and 810-27-1-4-.16, except as modified by this regulation.

2. The Property Factor.

(i) In General

(I) In the case of rented studios, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage or other permanent equipment such as sound recording equipment and the like; except that additional equipment rented from other sources or from the studio not covered in the basic or flat rental charge and used for one week or longer (even though rented on a day-to-day basis) shall be included. Lump-sum net rental payments for a period which encompasses more than a single income year shall be assigned ratably over the rental period.

(II) No value or cost attributable to any outer-jurisdictional, film or radio programming property shall be included in the property factor at any time.

(ii) Property Factor Denominator.

(I) All real property and tangible personal property (other than outer-jurisdictional and film or radio programming property), whether owned or rented, which is used in the business shall be included in the denominator of the property factor.

(II) Audio or video cassettes, discs or similar medium containing film or radio programming and intended for sale or rental by the taxpayer for home viewing or listening shall be included in the property factor at their original cost. To the extent that the taxpayer licenses or otherwise permits others to manufacture or distribute such cassettes, discs or other medium containing film or radio programming for home viewing or listening, the value of said cassettes, discs or other medium shall include the license, royalty or other fees

received by the taxpayer capitalized at a rate of eight times the gross receipts derived therefrom during the income year.

(III) Outer-jurisdictional, film and radio programming property shall be excluded from the denominator of the property factor.

(iii) Property Factor Numerator.

(I) With the exception of outer-jurisdictional and film or radio programming property, all real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor as provided in Regulation 810-27-1-4-.01(d).

(II) Outer-jurisdictional, film and radio programming property shall be excluded from the numerator of the property factor.

EXAMPLE: XYZ Television Co. has a total value of all of its property everywhere of \$500,000,000, including a satellite valued at \$50,000,000 that was used to telecast programming into this state and \$150,000,000 in film property of which \$1,000,000's worth was located in this state the entire year. The total value of real and tangible personal property, other than film programming property, located in this state for the entire income year was valued at \$2,000,000; and the movable and mobile property described in paragraph (8)(d)2.(iii)(I) was determined to be of a value of \$4,000,000 and such movable and mobile property was used in this state for 100 days. The total value of property to be attributed to this state would be determined as follows:

Value of property permanently in state:	\$2,000,000
Value of mobile and movable property: $(100/365 \text{ or } .273973 \times \$4,000,000)$:	<u>\$1,095,892</u>
Total value of property to be included in the state's property factor numerator (outer-jurisdictional and film property excluded):	<u>\$3,095,892</u>
Total value of property to be used in the denominator (\$500,000,000-\$200,000,000)	<u>\$300,000,000</u>
Total property factor percentage $(\$3,095,892 / \$300,000,000)$:	<u>1.0320%</u>

3. The Payroll Factor.

(I) Payroll Factor Denominator. The denominator of the payroll factor shall include all compensation, including residual and profit participation payments, paid to employees during the income year, including that paid to directors, actors, newscasters and other talent in their status as employees.

(ii) Payroll Factor Numerator. Compensation for all employees shall be attributed to the state or states as may determined by the application of the provisions of Regulations 810-27-1-4-.13 and 810-27-1-4-.14.

4. The Sales Factor.

(i) **Sales Factor Denominator.** The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under Regulation 810-27-1-4-.18.(c).

(ii) **Sales Factor Numerator.** The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to the following:

(I) Gross receipts, including advertising revenue, from television, film or radio programming in release to or by television and radio stations located in this state.

(II) Gross receipts, including advertising revenue, from television, films or radio programming in release to or by a television station (independent or unaffiliated) or network of stations for broadcast shall be attributed to this state in the ratio (hereafter "audience factor") that the audience for such station (or owned and affiliated stations in the case of networks) located in this state bears to the total audience for such station (or owned and affiliated stations in the case of networks).

I. The audience factor for television or radio programming shall be determined by the ratio that the taxpayer's in-state viewing (listening) audience bears to its total viewing (listening) audience.

II. Such audience factor shall be determined either by reference to the books and records of the taxpayer or by reference to published rating statistics, provided the method used by the taxpayer is consistently used from year to year for such purpose and fairly represents the taxpayer's activity in the state.

