NEW MEXICO

TAXATION & REVENUE

DEPARTMENT

CORPORATE INCOME TAX

AUDIT MANUAL

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This Corporate Income Tax Audit Manual (CITM) is designed to aid auditors in the performance of multistate audits. It is intended both as a tool to familiarize auditors with multistate issues and audit techniques, and as a quick reference for more experienced auditors. The CITM contains discussions of the laws, cases and department policies affecting multistate taxpayers, as well as audit steps and techniques for examining multistate taxpayers.

Manuals provided for the guidance of the audit staff are not authoritative, and may neither be cited to support an audit position nor relied upon by a taxpayer. In addition, the CITM should never be considered to be a substitute for researching the laws and court or decisions pertinent to an audit issue. Instead, the manual should be used as an initial step in understanding the issues. Proper use of the manual should provide direction for subsequent research, and will cut down on the time that would otherwise be needed.

The auditing methods and techniques suggested in this manual are intended primarily for guidance, and may not be necessary or applicable for every audit. Auditors should use discretion in deciding which techniques should be used in a particular audit. Furthermore, auditors are strongly encouraged to use their creativity and initiative to develop additional techniques.

Finally, the audit process is continually evolving as the tax law changes, as new court cases are decided, and as audit policies and techniques are developed and refined. To ensure the continued relevance of this manual, it is important that it be updated to reflect these changes.

0125 Audit Objectives/Standards

As recognized professionals, auditors are expected to conduct themselves and their work in a manner that is both fair and effective. Auditors are expected to correctly apply and administer the tax laws in a reasonable, practical, fair and impartial manner. Audits should be conducted in a reasonable manner within the bounds of the law, with sound administration, minimal delay, courtesy and respect to taxpayers. To achieve these objectives, auditors should conduct audits in a manner, which is not unnecessarily burdensome, costly or intrusive to taxpayers. Our goal is to continually strive for quality, effectiveness, and economy in the services provided to taxpayers.

All audits are to be conducted in accordance with the Taxpayer Bill of Rights, Section 7-1-11.2 NMSA 1978, effective July 1, 2003.

The audit process consists of identifying issues, obtaining, evaluating, and documenting information, and arriving at the correct determination, which is supported by a reasonable interpretation of the tax laws. Audits are to be conducted in adherence with the following audit standards in all cases:

- LEGALITY - Audit activities and conclusions must agree with established laws and legal interpretations.

- OBJECTIVITY - An objective examination of sufficient relevant, available factual data be made in a fair and unbiased manner.
- TIMELINESS - Audits must be conducted and completed promptly, with a minimum of inconvenience to taxpayers.
- SUPPORTABILITY - Recommendations must be adequately supported, consistent with both the facts and the law.

0130 Terms And Definitions

The following terms are used extensively in all phases of multistate audits, and in many cases the terms are statutorily defined. The field auditor should develop a working knowledge of these terms and definitions. (See Section 7-2A-2 NMSA 1978 for further terms and definitions.)

Allocation
Allocation is the assignment of non-business income and deductions to a particular state.

Apportionment
The process of applying an apportionment formula to business income in order to divide that income among the states in which the business is conducted.

Apportionment Formula
An apportionment formula is a formula composed of one or more factors. The purpose of using an apportionment formula is to attribute to each state its fair share of the total business net income of the taxpayer. The formula does not purport to "source" net income. Its use is based upon the premise that the net income of a unitary business is properly determined by its activities in a state as reflected by the factors in the formula.

New Mexico Formula
New Mexico normally applies the UDITPA formula. It usually consists of the three equally weighted factors of property, payroll and sales. However, in some instances, New Mexico will require the use of a different formula.

Business Activity
Business activity refers to transactions and activity occurring in the regular course of a particular trade or business of a taxpayer.

Business Income
Business income is income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from the disposition or liquidation of a business or segment of a business; it includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

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Combined or Combination Return
A return of the combined business operations and of the production of income of a unitary group of affiliated corporations; it is used to determine the net income of a taxpayer which conducts a unitary business with commonly owned and controlled domestic and/or foreign corporations.

Combination Return
A return that is based upon information in a combined report.

Commercial Domicile
The state in which is located the principal place from which the trade or business of the taxpayer is directed or managed.

Compensation
Means and includes wages, salaries, commissions, and any other form of remuneration paid to employees for personal services.

Corporation
A corporation means corporation, joint stock companies, real estate trusts organized and operated under the Real Estate Trust Act, financial corporations and banks, other business associations and, for corporate income tax purposes, partnerships and limited liability companies taxed as corporations under the Internal Revenue Code.

Currency Conversion
The exchange of a given amount of a currency for its equivalent in another currency. The term is not used in the sense of currency translation.

Currency Translation
The statement of the equivalent value in one currency of a given amount of another currency. In contrast to "conversion", "translation" does not refer to the actual exchange of an amount of one currency for its equivalent in another; "translation" is only a statement of valuation. For example, when the exchange rate for British pounds was 1.40, the translation of 1,000 pounds to U.S. dollars produced the equivalent valuation of $ 1,400. Conversion would have produced 1,400 U.S. dollars in actual cash.

Fiscalization
The process of placing the income and formula factors of related corporations which have a different income year-ends on a common income year-end in order to prepare a combined report.

Fiscalization is accomplished by placing the income and formula factors of all related corporations on the income year-end of the key taxpayer, generally the parent corporation.

Foreign Corporation

Any corporation other than a U.S. corporation and any corporation not incorporated in New Mexico, for purposes of the Corporate Income and Franchise Tax Act.

Formula Factors
The Uniform Division of Income for Tax Purposes Act provides that all business income shall be apportioned to this state by use of property, payroll, and sales factors.

1. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used everywhere during the income year.
2. The payroll factor is a fraction, the numerator of which is the total amount of compensation paid by the taxpayer in this state during the income year, and the denominator of which is the total compensation paid everywhere during the income year.
3. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year. For taxable years beginning on or after January 1, 1995 and beginning prior to January 1, 2011, manufacturers who have elected to apportion in accordance with the double-weighted sales apportionment formula set forth in Section 7-4-10 NMSA 1978 shall apportion in accordance with the double-weighted sales apportionment formula for every taxable year covered by the election.

Multistate Tax Compact, Multistate Tax Commission (MTC)
The Multistate Tax Compact is an agreement among participating states to facilitate the uniform administration of state taxes for multistate taxpayers. The Compact incorporates UDITPA, and establishes the Multistate Tax Commission (MTC). The MTC is charged with studying state and local tax systems, developing and recommending proposals for improvement and increased uniformity of state and local tax laws, and administering the Multistate Tax Compact. States join the MTC by enacting the Multistate Tax Compact (including the UDITPA provisions). New Mexico is a member state.

Legal Domicile
The state in which the corporation was incorporated.

Nexus
That connection with a state which is sufficient to give the state jurisdiction to impose a tax.

Non-business Income
All income other than business income.

Public Law 86-272
A federal law (15 USCA, Section 381 et seq.) which provides that a state cannot impose a net income tax upon a taxpayer whose only business activities within the state consist of the solicitation of sales of tangible personal property.

Sales
Gross receipts of the taxpayer for the purposes of the apportionment formula.

SBE
State Board of Equalization, State of California.

State
Any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country.

Taxable In Another State
For UDITPA purposes, the taxpayer is taxable in another state if either two conditions exist: 1) within that state it is subject to 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) if that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether the state actually imposes such a tax.

Limitation: A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer: 1) conducts activities in that state pertaining to the production of non-business income; or 2) conducts business activities relating to another separate trade or business through a separate corporation.

Taxpayer
Means any corporation or group of corporations subject to the taxes imposed by New Mexico Corporate Income and Franchise Tax Act. The use of the term “taxpayer” does not limit the use of the combined report procedure when applicable; nor does it necessarily extend jurisdictional nexus to corporations which are not present in a given state even though they are part of a unitary business which does have a jurisdictional nexus within that state. (*Edison California Stores v. McColgan*, 30 Cal. 2d 472 (1947); *Zale-Salem v. Oregon Department of Revenue*, 391 P. 2d 601 (1964); *Coca-Cola Co. v. Oregon Department of Revenue*, 533 P. 2d 788 (1975).

The Three-Unities Test
A test that was established in the case of *Butler Bros. V. McColgan*, 315 U.S. 501 (1942) for the purpose of defining a unitary business within the confines of a single corporation. The three unities, as set forth in that case, are:

a) Unity of Ownership: More than 50% of the component parts of the unitary business must be commonly owned, either directly or indirectly. Satisfaction of this requirement is a prerequisite to a finding that a component is unitary with other components of a business.
b) Unity of Operation: This quality is evidenced by central purchasing, advertising, accounting, management, etc. These central activities constitute a “flow of value”, the term which the U.S. Supreme Court has most recently used in defining a unitary business. *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).
c) Unity of Use: This quality if evidenced by a centralized executive force and by a centralized general operations systems. Such centralization also creates a flow of value.

Throwback Sales
A sale of tangible personal property shipped from an office, store, warehouse, factory, or other place of storage in a state in which a corporation is taxable (i.e. has a jurisdictional nexus) to a state in which the corporation is not taxable.

State-of-Origin Assignment: A throwback sale is assigned to the state from which the sold property was shipped if the taxpayer is taxable in that so-called "state of origin". (*Covington Fabrics Corp. v. South Carolina*, 264 S.C. 59, 212 S.E. 2d 574 (1975).)

Double Throwback
If the taxpayer is not taxable in the state of origin, the so-called "double throwback" rule applies. Under that rule, the sale is attributed to the state from which the sale was made. (*GTE Automatic Elec., Inc. v. Allphin,* 68 III. 2d 326, 369 N.E. 2d 841 (1977).)

Joyce Rule: If one corporation in a combined group is taxable in a particular state, one should not attribute to that state sales made into that state by other corporations which are included in the combined report but do not have a jurisdictional nexus in the state unless the latter are acting as sales agents of the former. This is the so-called Joyce rule. See *Appeal of Joyce, Calif. St.* Bd. *Of Equalization*, November 23, 1966.

Uniform Division Of Income For Tax Purposes Act (UDITPA)
The Uniform Division of Income for Tax Purposes Act (UDITPA) (Sections 7-4-1 to 7-4-21 NMSA 1978). It is the model statute which is included in the Multistate Tax Compact as Article IV.

UDITPA Formula Factors (See Definitions - Formula Factors)

Unitary Business
A business among the various components of which there exist flows of value which make it impossible to determine just how much of the total income of the business was produced by each component. (See *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983).) Such flows of value will exist when the components "contribute to or are dependent upon each other, regardless of whether the business conducts its operations through one corporation or through several corporations." (See *Edison California Stores v. McColgan*, 30 Cal. 2d (1947).) (See also Section 7-2A-2(Q) NMSA 1978 for purposes of selecting the combined unitary filing method.)

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Subsequent sections of this manual will cover specific, detailed aspects of the apportionment and allocation procedures applicable to multistate businesses. In order to set those rules into the proper perspective, this section of the manual is intended to provide an overall understanding of the framework of the New Mexico tax system as it relates to multistate businesses.

In order for a state to have jurisdiction to tax a corporation, that corporation must have a minimum connection or "nexus" within the state. Since this is a prerequisite to tax, this section of the manual will begin with a discussion of nexus, followed by coverage of the additional jurisdictional limitations imposed by Public Law 86-272. Once jurisdiction to tax has been established, a discussion of the distinction between the New Mexico Corporate Franchise and Income taxes is the logical next step. The concept of commercial domicile and its affect on many of New Mexico's sourcing rules will then be introduced.

1100 Nexus And A State's Right To Tax

The term "nexus" refers to the level of activity or presence that a taxpayer has established within a taxing jurisdiction. In order for a state (or other taxing jurisdiction) to impose a tax, the Due Process and Commerce Clauses of the U.S. Constitution require that the taxpayer have a certain minimum connection, or nexus, within the state. The point at which sufficient nexus is reached has not been precisely defined, but a number of court cases have addressed the issue and have provided some parameters.

For many years, the standard for establishing nexus was considered to be physical presence within the state. This standard was supported by the U.S. Supreme Court's decision in *National Bellas Hess Inc. v. Department of Revenue of Illinois,* 386 US 753, L.ed 2d 505, 87 S Ct 1389 (1967):

In *National Bellas Hess*, the state of Illinois attempted to impose a use tax on the Illinois sales of an out-of-state mail order house whose only contacts with the state were via the mail or common carrier. Catalogues and advertising flyers were mailed to customers in Illinois. The customers mailed merchandise orders to the Missouri headquarters, and the goods were then sent to the customers either by mail or by common carrier.

The Court stated that allowing states and other jurisdictions to impose use tax burdens based upon such minimal connections could entangle interstate businesses in a "virtual welter of complicated obligations to local jurisdictions with no legitimate claim to impose `a fair share of the cost of the local government'". The Court concluded that the mail order house did not have sufficient nexus in Illinois, and the requirement that they collect and pay the Illinois use tax therefore violated the due process and commerce clauses.

More recently however, the U.S. Supreme Court revisited the issue and issued a decision that suggests that physical presence may not always be necessary for nexus:

Quill Corp v. North Dakota (112 S.Ct. 1904, 119 L.Ed.2d 91 (1992)), involved whether a mail order house had sufficient nexus within North Dakota for that state to impose a use tax. The facts in this case were similar to those in *National Bellas Hess.* Quill solicited its sales of office equipment through catalogs and flyers, advertisements in national periodicals, and telephone calls. All of its merchandise was delivered to its North Dakota customers by mail or common carrier from out-of-state locations. Quill's only property within the state consisted of computer software programs that were licensed to some of its North Dakota customers that enabled them to check on Quill's current inventories and prices and to place orders directly (the trial court found this physical connection to be insignificant for nexus purposes).

The Court explained that the Due Process Clause concerns the fundamental fairness of government and requires (1) "some definite link, some minimal connection, between a state and the person, property or transaction it seeks to tax," and (2) that the "income attributed to the State for tax purposes must be rationally related to values connected with the taxing state." The Court held that the minimum connection would exist so long as an out-of-state corporation purposefully availed itself of the benefits of an economic market in the taxing state, even if it had no physical presence in the state. Since Quill had purposefully directed a substantial amount of its activities at North Dakota residents, it was clearly receiving benefits from its access to the state, and clearly had fair warning that its activity may be subject to North Dakota's jurisdiction. The Court therefore found that North Dakota's use tax did not violate Due Process.

In contrast to the "minimum connections" test for due process, the Court observed that the test under the Commerce Clause was a "substantial nexus" test. The Commerce Clause was intended to be a means of limiting state burdens on interstate commerce. In this context, the Court found the physical presence test of *Bellas Hess* to be appropriate. The artificiality of the bright-line physical presence rule was found to be more than offset by the benefits of firmly establishing boundaries of legitimate state authority. Furthermore, the *Bellas Hess* physical presence standard for state sales and use taxes had become part of the basic framework of the mail order industry. In the interest of "stability and orderly development of the law," the Court upheld physical presence as the relevant standard for substantial nexus under the Commerce Clause. The Court concluded that the facts in Quill did not constitute substantial nexus.

The implication of this decision on state franchise taxes is unclear. Although the Court admitted the physical presence standard to be artificial, they did not find that fault to be compelling enough to reject the long-standing rule that *Bellas Hess* had established in the area of sales and use taxes. Since there is no Supreme Court precedent on this issue for franchise tax purposes, an argument may be made that a less artificial standard should apply for franchise tax purposes. The South Carolina Supreme Court in Geoffrey, discussed below, has taken this position.

Geoffrey, Inc. v. South Carolina Tax Commission (437 S.E.2d 13 (1993), Cert. Denied, U.S. S.Ct., 11/29/93) was a South Carolina state income tax case involving the existence of nexus. Geoffrey was a Delaware company with no offices, employees or tangible property in South Carolina. Geoffrey executed a license agreement which gave its parent, Toys R Us Inc., the right to use the "Toys R Us" trade name (as well as other trade names, trademarks, merchandising skills, techniques and know-how) in all but five states. In consideration for the licenses, Geoffrey received a royalty of 1% of the net sales of Toys R Us, Inc. Subsequent to the agreement, Toys R Us began doing business in South Carolina, and made royalty payments to Geoffrey based upon their sales in that state. The State of South Carolina assessed income tax on Geoffrey's royalty income. Geoffrey filed a claim for refund, arguing that it did not have sufficient nexus in South Carolina for its royalty income to be taxable there. The South Carolina Supreme Court disagreed, holding that Geoffrey's presence in South Carolina satisfied both the Due Process and Commerce Clause tests.

Geoffrey had asserted that it had not purposefully directed its activity at South Carolina, pointing out that Toys R Us had no South Carolina stores when the license agreement was executed and that the subsequent expansion was purposeful on the part of Toys R Us, not Geoffrey. The Court responded that by electing to license its trademarks for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. By licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey was found to have the minimum connection required by due process.

The Court also found the "minimum connection" to have been satisfied by the presence within the state of Geoffrey's intangible property (the agreement resulted in a franchise in South Carolina; and when Toys R Us made sales, accounts receivable were generated for Geoffrey). With respect to the due process requirement that the tax be rationally related to benefits that have been conferred, the Court stated that by providing an orderly society, South Carolina had made it possible for Geoffrey to earn income from Toys R Us customers in that state.

In analyzing the Commerce Clause aspects of the case, the Court reiterated that the physical presence requirement of *Quill* was decided in the context of a use tax, and did not consider the issue for purposes of a franchise or income tax. The Court therefore did not consider physical presence to be the standard in this case, and concluded that by licensing intangibles for use in the state and by deriving income from their use there, Geoffrey had substantial nexus with South Carolina.

> **Note:** Geoffrey is a South Carolina case and may not be cited as precedent for New Mexico purposes. The case is instructive, however, because it indicates how at least one Court has interpreted *Quill.*

Clearly, a significant physical presence within a state will be enough to constitute nexus under both the Due Process and Commerce Clauses. The level of physical presence that is required is not as clear. For example, the existence of some floppy disks within the state was not found to be significant in Quill. If an auditor is asserting nexus in a case where the physical connections are arguably minor, the audit narrative should explain the importance of those connections to the business activity.

Constitutional nexus standards have been the subject of a good deal of controversy lately because of the new ways that business is being conducted in today's electronic age and because of recent court decisions that suggest that the traditional concepts of nexus may be expanding. Some of the controversy involves nexus through agency relationships. Another area of speculation centers around the level of physical presence that is required to establish nexus, and the possibility that nexus standards may be expanding to the point where nexus can exist for state franchise or income tax purposes in some situations even without the taxpayer having a physical presence within the state.

The trend in the courts appears to be a de-emphasis of the physical presence requirements in recognition of the changing business environment. For example, in the New York Court of Appeals cases of *Orvis Company, Inc*. and *Vermont Information Processing, Inc*. (86N.Y.2d 954 (1995)), the court stated that the "substantial *nexus*" that is required in order for a state to have jurisdiction to tax under the Commerce Clause does not necessarily mean "substantial *physical presence*." In the facts of those cases, the Vermont corporations marketed products to New York through mail order and had a substantial customer base in New York. Although visits by employees of the corporations to New York were described by the taxpayers as sporadic and occasional, the court believed that those visits significantly enhanced sales and benefited the business. Therefore, because there was a substantial economic presence in New York, the fact that the level of physical presence was "more than a slightest presence" was considered enough to establish nexus. (Note that these were sales tax cases, so Public Law 86-272 did not apply.) The Orvis and Vermont Information Processing cases were decided in a New York court and do not establish precedent for New Mexico, but the analysis used by the court may be helpful to an auditor attempting to establish nexus. For example, if a foreign corporation makes sales to a California destination and that the corporation's ties to the state are at least as strong as the ties that Orvis and Vermont Information Processing had with New York, then the auditor could use the rationale explained in the decision to assert that nexus has been established.

When a New Mexico taxpayer makes sales to a foreign destination, auditors are usually looking at the nexus issue from the opposite perspective because the sales may only be thrown back to New Mexico if the corporation does not have nexus in the foreign jurisdiction. Auditors should consider the *Orvis* and *Vermont Information Processing* cases in determining the strength of the taxpayer's connections in the foreign country. Remember, however, that the case law is still developing in this area so there is no bright-line threshold. If the auditor does not believe that substantial nexus has been established in the foreign country, it will be important to fully develop all of the facts and clearly explain the rational supporting the nexus determination.

In some cases, nexus may be established by activities of an agent rather than by activities of the taxpayer.

When a taxpayer is first entering a taxing jurisdiction or when the taxpayer's activities within a jurisdiction are increasing, it may be necessary to establish the date upon which nexus was established. Although a taxpayer may establish nexus during the income year, the state will not have authority to tax income earned prior to the date upon which nexus was achieved.

When considering the materiality of a nexus issue, auditors must remember to take into account the effects of P.L. 86-272 limitations and other exemptions from tax (such as the exemptions for insurance companies). If a corporation will be immune from state taxation under P.L. 86-272, nexus will be a mute point. In situations that do not involve sales of tangible personal property, P.L. 86-272 will not apply, but the sales factor rules will need to be carefully considered in order to determine whether nexus within a particular state will have a significant tax effect. For example, if a corporation derives income from intangible property used within the state, that income may be considered an identifiable income producing activity and included in the denominator of the sales factor. If the income producing activity occurs in this state, include in the numerator of the sales factor.

1110 Representative Nexus: Employees or Independent Contractors or Acting as an Agent

Nexus can be established where one company or a group of individuals are present in the State acting as representative(s) of an out-of-state company with no other presence in the State. The representative's presence is attributed to the out-of-state company to establish the required nexus between the State and the nonresident company.

Activities performed within a state may establish nexus even if an agent of the taxpayer, instead of by the taxpayer itself, performs those activities. The fact that an agent performs activities does not diminish the fact that the taxpayer is realizing benefits from within the state. Even the fact that the agent might also work for other principals is unimportant (although only the activities performed on behalf of the taxpayer may be considered in determining whether the threshold for nexus has been met). The relevant test for determining nexus therefore focuses on the nature and extent of the activities within a state, regardless of whether those activities are performed directly by the taxpayer or by an agent on the taxpayer's behalf. (*Scripto Inc. v. Carson*, 362 U.S. 207 (1960); *Illinois Commercial Men's Association v. State Board of Equalization*, (1983) 34 Cal.3d 839; *Dresser Industries, Inc.*, Cal. St. Bd. of Equal., Opinion on Petition for Rehearing, October 26, 1983).

Since performing warranty work through a subcontractor may be enough to establish taxability within the state, auditors should request copies of the manufacturer's warranty provisions. In addition, the auditor should determine how the warranties are honored and if the repairs are subcontracted or not. Copies of contracts for subcontracting of warranty services should be requested. The U.S. Supreme Court has held that the in-state presence of a representative of an out-of-state seller who conducts regular and systematic activities in furtherance of the seller's business, creates nexus *(Scripto Inc. v. Carson*, 362 U.S. 207 (1960*); General Trading Corp. vs. Iowa*, 322 U.S. 327 (1966*); Tyler Pipe Industries, Inc. vs. Washington Department of Revenue,* 483 U.S. 232 (1987*)*). Depending on the facts of an audit, the out-of-state manufacturer may have nexus in New Mexico by providing for repair facilities.

Corporations will often act as agents for unitary affiliates. For example, assume that Corporations A and B are unitary. Corporation A manufactures power tools in Wisconsin, and has no employees and engages in no direct activities in New Mexico. Corporation B is a building supply distributor operating in New Mexico. When B's employees solicit sales from building supply retailers in New Mexico, they also solicit sales of power tools on behalf of Corporation A. When power tool orders are taken, the orders are forwarded to Corporation A, and B's employees receive a commission. Corporation B's activities in New Mexico on A's behalf will cause A to have nexus within this state.

1200 Public Law 86-272

Public Law 86-272 was enacted by Congress as of September 14, 1959 to prohibit states from imposing an income tax upon a taxpayer whose only activity within a state is solicitation of orders for the sale of tangible personal property (15 USCA §381). Since such activity is generally sufficient to establish nexus, the business community was concerned that interstate commerce would be burdened because businesses would be subject to tax in many states in which they had minimal activities. Public Law 86-272 was enacted in response to this concern. Public Law 86-272 established the following provision in the U.S. Code:

> **TITLE 15: COMMERCE AND TRADE**
> **CHAPTER 10B: STATE TAXATION OF INCOME FROM INTERSTATE COMMERCE -- NET INCOME TAXES**
>
> **§381**
>
> No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, the following:
>
>> the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
>>
>> the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).
>
> The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to --
>
>> any corporation which is incorporated under the laws of such state, or
>>
>> any individual who, under the laws of such State, is domiciled in, or a resident of, such State.
>
> For purposes of subsection (a), a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in

> such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.
>
> For purposes of this section --
> The term "independent contractor" means a commission agent, broker, or other independent contractor who is engaged in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities; and the term "representative" does not include an independent contractor.

1210 Key Provisions Of Public Law 86-272

Immunity in a state does not apply to any corporation incorporated within the state. (Note that a corporation will be eligible for immunity if it is qualified to do business in the state, so long as it is not incorporated there. Since immunity only applies to taxes based on net income, a taxpayer qualified to do business in New Mexico would still be liable for the franchise tax.)

Immunity under P.L. 86-272 only applies to sellers of *tangible personal property.* Activities related to sales of real estate or intangibles, to the leasing, renting, or licensing of property, to the provision of services, or to any other transactions not specifically protected under P.L. 86-272 will cause a loss of immunity.

Activity within the state must not go beyond solicitation of orders for sales of tangible personal property. (An exception is made for de minimis activities.)

Approval of the orders must be made outside the state.

Deliveries to customers must be made from a point outside the state.

Certain in-state activities conducted on behalf of the taxpayer by an independent contractor will not cause loss of immunity even though such activities would not be allowed if performed by the taxpayer directly.

A single event during the income year can cause the loss of immunity for the entire year so long as the taxpayer had nexus within the state. If nexus is established mid-year, then the taxpayer would not be taxable prior to the date of nexus. The following example will illustrate this concept:

Example: ABC Corporation is a manufacturer of recycling equipment headquartered in Arizona. ABC made sales to New Mexico customers throughout 1994, but from January to June the sales were ordered over the telephone by the New Mexico customers, and were shipped by common carrier from the Arizona headquarters. ABC had no other connections with New Mexico during this time period. On July 1, 1994, ABC assigned an employee to live in New Mexico and solicit sales from New Mexico customers (this act established nexus). On December 1, ABC's employee exceeded the activities allowed under P.L. 86-272 by assembling a large recycling system at a customer's New Mexico location.

Although the employee's activity on December 1 caused loss of immunity under P.L. 86-272 for the entire year, ABC did not have nexus in New Mexico until July 1. Assuming that ABC is a calendar year taxpayer, New Mexico would have the right to tax ABC on its income attributable to New Mexico sources from July 1 to the end of the year.

The loss of immunity in one year does not carry over to a subsequent year. Therefore, if the employee's activities did not exceed allowable solicitation during 1995, ABC would again be immune from New Mexico tax in that year.

P.L. 86-272 only applies to interstate commerce and not to foreign commerce.

(a) Taxability in any particular state under P.L. 86-272 must be determined separately for each corporation in the combined group. Thus, the activities of one member of the combined group may not cause loss of immunity for another member. (An exception may arise when one member of the combined report acts as a representative or independent contractor for another member.)

(b) For sales factor purposes, sales to a state in which the taxpayer is immune from taxability under P.L. 86-272 will be "thrown-back" to the state from which the goods were shipped. *For apportionment purposes only however*, if any member of the combined group is taxable in the destination state, then the sales will be included in the combined group's sales factor numerator for that state.