(III) Gross receipts from film programming in release to or by a cable television system shall be attributed to this state in the ratio (hereafter "audience factor") that the subscribers for such cable television system located in this state bears to the total subscribers of such cable television system. If the number of subscribers cannot be accurately determined from the books and records maintained by the taxpayer, such audience factor ratio shall be determined on the basis of the applicable year's subscription statistics located in published surveys, provided that the source selected is consistently used from year to year for that purpose.

(IV) Receipts from the sale, rental, licensing or other disposition of audio or video cassettes, discs, or similar medium intended for home viewing or listening shall be included in the sales factor as provided in Regulation 810-27-1-4-.16.

(9) *Reserved.*

(10) *Special Rules: Publishing.* The following special rules are established with respect to the apportionment of income derived from the publishing, sale, licensing or other distribution

of books, newspapers, magazines, periodicals, trade journals or other printed material.

(a) *In General.* Except as specifically modified by this regulation, when a person in the business of publishing, selling, licensing or distributing newspapers, magazines, periodicals, trade journals or other printed material has income from sources both within and without this state, the amount of business income from sources within this state from such business activity shall be determined pursuant to Section 40-27-1, Article IV and the regulations adopted thereunder.

(b) *Definitions.* The following definitions are applicable to the terms contained in this regulation, unless the context clearly requires otherwise.

1. "Outer-jurisdictional property" means certain types of tangible personal property, such as orbiting satellites, undersea transmission cables and the like, that are owned or rented by the taxpayer and used in the business of publishing, licensing, selling or otherwise distributing printed material, but which are not physically located in any particular state.

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

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

4. "Terrestrial facility" shall include any telephone line, cable, fiber optic, microwave, earth station, satellite dish, antennae or other relay system or device that is used to receive, transmit, relay or carry any data, voice, image or other information that is transmitted from or by any outer-jurisdictional property to the ultimate recipient thereof.

(c) *Apportionment of Business Income.*

1. *The Property Factor.*

(l) *Property Factor Denominator.*

(i) All real and tangible personal property, including outer-jurisdictional property, whether owned or rented, which is used in the business shall be included in the denominator of the property factor.

(ii) *Property Factor Numerator.*

(I) All real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor.

(II) Outer-jurisdictional property owned or rented by the taxpayer and used in this state during the tax period shall be included in the numerator of the property factor in the ratio which the value of such property that is attributable to its use by the taxpayer in business activities in this state bears to the total value of such property that is attributable to its use in the taxpayer's business activities everywhere.

I. The value of outer-jurisdictional property to be attributed to the numerator of the property factor of this state shall be determined by the ratio that the number of uplinks and downlinks (sometimes referred to as "half-circuits") that were used during the tax period to transmit from this state and to receive in this state any data, voice, image or other information bears to the total number of uplinks and downlinks or half-circuits that the taxpayer used for transmissions everywhere.

II. Should information regarding such uplink and downlink or half-circuit usage not be available or should such measurement of activity not be applicable to the type of outer-jurisdictional property used by the taxpayer, the value of such property to be attributed to the numerator of the property factor of this state shall be determined by the ratio that the amount of time (in terms of hours and minutes of use) or such other measurement of use of outer-jurisdictional property that was used during the tax period to transmit from this state and to receive in this state any data, voice, image or other information bears to the total amount of time or other measurement of use that was used for transmissions everywhere.

(III) Outer-jurisdictional property shall be considered to have been used by the taxpayer in its business activities within this state when such property, wherever located, has been employed by the taxpayer in any manner in the publishing, sale, licensing or other distribution of books, newspapers, magazines or other printed material and any data, voice, image or other information is transmitted to or from this state either through an earth station or terrestrial facility located in this state.

EXAMPLE: One example of the use of outer-jurisdictional property is where the taxpayer either owns its own communications satellite or leases the use of uplinks, downlinks or circuits or time on a communications satellite for the purpose of sending messages to its newspaper printing facilities or employees in a state. The state or states in which any printing facility that receives the satellite communications is located and the state from which the communications were sent would, under this regulation, apportion the cost of the owned or rented satellite to their respective property factors based upon the ratio of the in-state use of said satellite to its total usage everywhere.

Assume that ABC Newspaper Co. owns a total of \$400,000,000 of property everywhere and that, in addition, it owns and operates a communication satellite for the purpose of sending news articles to its printing plant in this state, as well as for communicating with its printing

plants and facilities or news bureaus, employees and agents located in other states and throughout the world. Also assume that the total value of its real and tangible personal property that was permanently located in this state for the entire income year was valued at \$3,000,000. Assume also that the total original cost of the satellite is \$100,000,000 for the tax period and that of the 10,000 uplinks and downlinks of satellite transmissions used by the taxpayer during the tax period, 200 or 2% are attributable to its satellite communications received in and sent from this state. Assume further that the company's mobile property that was used partially within this state, consisting of 40 delivery trucks, were determined to have an original cost of \$4,000,000 and such mobile property was used in this state for 95 days. The total value of property to be attributed to this state would be determined as follows:

Value of property permanently in state:	\$3,000,000
Value of mobile property: $(95/365 \text{ or } .260274 \times \$4,000,000)$:	1,041,096
Value of leased satellite property used in-state: $(.02 \times \$100,000,000)$:	<u>2,000,000</u>
Total value of property attributable to state:	<u>\$6,041,096</u>
Total property factor percentage: $(\$6,041,096 / \$500,000,000)$:	<u>1.2082%</u>

2. *The Payroll Factor.* The payroll factor shall be determined in accordance with Section 40-27-1, Article IV.14 and the regulations promulgated thereunder.

3. *The Sales Factor.*

(i) *Sales Factor Denominator.* The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts that may be excluded under Regulations 810-27-1-4-.15, 810-27-1-4-.16, 810-27-1-4-.17, and 810-27-1-4-.18.

(ii) *Sales Factor Numerator.* The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to, the following:

(I) Gross receipts derived from the sale of tangible personal property, including printed materials, delivered or shipped to a purchaser or a subscriber in this state.

(II) Except as provided in paragraph (10)(c)3.(ii)(III), gross receipts derived from advertising and the sale, rental or other use of the taxpayer's customer lists or any portion thereof shall be attributed to this state as determined by the taxpayer's "circulation factor" during the tax period. The circulation factor shall be determined for each individual publication by the taxpayer of printed material containing advertising and shall be equal to the ratio that the taxpayer's in-state circulation to purchasers and subscribers of its printed material bears to its total circulation to purchasers and subscribers everywhere.

I. The circulation factor for an individual publication shall be determined by reference to the rating statistics as reflected in such sources as Audit Bureau of Circulations or other comparable sources, provided that the source selected is consistently used from year to year for

such purpose. If none of the foregoing sources are available, or, if available, none is in form or content sufficient for such purposes, then the circulation factor shall be determined from the taxpayer's books and records.

(III) When specific items of advertisements can be shown, upon clear and convincing evidence, to have been distributed solely to a limited regional or local geographic area in which this state is located, the taxpayer may petition, or the Commissioner may require, that a portion of such receipts be attributed to the sales factor numerator of this state on the basis of a regional or local geographic area circulation factor and not upon the basis of the circulation factor provided by paragraph (10)(c)3.(ii)(II). Such attribution shall be based upon the ratio that the taxpayer's circulation to purchasers and subscribers located in this state of the printed material containing such specific items of advertising bears to its total circulation of such printed material to purchasers and subscribers located within such regional or local geographic area. This alternative attribution method shall be permitted only upon the condition that such receipts are not double counted or otherwise included in the numerator of any other state.

(IV) In the event that the purchaser or subscriber is the United States Government or that the taxpayer is not taxable in a State, the gross receipts from all sources, including the receipts from the sale of printed material, from advertising, and from the sale, rental or other use of the taxpayer's customer's lists, or any portion thereof that would have been attributed by the circulation factor to the numerator of the sales factor for such State, shall be included in the numerator of the sales factor of this State if the printed material or other property is shipped from an office, store, warehouse, factory, or other place of storage or business in this State.