1220 Solicitation Of Sales Defined

In *Wisconsin Department of Revenue v. William Wrigley Jr., Co.,* 112 S.Ct. 2447, 120 L.Ed.2d 174 (1992), the U.S. Supreme Court established a standard for interpreting the term "solicitation." Under that standard, "solicitation of orders" means activities that are essential or entirely "ancillary" to making requests for orders.

The Court explained ancillary activities to be those activities that serve no independent business function apart from their connection to the soliciting of orders. If a company would engage in certain activities for reasons other than solicitation, the fact that they have assigned those activities to salespersons does not make the activities ancillary to solicitation of orders. The Court presented the following example:

"Providing a car and a stock of free samples to salesmen is part of the `solicitation of orders' because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the `solicitation of orders,' since there is good reason to get that done whether or not the company has a sales force. Repair

and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into `solicitation' by merely being assigned to salesmen."

Another example of how the Courts have limited the interpretation of "solicitation of orders" to mean activities directly related to making requests for orders is shown in the following case: In *Brown Group Retail v. Franchise Tax Board*, 44 Cal.App.4th 823 (1996), the taxpayer sold shoes to independent retailers. In addition to sales personnel who solicited sales within California, the taxpayer also employed two individuals within the state whose function was to help shoe retailers establish and enhance their stores. This involved providing assistance and advice regarding everything from site selection and store lease negotiations to improving inventory turnover, trimming windows and setting up bookkeeping systems. These services were provided free of charge, and the employees who provided the services were not allowed to take orders for sales. The purpose for providing these services was to increase the retailers' sales, which would in turn benefit the taxpayer. The Court held that while this activity was ultimately intended to increase the taxpayer's sales, it did not facilitate requests for sales. Therefore, it was not a protected activity under P.L. 86-272.

The language of P.L. 86-272 (15 USCS §381(c)) implies that maintenance of an office within the state goes beyond solicitation, even if that office is maintained exclusively to facilitate requests for purchases. In the *Wrigley* case however, the Court distinguished between offices that are formally attributed to the company, and in-home offices used by sales personnel to complete paperwork or hold occasional meetings. The in-home offices maintained by Wrigley's salespeople were found to serve no purpose apart from their role in facilitating solicitation, and so did not cause loss of immunity.

The Court in *Wrigley* also concluded that a de minimis exception should be applied. Even if a taxpayer performs activities within a state that are not "ancillary to solicitation," those activities should not cause the taxpayer to lose immunity if they are de minimis or trivial. In determining whether such activities are trivial enough to be considered de minimis, the nonprotected activities should not be looked at individually, but should be considered as a whole. The facts in *Wrigley* serve as an illustration of how the de minimis exception should be applied:

> In *Wrigley*, the Court found the following activities of the taxpayer to go beyond solicitation of orders: (1) replacement of stale gum in customers' displays; (2) "agency stock checks" (This consisted of directly selling gum to fill customers' display racks); and (3) storage of gum within the state for the primary purpose of stale gum replacement and agency stock checks. The taxpayer argued that these activities were minimal, and emphasized that the gum sold in agency stocks accounted for only .00007% of Wrigley's annual sales within that state, and amounted to only several hundred dollars a year. The Court did not agree that the activities were de minimis:
>
> *"We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose as*

> *well as for the less frequently pursued (but equally unprotected) purpose of selling gum through `agency stock checks'. Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State."*

The Multistate Tax Commission has adopted guidelines for applying P.L. 86-272 that reflect the standards established by the *Wrigley* decision. Contained in those guidelines are examples of activities that are generally considered to exceed solicitation, as well as examples of protected activities. Auditors should keep in mind that these rules are not intended to cover all possible situations. Each case will have to be judged on its own facts. More importantly, those facts must be considered in the context of the taxpayer's activities within the state as a whole.

Examples of Unprotected Activities:
The following activities are not generally considered to constitute solicitation of orders or to be ancillary to solicitation, and are not otherwise protected under P.L. 86-272. If the performance of any of these activities within a state exceeds a de minimis level, immunity under P.L. 86-272 may be lost.

Making repairs or providing maintenance or servicing. (The SBE confirmed that performing warranty repairs within the state went beyond solicitation of orders in *Appeal of Aqua Aerobic Systems, Inc.*, Cal. St. Bd. of Equal., 11/6/85.)

Collecting current or delinquent accounts, whether directly or through third parties.

Investigating credit worthiness.

Installation of the product, or supervision of installation. (In *Appeal of Riblet Tramway Company*, Cal. St. Bd. of Equal., December 12, 1967, the SBE found that a contractual right to inspect and approve the installation of a product will also cause loss of immunity.)

Conducting training courses, seminars or lectures for personnel other than personnel involved only in solicitation.

Providing any kind of technical assistance or service including engineering assistance or design service, when one of the purposes thereof is other than facilitating the solicitation of orders.

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.

Approving or accepting orders.

Repossessing property.

Securing deposits on sales.

Picking up or replacing damaged or returned property.

Hiring, training, or supervising personnel, other than personnel involved only in solicitation.

Using agency stock checks or any other process by which sales are made within the state by sales personnel.

Maintaining a sample or display room in excess of two weeks at any one location within the state during the tax year.

Carrying samples for sale, exchange or distribution in any manner for consideration or other value.

Owning leasing, using or maintaining any of the following facilities or property in state:

- Repair shop.
- Parts department.
- Any kind of office other than an in-home office as described below.
- Warehouse.
- Meeting place for directors, officers, or employees.
- Stock of goods other than samples for sales personnel or that are used entirely ancillary to solicitation.
- Telephone answering service that is publicly attributed to the company or to employees or agents of the company in their representative status.
- Mobile stores (vehicles with drivers who make sales from the vehicles).
- Real property or fixtures to real property of any kind.
- Consigning stock of goods or other tangible personal property to any person, including an independent contractor, for sale.
- Maintaining, by any employee or other representative, an office or place of business of any kind. An exception to this general rule applies only with respect to an in-home office located within the residence of the employee or representative that is not publicly attributed to the company. Even then, the use of such an in-home 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 other activities that are protected under P.L. 86-272. For this purpose, it is not relevant whether the company pays directly, indirectly, or not at all for the cost of maintaining the in-home office.

  A company will normally be determined to be maintaining an office or place of business within the state if they have a telephone listing or other public listing within the state (including a listing for an employee or representative if the listing identifies them in their representative capacity). Similarly, advertising or business literature that indicates that the company or its employee or representative can be contacted at a specific address within the state shall normally be construed as the company maintaining an office or place of business within the state. However, the normal distribution and use of business cards and stationary 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.

Entering into franchising or licensing agreements; selling or otherwise disposing of franchises and licenses; or selling or otherwise transferring tangible personal property pursuant to such franchise or license.

Shipping or delivering goods into this state by means of private vehicle, rail, water, air or other carrier, irrespective of whether a shipment or delivery fee or other charge is imposed, directly or indirectly, upon the purchaser, providing that the taxpayer exceed the De minimis nexus standard as disclosed in Regulation 3.5.19.15(F) NMAC.

Conducting any other activity which is not entirely ancillary to requests for orders, even if such activity helps to increase purchases.

Examples of Protected Activities:
The following activities will not cause the loss of immunity:

- Soliciting orders for sales by any type of advertising.
- 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 #18 above.
- Carrying samples and promotional materials only for display or distribution without charge or other consideration.
- Furnishing and setting up display racks and advising customers on the display of the company's products without charge or other consideration.
- Providing automobiles to sales personnel for their use in conducting protected activities.
- Passing orders, inquiries and complaints on to the home office.
- Missionary sales activities (the solicitation of indirect customers for the company's goods). For example, a manufacturer may sell only to wholesalers, but it may solicit retailers to buy its products from the wholesale customers. Such solicitation would be protected.
- Coordinating shipment or delivery without payment or other consideration.
- Checking of customer's inventories without charge (for reorder, but not for other purposes such as quality control).
- Maintaining a sample or display room for two weeks or less at any one location within the state during the tax year.
- Recruiting, training or evaluating sales personnel, including occasionally using homes, hotels or similar places for meetings with sales personnel.
- Mediating direct customer complaints when the purpose thereof is solely for ingratiating the sales personnel with the customer and facilitating requests for orders.
- Owning, leasing, using or maintaining personal property for use in the "in-home" office or automobile of an employee or representative, so long as the use of the property is

solely limited to the conducting of protected activities. Therefore, maintaining personal property such as cellular telephones, facsimile machines, duplicating equipment, personal computers and computer software shall not, by itself, remove the protection of P.L. 86-272 as long as such equipment is used only to carry on protected solicitation and activity entirely ancillary to such solicitation.

1230 Activities Of Independent Contractors

P.L. 86-272 extends protection to certain in-state activities if an independent contractor conducts them, even though immunity would be lost if those same activities were conducted directly by the taxpayer. Independent contractors may engage in the following limited activities within the state without causing the taxpayer to lose immunity:

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

Except for purposes of display however, the taxpayer may not maintain any inventory or stock of goods within the state under consignment with the independent contractor. Maintenance of such inventory will cause loss of immunity.

Sales representatives who represent a single principal are not considered to be independent contractors, and are subject to the same limitations as an employee.

In *Appeal of Nardis of Dallas, Inc.*, Cal. St. Bd. of Equal., April 22, 1975, a salesman solicited orders in California for a Texas-based company, and maintained a showroom within California for that purpose. The taxpayer argued that the salesman was an independent contractor, therefore the maintenance of the showroom should be a protected activity under P.L. 86-272. The SBE disagreed, stating that the salesman was not an independent contractor under the tests developed at common law. Factors that the SBE found to be significant in determining that an employer/employee relationship existed included the taxpayer's right to discharge the salesman upon notice, and the fact that the parties themselves believed that they had created an employment relationship, as evidenced by the payment of unemployment taxes. As an employee of the taxpayer, maintenance of the showroom went beyond the minimum activities allowed under P.L. 86-272.

1500 Commercial Domicile

Certain items of nonbusiness income from intangibles, such as interest and dividend income, are allocated to the state in which the corporation's commercial domicile is located. The commercial domicile of a corporation is defined to mean the principle place from which the trade or business of the taxpayer is directed or managed. The commercial domicile may be distinguished from the legal domicile, which is merely the state of incorporation.

In most cases, the commercial domicile of a corporation will be the state in which the headquarters or principle offices are located. In some situations however, it will not be as easy to identify where the actual control of the corporation took place, and the auditor will have to analyze the facts and circumstances.

CORPORATE INCOME TAX AUDIT MANUAL

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2000 PREAUDIT PROCEDURES

2000 Preaudit Procedures

The preaudit phase is vital to the audit process. This is the phase where the auditor determines whether to proceed with the examination or accept the returns as filed. If the determination is made to proceed, this is also the phase where the auditor plans the audit and performs the preliminary work. Proper attention to the preaudit procedures will improve the quality of the audit and help reduce total audit time.

The preaudit steps discussed in this section are fairly universal for all multistate audits. Once specific audit issues have been identified, the preaudit procedures may be expanded to specifically address those issues.

Care should be taken to keep an open mind throughout the preaudit phase. The information available during this phase is seldom sufficient to make any conclusive determinations. By becoming prematurely convinced of the outcome of issues, auditors can fall into the trap of only gathering information that supports a predetermined conclusion.

2100 Review Of Tax Returns Under Audit

The auditor should review all parts of the return in detail. The purpose for this review should be to become familiar with the return, and to make a preliminary identification of audit issues. Special attention should be paid to other data transmitted with the returns or contained in the audit file. Auditors should ensure that they have obtained all amended returns for the income years being addressed.

As the returns are being reviewed, auditors should take preliminary notes to record any questions or potential audit issues. Many of the questions contained in these notes will be resolved as the auditor progresses further through the preaudit procedures. Any remaining questions are issues that may be incorporated into the audit plan. For easier workpaper reference, notes on each subject matter should be started on a new page. For example, any notes on the property factor should be on a separate sheet from notes concerning the payroll factor. When the working papers are assembled in final form, the notes can then be included in the appropriate workpaper section.

If the auditor encounters any unfamiliar issues on the return, preliminary research should be conducted to become familiar with the issue. Such research during the preaudit stage will assist the auditor in determining the audit potential of an issue, and in planning the audit procedures, questions and types of records necessary to develop the issue.

Certain industries have unique issues and may require special apportionment rules. In such cases, research of the industry should be conducted in addition to research of the particular tax return items.

2200 Review Of Prior Audits

Prior audit reports, protests, and appeal files should always be reviewed. If a copy of the prior audit report is not retained in the program office or associated with the returns, it should be requested. Not only should the prior audit report help identify prior year adjustments which may be applicable to the current years, it should also help determine the extent of the audit scope. For example, if the sales factor numerator was extensively tested in prior years and no adjustments resulted, it might be possible to minimize the testing in the current years if business operations have not changed. Also, if an audit adjustment was made in prior years, the auditor **may** be able to use the factual development from the prior audit as a roadmap to streamline the verification of current year facts by directing the auditor's focus to the key areas. Although you may use the prior audit as a roadmap, audits that are based solely upon facts developed in a prior audit cycle without adequate factual development for the current period are not acceptable. This policy applies to unitary adjustments and any other issues that recur over more than one audit cycle**.**

The facts for the current audit cycle must be fully developed unless the taxpayer advises the auditor they agree with the adjustment. In such cases, if the taxpayer is willing to sign a statement confirming their agreement, there is no reason to require the taxpayer to undergo an extensive examination of the issue for the current years.

IMPORTANT: Prior audit reports can help to streamline the audit process and avoid duplication of efforts between audit cycles. On the other hand, improper reliance on a prior audit can result in audit adjustments that are unsupported. Judgment needs to be used in determining the degree of additional information that will be needed for the current years, and the auditor needs to keep in mind that facts often do change from year to year. Also, court decisions or changes in the statute or regulations can reverse prior interpretations.

Once the auditor has determined that some reliance may be placed on facts developed in the prior audit report, the auditor must determine the amount of additional information that will be necessary for the current cycle. If a unity issue was fully developed in the prior audit, the amount of additional information required to be verified may be limited. For example, such items as updating the amounts of intercompany sales, updating the amounts of intercompany financing, updating the number of personnel transfers between corporations, and addressing any new unitary ties may be all that is necessary. In other cases, the auditor will need to more fully develop weak facts or facts that were not addressed in the prior audit.

2225 Reliance On Prior Audits

Generally, auditors may not rely solely upon facts developed in a prior audit cycle. An exception may be made in cases where the taxpayer agrees that the prior year facts are applicable for the current years and agrees to the adjustment.

Prior year audit results should only be used as a starting point, not as the primary basis for an audit recommendation on the current audit cycle. Although auditors should strive to achieve consistent treatment from year to year (as long as the taxpayer continues to operate in the same manner), prior year determinations that were incorrect or based upon incomplete information should not be followed. The facts for the current cycle must be developed because facts often do change from year to year. Independent development of the current year facts will prevent an adverse protest or appeal resolution of the prior years from automatically applying to both audits, especially if the factual record for the current cycle is even stronger than in the prior cycle. For example, if the auditor can develop a more compelling case for unity in the current audit cycle, then the current audit may be sustainable even if the prior cycle was not. Assume, for example, that a prior audit found a taxpayer to be unitary with its affiliate based on strong centralized management as evidenced by internal memos, committee minutes, management reports, and documentation concerning centralized departments for various functions. If the auditor for the current years merely obtains a letter from the taxpayer confirming that the relationships between the corporations are the same as in the prior years, then a protest determination that the corporations are not unitary in the prior years will probably require that the current year adjustment also be withdrawn. On the other hand, by developing the current year facts, the auditor may discover that the level of management interaction has increased. Or, by discussing the case with the Department’s Legal Counsel, the auditor may learn that the taxpayer's arguments have minimized the importance of unitary ties such as centralized departments, so the auditor may be able to strengthen the case by focusing additional attention in the current years to developing the benefits realized through the centralized services.

Even if the prior audits are not being protested, the auditor should develop the current year facts rather than relying on facts developed in the prior audit. Otherwise, if the taxpayer decides to protest the current year determination, the audit adjustments will not be adequately supported. A hearing officer needs specific evidence in order to sustain a protest case; unsupported statements indicating that particular facts exist are neither persuasive nor reliable, and are not generally sufficient to support audit determinations.

> **Note:** When audit determinations are not consistent with prior periods, the reasons for the change in position must be clearly explained to the taxpayer. Auditors need to develop the current year facts in order to arrive at the correct determination for the current period. In some cases, changes in the underlying facts or in the relevant case law may cause an auditor to reach a conclusion for the current years that is different from the determination reached in the prior period. In other cases, the auditor may conclude that an adjustment is appropriate for the current period even though the prior year adjustment was based upon incomplete information, or has been modified, or withdrawn at protest. This situation sometimes occurs when the significance of an issue has increased over the years. For example, assume that no material tax effect would have resulted from decombination of a newly acquired corporation in the prior audit cycle. The prior auditor, therefore, made a few general observations regarding possible unity, and allowed the newly acquired corporation to be included in the group. In the current years, however, inclusion of the subsidiary has a significant tax impact. In this type of situation, following the prior audit determination without independently developing the facts would be inappropriate because the prior audit did not adequately develop this issue. (This example also illustrates the importance of informing taxpayers when issues that were included in the scope of the audit are accepted without being fully examined. In such cases, the taxpayer should be warned that no determination with respect to the issue has been made, and that the issue is subject to audit in subsequent years.) To avoid a perception that the department is being inconsistent in those situations, the auditor must clearly explain why the current year determination differs from the prior period outcome.

In some cases, an audit issue will not be material enough in the current audit cycle to warrant the resources that would be necessary to develop the facts regarding that issue. If that is the case, then the auditor should inform the taxpayer that the issue is not being included within the scope of the current year examination. When evaluating the materiality of the issue however, consideration should be given to the fact that audits are usually far less time-consuming in the subsequent cycles because the prior audit can be used as a roadmap that will direct you to the key areas to focus on, the specific documents that were found to be relevant, etc. Therefore, the materiality threshold for the subsequent audit of an issue will generally be lower than it would be for an initial examination of the same issue. In unusual circumstances, cases may arise where it will be beneficial to achieve consistent treatment of a unitary issue from year to year, but the materiality of the issue for the current audit cycle is not sufficient to justify an extensive examination. For example, assume the prior audit cycle combined a particular subsidiary, but the issue of combining the subsidiary in the current audit cycle is not material enough to warrant pursuing. On the other hand, you have discovered that the subsidiary was sold after the current audit period, so it will be necessary in the next audit cycle to determine the business or nonbusiness character of the stock gain or loss.

On a case-by-case basis, it may be acceptable in these types of situations for the auditor to obtain the taxpayer's agreement that the current year facts are the same as in the previous audit cycle. This agreement as to the facts can be obtained even if the taxpayer does not agree with the auditor's conclusion itself. If you believe that you have a case in which this exception would be appropriate, contact the supervisor so that the circumstances of the case may be evaluated before the taxpayer is approached regarding the agreement.

2300 Coordination With Pending Protests, Appeals, Etc.

Generally, action pending on the prior years will not preclude the auditor from beginning the current audit. In addition, a pending protest for prior years is not an acceptable reason for delaying an audit. Some taxpayers will resist providing information to an auditor until the prior year protest is resolved. As time passes, taxpayer personnel often change and information is no longer available or becomes much harder to retrieve. Therefore, the audits become more difficult for both the taxpayer and the auditor, and the ultimate development is often much less satisfactory. Auditors should explain to the taxpayer that each year stands on its own facts and should be prepared to issue demands.

Whenever prior years are still being worked, however, the auditor will need to be familiar with the status of the action and how the issues and possible resolutions of the prior audit report might affect the current years under audit.

If prior years have been resolved at the protest or appeal level, auditors must be aware of following final determinations without discovering the basis for those determinations.

2400 Review Of Public Information

By taking advantage of the public information that is available, a great deal of preliminary information can be gathered during the preaudit stage. Although the auditor should confirm information received from public sources before any adjustments are proposed, public information is invaluable for identifying issues and for determining the audit-worthiness and potential tax effect of unity issues. Since time at the taxpayer's location is limited, public information can also enable the auditor to complete a good deal of the groundwork prior to arriving at the taxpayer's place of business.

Much of the public information available can be obtained through the program office libraries, Lexis/Nexis, Internet Web-sites, and other databases, the state library, and other public libraries. The auditor may choose to request documents such as annual reports or SEC Form 10-Ks directly from the taxpayer. If, after reviewing the information provided by the taxpayer, the auditor decides that the returns are not good candidates for audit, a letter should be sent to the taxpayer informing them that an examination will not be conducted at the present time, but that the returns are still subject to audit at a later date.

The next few sections describe some of the most common sources of public information.

2410 Annual Reports

Companies that trade their stock on any United States exchange supply their shareholders with a copy of the annual report. Annual reports provide a good background on the business operations of the taxpayer, and often comment on management goals, major acquisitions or dispositions, transfers of key personnel, flows of goods and other interaction between the affiliated entities. This information can serve as a starting point for a unitary investigation.

The financial statements that accompany the annual report are an excellent source of financial data for preaudit test checks. In addition, the notes to the financial statements often disclose unusual transactions or accounting adjustments such as additions to reserves or asset writedowns. A review of the notes can be useful in identifying potential audit issues.

2420 SEC 10-Ks And Other Sec Filings

The Securities and Exchange Commission requires a variety of filings that may provide extensive unitary and financial information. Following are some of the more common filings that may be of use to the auditor:

Form 10-K

Publicly traded corporations are required to file an annual SEC 10-K with the Securities and Exchange Commission. Although much of the information found in a 10-K is similar to the information included in the annual report, there are some significant differences. Annual reports tend to be written from a public relations perspective, and may contain comments regarding the centralization or integration between the affiliates, or similar subjects with unitary implications. On the other hand, the 10-K will usually contain more detail of the business activities and financial data than is generally disclosed in the annual report. Consequently, the auditor should review both the annual reports and 10-Ks.

SEC 10-Ks may provide a detailed description of the corporation's divisions or lines of business. Often, they also identify the geographic regions where the taxpayer's property and markets are located. This data should be noted and may be useful in identifying potential nexus or throwback sales issues. For example, assume a company has divisions in New Mexico and Oregon. The 10-K might discuss the business activity of each division and also disclose that the Oregon division makes sales to customers in Washington, Oregon and New Mexico. This information should alert the auditor that some of the total Oregon division sales should be in the New Mexico numerator.

The SEC 10-K contains a list of the exhibits that were included in the filing. The auditor should review this list and request any of the exhibits that may be relevant to the examination.

Form 10-Q
The 10-Q is the quarterly report required to be filed with the SEC. The 10-Qs are also filed as transitional reports when the registrant changes its fiscal year-end. Although the data in these reports is unaudited, the Form 10-Qs may be useful in preparing fiscalization calculations or in other situations were interim financial data is necessary.

Form 8-K
The 8-K is titled the Current Report, and is used to report significant events that are deemed to be of importance to securities holders. Reports concerning the following types of events may be of particular assistance to auditors:

- When significant acquisitions or dispositions of assets occur other than in the ordinary course of business, the registrant is required to file an 8-K with a description of the transaction and the assets involved, the nature, amount and source of consideration given or received, and any material relationships that existed between the registrant and the other party to the transaction. If the registrant acquired plant, equipment or other physical property, the 8-K will disclose the nature of the business in which the assets had been used, and whether the registrant intends to continue such use or intends to devote the assets to other purposes. The filing requirement is triggered whether the acquisition or disposition has occurred due to purchase, sale, lease, exchange, merger, consolidation, assignment, abandonment, destruction, etc. Information reported on the 8-K may be valuable for verifying basis or computing gain with respect to assets that have been acquired or disposed of; and also may provide some clues to pursue in an instant unity or business/nonbusiness examination.

- When a change in control of the registrant has occurred, information must be reported concerning the details of the transaction (including the amount and source of the consideration used), the basis for the control, and the percentage of voting securities of the corporation owned directly or indirectly by the controlling shareholder(s). This information may be useful for determining whether unity of ownership exists in complex ownership structures.

Form 20-F
Form 20-F is the annual report required to be filed by foreign companies whose securities are registered with the SEC. The report is similar to the Form 10-K used by domestic entities and should be requested in lieu of the 10-K in foreign parent cases. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP, or must disclose the variations from GAAP and contain a schedule which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used. This information is useful for reconstructing worldwide income for foreign-owned groups.

Schedules 14A and 14C
Whenever a corporate action is taken which requires the authorization or consent of the shareholders, an information statement must be provided those shareholders. If proxies are solicited, the information statement is filed on Schedule 14A. Schedule 14C requires substantially the same information as 14A, but is used when proxies are not being solicited. Transactions that may be subject to shareholder approval include mergers and major acquisitions of stock or assets. The information statements will often contain information regarding the reasons for the transactions that may be useful in a unitary examination. The 10-Ks and 10-Qs filed by the registrant should identify whether there have been any matters submitted to a vote of the shareholders for which a Schedule 14A or 14C would have been required.

2430 Corporate Directories

Moody's Industrial Manuals and similar corporate directories provide brief descriptions of the business activities, corporate histories, lists of affiliates, summaries of financial statement data, and similar information. These directories are useful for identifying affiliates that may not have been included in the combined report, and for gleaning financial data for test combinations. Some of the directories specialize in certain areas (such as international companies), and may therefore contain more detailed information than some of the more generalized directories. Auditors should become familiar with the various directories available in their office or public library, and the types of information that those directories offer. Following is a list of some of the corporate directories that are available:

Moody's Investors Service
Standard & Poor's Corporations
Hoppenstedt International Reports
Directory of Corporate Affiliations
Japan Company Handbook
Janes Major Companies of Europe
Diamonds Japan Business Directory

Directory of Foreign Firms Operating in the U.S.
Funk & Scott Index to Industries & Corporations
Directory of Japanese Companies in the U.S.A.

2435 Business Periodicals & Trade Journals

Business periodicals and trade journals are often a good source of information about a taxpayer. Articles in these publications may cover anything from the business activities and history to the CEO's management style to the technologies that are utilized in production to the reasons behind the acquisition of a subsidiary. Information contained in periodicals is not written in a tax context, and may be misleading or incorrect in some respects. On the other hand, such articles can provide good background information and may produce leads for the auditor to pursue further during a unitary investigation.

Publications such as the Wall Street Journal and New York Times publish indexes identifying the companies that have appeared in articles. Many libraries will also have business periodical indexes that reference articles in a variety of publications. For taxpayers in specialized industries, trade journals are a good source for finding articles on even relatively small companies.
The Harvard School of Business distributes a catalog of research papers which have been written by its students. The papers are indexed by company name, and the catalog contains a brief description of the subject matter of each paper. The papers may be ordered for a relatively low cost. As with other third party articles, the information in the papers should not be relied upon as a basis for an audit determination, but it may provide valuable leads for the auditor to pursue.

2460 Reports of Privately Held Companies

If a company is privately held, it may or may not have supplied an annual report or certified statement to its shareholders. In most instances however, financial statements of some type will be furnished to either the shareholders or to a financial institution, which has provided funds to the corporation. Although these financial statements may not describe the business operations, the footnotes generally do include important information in regard to related party transactions.

Obtaining financial statements from privately held companies may be more difficult than from publicly held companies. If financial statements exist but the taxpayer refuses to supply the statements, the auditor should follow the standard steps recommended for failure to furnish information.

If an auditor believes that financial statements exist but has been told none were prepared, a review of the general ledger account "Legal and Accounting Fees" along with the supporting invoices can help identify if statements have been prepared.

2470 Internet Websites

The Internet, through business directories, individual company websites, research websites and general keyword searches, offers an immense amount of company information. Although it only includes information on publicly traded companies, of particular value is the U.S. Securities and

Exchange Commission Edgar database (http://www.sec.gov/cgi-bin/srch-edgar) which reports information such as type of industry, state of incorporation, industry segments, geographical marketplaces, types of business activities and company financial data.