Author: Verlon Frost, Jeff Taylor
Authority: Sections 40-2A-7(a)(5) and 40-18-57, Code of Alabama 1975
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810-27-1-4-.19 Public Law 86-272 Exemption from Income Tax.

(1) **Scope.**

(a) Public Law 86-272, 15 U.S.C. 381-384, (hereafter "P.L. 86-272") restricts a state from imposing a net income tax on income derived within its borders from interstate commerce if the only business activity of the company within the state consists of the solicitation of orders for sales of tangible personal property, which orders are to be sent outside the state for acceptance or rejection, and, if accepted, are filled by shipment or delivery from a point outside the state. The term "net income tax" includes a franchise tax measured by net income. If any sales are made into a state which is precluded by P.L. 86-272 from taxing the income of the seller, such sales remain subject to throwback to the appropriate state which does have jurisdiction to impose its net income tax upon the income derived from those sales.

(b) Signatory State is a state which has signed the Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States under Public Law 86-272, as amended, from time to time.

(c) It is the policy of Alabama hereto to impose its net income tax, subject to Alabama and Federal legislative limitations, to the fullest extent constitutionally permissible. Interpretation of the solicitation of orders standard in P.L. 86-272 requires a determination of the fair meaning of that term in the first instance. The United States Supreme Court has recently established a standard for interpreting the term "solicitation" and this regulation has been revised to conform to such standard. *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. ____, 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992). In those cases where there may be reasonable differences of opinion between Alabama and a Signatory State as to whether the disputed activity exceeds what is protected by P.L. 86-272, Alabama will apply the principle that the preemption of state taxation that is required by P.L. 86-272 will be limited to those activities that fall within the "clear and manifest purpose of Congress." See *Department of Revenue of Oregon v. ACF Industries, Inc., et al.*, ___ U.S. ____, 114 S.Ct. 843, 127 L. Ed.2d 165 (1994), *Cipollone v. Liggett Group, Inc.*, 505 U.S. ____, 112 S.Ct. 2608, 120 L. Ed.2d 407, 422 (1992); *Heublein, Inc. v. South Carolina Tax Com.*, 409 U.S. 275, 281-282 (1972).

(d) The following regulation reflects Alabama's practice with regard to:

1. whether a particular factual circumstance is considered under P.L. 86-272 or permitted under this regulation as either protected or not protected from taxation by reason of P.L. 86-272 under Secs. 40-18-31 or 40-27-1, Article IV.2; and

2. the jurisdictional standards which will apply to sales made in another state for purposes of applying a throwback rule with respect to such sales under Sec. 40-27-1, Article IV.16(b).

(2) **Nature of Property Being Sold**

(a) Only the solicitation to sell personal property is afforded immunity under P.L. 86-272; therefore, the leasing, renting, licensing or other disposition of tangible personal property, or transactions involving intangibles, such as franchises, patents, copyrights, trade marks, service marks and the like, or any other type of property are not protected activities

under P.L. 86-272.

(b) The sale or delivery and the solicitation for the sale or delivery of any type of service that is not either (i) ancillary to solicitation or (ii) otherwise set forth as a protected activity under the subsection (5)(b) below is also not protected under Public Law 86-272 or this regulation.

(3) Solicitation of Orders and Activities Ancillary to Solicitation.

(a) For the in-state activity to be a protected activity under P.L. 86-272, it must be limited solely to solicitation (except for *de minimis* activities described in paragraph (4) and those activities conducted by independent contractors described in paragraph (6) below).

(b) Solicitation means

1. speech or conduct that explicitly or implicitly invites an order; and
2. activities that neither explicitly nor implicitly invite an order, but are entirely ancillary to requests for an order.

(c) Ancillary activities are those activities that serve no independent business function for the seller apart from their connection to the solicitation of orders. Activities that a seller would engage in apart from soliciting orders shall not be considered as ancillary to the solicitation of orders. The mere assignment of activities to sales personnel does not, merely by such assignment, make such activities ancillary to solicitation of orders. Additionally, activities that seek to promote sales are not ancillary, because P.L. 86-272 does not protect activity that facilitates sales; it only protects ancillary activities that facilitate the request for an order. The conducting of activities not falling within the foregoing definition of solicitation will cause the company to lose its protection from a net income tax afforded by P.L. 86-272, unless the disqualifying activities, taken together, are either *de minimis* or are otherwise permitted under this regulation.