2480 Review of Federal Tax Returns

Form 1120

Complete copies of the Federal Form 1120 tax returns (along with all supporting schedules) should always be reviewed during the course of the audit. Depending upon the level of detail contained in the New Mexico return, it is often a good idea to perform this review during the preaudit phase. In some cases, the Federal 1120 and New Mexico CIT-1 will be the same and no new data will be discovered. Most often, the Federal 1120 will contain detail that was not included in the New Mexico return. A company-by-company breakdown of income, balance sheet and Schedule M-1 data is necessary to perform the test checks and reconciliations discussed. If not disclosed in the New Mexico return, that information can usually be found in the Federal 1120.

A comparison between federal and state returns will also highlight any differences in income resulting from the taxpayer using different treatment for state and federal purposes.

When reviewing the Federal 1120s, the auditor should ensure that *all* the federal returns for the members of the combined group have been provided. This may include returns filed on Federal Form 1120-DISC, 1120-FSC or 1120F *U.S. Income Tax Return of a Foreign Corporation* (the 1120F is filed by foreign corporations with income effectively connected to the United States).

Form 851

The New Mexico return will generally not contain the Federal Form 851 *Affiliation Schedule*. A review of this form is important because it contains the data needed to determine if there are any newly acquired domestic corporations or changes in stock ownership. Domestic companies, which have been sold, will be disclosed on the Federal Form 851 as well as on Schedule D.

Form 5471

When auditing a domestic parent with foreign subsidiaries, the auditor should ensure that copies of any Forms 5471 filed by the taxpayer are provided along with the Federal returns. Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, can be a valuable source of income and apportionment data for foreign subsidiaries. This form contains information regarding income, balance sheet data, earnings and profits, stock ownership, distributions, federal subpart F income, and related party transactions involving the foreign subsidiary. This data will be useful for developing unitary information, preparing test combinations and factor reconciliations, and verifying dividend deductions.

Form 5472
Form 5472, *Information Return of a Foreign Owned Corporation*, discloses information regarding a foreign-owned corporation's transactions with its foreign affiliates, and is useful for identifying unitary ties and intercompany transactions.

For federal purposes, Form 5472 is required to be filed by domestic corporations that have at least 25% direct or indirect foreign ownership, unless no reportable transactions exist (IRC §6038A). Reportable transactions generally include transactions between the domestic corporation and a foreign related party for monetary or nonmonetary consideration or for less than full consideration. Generally, most domestic corporations with a foreign parent will have a Form 5472 filing requirement for federal purposes.

> **NOTE:** The Federal Forms 5471 and 5472 are informational returns that must be attached to the Federal Form 1120. Although the forms are used by the IRS during an audit, the Forms 5471 and 5472 themselves are not actually audited. Any adjustments found by the IRS are made to federal taxable income, not to the Forms 5471 and 5472.

Form 8865
Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, discloses information similar to Form 5471 regarding a domestic corporation’s recognized income/(loss) amounts from a foreign partnership/LLC/joint-venture, and is useful for identifying unitary ties and intercompany transactions. This is required to be filed by the domestic corporations who recognize net income/(loss) from a partnership/LLC/joint venture for tax years ending on or before the ending date of the 2000 tax year.

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CORPORATE INCOME TAX AUDIT MANUAL

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Purpose of this Section

The discussion set forth in this section is meant to assist the auditor in establishing the basis for his/her conclusions; he/she should note all significant facts, whether supportive of or detrimental to those conclusions, regardless of whether they are that unity does or does not exist. The purpose of this section is to enable the auditor to conduct this portion of the audit in the most efficient, least disruptive manner possible. Toward the end, the following material contains discussions of the various aspects of unity as well as of the development of unitary facts in the process of performing the audit.

History and Theory of Unitary Apportionment

The history of the term “unitary business” makes apparent the fact that it derives from real property law, in which it was known as the “unit rule.” This rule was first approved by the United States Supreme Court in the case of Union Pacific Railway Co. v. Cheyenne, (1883) 113 U.S. 516. There the Court stated that a railroad cannot be regarded as mere land, such as farmland or building lots; but that the value of that portion of the railroad which is located within a state is dependent upon the value of the entire line as a transportation system. The effect was to require the application of an apportionment formula to the total value of such a transportation system in order to determine the value of the railroad’s tax base within any state. It should be noted that the unit rule was applied only to common carriers which involved a physical linking, e.g., railroad track, between in state and out-of –state property.

In 1897, the physical link requirement was modified when the U.S. Supreme Court recognized for the first time that a different type of linkage, that of unity of use and management of a business, could be considered when determining the value of the in-state property of a multistate business on an apportionment basis. The case was *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194.

In the 1920 case of *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, the Court approved for the first time a formula which had been designed for the purpose of allocating income to a state. In doing so, the Court said that “ The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States.” But nowhere in that decision did the Court refer to the business operation as a “unitary one”. It first used that term for state income tax purposes in the case of *Bass, Ratcliff & Gretton, Ltd. v. N.Y.* (1924), 266 U.S. 271. There the Court said:

> So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places – the process of manufacturing resulting in no profits until it ends in sales – the State was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.

While the *Bass, Ratcliff* decision was the first to apply the term “unitary business” to a business the income of which was subject to apportionment among the states in which it operated, the

Court was not there required to define the term; the reason was that the taxpayer had conceded that it was engaged in a unitary business.

Not until eighteen years later did the Court find it necessary to produce a definition. The case was *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Taxpayer operated a wholesale dry goods and general merchandising business, purchasing from manufacturers and others, and selling only to retailers. In various states, including California, it operated seven wholesale distributing houses, each of which stocked goods for its own territory, kept its own books of account, made its own sales, and handled its own sales solicitation, credit and collection arrangements. Each house incurred direct operating expenses which it charged against its income in preparing its state tax return. It also deducted as indirect expenses a portion of the overall expenses of the entire corporation, including executive salaries, corporate overhead, and costs incurred in the operating of a central buying division (which obtained volume discounts for the entire business) and a central advertising division; these expenses were allocated among the houses in accordance with recognized accounting principles to the accuracy of which the parties stipulated. This "separate accounting" approach resulted in Taxpayer's claiming that it had suffered an operating loss in California even though the corporation showed an overall profit.

The sole question before the Court was that of whether separate accounting or unitary apportionment should be utilized in determining the taxable base in California. The Court said that the answer depended:

> entirely on the nature of the business conducted within and without the state by appellant, a foreign corporation…[I]f there is any evidence to sustain a finding that the operations of appellant in California…contributed to the net income derived from its entire operations in the United States, then the entire business of appellant is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent over taxation to the corporation or under taxation by the state.

The Court held that the three-factor apportionment formula (property, payroll and sales) should be applied to the overall profit in order to determine taxpayer's California income tax liability. It said that Taxpayer's unitary nature had been established on the basis that there existed: (1) unity of ownership (2) unity of operation as evidenced by centralization of purchasing, advertising, accounting and management; and (3) unity of use by virtue of its centralized executive force and its general system of operation. This so-called three unities test became a standard against which to determine whether a business was truly unitary.

Having established that unitary apportionment was appropriate for application to a single corporation which operated a unitary business through at least partially independent branches in several states, California now sought to establish that it was appropriate for application to a unitary business which was operated through separate wholly owned subsidiary corporations. It succeeded.

The case was *Edison California Stores v. McColgan,* 30 Cal. 2d 472 (1947). The California Supreme Court's decision established an additional standard, known as the contribution or dependency test. In its decision, the Court said that:

> If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is not such dependency, the business within the state may be considered to be separate.

In 1933, the North Carolina Supreme Court had been the first to attempt to define a unitary business for state income tax purposes. In *Maxwell v. Kent-Coffee Mfg. Co.*[1], that court said:

> That term [unitary business] is simply descriptive and primarily means that the concern to which it is applied is carrying on one kind of business – a business the component parts of which are too closely connected and necessary to each other to justify division or separate consideration as independent units. By contrast, a dual or multiform business must show units of substantial separateness and completeness, such as might be maintained as an independent business… capable of producing profit in and of themselves.

In *Fleming v. Oklahoma Tax Commission*, 157 F.2d 888 (1946), at 891, the Circuit Court of Appeals of the Tenth Circuit commented:

> The very nature of a vast continental or interstate transportation system brings it especially within this concept of a unitary business. A railroad may well be likened to a spider's web, in which all of the strands are necessary to the common design and each contributes its necessary part to a single goal. It may be true…that the Chicago to Denver branch could be operated profitably by itself and that the income realized from its operation can be ascertained. It does not, however, follow that it could be operated as profitably by itself or that its income would be as great as it is as a part of a large railway network in which other parts lessen overhead burdens or funnel business to the system, which ultimately finds its way to this branch. No doubt its connection with the rest of the system brings it business which otherwise might well go elsewhere. To this extent it is dependent upon the rest of the system, and it cannot be said that no part of the income realized from the operation of this branch does not accrue by virtue of its connection with a large railway transportation system.

In general, a business will be considered to be unitary when the operations conducted in one state benefit and are benefited by the operations conducted in another state and if its various parts are so interdependent and of such mutual benefit that they form one integral business.

[1] 204 N.C. 365.

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In writing upon the unitary business subject[2], Altman and Keesling endorsed what is essentially the contribution or dependency test of *Edison Stores*. Albert H. Cohen defined a unitary business as one in which different activities are interrelated and are benefited by each other[3]. Russell Bock states that operations are considered to be unitary whenever there is any flow of goods or benefits between the part of the business within and the part outside the state, or when one part contributes directly or indirectly to the other.[4] The United States Supreme Court has also described a unitary business as one in which a "flow if value" takes place.

In Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, (1983), the Court was faced with a situation in which the Taxpayer was a Delaware corporation headquartered in Illinois and doing business in California and elsewhere through various subsidiaries which had been incorporated in the countries in which they operated. The questions before the court were: (1) Were the parent and its overseas subsidiaries engaged in a unitary business? (2) If so, do certain "salient differences" among national economies render the standard three-factor formula so inaccurate as applied to the multinational unitary enterprise as to violate the constitutional requirement of fair apportionment? And (3) In any event, did the state have an obligation under the Foreign Commerce Clause of the United State Constitution (Art.I, Section 8, cl. 3) to employ the "arm's length" analysis used by the federal government and most foreign nations in evaluating the tax consequences of intercorporate relationships?

The Court rejected geographical or transactional accounting as a means of determining locally taxable income, saying that it "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise".[5] It quoted from its 1980 decision in *Mobil*[6] to the effect that, when a single unitary business exists:

> separate [geographical] accounting, while it purports to isolate portions of income received from various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source". Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

The Supreme Court set forth various principles which pertain to the application of the unitary business principle in determining a business' tax liability to a state, e.g., the out-of-state activities

[2] G. Altman & F. Keesling, Allocation of Income in State Taxation (2d ed. 1950) (published by CCH), page 101.

[3] State Tax Allocations and Formulas, Journal of Taxation, July 1954.

[4] Guidebook to California Taxes

[5] 463 U.S. 159, 160.

[6] Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 438.

must be related in some concrete way to the instate activities (i.e., there must be some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation); there must be a rational relationship between the income attributed to the state and the intrastate values of the enterprise; and there must be some bond of ownership or control uniting the business.

"Having determined that a certain set of activities constitute a "unitary business," a State must then apply a formula …[that is] fair,"[7] the Court said. The formula must have "internal consistency – that is the formula must be such that, if applied in every jurisdiction, it would result in no more than all of the unitary business' income being taxed".[8] It must also have "external consistency – the factor or factors in the apportionment formula must actually reflect a reasonable sense of how income is generated"[9] so that it will " not result in discrimination against interstate or foreign commerce."[10]

Addressing the question of whether the foreign subsidiaries were engaged in a unitary business with the parent, the Court noted that "major policy decisions [by the subsidiaries] were subject to review by … [the parent]"[11] and that "high officials of … [the parent] … gave directions to subsidiaries for compliance with the parent's standard of professionalism, profitability, and ethical practices."[12] It also approved as reasonable the state court's endorsement of "an administrative presumption that corporations engaged in the same line of business are unitary, "saying that "[w]hen a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources."[13] The Court then said that, while "a substantial flow of goods" is often an indicator of unity, it is not a prerequisite to unity; that "the prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods."[14]

The Court then noted other factors which supported the state court's conclusion that the relationship of the parent to the foreign subsidiaries was a unitary one: the parent's assistance to

[7] 103 S.CT. 2942

[8] Ibid

[9] Ibid

[10] Id. 2943

[11] Id. 2946

[12] Ibid

[13] Id. 2947

[14] Ibid

its subsidiaries in obtaining used and new equipment and in filling personnel needs that could not be met locally, the substantial role played by the parent in loaning funds to the subsidiaries and guaranteeing loans provided by others, the considerable interplay between the parent and its foreign subsidiaries in the area of corporate expansion, the substantial technical assistance provided by the parent to the subsidiaries, and the supervisory role played by the parent's officers in providing general guidance to the subsidiaries. Significantly, the Court said that "[w]e need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business. Taken in combination, at least, they clearly demonstrate that the state court reached a [unitary] conclusion 'within the realm of permissible judgment'.[15]

The *Container* case is the most significant of all unitary cases which have ever been considered by the courts. It has lain to rest most of the challenges to the unitary concept, with the one possible exception of the concept's constitutional validity as applied to foreign parents having domestic subsidiaries. It has summarized in one cogent phrase, "flow of value", the many different types of sharings of functions to which courts have previously pointed as elements of unity. Regardless of whether those sharings apply to accounting, purchasing, insurance, personnel, training, research and development, executive force, legal staff, advertising, merchandising, credit control, quality control, patents, trademarks, trade names, copyrights, packaging, designing, planning, engineering, retirement benefits, health benefits, disability benefits, financing, facilities, customers or products, the fact is that flows of value are involved. The auditor must decide whether the combination of these flows provides a reasonable basis for a decision that unity exists.

The taxpayer may want to discuss in detail the 1982 cases of:

> *Asarco, Incorporated v. Idaho State Tax Commission*, 458 U.S. 307 (1982)
>
> *F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico*, 458 U.S. 354 (1982)

Any discussion will probably come up in the context of 1) the includibility of dividends in the apportionable base of the receiving corporation and 2) the extent of the unitary business.

a) In general, if the dividends are received from a corporation which is engaged in a unitary business with the receiving corporation but is not being combined with it for whatever reason, they should be included in the apportionable base except to the extent excluded by a state's statute. Both *Mobil* and *Woolworth* support this position.

b) Unitary ties. *ASARCO* will be cited in support of a contention that more than 50% ownership is not enough to establish control to the extent necessary for a unitary business determination.

[15] Id. 2948

The auditor should, therefore, obtain pertinent information concerning the exercise of actual control.

c) Grossup. The last paragraph of *Woolworth* seems to indicate that the U.S. Supreme Court does not look kindly on state taxation of the gross-up which is involved in the taking of foreign tax credits under the Internal Revenue Code. However, in the earlier part of that decision, the Court had already decided that the dividends in question were not includible in the apportionable income base (on the basis that unitary ties had not been established between the parent and the subsidiaries); so that the gross-up question had become moot by the time the Court got around to the gross-up question. Therefore, some states will correctly maintain that, technically, there is no judicial precedent for a conclusion that gross-up should not be includible in the apportionable income base.

Applying the Unitary Business Principle Through Combination

Preliminary Unitary Consideration

The audit: 1) the unitary business principle is a judicially defined principle; 2) common ownership always involves the potential of a unitary business; and 3) a Supreme Court challenge to a state court determination of unity will be unsuccessful if the state court applied the proper constitutional standards and if its judgment "was within the realm of permissible judgment".[16]

The constitutional test revolves solely around one issue: are the parent's stock investments in its affiliated corporations mere passive investments in discrete businesses or are they made for other business purposes. They are made for other business purposes if there is some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation—which renders formula apportionment a reasonable method of taxation. The controlling question is that of whether value is added to the integrated operations through conduct that cannot reasonably be characterized as normal activity to oversee an investment. Resolution of this question involves investigations of documents and personnel in addition to accounting records.

Application of the unitary business principle involves five separate but interdependent determinations: 1) the contours of a unitary trade or business; 2) the net income of the trade or business; 3) the expenses related to the production of that net income; 4) the instate apportionment factors of the taxpayer; and 5) the total factors of the trade or business.

1) The Contours of the Unitary Business. Before the net income of a trade or business, i.e., a unitary business, can be determined, one must determine what constitutes that

[16] See Container, 51 USLW 4987, 4997.2.

trade or business. It may include only a portion of the taxpayer's business activities and it may include the activities of commonly owned affiliated corporations or other legal entities. If the trade or business includes the activities of two or more commonly owned and controlled affiliates, a "combined report" is required.

2) The Net Income of the Unitary Business. After one has ascertained the contours of the unitary business, one must determine the net income of that business. The main problem here is to determine which income constitutes business income and which constitutes nonbusiness income, i.e., which income is and which is not functionally related to the trade or business carried on in part in the taxing state. Under current due process constitutional standards, the issue of which income is functionally related to the unitary business is not clear. This has resulted in the Supreme Court decisions in *ASARCO, Woolworth,* and *Container*. In the case of income from stock investments in subsidiaries, a functional relationship involves more than the general enrichment of the investor corporation from passive stock investments in discrete businesses which are totally unrelated to the business of the investor.[17]

3) The Expenses Related to the Net Income. Unrelated expenses must not be deducted in determining the amount of net income.

4) The Formulary Percentage of the Unitary Business. The property, payroll and sales associated with the production of the net income of the unitary business are included in the apportionment factors of the apportionment formula. This involves combining the factors of all the entities of the unitary business for both numerator and denominator purposes and then applying the resulting percentage to the apportionable net income.

The Nature and Purpose of a Combined Report

A combined report is an accounting method used to determine what portion of the net income of a corporate member of a unitary group of corporations is reasonably related to the corporation's presence and activities in the taxing state. The purpose of the combined report is to treat a business conducted by a group of corporations in the same manner for state income tax purposes as it would be treated were it conducted by a single corporation operating through divisions. In both instances, the unitary business principle is used to determine what divisions or commonly owned and controlled corporations are engaged in a unitary business, what constitutes the net income of that business, and how that income is to be apportioned.

[17] "Investment in business enterprise truly 'distinct' from a corporation's main line of business often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle. When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economics of scale or through operational integration of sharing of expertise – of the parent's existing business-related resources." Container, 51 USLW 4987, 4991.

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Common Ownership and Control

Common ownership does not exist unless the corporation is one which is a member of a group of two or more corporations more than 50 percent of the voting stock of each member of which is directly or indirectly owned by a common owner or by common owners, whether they be corporate or non-corporate entities, or by one or more of the member corporations of the group. Examples of common ownership are:

Corporation P owns 51% of the voting stock of corporation S1, corporation S1 owns 49% of the voting stock of corporation S2 and corporations S2 owns 51% of the voting stock of S3. Common ownership exists between P and S1 and between S2 and S3. No common ownership exists between P and S2 or S3 or between S1 and S2 or S3. If S1’s ownership of stock in S2 were increased to 51%, then all four of the corporations would be commonly owned. The same would be true if P owned 2% of the stock of S2 in addition to S1’s 49% of S2.

It must be noted that the ownership must be accompanied by actual control as a prerequisite to a unitary determination per *ASARCO*.

Unitary Business Defined for Combined Reporting

Business activities or operations carried on by two or more corporations are unitary in nature when the corporations are related through common ownership and control and when the trade or business activities of each of the corporations are of **mutual benefit, dependent upon, or contributory to** the activities of one or more of the corporations. This may be evidenced by facts which establish that the business of the commonly owned group of corporations is functionally integrated or is managed and controlled as a single business enterprise with resulting **economies of scale** rather than as separate discrete business enterprises carried on by each commonly owned corporation.

Examples of **functional integration** are: centralized manufacturing, warehousing, accounting, legal staff, personnel training, financing, purchasing, insurance, advertising, tax administration, and budgeting; coordinated expansion or contraction of business; integrated sales force, production activities, research and development activities, and physical facilities; and intercompany flows of goods and services.

Examples of **centralized management** are common officers or directors, exchanges of personnel, communication between management personnel, common planning, parental approval of major decisions of subsidiaries, common employment and personnel policies, common financial reports, common financial and production and pricing standards, common organizational and supervision of operational functions, common handling of public and governmental relations, common publications, common communications facilities, use of common physical facilities, common business organizational reports, use of common executive personnel, and common transportation facilities.

Economies of scale are closely associated with **functional integration** and **centralized management** as well as with the more elusive standard of the **transfer of value**. In fact, anything that is done in common by a parent and its subsidiaries strongly suggests the presence of economies of scale. For example, centralized purchasing by a parent for its subsidiaries would indicate savings through more efficient and more economical purchasing.

The ultimate question is that of whether there take place between members of the affiliated group transfers of value that would not be present between unrelated, independent, discrete business enterprises.

All of these aspects of unity tie in with the original *Butler Bros*. decision's three unities test of ownership, operation (staff functions) and use (line functions).

Determining the Contours of a Unitary Business

a) Burden of Proof. The task of the auditor is to establish and relate all pertinent facts in such a way and with such documentation as to support any conclusion as to what the contours of the business are.

b) Horizontal Relationships. Business activities carried on by two or more commonly owned and controlled corporations are generally unitary when all activities of the corporations are in the same general line of business and exhibit functional integration and economies of scale. For example, commonly owned or separately incorporated grocery stores will usually be engaged in a unitary trade or business.

c) Vertical Relationships. Business activities carried on by two or more commonly owned and controlled corporations are generally unitary in nature when the various members are engaged in a vertically structured enterprise. An example of this type of integration and interdependency is to be found in the metals industry, in which the business consists of the exploration, production, manufacture and distribution of products, such as the non-ferrous metal business of ASARCO.

d) Strong Centralized Management. The members of a group of commonly owned and controlled corporations which might otherwise be considered to be carrying on separate trades or businesses are considered to be engaged in a unitary trade or business when a strong centralized management determines policy for each corporation's primary business activities and when central offices perform such functions as accounting, financing, advertising, researching, or purchasing. Truly independent corporations would perform such functions themselves.

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Suggested Approach to Unitary Determination

The following list of suggestions may help the auditor to develop unitary and non-unitary facts. The suggestions apply for each audit year. The list should be used only for reference purposes as needed. As usual, common sense applies in determining the extent of utilization of any of these suggestions. The audit report should include pertinent information, whether it evidences unity or non-unity.

Corporate Ownership Structure

List each significant subsidiary, year incorporated, year acquired (if an already existing business), percent of the subsidiary's stock that is owned. Indicate whether any other affiliate or parent owns any portion of the subsidiary's stock and, if so, the percentage owned. Provide a chart if a complex second and third tiered ownership situation is involved.

Parent Operational Structure

Briefly describe the functions of each of the parent's operating divisions. Indicate: the location of each manufacturing or other operations facility included in each division; the specific products produced or otherwise processed at each plant or facility and/or the regular services rendered by each division; the names and positions of the key officials of each division and the city in which each is headquartered.

Whenever possible, obtain charts showing these divisions and any sub-units as well as the reporting lines of authority.

Subsidiaries Operational Structure

For each subsidiary, indicate where it is headquartered, where each of its manufacturing or other operations facilities is located, the specific product it manufactures or processes or distributes at each facility and/or the regular services where it renders at each location. Identify its principal operating officials and the location at which each performs his/her services. Describe the extent, if any, to which each subsidiary reports to and is under the operational control of a particular division of the parent or of another affiliate. Stating such information in chart form may be helpful.

Common Officers and Directors

a) For the parent corporation, separately for each audit year, list the names and positions of all corporate officers through the assistant or vice levels (e.g., vice-presidents, assistant secretaries and treasurers).

b) For the parent corporation, separately for each audit year, list the name of each director, the chairman, and the vice-chairman. Determine which directors were officers of the parent during the audit year and which position each of them held. For those board members who were not officers of the parent, indicate which were officers of any affiliate, the affiliate name and the position held there.

c) For each significant subsidiary, for the first audit year and separately for the last audit year, obtain the same information indicated in a) above.

d) For each subsidiary, obtain the same information requested in b) above for the first audit year and separately for the last audit year.

Parent Management Structure

a) Obtain a complete description of the parent's organizational structure showing the chain of command and reporting lines from the president and/or chief executive officer down through the organization, including its divisions. A chart or charts to illustrate this should be obtained, if at all possible. A major corporation will usually have such charts.

b) Obtain a complete description, for all principle U.S. and foreign affiliates, of regular procedures and requirements for reports to the parent on such items as 1) current sales, 2) current profit or loss statements, 3) annual budget, 4) requests for new or expanded production and distribution facilities, and 5) other periodic reports. Identify each category of required reports and indicate whether it moves through a particular division of the parent or directly to the headquarters office of the parent and, if so, to what official or unit at the parent's headquarters.

c) Obtain a complete description of the functions and responsibilities of each of the officers at the parent's headquarters as to both the parent's operations and the operations of any subsidiaries.

d) Obtain a complete description of the organization of the parent's Board of Directors and its committees, and the names of the member of each committee. A chart which shows this information may be available. Describe the duties and authority of each committee as to budgets, acquisitions, financing, new or expanded facilities, salaries of principal officers, etc., both for the parent itself and for its subsidiaries.

Intercompany Sales

Sales may move from parent to subsidiary, from subsidiary to parent, and/or from subsidiary to subsidiary. Summary schedules which lump subsidiaries as a group without further breakdown are not helpful in determining the extent of possible unity among the related corporations.

3000 UNITY/UNITARY

The auditor should obtain the following data, for each audit year:

a) For the parent, its total sales to all buyers, its total inter-affiliate sales, the name of each subsidiary to which it made sales, and the separate amount of sales to each subsidiary. Indicate also the general category or categories of products involved in these sales if the parent produces several different types of products.

b) For the parent as to its purchases from subsidiaries, the name of each selling subsidiary, the separate amount and type of products purchased from it, and the amount of the parent's total purchases from all sources.

c) For each subsidiary making inter-affiliate purchases from the parent or other subsidiaries, the separate amount and type of products purchased from each affiliate and the total amount of the purchasing corporation's purchases from all sources.

d) For each subsidiary making inter-affiliate sales, the name of the affiliate, the separate amount and type of product sold to it, and the selling subsidiary's total sales to all buyers.

Intercompany Financing

a) Identify loans from parent to subsidiaries existing at the beginning of the audit period. Show separate amount for each borrowing subsidiary, and determine the specific purpose for each substantial loan and whether it bears interest.

b) Determine the extent of any repayments made on each of such loans during each audit year.

c) Identify all new loans made by the parent during each audit year separately in amount as to each borrowing subsidiary. Indicate the purpose of the loan and whether it bears interest.

d) Identify new loans made during each audit year by a subsidiary to the parent or to another subsidiary as to year, amount, lending affiliate, borrowing affiliate, purpose, and whether it bears interest.

e) Obtain data showing to what extent, if any, the parent corporation was a guarantor of any loan which was obtained by a subsidiary during the audit period or which was outstanding during that period. Identify the year in which each loan was made, its amount, the name of the borrowing subsidiary and the purpose of the loan.

f) Identify for each subsidiary for each audit year the amount of loans which it obtained from outside sources independently and of which the parent was not a guarantor.

Royalty Income

a) As to royalties received by the parent, for each audit year, specify the total amount received from all sources, the total amount received from all affiliates, and the amount received from each affiliate. Describe which particular type or types of rights controlled by the parent were exchanged for its right to receive these royalty payments from each affiliate.

b) To the extent that any subsidiary received royalty payments either from the parent or from some other affiliate, provide the same detailed information as indicated in a) above.

c) Identify all situations in which a manufacturing plant of the parent and a manufacturing plant of a subsidiary produce identical products. Have the taxpayer explain to what extent, in such situations, the patents, processes and trademarks furnished by the parent, or vice versa, do and/or do not involve royalty payments.

Research

a) Identify the location of each research facility, the scope of its activities, the number of personnel, and the specific types of research conducted.

b) Provide the same data as in a) above for each research facility conducted by any subsidiary.

c) Explain in detail to what extent coordination, exchange of data, associated programs, and any other ties existed between a research facility of the parent and a research facility of a subsidiary or between facilities of two or more subsidiaries.

d) Identify all principal brand-name products sold during the audit years by domestic and foreign subsidiaries which are directly traceable to and result from research projects at the parent in current or prior years. (This type of information about the results of research projects can often be found in annual reports for current and prior years and is usually available if the corporate group deals in such items as drugs, cosmetics, household appliances, toiletries, non-prescription medicines, or other types of mass production consumer products new versions of which are periodically introduced to the market.)

Training Programs and Manuals

a) Obtain a detailed description of each of the major operational and administrative areas for which the parent has developed and used written manuals.

b) Explain which of these, if any, were utilized by any principal subsidiary. Explain which principal subsidiaries used these manuals and which did not.

c) Obtain a description of each type of major periodic training program or school conducted by the parent. Determine: 1) how many people at what position levels were trained annually under each program; and 2) the scope of the program coverage.

d) Determine the extent to which people from each principal subsidiary were and/or were not involved in each of the programs or schools identified in item c) above.

Computer Services

a) Obtain a list of each location at which the parent corporation maintains computer facilities. Explain which general type of usage (such as production data, sales data, accounting data, etc.) is provided at each location and obtain a complete description of the scope covered by each.

b) Obtain a list of locations at which each subsidiary maintains computer facilities. Provide the same information as in a) above for each location. Explain the extent to which each of these locations is tied in with one or more computer facilities of the parent to receive or exchange data, and indicate which ones have no-tie in with the parent's facilities.

Insurance

Typical types of insurance carried by the parent and its subsidiaries will include 1) fire, 2) comprehensive casualty, 3) theft, 4) group health, and 5) group life.

a) Indicate the specific types of insurance carried by the parent corporation. In any instance in which more than one type is negotiated through a single agent, identify the agent and the particular types of insurance it handles. Indicate to what extent any type of insurance coverage is negotiated separately at the division or other unit level rather than as overall coverage for the entire parent corporation.

b) Provide similar information concerning the principal subsidiaries, and indicate the extent, if any, of all premium restrictions which result from using the same agent(s).

c) Identify each subsidiary which independently negotiates for its own various insurance coverages.

Legal Services

a) Determine the regular services performed by the legal staff of the parent corporation; and report the number of attorneys on that staff.

b) Indicate which subsidiaries received or provided legal services from or to the parent or affiliates. Obtain specifics, if possible.

c) Report to what extent and for what specific services private law firms were retained by the parent, or by any subsidiary; indicate to what extent, if any, the same law firm regularly provided services to more than one affiliate.

Centralized Accounting

a) Describe the major aspects of the parent's accounting system, which principal subsidiaries utilize it to what extent, and which principal subsidiaries did not use it.

b) Report to what extent, if any, the subsidiaries were charged for central accounting services, the amounts charged to each, and the method or methods used to determine the amounts charged.

Centralized Purchasing

a) Describe any central purchasing activities of the parent as to specific categories of purchases, which particular principal subsidiaries received the benefits of such activities, and which particular principal subsidiaries did not.

b) Report the amounts of such purchases for each audit year to determine whether the activities were significant or relatively minor.

Advertising

a) Describe the extent, if any, to which the parent operated an advertising division or department, indicating in detail what specific activities it conducted for each principal category of products and the number of people it regularly employed for these activities.

b) Report which principal subsidiaries received the benefits of or utilized the advertising produced by the parent, the extent to which they were charged for this central advertising activity, how the charges were determined, and which principal subsidiaries either independently produced their own advertising or did not use any of the centrally produced advertising materials. Determine the annual advertising costs of the parent and of each affiliate for each audit year.

c) Determine whether the subsidiaries referred to their parent in their advertising, e.g., ABC Corporation, a subsidiary of XYZ Corporation.

Pension Plans

a) Obtain detailed information concerning each pension plan of the parent corporation, indicating which categories of officers or employees were eligible for each plan, whether it was contributory or noncontributory, and its general provisions as to when benefits became payable; and specify to what extent it involved any stock option provisions. (If stock options were provided under a separate plan, treat that separately.) Report who administers each plan.

b) Describe to what extent, if any, officials and/or employees of subsidiaries were eligible for any of the parent's pension plans. If they were eligible, report which principal subsidiaries were included in each of the parent's plans and which were not.

c) Obtain the same information for each pension plan at each principal subsidiary.

General Administrative Services

a) Obtain similar information with respect to the providing of any other centralized services, e.g., public relations, affirmative action, and governmental relations.

b) The costs of centralized services may or may not have been charged to subsidiaries for whose benefit they were performed. If the parent apportioned such costs, report the total costs for each audit year, the specific items of service or activity by the parent which these costs represented, the actual amount charged to each principal subsidiary, the method or methods used for apportioning the charges, and the name of each principal subsidiary which was not charged any portion of such costs.

Newly Acquired Subsidiaries

a) Obtain a detailed history of the operations of the new affiliate up to the date of its acquisition. Determine when it was incorporated, where headquartered, the nature of its principal income-producing activities, the location of each manufacturing or other facility and the products manufactured and/or services provided at each facility. Determine the extent, if any, to which it had any regular business relationships, such as selling to or purchasing from either its new parent or any of the parent's subsidiaries in the years preceding the acquisition.

b) Determine whether the new parent or any of its subsidiaries held any minority interest in the new corporation prior to the acquisition date. If so, explain the extent of such ownership and when acquired.

c) Obtain a list of the names and positions of all of the officers of the newly acquired corporation as of the beginning of the year during which the acquisition occurred.

d) Obtain a list of the names of all of the directors of the newly acquired corporation as of the beginning of the year during which the acquisition occurred. Cross-check with lists of the officers and directors of the parent and its subsidiaries at the start of that year and determine which, if any, of the directors were either officers or directors of the parent and/or of any of its subsidiaries.

e) Obtain details concerning the acquisition. Determine the date when it occurred, the percentage of shares held after the acquisition, what the selling price was and whether payment was in cash or shares of the parent's stock or a combination of both. Determine whether there was any agreement as a part of the sale that some or all principal officers were to be retained to continue to operate and manage the acquired corporation as before and, if so, what continuing employment commitment was made by the parent to each such officer.

f) Obtain a list of the names and positions of all of the officers of the acquired corporation as of the end of the year during which the acquisition occurred. As to any new officers, determine which, if any, were also officers or directors of the new parent or of any other subsidiary and, for each of them, the time when they obtained the additional position.

g) Obtain the same information with respect to the directors of the newly acquired corporation at the end of the acquisition year.

h) Obtain the same information with respect to all of the officers of the newly acquired corporation.

i) Obtain the same information with respect to the newly acquired corporation.

j) For the acquisition year and each subsequent year, prepare a separate list of changes instituted by the parent at the newly acquired corporation during that year alone, and of the dates on which instituted.

k) Determine the extent to which the new parent provided any centralized service to the acquired corporation, the nature of the service, and when it began to be provided to the acquired corporation.

Intercompany Personnel Transfers

a) Determine whether any person who became a new officer in the parent during the audit years had previously been an officer or key employee in a subsidiary of the parent. If so, determine his/her position formerly held, the year when he/she become an officer of the parent, and the number of prior years' service in the subsidiary and any other affiliates.

b) Obtain a list of any non-officer key employee transfers between affiliates for each audit year. These would include persons at the supervisor level or above at production plants, at distribution centers, and on administrative staffs. For each such person, list the name, the year of transfer, the old position held in which affiliate, and the new position held in which affiliate. This list should include transfers between the parent and subsidiaries as well as transfers between subsidiaries.

Lines of Business

General

The activities of many large corporate businesses are increasingly complex in this day of mergers, acquisitions, leveraged buy-outs, conglomeration, etc.. The organizational structures of many such businesses will constitute two or more unitary businesses; and one or more of those unitary businesses may consist of lines of business for which, even though they are unitary and technically combinable, the combining of their income and factors clearly will not produce a fair and reasonable result. Examples would be the combining of a retail line with a financial line, a manufacturing line with a retail credit line, a railroad with an oil company, and airline with a hotel chain, and a tobacco distributorship with a restaurant chain.

The airline and railroad examples are rather obvious problems since several states will apply to them formulas that differ from the standard three-factor formula. Indeed, the MTC itself has adopted regulations which set forth such a special formula for each of those industries. In some instances, the answer will be not to combine such lines in one report even though the unities and flows of value exist.

In such instances, however, it may be necessary to review the attribution of income between the two lines to ensure that income has not been misallocated between them on the basis of separate accounting. Adjustments may be called for if such misallocation is perceived. Having determined the apportionable income of each line, it is then appropriate to apply the applicable formula to that income. The results of the two formulary calculations can then be combined to produce the recommended assessment against the appropriate member or members of the unitary business.

This does not disregard the unities. It simply complies with the overriding constitutional requirement that the result be fair and reasonable.

In many instances, the two lines will be owned and controlled by a holding company which will engage in various financial operations for the benefit of the entire unitary business. Thus, it may invest temporarily excess operating funds for the two lines on a short term basis pending an operating need for them. The return on such unitary business investments should be included in the apportionable income of the two lines on some reasonable basis, e.g., proportional to the split of all other apportionable income or proportional to the split of gross receipts.

The very nature of a holding company is that it owns, controls and manages its subsidiaries and that it conducts no operating business. That is its reason for existing. Therefore, the unities required for combination will always exist in such cases; but the auditor must still pursue the collection of all pertinent information to support a unitary determination.

This can be a more complicated task in the case of a conglomerate. If the parent actually conducts an operating business which is separate and distinct from the unitary business of its subsidiaries, though, it may be that that operating business is only one of two unitary businesses in which the conglomerate engages, the second being that of managing and controlling its diversified subsidiaries. Such organizational challenges will try the mettle of any auditor.

3000 UNITY/UNITARY

3005 Unitary Combination Of Holding Companies

A holding company may be entirely passive, or may provide management and oversight functions to its subsidiaries. In either case however, the activities of the holding company are generally limited. There are no unique unitary tests designed for holding companies; the standard unitary tests (e.g., three unities, contribution/dependency) must be applied. Because those tests were designed to fit the fact patterns that are typically found in operating companies however, their application to holding company fact patterns is not always readily apparent. In cases, the auditor needs to carefully analyze the facts and circumstances of the case and determine the relative significance of the flows of value that can be identified.

The SBE emphasized that the standard unitary analysis (the three unities and contribution/dependency tests) is to be applied in determining whether a holding company and operating company are unitary. They rejected the generalization that "holding companies are essentially inactive and are per se incapable of providing or receiving a flow of value to or from an operating company." Instead, the SBE observed that since the typical characteristics of unity may not exist, the holding company context requires a focus on the economic realities of the particular corporate structure to determine whether unity is present. Citing *Appeal of Hollywood Film Enterprises* (Cal. St. Bd. of Equal., March 31, 1982), the SBE stated: "Factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider."

The flows of value that the SBE found in this case included intercompany financing of substantial value to the holding company, substantial amounts of money expended by the operating company for the holding company's public debt offering, and the covenant not to compete entered into by the holding company to protect the operating company from its former owner. The complete overlap of officers and directors, when considered in light of the other integrating factors, was seen as further evidence of the operation of the companies as a unitary business. The SBE concluded that there was substantial evidence to support a finding of unity.

The *Appeal of National Silver Co.*, Cal. St. Bd. of Equal., October 28, 1980, and *Appeal of Allright Cal., Inc.*, Cal. St. Bd. of Equal., January 9, 1979, both involved situations where the holding companies provided services for their subsidiaries, and were found by the SBE to be part of the unitary business. On the other hand, in *Appeal of Power-Line Sales, Inc.*, Cal. St. Bd. of Equal., December 5, 1990, and *Appeal of Insul-8 Corporation*, Cal. St. Bd. of Equal., April 23, 1992, the SBE did not allow the holding companies to be included in the unitary group on the basis that the taxpayers had failed to meet their burden of proving a unitary relationship.

3010 Insurance Companies

Insurance companies may or may not be included in the combined report. If the insurance company pays a premium tax to the State of New Mexico, then it should be excluded from the New Mexico corporate income tax return. If the insurance company doesn’t pay a premium tax to the State of New Mexico, then it maybe included on the New Mexico corporate income tax return.

The New Mexico Statute generally provides for a tax based on gross premiums of most insurance companies doing business in New Mexico.

Note that an insurance company, which is excluded from the combined report under New Mexico Statute, may still be unitary with or functionally related to its affiliates.

3015 Instant Unity

Occasionally, the issue is not whether entities are unitary, but *when* they became unitary. When a corporation acquires another corporation, a period of time often elapses before enough ties are established between the activities to constitute unity. The following SBE decisions illustrate some of the factors that may affect determinations in this area:

In *Appeal of Atlas Hotels, Inc. and Picnic 'n Chicken, Inc.*, a taxpayer engaged in a unitary hotel business acquired a corporation that owned and operated a chain of fast food outlets. Immediately upon acquisition, two of the hotel's top executives assumed positions as the two top executives of the fast food company, and began to run the day-to-day operations. Although ten-year employment agreements were signed with several of the top fast food executives as part of the purchase agreement, the duties of these "holdover" managers were restricted and their authority was very limited. Substantive changes to the overall operating philosophy of the fast food chain were immediately instituted, and several service functions were combined for the hotel and fast food operations. Since many of these managerial and operational changes were in the planning stage well before the actual acquisition date, implementation of the changes was commenced immediately upon acquisition. The FTB argued that the integration between the entities was not sufficient to demonstrate unity until the following year when the holdover management was discharged and the intercompany exchanges became more active. The SBE disagreed, and concluded that the activities were unitary immediately upon acquisition.

The *Appeal of The Signal Companies, Inc.,* Cal. St. Bd. of Equal., January 24, 1990, also involved unity with a newly acquired subsidiary. The taxpayer acquired the subsidiary in May 1975. In June 1975, three of the taxpayer's directors were appointed to the subsidiary's board. By July, the taxpayer's directors formed a majority of the subsidiary's directors and had gained control of the most important committees. In October 1975, an executive from the taxpayer's unitary business was elected as president and CEO of the subsidiary. Over the course of the year, the taxpayer and subsidiary exchanged technical and research information on several projects, the taxpayer-controlled board rejected certain plans that had been made by the former management of the subsidiary and instituted changes, and the subsidiary was included in the central planning being done for the affiliated group.

The taxpayer had included the subsidiary in the combined report from the date of acquisition. Upon audit, the FTB conceded that the subsidiary had become unitary by January 1, 1976, but did not allow combination for 1975. The department argued that the subsidiary was clearly not unitary on the date of acquisition, and the taxpayer had failed to establish a clear date during 1975 when unity was achieved. The SBE agreed that the taxpayer was not immediately unitary upon acquisition, and acknowledged that the ties between the companies were gradually established over a period of several months and that there was no single event or specific date upon which unity occurred. On the other hand, the SBE pointed out that all of the significant integrating factors upon which the FTB based its conclusion that the subsidiary was unitary as of January 1, 1976, were actually in existence by the beginning of the last quarter of 1975. Since the SBE found no basis for distinguishing between the unifying factors existing at January 1, 1976 and October 1, 1975, the SBE concluded that the taxpayer and its newly acquired subsidiary were unitary at least by October 1, 1975.

This case illustrates the importance of determining a date consistent with the unique facts of each case rather than by simply using an arbitrary benchmark.

In *Appeal of Dr Pepper Bottling Company of Southern California, et al.*, Cal. St. Bd. of Equal., December 5, 1990, the taxpayer was a soft drink bottler which was purchased by Dr Pepper Company (DPC), a corporation which manufactured and distributed soft drink concentrates and syrups. The bottler had been a licensee of DPC for many years prior to the acquisition, and over 50% of its concentrate and syrup purchases were from DPC.

The taxpayer/bottler did not file its returns on a combined basis with DPC. Upon audit, the FTB determined that the bottler was instantly unitary with DPC as of the date of acquisition. The taxpayer's argument was that there was no difference in the relationship between the two companies before and after the acquisition other than unity of ownership, and unity of ownership, by itself, cannot compel a finding of unity. The SBE rejected this argument, stating that a "vertically integrated enterprise was pre-existing here, needing only unity of ownership to result in a unitary business." Unity was held to have occurred on the date of acquisition.

To determine the point in time when the integration between two activities has developed to the extent that the unitary tests are met, the auditor must determine the changes that have taken place and the dates upon which those changes occurred. The first step in the analysis should be a detailed description of the operations of the new affiliate prior to the date of acquisition. Any pre-acquisition relationships between the entities should be identified and explained in detail.

When examining the details of the acquisition, the auditor should note the exact date on which it occurred, and review the purchase agreement and any other agreements related to the acquisition which may indicate terms and conditions of the sale. In particular, the auditor should be looking for terms that may limit the acquiring corporation's ability to integrate the new company into its operations. For example, some acquisitions may require that existing officers be retained to continue to operate and manage the target corporation.

Once the background information has been obtained, the next step should be to describe the changes instituted by the parent at the newly acquired corporation, and the exact date that each change took place. Such changes might include:

- Replacing officers, directors and key managers of the newly acquired subsidiary with individuals from the parent corporation (or from one of its existing subsidiaries);

- Providing centralized services such as accounting, legal services, pension plans or computer services to the newly acquired subsidiary;
- Transferring funds through intercompany financing;
- Imposing the parent company's policies and procedures on the newly acquired subsidiary (e.g., requiring a standard chart of accounts, standardized approval procedures for expenditures, etc.); or
- Decisions to discontinue certain product lines, to target new markets, etc.

3020 How Much Documentation Is Necessary If The Case Is Agreed?

Occasionally, taxpayers will agree to an adjustment to their method of filing before the factual development has been completed. It is difficult to expect a taxpayer to undergo the inconvenience and expense of a detailed unitary audit after they have already agreed to the adjustment. On the other hand, there have been instances where taxpayers have protested cases that were believed to have been "agreed." It may be difficult for the department to sustain these cases if the factual development is incomplete. To protect the state's interests while minimizing the inconvenience to the taxpayer, unitary adjustments resulting in a deficiency which are supported by incomplete factual development may only be made if the taxpayer provides a written statement with the following components:

> the taxpayer's agreement to the adjustment, *and*
>
> an acknowledgement that if the adjustment is protested or if a claim for refund is subsequently filed, the case will be returned to the auditor so that the audit may be completed.

The auditor is responsible for obtaining the appropriate amount of preliminary information prior to accepting such an agreement. It is at the discretion of the auditor as to the amount of preliminary information that is required and is based on the facts and circumstances of each case. The statement should be signed by an officer or other individual with the authority to bind the taxpayer.

3040 Recording The Paper Trail

The volume of information pertinent to these audits dictates that detailed workpaper files be kept, and that the information be clearly indexed and cross-referenced. Interview questions, initial document requests, and taxpayer responses should be kept in the audit report so that the reader can follow the actions that have been taken. Relevant data should be summarized and cross-referenced to the source documents in the file.

Whenever possible, copies of all documentation relevant to the auditor's determination should be included in the file. In some cases however, the documentation is too voluminous to be easily copied. In such situations (and only if the auditor does not feel that the information is important to the case), the auditor should write a memo to include in the file for support. The memo should describe the document, including the name or title of the document, the date it was issued, the number of pages, and a description of the contents. If applicable, the name of the person who prepared the report and the distribution of the report might be identified. The relevant information from the document should be described, and a list of the applicable page numbers should be identified. In the event that it becomes necessary to request the actual document at the protest, appeal or litigation level, the auditor should also note the name and title/position of the person to contact regarding the document, and where it is maintained.

Occasionally, taxpayers will allow auditors to look at documents in their offices but will refuse to allow auditors to photocopy the documents (or to provide the auditor with photocopies).

Auditors are entitled to photocopy documents. If the auditor is unable to obtain cooperation, the auditor and supervisor should contact the Legal Department for assistance.

3045 Partial Responses And Demands For Information

It is not uncommon for auditors to experience problems with taxpayers providing only partial responses, which do not satisfy the initial document requests. Auditors must then decide whether it is appropriate to issue a demand letter or whether it would be better to wait for the next response. This is often a difficult decision because of the conflicting goals of (1) maintaining a good working relationship with the taxpayer, and (2) maintaining control of the audit. In most cases however, the auditor should recognize that if the taxpayer is providing incomplete information, there is not a good working relationship already. It is usually better to document and monitor lack of cooperation as soon as it is suspected so that the taxpayer is immediately aware that such practices are not acceptable.

Auditors should recognize that uncooperative behavior may sometimes be more subtle than an express refusal to provide information. Taxpayer's representatives will sometimes attempt the following behaviors in order to control the progress of an audit:

- being vague about setting a time for the inspection of books and records;
- allowing only limited access or a trickling disclosure to records;
- absences of qualified personnel from the taxpayer's offices at the time of set appointments;
- absence of certain books and records due to their alleged necessity in other parts of the taxpayer's operation;
- limiting hours of inspection by late morning appointments, long lunch hours, and early closings;
- refusing to supply primary sources of information, thereby causing the auditor to accept something less than primary information;
- attempting to dictate to the auditor the records pertinent to the audit; or
- attempting to dominate the auditor with claims that the requests for information are irrelevant, immaterial and inapplicable to the audit.

It is very important that the auditor confront the taxpayer's representative as soon as possible with detailed evidence of the lack of progress. The actions of the representative that impaired the progress of the audit should also be memorialized in a letter to the taxpayer's representative, and be clearly documented in the file.

If the auditor has any doubt about what documents the taxpayer will provide and an out-of-town trip is involved, the taxpayer should be asked whether he intends to supply the documents before the auditor makes the trip. In this manner, the auditor may be able to save wasted time on a trip for which no documents are provided.

The auditor should make every effort to obtain the information necessary to conduct the audit and support its conclusions and recommendations. The need and relevance of the information should therefore be clearly communicated to the taxpayer. If the specific information requested does not exist or is overly burdensome for the taxpayer to provide, the taxpayer should be asked if alternative documents exist which will provide the substantiation that the auditor needs. The information requests must establish the time frames within which the information is to be furnished. When requested information is not provided or is unreasonably delayed, the auditor should reevaluate the relevance and need for the information before making a formal demand. Is the request reasonable? Has the information already been provided in an alternative form? Is the information necessary to decide the issue? Is the taxpayer's failure to provide the requested information due to reasonable cause?

In order to support this type of audit, it is critical that the file contains a good record to support the fact that the taxpayer was uncooperative. The audit file should document the reasons why the information requested from the taxpayer was necessary for a proper audit determination. Since the auditor's rationale for asking particular questions may not be obvious several years later as the case is protested, appealed or litigated, this explanation will prevent the taxpayer from successfully arguing that the questions were unreasonable.

The unsatisfied aspects of each information document request should be regularly monitored so that timely demands or subpoenas can be issued. The fact that a taxpayer has provided some of the information requested in an initial document request does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. For example, if a taxpayer is given an initial document request requesting five items, and only items 2, 4 and 5 are provided, the auditor may issue a demand for items 1 and 3. Without this audit trail, subpoenas are unlikely to be issued, and the failure to furnish penalty will be difficult to support.

In material cases, options for dealing with taxpayers include administrative subpoenas.

3090 Change In Position From Prior Years Audit

Occasionally, the findings in a current audit will indicate a determination that is contrary to the position taken by the department in an audit of prior years. The interpretation of a taxpayer's unitary facts should be applied consistently from year to year. Consequently, a change in position from the prior audit is not a decision that should be taken lightly. On the other hand, there are circumstances where such a change is appropriate.

3000 UNITY/UNITARY

A taxpayer's method of filing is sometimes either allowed or adjusted by auditors based upon insufficient evidence (such as when an audit is closed as a result of a taxpayer's failure to furnish information). In other cases, the prior audit determination may have been based upon theories that have been invalidated by the Courts. If the current audits of these taxpayers indicate the taxpayer's method of filing to be improper, it is essential that the auditor make the necessary changes to place the taxpayer on the correct method of filing.

It is also possible that facts have changed from the prior audit that will clearly indicate a change in the filing method. The auditor must document these changes in detail within his audit report. It is very important to note the dates that significant events occurred.
Most of these cases are not black or white situations. Before the auditor makes a change in the filing method, a thorough discussion of the facts should be held between the auditor and supervisor.

4000 INCOME

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4000 INCOME

4000 Determination of Domestic Combined Income

Line #28 of the Consolidated Federal 1120 will be the beginning point. Additions thereto will be Federal 1120 Line #28 Income of Unitary Domestic Companies not included in the consolidated return (i.e. possession companies, DISCs, and companies owned more than 50% but less than 80%). Exclude any non-unitary domestic companies that have been included in the consolidated return. Review interaffiliate transactions to see if Federal 1120 Consolidating Adjustments (transactions between Consolidated 1120 unitary companies and unitary companies not included in the Consolidated 1120) need to be revised. Eliminate dividends between combined domestic companies. The result will be Domestic Combined Income Before Special Federal Deductions.

4005 Consolidated Working Papers and Their Uses

Nature of Consolidated Statements

The consolidated statements appearing in the Annual Report or SEC Form 10-K show an overall picture of the financial position and operating results of the parent and those subsidiary companies which are operated under a common or unified control. For purposes of the consolidated statements, the independent legal existence of the separate companies is disregarded. The consolidated statements do not present the financial position and operating results of a single legal entity. These statements show the data of a business entity or economic unit consisting of a group of legal corporate entities. Consolidated statements should not be viewed as substitutes for the legal accounting statements which reveal the financial position and operating process of the individual legal entities. Both the consolidated and the individual legal entities statements should be available since each type serves distinct purposes and supplies data not revealed by the other. Request the consolidating working papers as a normal field audit practice; particularly when foreign affiliates are involved, because the individual legal entity's financial statements will usually be the best available source for determining the income of each foreign affiliate.

Source of Foreign Financial Statements

Foreign affiliates' individual financial statements, which have been translated into U.S. dollars and expressed in conformity with generally accepted U.S. accounting principles, are usually the best sources for determining foreign source income for inclusion in the combined report. Usually, the most readily available source of the foreign affiliates' individual financial statements is the consolidated working papers which are prepared to support the preparation of the consolidated financial statements. The working papers are usually prepared in a format which allows the combining of similar items of each individual legal entity and the eliminating of intercompany items by listing each entity horizontally.

Information Included in Consolidated Statement

Included in the useful information that can be obtained from the consolidated working papers are:

a) Intercompany transactions which can be used to help substantiate unity, such as intercompany receivables and payable, intercompany purchases and sales, interest, rents, other intercompany revenue and expense items, intercompany loans and financing, and intercompany unrealized profit.

b) Currency translation gains and losses.
c) Income and financial position on an individual company basis.
d) Differences in accounting methods used by the various members of the group.
e) Differences in accounting periods.
f) Net operating loss schedule

4010 Currency Translations

Inclusion/Exclusion

Currency gains or losses on closed transactions (realized) are includable in income, while unrealized gains or losses resulting from the re-statement or re-evaluation of assets or liabilities to reflect changes or fluctuations in currency values are not included in taxable income for state purposes. This does not necessarily follow federal tax treatment for U.S. corporations.