(4) De Minimis Activities

(a) *De minimis* activities are those that, when taken together, establish only a trivial connection with the taxing State. An activity conducted within a taxing State on a regular or systematic basis or pursuant to a company policy (whether such policy is in writing or not) shall normally not be considered trivial. Whether or not an activity consists of a trivial or non-trivial connection with the State is to be measured on both a qualitative and quantitative basis. If such activity either qualitatively or quantitatively creates a non-trivial connection with the taxing State, then such activity exceeds the protection of P.L. 86-272. Establishing that the disqualifying activities only account for a relatively small part of the business conducted within the taxing State is not determinative of whether a *de minimis* level of activity exists. The relative economic importance of the disqualifying in-state activities, as compared to the protected activities, does not determine whether the conduct of the disqualifying activities within the taxing State is inconsistent with the limited protection afforded by P.L. 86-272.

(5) Specific Listing Of Unprotected And Protected Activities

(a) Unprotected Activities. The following in-state activities (assuming they are not of a

de minimis level) are not considered as either solicitation of orders or ancillary thereto or otherwise protected under P.L. 86-272 and will cause otherwise protected sales to lose their protection under P.L. 86-272:

1. Making repairs or providing maintenance or service to the property sold or to be sold.
2. Collecting current or delinquent accounts, whether directly or by third parties, through assignment or otherwise.
3. Investigating credit worthiness.
4. Installation or supervision of installation at or after shipment or delivery.
5. Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.
6. Providing any kind of technical assistance or service including, but not limited to, engineering assistance or design service, when one of the purposes thereof is other than the facilitation of the solicitation of orders.
7. Investigating, handling, or otherwise assisting in resolving customer complaints, other than mediating direct customer complaints when the sole purpose of such mediation is to ingratiate the sales personnel with the customer.
8. Approving or accepting orders.
9. Repossessing property.
10. Securing deposits on sales.
11. Picking up or replacing damaged or returned property.
12. Hiring, training, or supervising personnel, other than personnel involved only in solicitation.
13. Using agency stock checks or any other instrument or process by which sales are made within Alabama by sales personnel.
14. Maintaining a sample or display room in excess of two weeks (14 days) at any one location within the state during the tax year.
15. Carrying samples for sale, exchange or distribution in any manner for consideration or other value.
16. Owning, leasing, using or maintaining any of the following facilities or property in-state:
 - (i) Repair shop.

- (ii) Parts department.
 - (iii) Any kind of office other than an in-home office as described as permitted under subsection (5)(a)18 and (5)(b)2.
 - (iv) Warehouse.
 - (v) Meeting place for directors, officers, or employees when done on a regular or systematic basis during the tax year.
 - (vi) Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
 - (vii) Telephone answering service that is publicly attributed to the company or to employees or agent(s) of the company in their representative status.
 - (viii) Mobile stores, *i.e.*, vehicles with drivers who are sales personnel making sales from the vehicles.
 - (ix) Real property or fixtures to real property of any kind.
17. Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
18. Maintaining, by any employee or other representative, an office or place of business of any kind
- (i) Other than an in-home office located within the residence of the employee or representative that (1) is not publicly attributed to the company or to the employee or representative of the company in an employee or representative capacity, and (2) so long as the use of such office is limited to soliciting and receiving orders from customers; for transmitting such orders outside the state for acceptance or rejection by the company; or for such other activities that are protected under Public Law 86-272 or under subsection (6)(b) of this regulation.
 - (ii) A telephone listing or other public listing within the state for the company or for an employee or representative of the company in such capacity or other indications through advertising or business literature that the company or its employee or representative can be contacted at a specific address within the state shall normally be determined as the company maintaining within Alabama an office or place of business attributable to the company or to its employee or representative in a representative capacity . However, the normal distribution and use of business cards and stationery identifying the employee's or representative's name, address, telephone and fax numbers and affiliation with the company shall not, by itself, be considered as advertising or otherwise publicly attributing an office to the company or its employee or representative.
 - (iii) The maintenance of any office or other place of business in Alabama that does not strictly qualify as an "in-home" office as described above shall, by itself, cause the loss of protection under this regulation.

(iv) For the purpose of this subsection it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining such in-home office.

19. Selling or otherwise transferring intangible personal property which is neither an isolated or transient event nor intrinsic in the related tangible personal property sold or transferred within the state.

20. Conducting any activity not listed in subparagraph (5)(b) below which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

(b) Protected Activities. The following in-state activities will not cause the loss of protection for otherwise protected sales:

1. Soliciting orders for sales by any type of advertising.
2. Soliciting of orders by an in-state resident employee or representative of the company, so long as such person does not maintain or use any office or other place of business in the state other than an "in-home" office as described in subsection (5)(a)18 above.
3. Carrying samples and promotional materials only for display or distribution without charge or other consideration.
4. Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.
5. Providing automobiles to sales personnel for their use in conducting protected activities.
6. Passing orders, inquiries and complaints on to the home office.
7. Missionary sales activities; i.e., the solicitation of indirect customers for the company's goods. For example, a manufacturer's solicitation of retailers to buy the manufacturer's goods from the manufacturer's wholesale customers would be protected if such solicitation activities are otherwise immune.
8. Coordinating shipment or delivery without payment or other consideration and providing information relating thereto either prior or subsequent to the placement of an order.
9. Checking of customers' inventories without a charge therefor (for re-order, but not for other purposes such as quality control).
10. Maintaining a sample or display room for two weeks (14 days) or less at any one location within the state during the tax year.
11. Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.
12. Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.
13. Owning, leasing, using or maintaining personal property for use in the employee or representative's "in-home" office or automobile that is solely limited to the conducting of

protected activities. Therefore, the use of personal property such as a cellular telephone, facsimile machine, duplicating equipment, personal computer and computer software that is limited to the carrying on of protected solicitation and activity entirely ancillary to such solicitation or permitted by this regulation under subparagraph (5)(b) shall not, by itself, remove the protection under this regulation.

(6) Independent Contractors

(a) P.L. 86-272 provides protection to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the company or its employees or other representatives. Independent contractors may engage in the following limited activities in the state without the company's loss of immunity:

1. Soliciting sales.
2. Making sales.
3. Maintaining an office.

(b) Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as those provided under P.L. 86-2722 and this regulation.

(c) Maintenance of a stock of goods in the state by the independent contractor under consignment or any other type of arrangement with the company, except for purposes of display and solicitation, shall remove the protection.

(7) Application Of Destination State Law In Case Of Conflict

(a) When it appears that Alabama and another Signatory State, due to the use of a throwback rule, have included or will include the same receipts from a sale in their respective sales factor numerators, at the written request of the company mailed to both states, Alabama may confer in good faith with the other state to determine which state should be assigned said receipts. Such conference may identify what law, regulation or written guideline, if any, has been adopted in the state of destination with respect to the issue. The state of destination shall be that location at which the purchaser or its designee actually receives the property, regardless of f.o.b. point or other conditions of sale.

(b) In determining which state is to receive the assignment of the receipts at issue, preference may be given to any clearly applicable law, regulation or written guideline that has been adopted in state of destination. However, except in the case of the definition of what constitutes "tangible personal property", Alabama is not required by this regulation to follow any other state's law, regulation or written guideline should Alabama determine that to do so (i) would conflict with its own laws, regulations, or written guidelines and (ii) would not clearly reflect the income-producing activity of the company within Alabama.

(c) Notwithstanding any provision set forth in this regulation to the contrary, as between Alabama and any other Signatory State, Alabama will apply the definition of "tangible personal property" that exists in the state of destination to determine the application of P.L. 86-272 and issues of throwback, if any. Should the state of destination not have any

applicable definition of such term so that it could be reasonably determined whether the property at issue constitutes "tangible personal property", then Alabama will treat such property in any manner that would clearly reflect the income-producing activity of the company within Alabama.