Analysis

In practice, when the Annual Report, SEC Form 10-K, or consolidating workpapers are used as sources for foreign source income, the realized and unrealized gains and losses are often netted together. When the realized and unrealized gains and losses cannot be determined by an examination of the source documents, request that the taxpayer provide an analysis of the translation gain or loss. Quite often, the taxpayer is either unable or unwilling to provide the necessary detail to identify unrealized currency transactions. In this event, a decision is required on the part of the auditor as to whether to allow or to disallow the total gain or loss. This decision should consider the materiality of the amounts involved and/or consistency with prior audit treatment. Starting with the application of FASB #52, the realized gains and losses are includable in current year income while unrealized gains and losses from translations are entered directly to the stockholders' equity section, with the exception of a foreign currency "transaction gain or loss". A transaction gain or loss occurs when an obligation must be settled in a currency other than the functional (reporting) currency of the foreign entity and there is a change in the exchange rate. Such a gain or loss is recognized in the period in which the rate change takes place rather than in the period in which the transaction closes. Such gains or losses need not be adjusted unless there is a significant difference in tax consequences between the period when the gain or loss is recognized and the period in which it is realized.

4015 RAR Adjustments

Take RAR adjustments into account in determining income. Prepare a separate schedule detailing such adjustments. **(See Section 5040 – RAR Adjustments)**

4020 FSC Income

Federal Form 1120 – FSC
The income from Foreign Sales Corporations (FSC) is reported for federal purposes on Federal Form 1120-FSC. Use the line, Taxable Income Before Net Operating Loss and Special Dividend Deduction, as the source for the taxable state income of a FSC.

Deferrals
A FSC will often report on an accounting period other than that of the parent in order to take advantage of special rules for the deferral of FSC income for federal purposes. Since the federal deferral rules are not applicable for most state purposes, fiscalize the income of a FSC reporting on a different accounting period to the parent's year end. Use book income on a year-end which is common with the parent, if available.

Verification
Some ways to verify that a FSC corporation exists are:

1) By checking Schedule C, Dividends, of the Federal Form 1120, to see if taxable dividends from a FSC are included in income;
2) By checking the detail to Line 26, Other Deductions, Federal Forms 1120, for FSC commissions paid; By checking Schedule M-1, Federal Form 1120, for FSC expenses; and
3) By check the list of company affiliates in the SEC Form 10-K.

Interaffiliate Deemed Dividends
In addition, when a FSC corporation is included in a combined report, any FSC deemed dividends that have been included in the income of its parent should be eliminated, as intra-business transactions.

States' Treatment of FSCs
The inclusion of FSC income in a combined report will vary from state to state. Determine the applicable inclusion or exclusion for each state.

CORPORATE INCOME TAX AUDIT MANUAL

5000 BUSINESS/NON-BUSINESS INCOME

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5000 BUSINESS/NON-BUSINESS INCOME

5000 General

This index establishes that basis for a determination of the extent of the apportionable net income of the taxpayer. As a matter of constitutional law, only net income that is directly related to or functionally integrated with the taxpayer's conduct of a unitary business may be subject to apportionment. The remainder of the taxpayer's income, including expenses attributable thereto, is subject to specific allocation. As used here, business income means apportionable income; and non-business income means allocable income.

General tests may be applied initially to determine whether any class of income (e.g., dividends, interest royalties and rents) is business or non-business in nature. In addition, however, the auditor must monitor facts that are peculiar to each particular class.

Recent Supreme Court cases appear to lead to the following propositions with regard to the distinction between business and non-business income:

a) All income included in the apportionable base and, therefore, classified as business income, must be unitary income.
b) Unitary income includes income from the unitary business operations of the taxpayer; it also includes dividend income, interest income, rental income and royalty income that is earned in or related to the unitary business even if it is received from payors that are not engaged in the same unitary business with the taxpayer.

The auditor should, with respect to each item of income, determine:

a) The nature of its source and the nature of any relationship of that source to the taxpayer. For example: Was the dividend paid by a subsidiary which is in the same line of business as the parent? Was the rental income earned from property used in the taxpayer's business?
b) The purpose behind the making of the investment. For example: Did the interest income constitute income earned on a short-term investment of working capital which the taxpayer intended to use late in the unitary business? Was the dividend received from a subsidiary which supplied raw materials or important services to the unitary business?
c) The source of the funds used to make the investment. For example: Did the taxpayer set the funds aside as self-insurance for worker's compensation?
d) The taxpayer's rationale for treating income as business or non-business in nature and the consistency or inconsistency with which the taxpayer has reported such treatment to other states.

The purpose of investing in income-producing property is controlling in most instances for the purpose of distinguishing between that income which is business income and that which is non-business income. If the investment has been made for a purpose other than that of investing surplus funds which are not needed or utilized in the business of the taxpayer, the income from that investment is business income; but if the investment was made solely for the purpose of obtaining a return on such surplus funds and if the investment is unrelated to the taxpayer's business operations, the income in most instances is non-business income. In other circumstances, income from the investment would be classified as business income since it is functionally related to the taxpayer's trade or business operations.

Examples of business income would be: Income that is "effectively connected" with the taxpayer's business operations under Section 864(c)(2) of the IRC, as implemented by Treasury Regulation Sec. 1.864-4(c)(ii); and income that is classified as ordinary business income under the business purpose test of *Corn Products Ref. Co. v. Commissioner,* 350 U.S. 46 (1955).

5005 Business Income Tests

The New Mexico Regulations establish tests by which to determine whether income is business or non-business in nature. They were adopted prior to the *ASARCO, Woolworth and Container* decisions. But they remain valid except to the extent that they may imply that investments that are completely dissociated from the unitary business of the taxpayer give rise to business income.

Two tests can help to resolve business/non-business income problems:

a) Does the property that produces the income arise from transactions or activities conducted in the course of the taxpayer's trade or business operations? (**Transactional test)**
b) Is the property functionally related to the taxpayer's unitary business, i.e., was the acquisition, management and disposition of the property accomplished as an integral part of the taxpayer's business? **(Functional test)**

In short, was the acquisition of the property or its subsequent use or disposition accomplished for the purpose of furthering the taxpayer's business or did it constitute a mere investment the sole purpose of which was to produce investment income?

The taxpayer need not be engaged in a unitary business with the payor of the income for that income to be classified as business income.

5010 General Tests

In applying phrases such as "functionally related" and "effectively connected," one may find it helpful to relate them to specific examples such as those that are included in the New Mexico Regulations. The business/non-business income issue generally arises with respect to intangible income such as dividends; interest from sources like bonds, debentures, charge accounts and credit card operations; royalties from sources such as patents, trademarks and copyrights; and gains or losses from the disposition of intangibles such as stocks and bonds. Any large taxpayer is likely to have many intangible investments involving many items of income, and the purposes of the investments may vary, which in turn can affect the business/non-business income determination.

A determination of whether each such investment is functionally related to the taxpayer's unitary business can consume more auditing effort than is justified by the potential tax liability or tax savings at issue. The taxpayer will often arbitrarily classify all investment income from intangibles as non-business income for this reason. The auditor must seek to resolve the business/non-business income issue without placing an undue burden on either audit resources or taxpayer resources.

The auditor should look for significant individual items, such as dividends from subsidiaries and income from investments, that can be lumped into specific categories. If he/she needs to rely on sampling techniques, he/she should work out with the taxpayer an adequate sampling approach by class of income for one year and then apply the findings to all items in each class and to all years.

5015 General Categories

General categories of business income include:

a) Income from investments which have been made in stocks, bonds and loans for the purpose of securing a source of supply or a market.
b) Income from investments of working capital, whether short term or long term in nature.
c) Income from patents, copyrights and trademarks which have been developed by the taxpayer and used in its business.
d) Income traceable to reserves for the normal cycling or fluctuations of the taxpayer's business.
e) Income from investments which were made by the taxpayer for the purpose of expanding its business; e.g., the formation of a subsidiary that engages in the same line of business.
f) Income from commonly owned and controlled corporations.
g) Income from the disposition of investments which produced business income when held by the taxpayer.

General Categories of non-business income include:

a) Income from surplus funds that are not needed in the taxpayer's business and that are invested in a business which is not functionally related to that of the taxpayer.
b) Income from corporation business activities which are unrelated to the business of the taxpayer.
c) Income from the disposition of assets which produced non-business income when held by the taxpayer.

5020 Specific Factual Determinations

Purpose of Investment

The auditor must determine the purpose for which the taxpayer made the investment that produced the intangible income in question. If idle funds were used to invest in assets that were totally unrelated to the taxpayer's business and if there is no indication that such funds were reserves for use in that business, the reasonable inference is that the investment was made for a non-business purpose. This will be so even if the income has been commingled with operating funds of the taxpayer. But, if the investment was made for a purpose associated with the taxpayer's unitary business, then the reasonable inference is that the investment was made for a business purpose.

Common Facts

Early questions should include:

a) Why did the taxpayer classify the income in question as non-business income and on what information did it rely in doing do?
b) How has the taxpayer accounted in its books and records for the assets and the income derived therefrom?
c) Has the taxpayer specifically allocated on returns to appropriate states that income which it has classified as non-business income on the returns which are being audited?
d) Has the taxpayer deducted from apportionable net income the expenses of producing income which it claims to be non-business income? If not, then how did the taxpayer determine which expenses were attributable to the claimed non-business income?
e) Did the taxpayer adjust the apportionment formula factors to exclude from them any property, payroll or sales associated with the production of the claimed non-business income? If so, how did it determine those adjustments?
f) Did the taxpayer own a controlling interest in the payor of the income in question?
g) What business relationship, if any, other than that of a mere investor, did the taxpayer have with the payor of the income?
h) What was the purpose of this specific investment by the taxpayer?
i) What was the source of the capital with which the taxpayer purchased or otherwise acquired the property which gave rise to the income?
j) What interest expense did the taxpayer deduct in computing net apportionable income? How much of it was attributable to the investment in question?

Dividend Income

Dividend income is business income if the dividends were earned in the course of activities which were directly related to or functionally integrated with the conduct of the recipient's unitary business. There is no constitutional requirement that the payor be connected to the recipient by more than 50% ownership.

a) Obtain all relevant dividend income information required to support Line 4 of Federal Form 1120.
b) Prepare a schedule for each year under examination, detailing the dividend income by type. This can be used as the source reference for applicable state adjustments such as Section 78 Grossup.
c) Present the schedule to the taxpayer with the request that it be completed for any dividend income which the taxpayer deems to be non-business income. The auditor should identify on the schedule(s) any dividend income which he/she recommends to

be considered as non-business income. The auditor should include in the audit narrative appropriate comments to support the recommendations.

d) If the auditor has recommended that any dividend income be treated as non-business income, he/she should prepare the Non-Business Dividend Schedule to determine directly related expenses, indirect expenses and dividend expenses proration.

e) Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions with respect to dividends received from each payor corporation during each of the years under audit:

1) What was the amount of dividends?
2) What was the purpose of the acquisition of the stock which produced the dividends?
3) How was the stock acquired? From a subsidiary formed by the taxpayer? As a part of the acquisition of a going business? Other? [Identify all persons, documents and communications that are relevant to the acquisition of the stock.]
4) What portion of the stock of the dividend payor did the taxpayer own?
5) How did the taxpayer account for the dividend income?
6) Did the taxpayer deduct related expenses from its apportionable income?
7) What business, if any, did the taxpayer conduct with the dividend payor?
8) What, if anything, did the taxpayer's ownership of the stock of the dividend payor contribute to the taxpayer's business?
9) How many transactions took place in which the taxpayer acquired stock of other corporations? [Schedule by year.]
10) Is the dividend payor a part of the unitary business of the recipient?
11) Are the dividend payor and the taxpayer engaged in the same line of business?
12) How and to what extent did the taxpayer exercise management, supervision and/or control over the dividend payor corporations? [Identify all persons who participated in such activities; identify all communications that were involved; and identify all relevant documents.]
13) What relationships existed between the taxpayer and the dividend payors?
14) Relate, in detail: the extent to which the taxpayer:
    (a) Sells products to or purchases products from those corporations;
    (b) Lends monies to or borrows monies from them; and/or
    (c) Exchanges personnel with them.
15) The extent to which the taxpayer shares with those corporations any of the following:
    (a) Research and development facilities and results;
    (b) Trade names and trademarks;
    (c) Fringe benefits;
    (d) Personnel, especially executive personnel;
    (e) Training programs;
    (f) Technical expertise;
    (g) Legal services;
    (h) Accounting services;
    (i) Advertising services; and/or

(j) Other services.

[Identify all persons who may have knowledge of these relationships, and identify all pertinent documents and communications, whether oral or written.]

Interest Income

Interest income is business income if it has been earned on funds used in the regular conduct of the taxpayer's business regardless of how those funds were invested. Interest income earned from intangibles acquired as short-term investments of capital used in the regular conduct of the taxpayer's business is also generally business income.

Obtain all interest income information required to support such income reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:

a) Other Interest Income
   1) What was the purpose of the purchase of the interest-bearing assets?
   2) Was the capital used to purchase or acquire these interest-bearing assets derived from the business operations of the corporation? If not, explain.
   3) Was this interest income utilized in the overall operations of this corporation? If not, explain.
   4) Indicate how many transactions have given rise to the entries into the interest-bearing asset account for each of the taxable years.
   5) Indicate the number of years during which the corporation has owned interest-bearing assets.

b) Relationships Between the Creditor Company and the Debtor Company
   1) Identify all relationships between the creditor company and the debtor company (other than the debtor-creditor relationship itself).
   2) Identify all persons who have knowledge of these relationships and all pertinent documents and communications.
   3) Indicate the amount of interest income which was received from persons with whom the company or its affiliated and subsidiary corporations had no business relationships other than that of creditor.

c) Sources of Funds/Interest Income
   1) Identify the source of the funds used to make the loans that gave rise to interest income.
   2) Identify all pertinent documents and communications.

d) Company's Characterization
   1) Short-Term Interest. Present the Interest Income Analysis Schedules to the taxpayer with the request that they be completed for any short-term interest which the taxpayer deems to be non-business income. If the company has specifically allocated any of that income, state the standards used by the

company in making that determination. The auditor should identify on the schedules short-term interest which he/she recommends to be treated as non-business income.

2) Long-Term Interest. Present the Interest Income Analysis Schedules to the taxpayer with the request that they be completed for any long-term interest which the taxpayer deems to be non-business income. If the company has specifically allocated any of that income, state the standards used by the company in making that determination. The auditor should identify on the schedules short-term interest which he/she recommends to be treated as non-business income. The auditor should include in the audit narrative appropriate comments to support such recommendations.
3) How did the company account for its interest income statements to its shareholders in its annual reports?
4) Determine whether related expenses have been deducted from apportionable income in current year or previous year.

e) Purpose of Investment
   1) Did the money to make the loan that produced the interest income constitute part of the company's working capital?
   2) Expenses Related to Allocated Interest Income. If the auditor has recommended that any interest income be treated as non-business income, he/she should prepare the Non-Business Income Schedule to determine directly related expenses, indirectly related expenses, and the interest expense proration.

Rental Income from Real and Tangible Personal Property

Rental income is business income when the rental of the property is a principal business activity of the taxpayer or when the rental of the property is related to or incidental to the taxpayer's principal business activity.

a) Obtain all rental income information required to support such income as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:
   1) Were the funds used to acquire or construct this rental income property derived from the business operations of this corporation? If not, explain.
   2) Was the value of the property included in the property factor of the apportionment formula?
   3) Indicate the number of years during which the corporation has owned rental income property and realized rental income.
   4) Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

b) Present Rental Income Analysis Schedule to the taxpayer with the request that they be completed for any rental income which it deems to be non-business in nature. The auditor should reflect on the Non-Business Income Schedule any rental income for which he/she recommends treatment as non-business income. The auditor should make appropriate comments in the audit narrative to support such recommendations.

Royalty Income

Patent and copyright royalties are business income if the patent or copyright with respect to which the royalties were received arises out of or was created in the regular conduct of the taxpayer's business or if the purpose for acquiring and holding the patent or copyright was related to or incidental to such business.

a) Obtain all royalty income information required to support such income as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:
   1) Indicate the number of years this corporation has owned royalty assets and realized royalty income.
   2) Identify the sources of the inventions, patents, copyrights, trademarks, etc., which gave rise to the royalty income.
   3) Identify the entities from which the company derived royalty income; include the amounts received from each such entity.
   4) Determine the nature of the company's relationship with each of those entities. Identify all pertinent documents and communications.
   5) Does the company own any trade names, trademarks, licenses, franchises, copyrights, or other patents in common with its affiliates? If so, identify their origin, the person who produced them, and all documents or communications pertaining to their use.
   6) Has the company sold to or acquired from any affiliates any trade names, trademarks, licenses, franchises, copyrights, patents, etc.? If so, identify all persons who have knowledge of such activity; and identify all pertinent documents.
   7) Identify all transactions between the company and its affiliates involving trade names, trademarks, licenses, franchises, copyrights, patents, etc., which have given rise to royalty income.
   8) Does the company make available to affiliates any trade names, trademarks, licenses, franchises, copyrights, patents, etc., which are not made available to the general public? If so, identify all persons who have knowledge of these activities, and identify all pertinent documents and communications.
   9) Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

b) The auditor should present the Royalty Income Analysis Schedule to the taxpayer with the request that they be completed for any royalty income which the taxpayer deems to be non-business in nature. The auditor should reflect on the Non-Business Income Schedule any royalty income for which he/she recommends treatment as non-business income. He/she should make appropriate comments in the audit narrative to support those recommendations.

5000 BUSINESS/NON-BUSINESS INCOME

Gain or Loss on Sales of Assets

Gain or loss from the disposition of property is business income if the property, while owned by the taxpayer, was used in the taxpayer's business. The gain or loss from the disposition of property is non-business income if the property was utilized for non-business purposes for a significant period of time before its disposition.

a) Obtain all information relevant to the Gains or Losses on Sale of Assets required to support income/loss as reported on the Federal Form 1120. Prepare and attach to this section an indexed narrative which responds to the following questions and suggestions:
   1) Describe briefly the use of the assets which generated the net gain or loss for the taxable years under examination.
   2) Determine whether related expenses have been deducted from apportionable income in the current year or in previous years.

b) The auditor should present the Net Gain (Loss) Analysis Schedule to the taxpayer with the request that they be completed for any gains (losses) which the taxpayer deems to be non-business in nature. The auditor should reflect on the Non-Business Income Schedule any gains or losses for which he/she recommends treatment as non-business income. The auditor should make appropriate comments in the audit narrative to support such recommendations.

Other Income

Obtain all information relevant to other income required to support Line 10 on the Federal Form 1120. Prepare a schedule deemed necessary by the auditor. Allow the taxpayer the same opportunity as in the instances set forth above to demonstrate which income it deems to be non-business and why. Prepare appropriate schedules and enter appropriate comments in the audit narrative to support any auditor recommendations that any income be treated as being non-business in nature.

5025 Expenses Attributable To Nonbusiness Income

To the extent that expenses have been incurred for the production of nonbusiness income, those expenses will not be allowed as a deduction from business income. For example, assume a taxpayer invests in an apartment building from which it derives nonbusiness rental income. The depreciation, maintenance, management fees, and any other expenses attributable to that property will not be allowed as a deduction from the taxpayer's business income. Instead, the expenses will be netted with the gross rents received from the property, and the net income or loss from the activity will be treated as nonbusiness.

In some cases, an expense may be applicable to more than one nonbusiness activity, or to both, a business and a nonbusiness activity. In such cases, the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner that fairly distributes the deduction. The allocation method may vary depending upon the type of expense. For example, a ratio of time spent on the various activities may be an appropriate method for allocating employee compensation expenses. Square footage of floor space may be a better basis to use for the allocation of building expenses. In general, any method of proration which is reasonable under the circumstances and which bears a rationale relationship to how the expenses are incurred will be allowable so long as the same method is used consistently from year to year.

5030 Consolidated Federal Form 1120

Every U.S. corporation which is not expressly exempt from tax must file an annual income tax return for federal purposes, regardless of whether there is positive income or a tax due. The return form for most corporations is the Federal Form 1120. Other corporate returns are Federal Form 1120F for domestic operations of foreign companies, Federal Form 1120- FSC for Foreign Sales Corporations, and Federal Form 1120-DISC for Domestic International Sales Corporations. Federal Form 1120X, Amended U.S. Corporation Income Tax Return, is used to amend the original Form 1120.

If certain conditions are met, domestic members of an affiliated group of companies may elect to file a consolidated Federal Form 1120. The federal consolidated return includes a parent corporation and all affiliates owned (directly or indirectly) at least 80% by that parent. As a result, only parent/subsidiary groups may file on a federal consolidated basis. Brother/sister groups owned by an individual or by a foreign corporation will not be eligible. See IRS Publication 542, *Tax Information on Corporations* for a more in-depth discussion of Form 1120 filing requirements.

On the other hand, if the federal 1120 has not been audited, then the auditor should review the income statement for material issues and unusual transactions. This does not mean that auditors are required to perform detailed income and expense audits on all taxpayers that have not undergone a federal audit, but it does mean that auditors can’t assume that no issues exist with respect to income and expenses just because the items were reported the same way for federal and state purposes. In addition, if an income reconciliation is prepared from an unaudited federal return, the results should be double-checked against a reconciliation of income from another source (such as audited financial statements). If a material difference is detected, than additional audit work will be necessary.

> **Note:** If the IRS scopes a return and performs preliminary audit procedures before determining that the return will be accepted as filed, the federal return is considered to be unaudited. Since the return has not been subjected to a complete IRS examination, auditors should look upon the income and expense items reported on the federal return as having no greater reliability than state-only items reported on an unaudited New Mexico return.

Strengths:

The benefit of reconciling net income to an audited federal return is that the income base and the book/tax adjustments will already have been audited by the IRS. Although the auditor should still perform a quick review of the components of net income and the Schedule M-1 adjustments to look for items which result in federal/state differences, this review will be substantially less detailed than the review that would be required if no federal audit had been performed.

Weaknesses:
Since the federal consolidated return does not include brother/sister groups or foreign corporations, it is not as useful as the consolidated financial statements for identifying unitary affiliates that may have been left off the combined report. In addition, although other sources may be used to verify the income of non-consolidated corporations (once they have been identified), intercompany eliminations will not have been taken into account.

5035 Captive Insurance Subsidiaries

Corporations often form captive insurance subsidiaries to provide for their insurance needs. The traditional captive insurance situation, in which the insurance subsidiary insures only its parent and/or members of the affiliated group, is really a form of "self-insurance" because the parent ultimately retains all of the risk. For example, assume a captive insurance company has an investment account of $1.1 million, insurance liabilities of $1 million, and capital of $100,000. The captive insurance company has an insurance claim of $1,050,000. The claim reduces dollar for dollar the value of the parent's investment in the subsidiary. Taxpayers who place funds into a reserve for losses do not get a deduction until the losses are actually incurred. By the same token, taxpayers who structure the same result by paying premiums to a wholly owned subsidiary should not get a deduction.

A captive insurance company which pays a premium tax to the State of New Mexico is exempt from any corporate income tax or franchise tax. A captive insurance company which doesn’t pay a premium tax to the State of New Mexico and is unitary with one or more domestic companies maybe included on a combination unitary return.

Audit techniques:
The search for related corporations that are normally performed to reveal unitary issues may reveal insurance subsidiaries. The existence of insurance subsidiaries may also be identified in the annual reports, SEC 10-Ks, or the Form 1120.

Most domestically organized insurance companies will be subject to regulation by the insurance departments of the states in which they operate.

5040 RAR Adjustments

If a federal audit has been performed, it may be necessary to modify net income to reflect the federal adjustments.

Before picking up the federal adjustments, the auditor should consider whether the adjustments are applicable under state law. Obviously, it is important to verify that the federal RAR does not included adjustments attributable to corporations that are not included in the combined report. Adjustments to dividend income may or may not be applicable to

New Mexico depending upon whether the dividend is subject to intercompany elimination for state purposes. It is a good idea to analyze the RAR adjustments in conjunction with the taxpayer's state adjustments to ensure that the state adjustments are consistent with revised federal income.

It may be necessary to review the detail of material RAR adjustments to determine whether those adjustments are applicable for New Mexico. On the other hand, a review of the detail underlying a federal depreciation adjustment may reveal that the depreciation was revised because of an adjustment to the cost basis of the asset.

RARs may include IRC §482 transfer pricing adjustments to reallocate income or deductions between members of a commonly controlled group. This type of adjustment might be necessary if taxpayers manipulate prices charged in transactions between related parties in order to minimize income in high-tax jurisdictions. If the federal §482 adjustment is not picked up, then any collateral adjustments should also be disregarded (collateral adjustments may also be identified on the RAR as correlative or conforming adjustments). As an example of a collateral adjustment, assume that the IRS determines that a U.S. subsidiary paid inflated prices for inventory and equipment purchased from its foreign parent. The RAR might increase the U.S. subsidiary's taxable income, recharacterize a portion of the payments as a dividend, and reduce the basis of the equipment.

CORPORATE INCOME TAX AUDIT MANUAL

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6000 Apportionment Formula

Apportionment is the process by which business income is divided between taxing jurisdictions. The apportionment formula calculates the percentage of the property, payroll and sales of the unitary business, which are attributable to New Mexico. The total business income of the unitary business is multiplied by this percentage to derive the amount of business income apportioned to this state.

For purposes of the apportionment formula, the property factor generally includes all real and tangible personal property owned or rented and used by the taxpayer during the income year, and the payroll factor includes all forms of compensation paid to employees. These factors are intended to reflect the capital investment and labor activities that generate income. The sales factor generally includes all gross receipts from the sale of tangible and intangible property, and is intended to recognize the contribution of the market state towards the production of income.

Alternate Formulas

In unusual situations where alternative apportionment procedures have not been developed and where application of the standard formula will produce incongruous results, the taxpayer may request permission for (or the State of New Mexico may require) use of another method for allocating and apportioning its income. Such other methods may include exclusion of one of the factors, the inclusion of an additional factor, or the doubling of an additional factor. The authority for use of a special apportionment method is found in Section 7-4-19 NMSA 1978, and is generally only invoked in exceptional cases. Auditors should consult with their supervisors if they come across a case, which may require development of a special formula not described in the Regulations under Section 7-4-19 NMSA 1978, or in this manual.

6005 Property Factor

Nature of Facts

The use of a property factor in the apportionment formula reflects the income-producing nature of invested capital. The numerator of the property factor is the average value of all owned or rented real and tangible personal property used in the production of business income in the state. The denominator is the total of all such property owned or rented by the taxpayer everywhere.

General

The auditor must obtain a “51 state breakdown” of property, payroll and sales of the taxpayer for each of the years under examination.

Property owned by the taxpayer is valued at its original cost and will generally be the federal tax basis. Rented property is valued at a capitalized annual rent expense (generally 8 times).

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If you are placing the taxpayer on a combined basis and the annual report or SEC 10-K is available, use the annual report to construct the property factor. Major differences between book and tax basis, if any, can be supplied by the taxpayer and these items would appropriately be included. If an annual report or 10K is not available, the balance sheet of the Federal 1120 will generally be used. Further detail may be needed to exclude items such as construction-in-progress.

In the case of a privately held company with foreign subsidiaries, the CPA's certified financial statements (balance sheets) may be used to obtain information concerning foreign subsidiaries' property. This data will usually be contained in the consolidating workpapers.

The taxpayer's records usually show the location of property on a state by state basis (51 state breakdown). Verify the location figures by reference to actual tax returns on a sample basis. Compare the total of all property as shown on the 51 state breakdown with the amount actually used in the denominator. If there is no major difference, you may conclude that the numerator amounts shown for the different states account for all property. This information will be needed for verifying the property factor, as well as for sales attribution purposes.