(8) Miscellaneous Practices

(a) Application of Regulation to Foreign Commerce. Alabama will apply the provisions of Public Law 86-272 and of this regulation to business activities conducted in foreign commerce. Therefore, whether business activities are conducted by (i) a foreign or domestic company selling tangible personal property into a country outside of the United States from a point within Alabama or by (ii) either company selling such property into Alabama from a point outside of the United States, the principles under this regulation apply equally to determine whether the sales transactions are protected and the company immune from taxation in either Alabama or in the foreign country, as the case might be, and whether, if applicable, Alabama will apply its throwback provisions.

(b) Application to Corporation Incorporated in Alabama or to person resident or domiciled in Alabama. The protection afforded by P.L. 86-272 and the provisions of this regulation, except for purposes of applying a throwback rule, do not apply to any corporation incorporated within Alabama or to any person who is a resident of or domiciled in Alabama.

(c) Registration or Qualification to Do Business. A company that registers or otherwise formally qualifies to do business within Alabama does not, by that fact alone, lose its protection under P.L. 86-272. Where, separate from or ancillary to such registration or qualification, the company receives and seeks to use or protect any additional benefit or protection from Alabama through activity not otherwise protected under P.L. 86-272 or this regulation, such protection shall be removed.

(d) Loss of Protection for conducting unprotected activity during part of tax year. The protection afforded under P.L. 86-272 and the provisions of this regulation shall be determined on a tax year by tax year basis. Therefore, if at any time during a tax year the company conducts activities that are not protected under P.L. 86-272 or this regulation, no sales in Alabama or income earned by the company attributed to Alabama during any part of said tax year shall be protected from taxation under said Public Law or this regulation.

Author: Joe Garrett, Jr., Ladonna Roshto and Christy Vandevender
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810-27-1-7-.01 Multistate Taxpayers: Recordkeeping for Sales, Use, or Rental Tax Transactions.

(1) In General. In addition to all other recordkeeping requirements otherwise set out in Title 40, Code of Alabama 1975, or any regulations thereunder issued from time to time, every multistate retailer, seller, vendor, or person doing business in Alabama or storing, using, or otherwise consuming in Alabama tangible personal property purchased from a retailer and every multistate lessor of tangible personal property for use in Alabama shall keep complete and adequate records as may be necessary for the Department of Revenue or its authorized representatives to determine the amount of sales, use, or rental tax for the payment or collection of which that retailer, seller, vendor, person, and lessor is liable under Title 40, Chapters 2A, 12, or 23, Code of Alabama 1975. Unless the Department of Revenue authorizes an alternative method of recordkeeping in writing, these records shall show:

(a) Gross receipts. Gross receipts from sales, or rental payments from leases, of tangible personal property (including any services that are a part of the sale or lease) made in Alabama, irrespective of whether the retailer, seller, vendor, person, or lessor regards the receipts to be taxable or nontaxable.

(b) Deductions. All deductions allowed by law and claimed in filing the return.

(c) Purchase price. Total purchase price of all tangible personal property purchased for sale or consumption or lease in Alabama.

These records must include the normal books of account ordinarily maintained by the average prudent businessman engaged in such business, together with all bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account together with all schedules or working papers used in connection with the preparation of tax returns.

(2) Microfilm and Microfiche Records. Records, including general books of account, such as cash books, journals, voucher registers, ledgers, and like documents may be microfilmed or microfiched, as long as such microfilmed and microfiched records are authentic, assessable, and readable and the following requirements are satisfied:

(a) Appropriate facilities are to be provided for preservation of the films or fiche for the periods required and open to examination and the taxpayers must agree to provide transcriptions of any information on microfilm or microfiche which may be required for verification of tax liability.

(b) All microfilmed and microfiched data must be indexed, cross-referenced, and labeled to show beginning and ending numbers and to show beginning and ending alphabetical listing of documents included, and must be systematically filed to permit ready access.

(c) Taxpayer must make available upon request of the Department of Revenue a reader/printer in good working order at the examination site for reading, locating, and reproducing any record concerning sales, use, or rental tax liability maintained on microfilm or microfiche.

(d) Taxpayer must set forth in writing the procedures governing the establishment of

its microfilm or microfiche system and the individuals who are responsible for maintaining and operating the system with appropriate authorization from the Board of Directors, general partner(s), or owner, whichever is applicable.

(e) The microfilm or microfiche system must be complete and must be used consistently in the regularly conducted activity of the business.

(f) Taxpayer must establish procedures with appropriate documentation so that the original document can be followed through the microfilm or microfiche system.

(g) Taxpayer must establish internal procedures for microfilm or microfiche inspection and quality assurance.

(h) Taxpayers are responsible for the effective identification, processing, storage, and preservation of microfilm or microfiche, making it readily available for as long as the contents may become material in the administration of any state revenue law.

(i) Taxpayer must keep a record identifying by whom the microfilm or microfiche was produced.

(j) When displayed on a microfilm or microfiche reader (viewer) or reproduced on paper, the material must exhibit a high degree of legibility and readability. For this purpose, legibility is defined as the quality of a letter or numeral that enables the observer to identify it positively and quickly to the exclusion of all other letters or numerals. Readability is defined as the quality of a group of letters or numerals being recognizable as words or complete numbers.

(k) All production of microfilm or microfiche and processing, duplication, quality control, storage, identification, and inspection thereof must meet industry standards as set forth by the American National Standards Institute, National Micrographics Association, or National Bureau of Standards.

(3) Records Prepared By Automated Data Processing Systems (ADP). An ADP tax accounting system may be used to provide the records required for the verification of tax liability. Although ADP systems will vary from one taxpayer to another, all such systems must include a method of producing legible and readable records which will provide the necessary information for verifying such tax liability. The following requirements apply to any taxpayer who maintains any such records on an ADP system:

(a) Recorded or Reconstructible Data. ADP records shall provide an opportunity to trace any transaction back to the original source or forward to a final total. If detailed print-outs are not made of transactions at the time they are processed, the systems must have the ability to reconstruct these transactions.

(b) General and Subsidiary Books of Account. A general ledger, with source references, shall be written out to coincide with financial reports for tax reporting periods. In cases where subsidiary ledgers are used to support the general ledger accounts, the subsidiary ledgers shall also be written out periodically.

(c) Supporting Documents and Audit Trail. The audit trail shall be designed so that the details underlying the summary accounting data may be identified and made available to the

Department of Revenue upon request. The system shall be so designed that supporting documents, such as sales invoices, purchase invoices, credit memoranda, and like documents are readily available.

(d) Program Documentation. A description of the ADP portion of the accounting system shall be made available. The statements and illustrations as to the scope of operations shall be sufficiently detailed to indicate:

1. the application being performed;
2. the procedures employed in each application (which, for example, might be supported by flow charts, block diagrams, or other satisfactory descriptions of the input or output procedures); and
3. the controls used to ensure accurate and reliable processing. Important changes, together with their effective dates, shall be noted in order to preserve an accurate chronological record.

(e) Data Storage Media. Adequate record retention facilities shall be available for storing tapes and printouts, as well as all supporting documents as may be required by law.

(4) Records Retention. All records pertaining to transactions involving sales, use, or rental tax liability shall be preserved for a period of not less than six (6) years from the date the related return was filed or longer if required under Title 40, Chapter 2A, Code of Alabama 1975, and the related regulations thereunder.

(5) Examination of Records. All of the foregoing records shall be made available for examination on request by the Department of Revenue or its authorized representatives in accordance with Title 40, Chapter 2A, Code of Alabama 1975, and the related regulations thereunder.

(6) Failure of the Taxpayer to Maintain and Disclose Complete and Adequate Records. Upon failure by the taxpayer, without reasonable cause, to substantially comply with the requirements of this regulation, the Department of Revenue in accordance with Title 40, Chapter 2A, Code of Alabama 1975, and the related regulations thereunder shall:

(a) Impose and not abate or reduce in amount any penalty as may be authorized by law.

(b) Enter such other order as may be necessary to obtain compliance with this regulation in the future by any taxpayer found not to be in substantial compliance with the requirements of this regulation.

Author: Peter M. Petrillo, Jr.

Authority: Sections 40-2A-7(a)(5), 40-23-31 and 40-23-83, Code of Alabama 1975

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