Generally, the ending balance of one year will be the beginning balance for the next year; however, adjustments may be needed for newly acquired corporations or entities sold. In addition, consider previous audit adjustments.

Denominator

Consider the following items in verifying original cost:

The use of the annual report to test the denominator of the property factor is the quickest method to use. If annual reports are not available, year-end trial balances or CPA audited balance sheets provide a satisfactory source for verifying owned property at original cost.

The return depreciation schedule shows property at the federal tax basis. If the balance sheet amounts vary significantly from the cost as shown for depreciation purposes, the balance sheets may not be on a federal tax basis or other differences such as construction-in-progress may be included.

The property ledger may be used for the reconciliation or verification of the differences if material.

If the taxpayer reports its foreign subsidiaries' inventory at a different cost basis for book purposes but adjusted to the parent's basis for determining the unitary business income, the adjusted amount should be reflected in the denominator to get all operations on the same basis.

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Used or Available for Use

The word “used” encompasses “available for use” or “capable of being used” to produce business income. If the property is used for the production of non-business income, it is excluded from the property factor. Types of property that are available for use but are not actually used would include timber tracts for lumber companies, oil leases for oil companies, and mineral leases for mining companies. A plant that is temporarily idle is available for use, as is a plant that is for sale. If the plant is not sold within the lapse of an extended period of time, normally five years, however, it is removed from the property factor.

Sources of information as to non-business property may be found in annual report notes, board minutes, depreciation schedules and the SEC 10K Report.

Owned Property

Property owned by the taxpayer and used to produce business income is included in the property factor. Only real property and tangible personal property are to be included, except in the cases of certain special industry formulas.

Average Value

The average value to be used in the property factor is determined by averaging the values at the beginning and ending of the income year. The Department may require or allow averaging by monthly values when necessary to reflect the average value for the income year properly. If significant property is added during the latter part of a month, consider using a daily average for that month. Significant acquisitions or dispositions of property which can cause material fluctuation should be accounted for by weighted averages.

Construction in Progress

Property under construction during the income year is excluded from the factor until it is actually used in the regular course of the trade or business. If it is partially used in the regular course of the trade or business while under construction, the value of the property to the extent used is included in the property factor. This type of property will appear on the depreciation schedule. (Goods in process are to be included in a manufacturer’s property factor.)

When this item does not appear on the depreciation schedule, it will normally be found on the balance sheet as a separate item. Construction in progress may be found in the annual reports, Schedule L of the 1120, SEC 10K Report, general ledger and the property ledge.

Inventories

The valuation of inventories for purposes of the property factor is generally to be derived from the valuation used for federal income tax purposes. If the taxpayer reports its foreign subsidiaries' inventory at a different cost basis for book purposes but adjusted to the parent's basis for determining the unitary business income, the adjusted amount should be reflected in the denominator.

Excise Taxes

Excise taxes are included as part of the value of beginning and ending inventories since taxes represent part of the cost of goods sold.

The auditor should ascertain that the average of inventory per balance sheet agrees with the total utilized in computing the factor. If not, the difference might be due to the elimination of the excise taxes in the property factor. Excise taxes should be included. Excise taxes are imposed on the alcoholic beverage, tire manufacturing, tobacco and oil industries.

In-Transit

Property in transit between locations of the taxpayer to which it belongs is considered to be at the destination for purposes of the property factor.

Property in transit between a buyer and seller and which is included by a taxpayer in the denominator must be included in the numerator of the state of destination. *Montgomery Ward and Co., Inc. v. Franchise Tax Board*, 6 Cal. App. 3d 149, *appeal dismissed* 400 U.S. 913 (1970). Examination of bills of lading may reveal the final destination of inventory in transit.

Inventory in transit to a state should not be interpreted as giving the state jurisdiction to tax if that is the only business connection which the corporation has with that state.

Progress Billing

Progress billings or payments are amounts received under a long-term contract. To the extent that costs of tangible property on a project exceed progress billings (either on a cash or accrued basis), include the excess costs in the property factor. This is done because the taxpayer has an equity interest to the extent of its net investments. If progress billings or payments exceed costs on a project, do not reflect them in the property factor since a net liability will exist. In all cases, each contract must be treated separately; excess costs on one contract may not be offset against excess billings on another. In the case of fixed-price U.S. Government contracts, title to property on hand and title to future purchases passes to the government when the first progress payment is made. In a "cost plus a fixed fee" contract, the taxpayer does not acquire title to the material or work in process at any time. Despite the fact that legal title is vested in the government, the taxpayer has an equitable interest in the property to the extent of its net investment.

Cost in excess of billings may be found in the Schedule L of the 1120, the general ledger and the annual reports.

Example: If $1,000,000 has been invested in tangible property in the contract and the government has been billed for $600,000, the net difference of $400,000 should be included in the property factor. Contracts with billings in excess of cost cannot be netted against other contracts with costs in excess of billings.

Work in Process

Work in process inventory is generally valued in the same manner as it is for federal income tax purposes.

Intercompany Profits in Inventory

Normally, no adjustment needs to be made to eliminate intercompany profits in inventory. However, if the taxpayer insists on this adjustment for income purposes, then the corresponding adjustment should be made to the average inventory as used in the property factor. The intercompany profits in inventory can be found in the consolidating adjustments to the consolidating financial statements and the general ledger.

Example:

INTERCOMPANY PROFIT IN BEGINNING INVENTORY	INTERCOMPANY PROFIT IN ENDING INVENTORY	DECREASE IN TAXABLE INCOME
$ 1,892,723	$ 2,546,094	= $ 653,371

For property factor purposes, the $1,892,723 and $2,546,094 will be eliminated for the beginning and ending values.

Currency Translation

When combining foreign subsidiaries, state the foreign inventories and the physical assets in U.S. dollars at the exchange rate as of the date of acquisition. The conversion rates of foreign currencies are usually obtainable from the library or from large multinational banks. The taxpayer will usually have made this conversion for its own financial statements.

Land

Land is includable in the total property factor at original cost if used in the unitary business. Include in the factor any land which is temporarily out of use and any business land held for sale. Do not include non-business land in the factor. Vacant land purchased for prospective use in the business is not included in the factor until such use actually takes place. For example, if land is purchased for the building of a factory, do not include the land in the factor until the factory is built.

Land permanently removed from the unitary business is not included in the factor. Examples of this are land permanently converted to non-business usage and excess land which has been vacant for a substantial amount of time, usually five years or more.

Leasehold Improvements

Treat leasehold improvements as property owned by the lessee taxpayer regardless of whether the taxpayer is entitles to remove the improvements or whether the improvements revert to the lessor upon expiration of the lease.

Mobile or Movable Property

This class of assets is easily identified and normally does not present a problem in the denominator.

Offshore Property

The value of offshore oil wells located outside the three-mile limit on the continental shelf and under federal jurisdiction is included in the denominator but not in the numerator of any property factor. Any property connected with federal oil leases that lies within the three-mile limit is included in the numerator of the property factor.

Reorganizations

“Original cost” is the basis of the property for federal income tax purposes. In the case of a tax-free reorganization, the transferor’s basis is carried over to the transferee as the transferee’s original cost.

If the reorganization is not completely tax free, the original cost will be the transferor’s basis plus the gain recognized on the transactions. The Request for Ruling on a tax free reorganization attached to the 1120 is the best source for this information. The Annual Report or SEC 10-K Report may disclose further information.

Wasting Assets

Mineral deposits and oil reserves are included in the property factor at original cost. The treatment of intangible drilling costs expensed for federal tax purposes varies from state to state, although only two member states currently exclude them. Expenses capitalized for tax purposes are included in the cost. No reduction to cost is made for depletion.

Partnership Property

Examination of items making up “Other Income” (Line 10 of the 1120) will indicate whether the taxpayer owns partnership interests. Copies of partnership returns normally can be used to determine the appropriate factors to be included if the partnership business is unitary with the taxpayer.

The partnership's real and tangible personal property, both owned or rented and used during the income year in the regular course of the trade or business, is to be included in the denominator of the taxpayer's property factor to the extent of the taxpayer's single direct general partnership interest in the partnership. The value of such property located in the state is to be included in the numerator of the taxpayer's property factor. The value of the property which is rented or leased by the taxpayer to the partnership or vice versa is to be excluded from the property factor of the partnership to the extent of the taxpayer's single direct general partnership interest in the partnership.

Computer Equipment and Programs

Include computer equipment (hardware) in the property factor at original cost.

In the case of computer software programs which are purchased by a taxpayer, a question arises as to whether the software is tangible or intangible property. Tangible software is packaged software. Intangible software is custom software. If the software is tangible, include it in the property factor; if intangible, omit it.

Safe Harbor Leases

For corporate income and franchise tax purposes, New Mexico recognizes the provisions of the Internal Revenue Code as they apply to safe harbor leases (SHL) transactions (at Section 168(F)(8)). Therefore no modifications are made to Federal taxable income for SHL transactions.

1. Situs the SHL property to the purchaser/lessor at the seller/lessee's original cost of the property.

2. Take into account the rental expense of the SHL property at eight times the net annual rental rate in determining its value for the property factor purposes of the seller/lessee.

3. The payroll factor of neither party is affected.

4. Include the rental income in the gross receipts factor of the purchaser/lessor.

5. Include the interest income on the proceeds from the sale of the federal tax benefits in the gross receipts factor of the seller/lessee.

6. Verify transaction for potential gross receipts tax liability (See G.R. 3(F):67, 28:7, 49:3 in the Gross Receipts and Compensating Tax Act Regulations.)

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The Economic Recovery Tax Act of 1981 contains a provision which is commonly referred to as a "safe harbor" leasing arrangements. This transaction is one of form rather than substance. It allows a taxpayer to transfer or to sell future federal tax benefits (i.e., investment tax credits and accelerated depreciation deductions) for cash.

The following is an example of a typical federal safe harbor lease transaction:

Assume that Corporation X acquires property worth $1 million but cannot use the tax benefits. X and Corporation Y agree, pursuant to the safe harbor rules, that X will transfer the property in a paper transaction to Y but X will retain all economic benefits and burdens of ownership, including title for state law purposes. Y will then lease back the property to X for the projected economic useful life of the property at which time there will be a paper transfer of the property back to X for $1. Y agrees to pay $100,000 to X in cash and to give X a note for $900,000 plus interest at 15%. In return, X agrees to pay rent in an amount exactly equal to Y's $900,000 net obligation plus interest.

There has been no change of ownership or business purpose as a result of the transaction. X is still in actuality the owner and user of the property and Y has no profit from the transaction, excluding tax benefits. However, federal tax law will recognize the form of the transaction, producing the following economic consequences:

For Y, the 10% investment tax credit will offset exactly the $100,000 cash payment made to X. The present value of the tax savings due to depreciation, investment tax credit, and interest deductions will exceed the present value of the tax on the rental income, producing a return on Y's initial investment solely from tax savings.

For X, the transaction results in a reduction of cost of $100,000, which is the amount of the up-front payment by Y.

In substance, there has been no transfer of property for state purposes and, therefore, X will continue to be deemed to be the owner of the property. The problem is the $100,000 cash payment received by X from the sale of the tax benefits to Y.

It is the position of some states that the $100,000 payment by Y to X for state purposes has no tax consequences for Y and should be ignored. The tax consequences to X is a reduction in its depreciable basis from $1 million to $900,000, which amount is recoverable for tax purposes through depreciation over the asset's useful life. If X is an apportioning taxpayer, the basis for property factor purposes will also be $900,000. Any interest payments to third party creditors in this example would be considered to be outside the safe harbor lease arrangement and would be accorded the usual tax treatment. Other states will follow the federal rule.

The above example does not cover every possible arrangement under the federal safe harbor lease rules. To obtain the information which is necessary to adjust the property factor, refer to the Federal 1120 Form 6793. This form must be attached to every 1120 of a corporation which is involved in a safe harbor lease.

Intercompany Profits in Assets

It is New Mexico's position not to recognize the increase in basis of assets for the property factor when assets are sold at a gain between members of a combined group and the gain is not recognized. When the gain on the intercompany sale is not recognized, the companies must maintain records of the deferred gain and the original cost. If for federal purposes the consolidated group elects not to defer the gain on intercompany items, New Mexico's policy is to follow the federal treatment. Accordingly, depreciation is allowed at the stepped-up basis (purchaser's cost) and the property will be included in the property factor at the stepped-up basis.

For federal consolidated return purposes, a portion of the deferred gain is recognized each year and a corresponding amount of depreciation is allowed. The fact that we do not make an income and expense adjustment to correct the federal treatment is not pertinent. This would be a meaningless adjustment since the two items wash.

Foreign Affiliates

It is desirable to include foreign affiliates' property at original cost adjusted to U.S. tax basis. If this is not practical, book values may be utilized.

Rented Property

General

Under UDITPA, rental property is part of the property factor. Rental expense may be ascertained from the Federal 1120 at Page 1, Line 16, cost of goods sold schedule and schedule of other deductions. Other accounts should be examined for rental expense.

Rents capitalized should be examined to see that certain items have not been included, such as advance rents, daily rents and service charges. Examination of lease agreements will indicate the presence of some of these excludable items.

Depending upon materiality, the SEC 10Ks and Annual Reports can be used to reconcile rental expense. In many cases the taxpayer's workpapers will show rent expense by state and total. The total rents per the workpapers should be verified to the applicable sources. If the taxpayer cannot provide foreign rents, a reasonable provision may be made.

Advance Rentals

Advance rentals not deductible in the current year are not capitalized in that year. For example, if the first and last month's rent of a five-year lease were paid during the first month, the last month's rent would not be capitalized until the fifth year. If the Federal 1120 was used to compute the capitalized rents, no advance rentals are to be included.

Annual Rental Rate

The annual rental rate is the amount paid as rental for property for a 12-month period. Where property is rented for less than a 12-month period, the rent paid for the actual period of rental constitutes 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), annualized the rent paid for the short tax period. If the rental term is for less than 12 months, do not annualize the rent beyond its term. When the rental term is on a month-to-month basis, do not annualize it; the term is too uncertain. Do not deduct subrents of business income in arriving at annual rent expense. Analyze the rental income, and rental expense per the 1120 and the general ledger accounts to determine subrentals for adjustment.

Additional Rent or Payments In-Lieu of Rent

Any amounts paid as additional rent for the income year such as a percentage of sales, taxes or interest on rented property, insurance, repairs, or the like are considered to be paid as rent and are, therefore, to be capitalized into the property factor. An examination of property leases will disclose the existence of those charges.

Items Not Included as Rent

Some expense items paid, such as daily rents and service charges, are not included as additional rent. These items are considered to be day-to-day expenses of the business and are not to be included in the property factor. An examination of property leases will disclose the existence of those charges.

Daily Rents

Daily rents for such things as hotel rooms, daily rental of automobiles, etc., are not capitalized. However, if such items are rented for long term periods, such as the lease of an automobile rather than its purchase, the rent is capitalized into the property factor.

Service Charges in Rents

Annual rents do not include any expenses for service charges such as janitorial services, utilities and the like. When such expenses are included as rent, but are not segregated so that they can be determined, consider the relative values of the rent and other expenses and make any appropriate adjustment.

No Average Value for Rentals

UDITPA provides for the use of the average value of property. Some practitioners have interpreted this to mean that they must somehow average the value of rented property. The only allowable method is to capitalize at eight times the rent paid. The taxpayer's apportionment workpapers will usually disclose whether rents have been properly capitalized.

Capitalization of Net Annual Rate

The average value, which for rental property is the amount paid as rental for the income year (unless annualized), is to be multiplied generally at eight times to get the value to be included in the property factor.

Examine income accounts for subrental income. When subrental income is determined to be business income, deduct this amount from rental expense to arrive at net annual rental expense.

Rental Included in Construction in Progress

Rent paid for tangible personal property used in the construction of an asset should be capitalized into cost. For example, if a taxpayer constructed its own building using rented scaffolding, the scaffolding rent is capitalized into the cost of the building. Since the cost of the building is not included in the property factor until it is available for use, it follows that the rent paid for the tangible property used during the construction should not be reflected in the property factor because it is not "used in the business". Therefore, the rent paid for the scaffolding would not be included in the property factor.

Rented Mobile Assets

The value of mobile or movable assets when rented is included in the property factor generally at eight times the net annual rental rate.

No Rental or Nominal Rental

Examination of board minutes, leases and agreements may reveal information concerning facilities which are provided at either no rental or nominal rental.

If property is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, determine the net annual rental rate for such property on the basis of a reasonable market rental rate for such property. This frequently happens when a local government desires to attract new industry. If necessary, require the taxpayer to establish the fair rental value by competent appraisal.

Usually low rent expense should alert the auditor to the possibility that an adjustment may be necessary. Comments and notes to the financial statements are a good source for this information.

Offshore Rentals

As with owned offshore properties, it is possible for a taxpayer to rent offshore properties which lie outside a state's boundaries. These properties could consist of oil platforms, pipelines, barges, etc., and should be capitalized in the same manner as are other rentals.

Rental Computer Equipment and Programs

The rental of computer hardware will be capitalized generally on the basis of a factor of eight. If determined to be tangible personal property, software rentals will be capitalized.

Most rented computer programs will be canned programs and, therefore, will be considered to be tangible personal property. It is important to distinguish between computer rentals, on one hand, and fees paid for computer services, on the other; the latter are not capitalized as rents.

Rental Partnership Property

If a corporate taxpayer owns an interest in a partnership which is unitary, intercompany rents are offset to the extent of its partnership interest are not included in the net annual rental rate. If the rented property is owned by the corporate partner, include the cost of the rental property in the property factor. If the partnership is on a different fiscal year than the corporate partner, generally, no fiscalization takes place.

If the rented property is owned by the partnership, include the taxpayer's share of the cost, based on its interest in the partnership, in the property factor. In addition, include the amount of the rental expense in excess of the corporate partner's share of the partnership rental income in the net annual rate of the corporate partner. Partnership rents can be readily obtained by inspection of the partnership return.

Safe Harbor Lease Rents

Take into account the rental expense of the SHL property at eight times the net annual rental rate in determining its value for the property factor purposes of the seller/lessee.

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Rents: Direct Financing & Operating Leases; Sales and Leasebacks

An operating lease is a lease in which the lessee records on its books rental expense. In a financial lease, the lessor capitalizes an asset account (building, equipment or machinery). A corresponding liability account is established for the present value of the future lease payments discounted at the lessee's incremental borrowing rate.

Both the Annual Report and the SEC 10K Report will disclose whether a financial lease exists. The Federal 1120 will disclose whether the taxpayer is deducting depreciation or rent expense. If rent expense is deducted, it should be capitalized times eight, and the cost of the asset should be excluded from the property factor. If depreciation is deducted, the auditor should include the original cost of the lease in the property factor, and any capitalized rent expense should be excluded.

Rental Inventory in a Public Warehouse

Rent paid for space in a public warehouse is included in the property factor. Examine the total charges paid. Eliminate all non-rent items such as service charges, ins and outs, janitorial services, utilities, etc., in determining the correct rental amount. Since public warehouses are legally required to keep such records, details are usually available and can be obtained from the taxpayer.

Rented U.S. Government Owned Facilities

If the taxpayer uses government facilities for no rent or for a nominal rent, a reasonable rental rate must be determined for property factor purposes. Any reasonable method of valuation, e.g. that of a competent appraiser, is acceptable.

The facilities must actually be used in the production of a unitary product. If the contract specifies only that the taxpayer is to "manage, operate, and maintain the government plant", the rental value of the property may not be includable in the property factor (see *McDonnell Douglas Corporation v. Franchise Tax Board*, 69 Cal. 2d 506 (1968)).

To make a start in locating U.S. Government owned facilities, question the taxpayer. Additional sources of this information are the annual reports and SEC 10K Reports.

Undoubtedly, the valuation of property used by a taxpayer either rent-free or for a nominal rental will present the most difficult problems to be encountered in determining the valuation of property. This determination should, of course, be the burden of the taxpayer; but, if the taxpayer is uncooperative or refuses to obtain such information, the auditor will have to develop a figure which will serve to protect the states' interest.

Even though the regulations require a valuation on the basis of a reasonable rental, if you can obtain the original cost either from the taxpayer or from an agency of the U.S. Government, then use the original cost of the facilities. Admittedly, this could be an inflated value because of the use of cost-plus contracts, but it is a figure which may be available; if so, use it or adjust it in whatever way is feasible to arrive at a fair value. Real estate or personal property tax bills, insurance coverage values or notes to financial statements may help to provide reasonable rental rates.

Wasting Rental Assets

Royalties paid for the use of mineral and oil tracts are economic interest in real property and are not capitalized as rents for inclusion in the property factor.

Intercompany Rents Eliminated

When combining unitary companies, eliminate intercompany rents. Consolidating working papers for the Income Statement should pinpoint intercompany rents in the eliminations column. On the Consolidated 1120, intercompany rents frequently will not have been eliminated. An analysis of rental income per the 1120 may be necessary when no consolidating adjustments, annual report or financial statements are available.

Rental Expenses of Foreign Affiliates

When combining unitary foreign subsidiaries, convert to U.S. dollars then net annual rent expense to be capitalized and used in the property factor; in doing so, use the simple average of the beginning and end-of-year exchange rates. Sources of total rents are the SEC 10K Reports, workpapers used to prepare the consolidated financial statements and the internal reports received by the taxpayer from foreign subsidiaries.

Numerator

The rules set forth in determining the denominator of the property factor, as well as those set forth below, are all applicable in the determination of the numerator of the property factor.

The numerator is defined as the average value of the taxpayer’s real and tangible personal property owned or rented and used in the state during the income year for the production of business income. Non-business property is excluded.

Test checks of physical inventories and fixed assets by locations can be made as noted below.

Original cost is usually the federal tax basis of the property when acquired by the taxpayer, adjusted by later capital additions or improvements and partial dispositions of property located in the state.

The following are areas to consider in determining the property numerator:

a) Taxpayers generally maintain some type of fixed asset ledger which will contain, among other items, the location of its properties.

b) Locations of fixed assets may also be found by examination of property tax bills which serve to verify the locations of inventories.

Inventories (See **PROPERTY FACTOR – Denominator -** Inventories)

The valuation of inventory for the property factor is identical to the valuation used for total inventory on the federal income tax return.

Generally, a taxpayer will have inventory listed by locations in the various states totaling to inventory everywhere. A state's inventory is not limited to that which may be located at a taxpayer's owned or rented location, but also includes inventory which may be located at a public warehouse or which may be on consignment to a customer in the state.

Examination of the internal records or workpapers should disclose the locations of various inventories. A test of the reasonableness of a state's inventories can be made by comparing turnover of the state's inventories with turnover of inventories everywhere.

Inventory in Transit (See **PROPERTY FACTOR – Denominator –** In-Transit)

Inventory in transit to a state is includable in the numerator of the factor although not physically present in the state at year end. Inventory in transit may be identified by reconciling total inventory, beginning and end-of-year, with the total inventories by location. Examination of bills of lading will reveal destinations of inventory in transit properties.

If there is no way to identify the destination of inventory in transit for inclusion in the numerator, the following adjustment can be made:

> Ratio of:
> Inventory Identified at State's Location x Total Inventory in Transit = State's In-Transit Inventory

Fixed Assets

Items included in the denominator must be identified as to their location for possible inclusion in the numerator. The fixed asset ledger will generally show the locations of fixed assets.

Mobile Property (See **PROPERTY FACTOR – Denominator –** Mobile or Movable Property)

Except under special circumstances, mobile or movable assets will be assigned to the numerator based upon time spent in the state. Due to the inherent difficulty in determining this item, the taxpayer's method of apportioning should be reviewed for reasonableness; amounts involved should be considered before a detailed analysis is made.

Computer Equipment and Programs (See **PROPERTY FACTOR – Denominator –** Computer Equipment and Programs)

Computer equipment and programs physically located in the state will be included in the numerator of the property factor.

Direct Financing and Operating Leases, Sale and Leaseback (See **PROPERTY FACTOR – Denominator –** Safe Harbor Leases)

Identification of leases located in the state must first be determined. An analysis must be made to determine that the same treatment is given the numerator and the denominator. If the property in question is a financial lease and is being depreciated for federal purposes as a fixed asset, it should be included in the property factor at original cost. If it is treated as rent for federal purposes, capitalize the rent at eight times.

Offshore (See **PROPERTY FACTOR – Denominator** – Offshore Property, **PROPERTY FACTOR – Denominator** – Offshore Rentals)

Offshore oil wells located within the three mile limit of the state's shore will be included in the numerator of the factor.

Land (See **PROPERTY FACTOR – Denominator –** Land)

Land owned in the state will be included in the numerator of the property factor at cost. The property ledger should indicate the location and costs of such property. Large acquisitions of land will usually be mentioned in the annual report, particularly when a new plant is being planned. Non-business property is not included in the factor.

Rented Property (See **PROPERTY FACTOR – Denominator**)

Property rented in the state will be included in the property factor for numerator purposes at eight times the rental value.

The SEC 10K Report may contain descriptions of rented property and the number of square feet at particular locations. The auditor should question the taxpayer about the property located in each state. Large corporations sometimes maintain computer listings of rented property. The taxpayer's workpapers used to prepare the apportionment formula should be carefully examined and the total rents should be compared to the everywhere rents in the denominator. A smaller number of the workpapers may indicate that not all rents are included in the numerators. Taxpayers may forget to put employees' car lease expense, office rents and public warehouse rents in the numerators.

Computer Equipment (See **PROPERTY FACTOR – Denominator –** Computer Equipment and Programs)

Computer equipment rented and physically located in the state will be included in the numerator at eight times the rental rate.

Offshore Rentals (See **PROPERTY FACTOR – Denominator –** Offshore Property, **PROPERTY FACTOR – Denominator** – Offshore Rentals & **PROPERTY FACTOR – Denominator -** Offshore)

Include rented offshore property located within the three-mile limit (e.g., platforms, pipelines, barges, etc., generally used in the oil industry) in the property factor at eight times the annual rental rate.

Partnerships (See **PROPERTY FACTOR – Denominator** – Partnership Property & **PROPERTY FACTOR – Denominator** – Rental Partnership Property)

The state's rental expense of unitary partnerships to the extent of the profit and loss ratio will be included in the numerator of the factor at eight times. If the partnership operates in a number of states, look to the rental analysis by state to determine the portion of rental expense to be included in each numerator.

Intercompany Rents

Eliminate the state's intercompany rents for numerator purposes in the same manner as for the denominator.

6010 Payroll Factor

General

The use of a payroll factor in the apportionment formula reflects the income-producing nature of labor.

Obtain a "51 state breakdown" of payroll, sales and property of the taxpayer in each year under examination.

Compensation, for purposes of the payroll factor, includes only amounts paid to employees. Exclude payments to independent contractors or any other persons not properly classified as employees. Include only amounts paid directly to employees. Exclude items such as employer-paid payroll taxes and pension and welfare payments.

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Denominator

Any compensation which is associated with income but is determined to be non-business or to be income for a separate business must be eliminated from the payroll factor.

Compensation

The term "compensation" means salaries, wages, commissions and any other form of remuneration paid to employees for personal services. Compensation also includes the value of room and board, rent, housing, lodging and other benefits and services provided employees by the corporation in return for services rendered when such amounts constitute taxable income to the employee under the Internal Revenue Code. These amounts are generally reported for unemployment compensation purposes.

Employee-Employer

The New Mexico Unemployment Compensation Act does not define "employee". Generally, an employment relationship exists when the person for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the results of the accomplished but also as to the details and means of accomplishing more results. However, it is not necessary that the employer actually direct and control the manner in which the services are performed; he need only have the right to do so.

Services by Affiliated Corporation Not Combined

Whenever services are performed for a taxpayer by an affiliated corporation which is not combined as part of the unitary business, the amounts paid for such services are not included in the payroll factor. This is true even though one or more employees of the affiliated corporation perform the services and even though the taxpayer reimburses the affiliate for the exact amount of the compensation.

No Salaries Paid for Services Rendered

Frequently, an employee will perform services for which he is not paid. An example; an officer of the parent corporation is also an officer of a subsidiary company (the taxpayer) and performs services for the subsidiary but is not compensated for such services since the parent pays the officer his entire salary. If the operations of the parent and subsidiary are not unitary, no salary will be attributed to the subsidiary for the services performed for it by its employee-officer.

There are other circumstances in which an employee will perform services and receive no compensation. In all such cases, no salary or wages will be attributed to the employee for purposes of the payroll factor.

Foreign Salary Benefits

In the case of employees not subject to the Internal Revenue Code because employed in foreign countries, make the determination of whether benefits would constitute income to the employees as though such employees were subject to the Internal Revenue Code. Develop the payroll for employees of a foreign parent or of foreign subsidiaries on the same basis as for domestic employees.

Inclusions

The following are examples of payroll which may be included in the denominator of the factor:

Construction of Assets

Compensation paid to employees for the construction of a fixed asset, even though it is capitalized into the cost of the fixed asset, is nevertheless included in the payroll factor.

This differs from the pre-UDITPA practice which called for the elimination of such wages from the payroll factor. The change was made because the employees perform services in connection with a business asset which, upon completion, is used to earn business income. State employment 940's and 941's include this type of payroll. If the payroll factor is developed from other sources, see to it that compensation paid employees for the construction of fixed assets is included.

Operations of U.S. Government Plant

There are occasions when a taxpayer operates a U.S. Government owned plant for a fee. In such cases, the workers are generally the employees of the taxpayer and the compensation paid to them should be included in the payroll factor. State employment 940's and 941's include this type of payroll.

Partnership Share

When a corporate taxpayer owned an interest in a unitary partnership, its share of the partnership's compensation is includible in its payroll factor to the extent of its single direct general partnership interest. The partnership tax returns will normally disclose the payroll amounts.

Example: Corporation A owns a single direct general partnership 20 percent interest in Partnership P; the distributive share of P's income is includible in the business income of A to be apportioned by formula. A's payroll is $1,000,000 and the payroll of P is $800,000. A's total payroll for purposes of the payroll factor will be $1,160,000 ($1,000,000 plus 20 percent of $800,000).

Offshore

Compensation paid to employees working on offshore oil platforms outside the limits of any state is to be included in the denominator of the payroll factor but not in the numerator. The limit of state jurisdiction is three miles off the coast or adjacent islands.

Payroll of Foreign Affiliates

Payroll of foreign affiliates included in a combined return will be included in the denominator of the payroll factor. If foreign currency is used, translation will be made.

Many companies prepare their foreign payroll factor from information received directly from the foreign subsidiary. If material, you may wish to test the foreign payroll. In testing the reasonableness of foreign payroll, examine the ratio of payroll to sales or cost of goods sold. Foreign payroll can also be verified to the detailed income statements.

Numerator

Compensation in a State

Compensation is paid in a state if:

a) The individual’s services is performed entirely within the state, or

b) The individual’s services is performed both within and without the state, but the service performed without the state is incidental to the individual’s service within the state, or

c) Some of the service is performed in the state and (1) the base of operations or if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) 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 individual’s residence is in the state.

The New Mexico Unemployment Compensation Act provides four tests to determine whether or not the employee’s services are in employment subject to the law of a given state. These tests are applied to the employee and not to the employer. The four tests are applied in the order indicated. If the first test is not applicable, the second is applied; if the second is not applicable, the third is applied; and, if the third is not applicable, the forth is applied.

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The four tests:

a) Localization of Services. An employee’s services are in employment and “localized” in a state if all of his services are performed in the state or if a majority of his services are performed in that state with incidental services performed outside of that state.

b) Base of Operations. An employee’s services are in employment in a state if some of them are performed in that state and his base of operations is in that state. (“Base of Operation” is interpreted as meaning the place of more or less permanent nature from which the employee starts his work and to which he customarily returns to perform the terms of his contract with his employer, to seek other employment or to apply for employment benefits.)

c) Place of Director and Control. An employee’s services are in employment in a state if some of his services are performed in that state and the place from which the employer exercises general direction and control over the employee is in that state.

d) Residence of Employee. An employee’s services are in employment in a state if some of his services are performed in that state and his residence is in that state.

Some services must be performed in a state before the above four tests can be applied to allocate all of the services to that state. In the event that none of the four tests is applicable, the services performed in each state will be under the jurisdiction of that state; and, unless coverage is elected under an interstate reciprocal arrangement, a split reporting to two or more states will result.

Mobile Employees

Special industry formulas such as those for airlines, contractors, trucks and railroads apply in some cases. In all other cases, assign the compensation of mobile employees (such as salesmen who perform their services in more than one state) to one state under the above rules. This is different from the pre-UDITPA practice of assigning such compensation to the various states in which the services were performed based on time or some other factor.

Reconciliation

Verify total wages paid, reconcile the amounts to Federal Form 940 workpapers and/or to Federal Form 841, where applicable. Usually, any differences will result primarily from the fact that the Federal Forms 940 are prepared on a cash basis, while income statements are prepared on an accrual basis. Minor differences which have little or no effect on the final percentage should be disregarded.

Note: Since the numerator definition of state payroll is derived from the New Mexico Unemployment Compensation Act, the New Mexico payroll factor will be substantially the same as wages reported by the taxpayer to the Department of Labor in New Mexico for unemployment insurances purposes.

6015 Sales Factor

General Discussion

The use of the sales or gross receipts factor reflects the income-producing nature of sales.

The auditor must obtain a “51 state breakdown” of sales, property and payroll for each year under examination.

Section 7-4-16 NMSA 1978 and Regulation 3.5.16.8 NMAC states: “’Sales’ means all gross receipts of the taxpayer not allocated under sections 7-4-5 through 7-4-9 of this Act”.

Therefore, all income not specifically allocated is to be apportioned. In other words, receipts which are considered to be business income subject to formulary apportionment are to be included in the Sales Factor. If any treatment or consideration of this factor produces a distortion or is contrary to state laws and/or policies, explain the exception, attach the explanation thereto and index it appropriately.

Denominator

The Annual Report is an excellent tool for testing the denominator. If necessary, modification can quickly be made. Some modifications are addressed in the following sections. If the taxpayer has used the Federal 1120 to compile the domestic factor and the Federal 5471 to compile the foreign factor, it is possible that intercompany sales may not have been eliminated. Form 2952 contains a section for listing intercompany sales but it may not be reliable. The pre-audit procedures test of any significant differences between the annual report sales and sales reported in the apportionment formula will generally disclose whether intercompany sales have been eliminated.

In most cases, significant intercompany sales will not be present between companies which are not truly unitary. If significant intercompany sales do exist, the auditor should document any determination that an entity should not be included.

In auditing this factor, bear in mind that the taxpayer may be reporting to New Mexico only those sales of a particular line of merchandise the shipments of which are made from inventories located in New Mexico. Other lines of merchandise may be sold to customers in New Mexico; since such shipments are made from out-of-state inventories and are thus interstate sales, the taxpayer may incorrectly be excluding them from the numerator.

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Review the following sales or receipts in consolidated worksheets and taxpayer workpapers for adjustment purposes:

a) Sales of tangible personal property are assigned to the state if the seller is taxable in that state.

Note: "taxable" refers to either actual or potential. A seller is taxable in a state or country if that state or country has jurisdiction to tax. (See **Relevant Law – Public Law 86-272**.)

b) Interest receipts and service charges (carrying charges) resulting from sales of tangible personal property are assigned in the same manner as the sales of the tangible personal property to which they relate. If these items cannot be broken out by state, then they should be removed from both the numerator and denominator and should be specifically noted in the narrative.

c) Sales of real estate are assigned to the state in which the property is located.

d) Rents and royalties pertaining to stationary personal property are assigned to the state in which the property is located.

e) Royalties from patents, processes and copyrights which are used in fabrication and production are generally assigned to the state in which the fabrication and production takes place. (See **SALES FACTOR – Types of Receipts** – Royalties)

f) U.S. Government Sales will be included in the numerator of the state from which shipment is made.

g) Throwback Rule: Shipments to a state in which the taxpayer is not taxable will be attributed to the state of origin.

h) Double Throwback Rule: Shipments from a state in which the taxpayer is not taxable to a state in which the taxpayer is not taxable will be attributed to the state from which the sale was made.

Note: Data should be traced to source documents to the extent deemed necessary by the auditor in charge.

Direct special attention to gains which are related to transactions involving fixed assets, personal property and intangibles, interest income on passive investments or royalty income. Keep the following regulation in mind:

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Regulation 3.5.19.11 NMAC Special Rules: Sales Factor. The following special rules are established in respect to the sales factor of the apportionment formula:

1) 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, exclude such gross receipts from the sales factor. For example, exclude gross receipts from the sale of a factory or plant.

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

3) When the income-producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income-producing activity occurs in the state, in the numerator of the sales factor as well. For example, usually the income-producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (Regulation 3.5.16.8(A)(1) NMAC) and income from the sale, licensing or other use of intangible personal property (Regulation 3.5.18.8(B)(1)(d) NMAC).

4) When business income from tangible property cannot be readily attributed to any particular income-producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and is to be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest are to be excluded from the denominator of the sales factor.

Substantial Receipts

Gross receipts in the sales factor can include items that are not trade revenues. The purpose of this exclusionary rule is to prevent distortion of the sales factor by the inclusion of unusual non-recurring items having a significant effect on the revenue factor. The rules for exclusion or inclusion of substantial gross receipts are not as simple as they might seem. The rules provide that substantial gross receipts derived from the regular or routine disposition of fixed assets of a taxpayer are includable in the sales factor.

For example, if a large retail grocery chain owns its own fleet of wholesale delivery trucks and replaces them on a regular replacement program, then the gross receipts from the truck dispositions are includable in the sales factor. The amount involved could be substantial if, say, units in a truck fleet numbering 100 were replaced on a regular basis. Nevertheless, the amounts are includable in the factor.

On the other hand, suppose that the grocery chain in the previous example decided to make its business smaller and more economical by making a one-time reduction in its truck fleet from 100 to 50 trucks. The gross receipts from the sale of the 50 trucks would be excluded from the sales factor if the amounts were substantial. The rationale is that the 50-truck disposition is not regular or routine, and that the inclusion of the sales price of those trucks in the factor would distort the apportionment factor.

The auditor can determine rather easily if there is a substantial gross receipts problem. A quick scan of the return will show whether the taxpayer has included in the sales factor receipts other than trade revenues. The taxpayer's apportionment workpapers will provide detail as to what items have been included in the factor, including gross receipts from sales of assets. The gain and loss schedule (Schedule D) will reveal large sales of business assets. Annual Reports generally discuss in narrative form, as do the notes to the financial statements, large acquisitions or disposals of plant and equipment. The nature of the taxpayer's business may indicate to the auditor the existence of asset dispositions giving rise to substantial gross receipts. For example, if an airline company has an airplane replacement program that is routine or regular in nature, sales of airplanes would be reflected on Schedule D of the return. The auditor should also question the taxpayer as to the occurrence of unusual and substantial gross receipts. Taxpayer will also know of asset replacement programs. These various sources of information will enable the auditor to discover unusual and substantial gross receipts and then to apply the above rules as to inclusion or exclusion from the sales factor.

The auditor should be careful to consider materiality when dealing with substantial gross receipts from asset dispositions. The addition or deletion of such receipts may at first glance seem to have a small effect on the sales factor percentage. However, that small change when applied to a large amount of business income may make a substantial tax difference. On the other hand, inclusion or exclusion of substantial gross receipts may be immaterial and may have very little tax impact. In the latter instance, the auditor would be wise to abandon the whole substantial gross receipts issue and to pursue more important audit areas. The auditor should make a test check of tax impact before pursuing adjustments in this area.

Taxpayers should be consistent in their treatment of gross receipts to the various states that have adopted UDITPA. For example, a taxpayer should not be reporting includable substantial gross receipts from asset disposition in the sales factor denominator to California when those assets were sold in New Mexico and then exclude those items from both the numerator and denominator of a return filed in New Mexico. A sampling of Taxpayer's copies of a few state tax returns will reveal any consistency problem.

The auditor should be aware that many taxpayers inadvertently make that error of including all sales prices of all assets sold during a year, instead of making an analysis of properly includable and excludable items.

Errors also occur in including sales of non-business assets, vacant land and other property that has not yet entered the unitary business. Other errors involve the inclusion of only gains or losses on asset dispositions rather than of the gross sales price. The error that probably has the most tax impact and requires careful auditor scrutiny is inclusion of distortive asset sales such as abnormal factory or plant sales.

Insubstantial Receipts

Regulation 3.5.19.11(A)(2) NMAC states that the inclusion in the factor of gross receipts from incidental or occasional business transactions that are insubstantial in amount may not materially affect the apportionment of income to at state. The regulation, by way of example, states that gross receipts from the sale of office furniture, business automobiles, etc., may be included or excluded from the sales factor if insubstantial in amount. Thus, minor gross receipts such as interest, royalties, and sales of assets are includable or excludable at the taxpayer’s option.

The auditor’s main problem with minor gross receipts is one of materiality. If gross receipts from incidental items as noted above are not material, the taxpayer has the choice of including or excluding them. The taxpayer must be consistent between years. Taxpayers cannot exclude items in one year and include them in the next year in an effort to maximize the tax advantage. No particular techniques are available to the auditor as to what is material in this area. A common sense approach must be followed.

What is material to a taxpayer paying $5,000 a year in income tax is not material to one paying $500,000 a year. Inclusion of gross receipts of interest and sales price of assets in an amount of $50,000 to a taxpayer with trade revenues of $500,000 is substantial and requires further analysis. That $50,000 to a taxpayer with trade revenues of $50,000,000 is certainly immaterial and is left to the option of the taxpayer for inclusion or exclusion. Situations that are not readily determinable as the above require auditor judgment. If the taxpayer has been consistent in its treatment of these gross receipts and if the potential tax change is not material, the auditor should not disturb the taxpayer’s method. The auditor should prepare a workpaper testing the tax effect of inclusion or exclusion of incidental gross receipts in the sales factor. If in the judgment of the auditor the tax effect is not material, the taxpayer’s method should not be altered.

This is assuming that the taxpayer has been consistent between years. If the test check turns out to be material, then the auditor must further analyze whether or not they are includable in the sales factor. Rules for inclusion of material amounts such as royalties, rents, and interest are discussed later in this Manual.

Government Facilities/Cost Plus Fixed Fee Contracts

Some taxpayers, because of the type of business they are in, manage a U.S. Government owned facility for the benefit of the government. The output of the facility is sold to the government by the taxpayer at a profit. The contract for the management of the facility usually calls for a reimbursement to the taxpayer for all costs of management plus a fee. Costs can include reimbursable salaries, wages, manufacturing and operating costs. The fee can be a set amount or a nominal amount such as $1. In some instances in which the fee is nominal, the profit of the taxpayer probably is contained in the goods or services sold to the government from the managed facility. In other instances, the fee may be substantial and may represent the entire profit for the management and sale of output to the government.

In any event, all reimbursements, fees, and sales of output by the taxpayer to the government are includable in the sales factor denominator.

In this type of arrangement, the facility and the product or service sold to the government actually belong to or are owned by the government. To give weight to a taxpayer's business activity in operating a facility for the government, include in the sales factor all revenues received for expense reimbursement and/or as profit.

The primary audit problem in this area is that of knowing whether a taxpayer is involved in managing a government facility or in selling goods or services to the government. As a beginning step, the auditor should examine the apportionment schedule of the tax return to see if the taxpayer reports any revenue activities to the state from government sales. If taxpayer is a public company, Annual Reports and S.E.C. Forms 10-K will likely include a discussion of any material contract or business area dealing with the government. The taxpayer's apportionment workpapers and the general ledger will probably contain details as to the revenue from this area.

If questioned, the taxpayer will indicate a revenue source from the government. After acquiring knowledge of revenue from a government source by the taxpayer, the auditor should ask the taxpayer how the amount was included in total sales. Questions should be asked that insure that all reportable revenues have been included in the sales factor. The auditor may wish to examine the contract (if not a secret contract) between the government and the taxpayer to determine revenues paid. The taxpayer's sales journal or general ledger should be examined to insure that the proper amount of revenue has been reported. Annual reports and SEC Forms 10-K may indicate book revenue from the government under the caption "Segment Information". The auditor must then determine whether tax revenue and book revenue are reported differently. If there is a difference, the variance must be analyzed to be sure that the tax revenue has been reported properly for sales factor purposes. Again, this variance will be reflected in the sales factor reconciliation to the Annual Report.

Excise Taxes

Regulation 3.5.16.8(A)(1) NMAC provides that certain taxes included in the sales price of products or passed on to the buyer are includable in the sales factor. Theses taxes include federal and state excise taxes and state sales taxes. The auditor must make sure that the taxpayer has included these taxes in the sales factor. Federal excise taxes on tires, gasoline, fire arms, and telephone service present no problem as they are uniformly collected by the selling taxpayer as part of the sales price and passed on to the ultimate consumer.

The treatment of federal excise taxes on liquor, beer, and tobacco products, however, is not uniform. Thus, the tax is not collected on these items if consumption is outside the U.S.. State sales and excise taxes vary from state to state. Some states, such as Oregon, have no sales tax. The laws of the states also vary, some sales under certain conditions being taxable while others are not.

The audit problem is to determine whether excise and sales taxes are present and, if so, to make sure that the proper amounts are included in the sales factor. The taxpayer is generally a collector of sales and excise taxes. The tax is collected as part of the selling price and is then paid to the federal or state taxing authority.

Sales to a buyer for the purpose of resale to the ultimate consumer are non-taxable. In these situations, the taxpayer does not collect a sales tax, since the buyer will collect it from the ultimate consumer. As to taxable sales, however, the taxpayer's sales records should indicate the amount of excise and sales taxes collected, since the taxpayer is responsible as a collector to the taxing authority. The sales factor should then include those applicable taxes. When a taxpayer has not included these taxes in the factor, the auditor should request that the taxpayer provide the required information. In some instances, such a reconstruction may not be practical. In such a case, the auditor should ignore the problem and should proceed without any inclusion of these taxes in the factor. Materiality may play a part in a reconstruction situation and the auditor should consider the potential tax revenue impact versus the work involved.

Compensation for Services

Gross receipts are sometimes received by a taxpayer for services rendered by its employees or by independent agents on behalf of the taxpayer. A good example of this is a maintenance contract sold to a customer buying machinery from the taxpayer. Receipts from such sales are includable in the sales factor.

The auditor must be alert to determine whether such income exists. The taxpayer's type of business may indicate the possibility of such income. A computer manufacturer could very easily have this type of income while a tire manufacturer would most likely not. The taxpayer should be questioned directly in this area. A review of the tax return should also be made. The income may be buried in "cost of sales", or it may appear as a gross receipt in " other income" or as a reduction in cost of sales in "other deductions"; or it may be "netted" as an expense reduction or increase in other income. In conjunction with a review of the tax return, the general ledger should be examined to locate this gross receipts amount.

Gross Receipts From Trade or Business

Receipts from a trade or business are included in the sales factor. Tangible property manufactured and sold or property purchased and resold is included in the sales factor at the selling price. Selling price means gross sales price less returns and allowances. Cash discounts are not used as a reduction of the gross sales price. “Returns” are defined as goods returned for credit. “Allowances” are credits for breakage, spoilage, inferior quality, shortages in shipping, and the like. The above rules define includable net sales in the factor as they appear on the federal and state tax returns line item entitled “gross sales less returns and allowances”.

The typical apportioning taxpayer has a total sales factor composed of trade revenues and other gross receipts (rent, royalties, etc.). Many taxpayers, for convenience, use only trade revenues, since other gross receipts are immaterial. The auditor should compare trade revenues reported in the apportionment schedule of the return to net trade revenues in the tax return. The amounts reported should be the same. This procedure is effective with taxpayers that are combined with domestic affiliates only. Many taxpayers do not eliminate intercompany or even intracompany sales from Line 1 of the Federal 1120. A taxpayer’s apportionment workpapers will generally show a sales run by states and in total. The total should tie into tax return trade revenues. Computer sales runs and general ledger accounts for sales and for returns and allowances can be compared to reported amounts per tax return. Two problem areas are encountered sometimes in the reporting of trade revenues.

The first involves the assignment of revenues to the various states in which the taxpayer files returns. Sometimes, a taxpayer will show sales runs by destination at gross rather than on a net of returns basis; this interferes with a net sales computation.

The second problem arises when a taxpayer’s sales by destination are available only on a book or financial accounting basis. These amounts may vary from the tax basis sales due to Federal 1120, Schedule M-1 adjustments. In both instances, the taxpayer may attempt to comply with the proper method by estimations which convert sales to a net amount and to a tax basis. This is usually accomplished by applying percentages of the variances ratably to each state.

For example:

Total Gross Sales	$1,100,000
Total Returns and Allowances	-100,000
Total Net Sales	$1,000,000
Sales Run by States at Gross	
New Mexico	$500,000

Arizona	400,000
Oregon	200,000
Total	$1,100,000

Total Net Sales Divided by Total Gross Sales = 91%

Sales Run by States at Net

New Mexico	(91% x $500,000)	$455,000
Arizona	(91% x $400,000)	364,000
Oregon	(91% x $200,000)	181,000
Total		$1,000,000

The same format is used when there is a variance between tax and book sales. Usually the taxpayer's estimated methods are acceptable, as the tax impact is not material.

Gain or loss on Sale of Assets

The gross sales prices of tangible assets used in the business are generally includable in the sales factor as a gross receipt. Exceptions to this rule are: 1) receipts from occasional sales of assets if the amounts are large and would distort the factor; and 2) insubstantial receipts that can be included or excluded on an optional but consistent basis. Include only the net gains from sales of business intangibles; exclude net losses.

Interest

Section 7-4-18 NMSA 1978 provides that income from intangible property must be traceable to some income-producing activity of the taxpayer in order to qualify for inclusion in the sales factor. Interest income is income from intangible property. Regulation 3.5.18.8(B) NMAC defines income-producing activity as activity directly engaged in by the taxpayer in the regular course of its business. When interest income is involved, some direct activity by the taxpayer must be traceable to a location that gives rise to that interest. This rule will prevent many types of business interest from being included in the sales factor as the income-producing activity of the taxpayer often will not be assignable to any particular location. For instance, excess cash routinely invested on a short-term basis in bank CDs requires no activity on the part of the taxpayer and is handled by the bank. Interest received on bonds, debentures, or government securities when the instrument is merely held by the taxpayer will be excluded from the factor.

Includable interest income is interest on: 1) accounts receivable, 2) goods sold on installments plans, and 3) deferred payments. In such instances, the interest is traceable to a particular sale and to a particular customer. Some larger corporations will have a cash management program or will maintain an investment unit, employing individuals to invest temporary excess cash. In this situation, the employed people are performing an income-producing activity traceable to their work location; and interest income generated from various sources by them will be includable in the sales factor. The depositing of receipts and the recording of collections in accounts of record are not income-producing activities.

The principal difficulty in this area is that of segregating includable from excludable interest. Before attempting this, the auditor should test check the tax effect of any contemplated adjustment. In many cases, the tax effect is immaterial. If a segregation is necessary, it must usually be prepared by the taxpayer. The auditor should ask the taxpayer for a breakdown of interest income by location of the activity that generated the income. Thus, accounts receivable interest will follow the location of the customer, as will interest on installment sales. Interest income from a cash management program will be assigned to the location at which the employee investors are located.

Rents

Rental income that is business income is included in the sales factor. Gross rents, before deductions such as taxes and interest, are used for factor purposes.

Rental income generally appears on the tax return as a separate line item. However, in some instances, it may appear on the tax return in “other income” or it may even be netted against cost of sales or “ other deductions”. A review of the general ledger and the taxpayer’s apportionment workpapers may indicate the existence of this income. If the auditor is working at the taxpayer’s owned facility, the existence of office space rented to outsiders may be apparent. The taxpayer may also be asked if any facility is rented to outsiders.

Royalties

Royalty income is included in the sales factor if it is business income. Royalties are generally of three types:

a) Royalties from natural resources such as oil and gas in place.
b) Royalties from tangible personal property such as machinery.
c) Royalties from intangible personal property such as patents, licenses, and copyrights.

Gross royalties are included, not net amounts after depletion, taxes, etc.. Item c) is subject to Regulation 3.5.18.8(A) NMAC, as is interest income. There must be some income-producing activity on the part of taxpayer or else the royalties are not included in the sales factor. Income-producing activity in this area usually involves direct costs. If no direct costs are involved in obtaining royalties from intangible personal property, the royalties should not be included in the factor. Expenses such as salaries and office costs incurred in servicing patents or copyrights are examples of direct costs. The mere holding of a patent or copyright is not enough to justify including the royalties in the sales factor.

In many cases, the amount of royalties is minor and the auditor need not be concerned because of lack of materiality. If royalties are material, several sources are available to determine their amount. The Federal tax return has a line on Page 1 for gross royalties. The taxpayer's general ledger or apportionment workpapers should indicate the presence of this income. As with interest, passive royalties are to be excluded. The auditor must ask the taxpayer for a description of each type of royalty so that excludable items may be determined.

Dividends

Net Dividends, gross dividends minus special deductions, which are non-business income are not to be included in the sales factor. If net dividends are business income and are not excludable as an insubstantial receipt, then they are to be included in the sales factor.

The existence of dividends is usually evident from the tax return, and no technique other than a review of that return is required.

Insurance Proceeds

If insurance proceeds are not excludable as insubstantial, then the taxable portion thereof is included in the sales factor.

Most insurance proceeds will probably be of an immaterial amount, and inclusion in or exclusion from the factor will have little tax effect. If material, the amount can generally be found in "other income" on the tax return. In some cases, the proceeds may be offset against expenses in cost of sales or "other deductions". The taxpayer's general ledger or journal entries may show the existence of this income.

Partnerships

A corporation which owns a single direct general partnership interest in a unitary partnership or a joint venture should include a portion of the sales of that entity in its sales factor. The portion includable is the percentage interest owned by the corporation in the profits and losses of the partnership. This percentage may vary from year to year if the profit-and-loss ratio changes. It is possible that a corporate partner may have an interest in the profits and losses of a unitary partnership that will call for profits to be shared but for no losses to be shared. It is also possible that losses will be shared but not profits. Variations can occur. Thus, only losses may be shared for a number of years and then only profits may be shared for a later period of time. If no profits are reportable by a taxpayer, no sales should be included in the sales factor. Only a single direct general partnership interest by a corporation in a unitary partnership qualifies. Indirect ownership does not qualify.

For example, Corporation C has a 50 percent single direct general partnership interest in Partnership P. The partnership is unitary with C. C has total sales of $1,000,000 and P has sales of $200,000. The total sales factor of C is computed as follows:

C Sales		$1,000,000
P Sales	$200,000	
C's 50% Interest in P		$100,000
Total C Sales		$1,100,000

Intercompany sales in these situations will be discussed under Intercompany Elimination. (See **SALES FACTOR - Intercompany Eliminations**)

If a corporation has an interest in a partnership, the income or loss from it will usually be reflected in "other income" on the tax return. Balance sheet assets will usually show the equity interest in the partnership, and Schedule M-1 will reveal any tax basis differences between book and partnership income. The taxpayer's apportionment workpapers will show apportionment factor detail if the partnership has been accounted for properly. The auditor should then examine a copy of the partnership return. This will permit a verification of total sales and of the profit-and-loss ratio of the corporation's interest in the partnership. Once the existence of a partnership has been found, the auditor must determine by the usual tests whether a unitary relationship exists.

Management Fees

Management fees that constitute business income are includable in the sales factor. An example of these would be fees received for operation of a facility for the government.

The tax return will usually list these fees as "other income". The general ledger will usually contain an account in which management fees are detailed.

Other

Corporations have numerous miscellaneous gross receipts that constitute business income and should be included in the sales factor unless excludable as insubstantial. Some of these are mentioned below. Due to the minor tax implications of these items, no techniques are detailed for auditor guidance.

Vending Machine Income

This income results from vending machine sales to employees at a corporation's various facilities. It is includable in the sales factor unless excludable as insubstantial.

By-Product and Scrap

Sales of by-products and scrap are included in the sales factor.

Cafeteria Operations

Gross receipts from cafeteria operations for the benefit of employees at corporate facilities are includable in the sales factor.

Intercompany Eliminations

In general, revenues from interaffiliate sales between members of a combined group of corporations conducting a unitary business are to be eliminated from the sales factor. If Corporation A sells goods to Corporation B at $90 and B sells to outsiders at $100, only the $100 enters the total sales factor; the $90 is eliminated as an interaffiliate sale. Various types of interaffiliate revenues that are eliminated from the sales factor are detailed below. The sales factor includes only sales to purchasers outside the unitary group.

Examples of common interaffiliate revenues that are eliminated are:

Sales
Rents
Interest
Dividends
Management Fees
Administrative Fees
Service Fees
Royalties

Interaffiliate sales between a corporation and a unitary partnership are eliminated to the extent of the percentage interest in the partnership by the corporation.

For example:

a) Corporation A and Partnership P are unitary. A has a 50 percent single direct general partnership interest in P. A sells $100,000 to P. In the computation of the sales factor of A, 50 percent of the $100,000 sales to P, or $50,000, will be eliminated.

b) Assume the same facts except that P sells $100,000 to A. In the computation of A’s sales factor, 50 percent of P’s sales to A will be eliminated.

In both cases, A will be reported 50 percent of P’s sales.

The auditor will be dealing with a combined report with two or more corporations if intercompany items are to be present. It is also possible that intercompany sales may not have been eliminated. Tax returns will not generally show these items. The taxpayer's apportionment workpapers may or may not have this detail. If a combined group involves a U.S. domestic parent corporation with foreign affiliates, Federal Form 2952 may show interaffiliate transactions on Page 2 of that form. If consolidated financial statements are prepared, the workpapers will reveal interaffiliate eliminations. Taxpayer's general ledger may have accounts relating to intercompany items.

Numerator

The sales factor numerator is defined in Regulation 3.5.16.10 NMAC as follows:

> The numerator of the sales factor shall include gross receipts attributable to this state and derived by the taxpayer from transactions and activity in the regular course of its trade or business. All interest income, service charges, carrying charges, or time-price differential charges incidental to such gross receipts shall be included regardless of (1) the place where the accounting records are maintained, or (2) the location of the contract or other evidence of indebtedness.

Numerator Sales Rules

Rules for the total sales factor as outlined above are also applicable to numerator sales.

Sales of Tangible Personal Property (Except Sales to the U.S. Government)

Three basic rules apply in determining whether sales of tangible personal property are assignable to a state and are to be included in the numerator of that state.

a) Destination Rule: A sale of tangible personal property is assignable to a state if the product is delivered or shipped to a purchaser in the state and the seller is taxable in the state.

b) Throwback Rule: A sale of tangible personal property is assignable to a state if the product is shipped from an office, store, warehouse, factory, or other place of storage in the state and the seller is not taxable in the state of destination.

c) Double Throwback Rule: A sale of tangible personal property is assignable to a state if the sale is made from the state and if the seller is not taxable in either the state of destination or in the state from which shipment is made.

Under a), goods shipped to a customers by a taxpayer from a State X inventory to a State X destination are State X sales. Under b), goods shipped by a taxpayer from a State X inventory to a customer in State Y are also State X sales if the taxpayer is not taxable in State Y. Under c), gross receipts from sales of goods sold from State X but shipped on behalf of the seller by the seller's supplier from State Z to the buyer in State Y are State X sales if the seller is not taxable in either State Y or State Z. For further examples, see Regulation IV.16.(a)(2-7). (See **SALES FACTOR - Taxable** for the definition of taxable.)

Tangible vs. Intangible

The rules set forth in **SALES FACTOR - Sales of Tangible Personal Property** do not apply to sales of real estate, services, or intangibles. Tangible property is defined as commodities that are perceptible to the senses and movable. It is usually discernible from intangible property. However, some property is borderline and difficult to identify as to type. For example, water and gasoline are considered to be tangible property, while money is considered to be intangible property.

Taxable

A taxpayer is taxable in a state if it is subjectable to the taxing jurisdiction of that state for the purposes of a tax which is imposed on or measured by income. If the taxpayer has sufficient contact (sometimes called "jurisdictional nexus" – see **Relevant Law – Public Law 86-272**) with a state to be considered taxable in the state, it will be considered to be taxable there even if the state does not impose a tax upon or measured by net income. Sales into such a state will not be thrown back.

Delivered or Shipped to a Purchaser Within This State

"Delivered…to a purchaser…within this state" refers to the state in which the purchaser takes possession of the property.

The word shipped is used to describe the delivery of goods to carriers for the purpose of being transferred from one place to another. Included within the meaning of this term is movement by private carrier (owned by the vendor) as well as movement by common carrier. Shipment does not occur when delivery is taken by an employee of the purchaser.

If a shipment occurs, the destination of the shipment will determine whether the sale is in a state. If a shipment does not occur, the point of delivery will be the determining factor. (Exceptions: See third page of Index 1124 for rule pertaining to Minnesota.)

Some examples:

a) Question: Company A purchases oil in Foreign Country X. Company A arranges for pickup of the oil by Common Carrier M (which could be a subsidiary of Company A) at the foreign country dock for delivery to State Y. The seller, Company B, is taxable in State Y. Is this a State Y destination sale of Company B?

   Answer: Yes. Inasmuch as the Common Carrier M is an independent contractor, its actions should not be imputed to the purchaser. The delivery exception should be limited to deliveries involving employees of the purchaser.

b) Question: Company C purchases salt from Company D. The salt is picked up at the dock in Foreign Country Y by a carrier chartered by Company C for delivery to State Z. The vendor, Company D, is taxable in State Z. Is this a State Z destination sale for Company D?

Answer: The question should be decided by the nature of the charter. If it is a "bare boat" charter (one in which Company C has not only chartered the boat for the period but also has supplied employees to serve as the crew), the delivery has occurred in Country Y, not in State Z. Therefore, the sale is not a State Z sale.

However, if the charter is a "time charter" (the owner's crew continues to operate the ship and to control the crew), the relationship of the ship and its crew to the purchaser is in the nature of that between an independent contractor and its client. (See *Standard Fruit and Steamship Co v. Metropolitan Stevedore Co.* 52 C.A.3d 305 (1975), citing De Kerchover's Internat. Maritime Dict., (2d ed. 1961) and Civil Code Section 159.) Therefore, no delivery takes place in Foreign Country Y and the sale is includable in the numerator of the State Z sales factor of Company D.

c) Question: Company E is a mail order house located in State T; it has catalog order stores in various states. Goods ordered by a customer in State W are delivered to a State A store which is near the border of State W. The customer picks up the goods at the catalog order store in State A. Is this a State W or a State A sale for Company E?

Answer: As long as the transaction is not a sham, this sale should be deemed to be a State A sale.

Delivery to an agent of the seller for transportation to the buyer's principal location is considered to be a sale to the latter location.

A taxpayer's sales to a state will be assigned to that state only during the time period for which the taxpayer is taxable in that state.

Jurisdictional Nexus (See **Relevant Law – Public Law 86-272)**

Pursuing Potential Throwback Sales

Sales assignments to other states from shipping points originating in New Mexico will not be permitted unless one of the following conditions is met:

a) The taxpayer files a return in that state, reporting those sales there. A tax return must be more than just a qualifying return. It must indicate an active apportionment of income. It is possible that a return has been filed in a state because the taxpayer thinks that employee activity surpasses the limits of P.L. 86-272 even though no office or property is located there. The filing of a return in a state is prima facie evidence of taxability; the auditor should not challenge it unless he/she suspects a sham and unless material tax effect is involved. If the auditor decides to pursue the taxability or non-taxability of the taxpayer in the destination state, he/she will request copies of the returns filed in the destination state, for the period of audit.

b) The taxpayer submits to the auditor the Affidavit of Taxability in Specific State, properly signed by an officer or authorized employee, stating the factual basis for claiming taxability in a state in which it is not filing returns. Particular care should be taken to check for non-taxability in states that do not impose a tax on or measured by income, i.e., Michigan, Nevada, South Dakota, Texas, Washington and Wyoming. Taxpayer affidavits or self-serving statements are not sufficient. Employee sales activities such as approving sales at customer locations, collecting overdue accounts and resolving complaints are acts that go beyond P.L. 86-272. The auditor should be aware that employee activity must be on a regular basis and not just isolated or incidental in nature in order to make the taxpayer taxable in a state. Materiality will govern the audit effort in this area. Refusal by the taxpayer to provide the Affidavit and/or copies of returns filed in the destination state will be prima facie evidence that taxability does not exist.

Joyce Rule Re: Sales Attribution

The taxability in any particular state of each corporation in a combined unitary group must be determined separately. Thus, if one corporate member is taxable in a state, only its sales can be assigned to that state. However, taxability of a division of a company establishes taxability for the entire corporation unless that division is not unitary with the rest of the group. (See *Appeal of Joyce, Inc., California St. Bd. Of Eq.* (Nov. 23, 1966)).

Availability of Sales Attribution Information

Larger taxpayers may have products shipped from various inventory locations to many states and foreign countries. Most sellers of tangible personal property maintain sales records by both destination and origin; therefore, sufficient information will usually be available for throwback and double throwback purposes.

Workpaper Nexus Chart

If the auditor suspects a throwback sales problem, it may be helpful to construct a chart somewhat as follows:

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NEXUS CHART

STATE NAME	RETURN FILED	INVENTORY	RENTED PROPERTY	PAYROLL

Include only those states which are destination states for products shipped from the taxing state. Make a separate chart for each corporation for each year. Eliminate as throwback potentials those states for which nexus has been established.

Mail Order Sales

Mail order sales shipped from State A to State B in which the taxpayer is not taxable are throwback sales.

Sales of Tangible Personal Property to the U.S. Government

Origin Rule

Sales of tangible personal property to the U.S. Government are assigned to the state from which the goods are shipped. The reason origin is used rather than destination is that in many instances the government gives coded destination instructions to vendors for security reasons so that the destination of products is not known. Only sales to the U.S. Government are treated in this manner.

Annual Reports and SEC Forms 10-K will generally contain a business segment describing work done for the government. The taxpayer’s apportionment workpapers and general ledger might also indicate accounts dealing with the government. Once it has been established that government revenues exist, the auditor must determine the type of revenues involved. Sales of tangible personal property to the U.S. Government must be segregated from other sales because of the applicable origin rule. The taxpayer can generally provide this information. The auditor may wish to verify revenue by examining contracts with the government, tab sales runs, and general ledger amounts. Once the amount of government sale of tangible personal property is known, then all of these sales shipped from each state must be determined. The taxpayer’s sales runs or other records will generally indicated origin sales which will be assignable to the state’s numerator.

Sales to Subcontractors

Only payment s made directly by the U.S. Government to a seller pursuant to a contract for sales of tangible personal property are to be treated as gross receipts from sales to the U.S. Government. Sales made by a subcontractor to a Government prime contractor are not included in this category even though the Government is the ultimate recipient and the work is subject to Government approval. This simplifies the audit work since the auditor need only determine if a direct sale of property took place between a taxpayer and the Government.

Shipped from a State

A sale of tangible personal property to the U.S. Government is shipped from a state when shipment takes place from an office, store, warehouse, or other place of storage in the state. For example, if a munitions plant sells bombs to the Government and shipment takes place in Idaho and the bombs are stored thereafter in Nevada, the sale is assigned to Idaho. Some sales to the Government involve work done on a product in stages in several states. Thus, work may be started on a missile in an eastern state. The missile may then be moved to another state where more components are added.

Finally, the product may be moved to North Dakota where it is completed. Sale and shipment of the finished missile to the Government takes place in North Dakota. If one taxpayer is involved in the entire project, the sale is a North Dakota sale. If different contractors are paid by the Government for work completed in various states, only the incremental work done in North Dakota by the taxpayer is a North Dakota sale.

When sales to the Government constitute a mixture of tangible personal property and other types of sales, a breakdown between the types of revenue is necessary. For instance, a sale of computers coupled with a service contract requires an assignment of the computer sale under special rules for sales of tangible person property to the Government while the service contract is assigned under normal rules for service revenue.

No Shipment Made

In some instances, a sale of tangible personal property is made to the Government but no shipment takes place. This may happen in the case of a contract to build a prototype or model. The Government may not want the product after the model is made; or a new contract may be made to advance or modify the model. Nevertheless, the Government pays the taxpayer for work done. In these situations, the product is deemed to have been shipped when the Government accepted the fact that the contract had been completed. The sale of the product is assigned to the state in which the product was worked on.

Other Sales

Regulation 3.5.18.8 NMAC provides the basic rules for assigning sales other than tangible personal property. This includes sales to the Government. Sales other than tangible personal property are assignable to a state if the income-producing activity that gave rise to those receipts is performed wholly within this state. If such income-producing activity is performed within and without State A and the greater activity is within, based on costs of performance, then the receipts are assignable to State A.

Income Producing Activity Defined

Income producing activity applies to each separate item of income and activity engaged in by the taxpayer. Thus, if a taxpayer sells a service maintenance contract along with a machinery sale, there is probably an income-producing activity which gives rise to the revenue from the service contract. Activities performed on behalf of the taxpayer, such as those of an independent contractor, are not included as income-producing activities. As an example, if a service contract is subcontracted, there is no income-producing activity on the part of taxpayer. “Separate items of income” also are involved in income-producing activity. For example, if the taxpayer’s employees perform all service under a maintenance contract for a customer at one location in State A, the entire income-producing activity takes place in State A, and all receipts from the contract are assigned to State A. This is a separate item of income. Receipts from the rental of a machine are another example of a separate item of income.

Some basic categories of income-producing activities are:

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

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

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

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

Cost of Performance Defined

When income-producing activity must be assigned within and without a state to determine the sales assignment of receipts, that activity is based on costs of performance. Costs of performance are defined as direct costs consistent with generally accepted accounting principles. Direct costs are wages, taxes, interest, depreciation, and other costs involved with real and personal property. Intangible property such as patents and copyrights may or may not have costs of performance.

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Types of Receipts

General

Various types of receipts from tangible, real, and intangible property exist. The rules for assignment of these sales to a state are discussed below. The auditor should be aware that, if any of the receipts discussed below are insubstantial, they may be included or excluded from the denominator at the taxpayer's option for purposes of the sales factor. When this is the case, the tax effect of inclusion or exclusion from the numerator may also be immaterial. The auditor should not spend audit time dealing with insubstantial receipts.

Personal Services

Personal services involve the creation of a product by employees of the taxpayer. An architect would perform a service by creating blueprints for a structure. The service is the blueprint work and the end product is the blueprints. Intangible income often results from a personal service. An employee scientist may perform a service and create a process which is patented. Royalties may be received as a result of having licensed the use of the patent to others. Personal services created the patent which gave rise to the secondary income of royalties, an intangible. Frequently, there is a mix of tangible personal property sales and sales of personal services. A machinery sale may be accompanied by the sale of a maintenance contract to service the machine. The maintenance is done by the taxpayer's employees and is mainly a personal service.

Personal service receipts are assigned to the state in which the services are performed. If the services are performed in more than one state, then the income-producing activity and costs of performance need to be considered. Time is usually the measure to those costs. Only time actually spent performing the service is used as a measure. For example, an advertising agency may spend 1,000 hours working up a newspaper and TV ads for a client. The taxpayer's employees in State A spend 400 hours on the TV ad, and employees in State B spend 600 hours on the newspaper work. If the commission on the job was $100,000, then $40,000 would be assigned to State A and $60,000 to State B.

Taxpayers whose activity is principally that of performing personal services present a different type of problem than do those who render only incidental personal services. The auditor must first identify the type of service involved and then assign the receipts from that service among the states in a proper ratio.

Incidental personal service income usually is preceded by some other type of sale. For example, a computer manufacturer may sell hardware along with a personal service maintenance contract. The personal service receipts will be assigned to the state in which the services are performed. No particular techniques are available in this area. In many instances, all of the revenue from the contract may be attributed to one state. In other cases, a time ratio or a direct costs-of-wages ratio may be appropriate if activity between states is not clearly definable. The auditor should examine the taxpayer's method to see if it is reasonable and, if so, should not disturb it.

Dividends

Dividends are included in the sales factor only when they constitute business income. If the taxpayer has an income-producing activity such as an investment employee staff, then the dividend receipts are assigned to the location of the employees, which may or may not be the taxpayer's commercial domicile.

The auditor should question the taxpayer as to the manner in which the dividends are generated and the place at which the employees are located. Commercial domicile is not a criterion for assignment of interest or dividend income which is business income.

Dividends are frequently considered to be business income, not because of an investment staff activity, but because the holding of the dividend-paying security meets the functional test: the security is held as an asset functionally integrated with the business operations of the taxpayer. In these circumstances, an income-producing activity by an employee or investment staff cannot be identified with the investment, so that the auditor must use other means for assigning the income to the numerator.

The auditor must apply the method used by each of the individual states for which he/she is performing the audit. For example, California considers dividends from a functionally integrated security to result form the total income-producing activity of the taxpayer, and assigns those business dividends to the sales factor numerator multiplied by an average of the property and payroll factor ratios.

Interest

Regulation 3.5.19.11(B) NMAC excludes many passive types of interest from the sales factor. Interest may also be excluded if its amount is immaterial. If interest is included because an income-producing activity can be determined, then it is assignable to the state in which the activity took place. Thus, interest on accounts receivable and on deferred payment sales would be assigned to a state if the original sale was assigned to that state. Interest generated from investments of excess cash in commercial paper, bank CDs, etc., is generally not includable in either the denominator or numerator of the sales factor. But, if employees are assigned to invest cash in instruments, then the location of those employees determines the state to which the interest receipts are assigned.

The auditor should ask the taxpayer to prepare a schedule of interest by category. Only interest that has a underlying income-producing activity is used for sales factor purposes.

Rents

Rents from real or stationary personal property are assigned to the sales factor numerator of the state in which the property is located. Rental income form mobile property is assigned among states on the basis of the amount of time during which the property was used in each state. Thus, a lessor of airplanes would report revenue to a state based upon the amount of time a plane spent there compared to total time everywhere.

Generally, the auditor should have no problem with rents from real or stationary property. The taxpayer and/or his records will indicate the rental source as either in or out of a state. The general ledger and property ledgers should indicate property locations. Rent from movable equipment should also be available on state-by-state basis from property records. Taxpayers must generally pay property tax on equipment and records by location; and time spent in various location is usually readily available.

Partnerships

(See **SALES FACTOR - Intercompany Eliminations)**

Gain on Sale of Assets

Gross receipts from the sale of assets should be excluded from the sales factor, if distortive. They may be included or excluded at the taxpayer’s option if not material as insubstantial receipts. If included in the sales factor, they should be assigned to the state in which sold. Sales of intangible property such as patents and copyrights, assuming that the income is business income, are assignable to the holding location of the property, which is generally the taxpayer’s commercial domicile. Only net gains from the sale of intangibles are included in the sales factor.

As a practical matter, most sales of assets pertain to land, buildings, and equipment. The taxpayer’s property records and ledgers or apportionment workpapers should give the location of each property sold.

Royalties

Royalties are not included in the sales factor if no underlying income-producing activity exists in connection with the earning of those royalties. For royalties to be includable in the factor, direct costs of performance must be present. For instance, if a corporation has a number of patents which are licensed to others in return for royalty income and if employees are used to monitor and to service those licenses, then an income-producing activity exists. If the employees are located in State A, the royalty receipts are assigned to State A.

Since royalty income is assigned on the basis of costs of performance, the auditor must determine direct costs attributable to each state; if the greater cost is in State A, the entire royalty income will be included in the numerator of State A. Items such as salaries, office costs, and other expenses items used to service patents, copyrights and the like must be analyzed. In most instances, the taxpayer will have to be asked prepare schedules in this area.

U.S. Government

Sales to the U.S. Government of other than tangible personal property are subject to the rules stated in this Index at **SALES FACTOR – Types of Receipts**. Special rules apply only to the sale of tangible personal property to the Government.

7000 SPECIAL SITUATIONS

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7000 SPECIAL SITUATIONS

7000 New Mexico's Treatment of Franchise Tax

The New Mexico Franchise Tax is imposed upon every domestic corporation and upon every foreign corporation employed or engaged in the transaction of business in, into or from this state or deriving any income from any property or employment within this state and upon every domestic or foreign corporation, whether engaged in active business or not, but having or exercising its corporate franchise in this state. (Section 7-2A-3(B) NMSA 1978)

The New Mexico franchise tax is a fixed amount of $ 50 per year. It is a tax for the privilege of doing business in New Mexico, and it is not measured by or computed on net income or gross receipts. The franchise tax is due and payable even though no income tax is due. New Mexico's position is that since the franchise tax is not measured by net income it does not violate the restrictions imposed by 15 U.S.C.A. Section 381 (known as Public Law 86-272).

7005 New Mexico's Treatment of Repurchase Agreements (REPOS)

Income/interest generated from the sale and repurchase of U.S. Government Obligations ("REPOS") are not excludable from apportionable business income as income/interest from U.S. Obligations. Therefore, the income/interest generated from REPOS are included both in apportionable business income and in the sales factor as gross receipts. (Ruling 200-89-1).

REPOS are collateralized loans back by U.S. Obligations. *Massman Construction Co. v. Director of Revenue (Missouri), 1989 WL 11366* (Missouri Supreme Court, Feb. 14, 1989), *In re Sawyer Estate, 546 A,2d 784* (Vermont Supreme Court 1987), *Capital Preservation Fund, Inc. v. Wisconsin Department of Revenue, 429 N.W. 2d 551* (Wisconsin Ct. App. 1988), *Andras v. Illinois Department of Revenue, 506 N.E. 2d 439* (Ill. Ct. App. 1987), *cert denied, 108 S. Ct. 1223 (1988), Borg v. Department of Revenue (Oregon), 1988 WL 83815* (Oregon Tax Court, Aug. 12, 1988) and *S.E.C. v. Miller, 495 F. Supp. 465* (S. D. N.Y. 1980).

7010 New Mexico's Position On Limited Partnership Interests

For corporate income and franchise tax purposes, New Mexico recognizes two types of limited partnership interest:

1. General Partner Interest

   A corporation which is a single direct general partner in a limited partnership is to include its proportionate share of the partnership's sales, property and compensation in the corporation's sales, property and payroll factors.

2. Limited Partner Interest

   A corporation which is a single direct limited partner may recognize the income/(loss) received from the partnership as business or non-business income in accordance with the UDITPA. If business income, it may include the net recognized gain/(loss) amount in the sales factor.

3. Member of a Limited Liability Company

   A corporation which is a member of a limited liability company can receive treatment either as a general partner or a limited partner. If the corporation functions as a single direct general partner, then include its proportionate share of the partnership's sales, property and compensation in the corporation's sales, property and payroll factors. If the corporation functions as a single direct limited partner, then it may include the net recognized income/(loss) amount in the sales factor.

   Partnership income which is business income is included in the apportionable base. Partnership income which is non-business income is treated as other passive income (i.e. dividends, interest and royalties) and included in allocable income under the provisions of the UDITPA.

7015 Non-Business Related Expenses

When an auditor has determined that certain income items are non-business the auditor will reduce the non-business income by its related expenses. In the event related expenses cannot be readily ascertained by either the taxpayer or the taxpayer or the auditor, the auditor will estimate those expenses using the following formula:

$$\frac{\text{Total Deductions per Form 1120 or 1120S}}{\text{Gross Receipts per Line 1 Form 1120 or 1120S}}$$

Times Allocated Non-Business Income = Related Expenses

7020 Net Operating Losses and Net Capital Losses

Net operating losses (NOL) in New Mexico have different treatments depending on when such losses were incurred.

1. For tax years beginning before January 1, 1991 the NOL will be carried back and forward following federal rules. That is three years back and up to fifteen years forward.

2. For tax years beginning on or after January 1, 1991 the NOL is limited to only a five year carry forward.

3. In the event a taxpayer has both net operating losses incurred before and after January 1, 1991 the auditor will ensure that a first-in-first-out (FIFO) method is employed by the taxpayer. That is any losses incurred prior to January 1, 1991 will be fully utilized before using those losses incurred after January 1, 1991. However, the five year limitation still applies to the tax years beginning on or after January1, 1991.

Net capital losses are to be treated the same as for federal purposes in carry back and carry forward application. When a net capital loss is carried back the auditor will adjust the sales factor of a taxpayer for the reduction of capital gains of the prior year. Similarly, if the net capital loss is carried forward the auditor will use the net gain or loss for that year in the sales factor after application of the net capital loss carry forward.

7025 U.S. Obligations in New Mexico

New Mexico as well as other states are precluded by federal law from taxing the income from U.S. Obligations either directly or indirectly. Therefore, the auditor will exclude such income from base income before computation of New Mexico taxable income.

In the event such a computation results in a negative New Mexico taxable income the auditor will allow the negative income to be treated as a Net Operating Loss (NMNOL) for New Mexico as follows:

1. For tax years beginning before January 1, 1991 the NMNOL will be carried back and forward following federal rules. That is three years back and up to fifteen years forward.

2. For tax years beginning on or after January 1, 1991 the NMNOL is limited to only a five year carry forward.

The exclusion of interest in U.S. Obligations can be used to increase a net operating loss of a corporation for New Mexico reporting purposes.

7030 Non-New Mexico Government Obligations

For tax years beginning on or after January 1, 1991 taxpayers are required to add back to federal taxable income interest and dividends earned on obligations of Non-New Mexico governmental entities.

Non-New Mexico governmental entities includes the forty-nine other states, their agencies, city and county governments and their agencies.

There are certain dividends and interest of U.S. Possessions which are classified as being exempt from state taxation. Several such possessions are the Virgin Islands and Puerto Rico. Be on the look out for these types of entities.

7035 Treatment of Foreign Dividends and Subpart f Income

Separate Filers:

Separate filers can deduct 70%, 80% or 100% of their foreign dividends and subpart f income, depending upon ownership by the taxpayer, pursuant to the Schedule CIT-D form.

Combined and Consolidated Filers:

These filers are offered factor relief as specified by the Detroit formula for their foreign dividends or subpart f income, providing the taxpayer owns greater than 50% of the foreign payor as disclosed in our instructions. We also allow a 70% or 80% deduction for foreign dividends or subpart f income from foreign payors 50%-or-less owned by the taxpayer.

7040 Treatment of Real Estate Investment Trusts

A real estate investment trust (REIT) that does business in New Mexico and files a federal Form 1120-REIT must file a New Mexico PTE return.

APPROVED:

____________________________________ _____________
SECRETARY Date

7000 SPECIAL SITUATIONS

CORPORATE INCOME TAX AUDIT MANUAL

Section 8000

APPENDICES

A - Forms/Questionnaires

B – General Review Procedures for Income Taxes

1. **Corporate Income Tax**
2. **Pass-Through Entities**
3. **Personal Income Tax**

C - Significant New Mexico D&Os and Rulings

Appendix A – Forms/ Questionnaires

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BUSINESS ACTIVITY QUESTIONNAIRE

COMPLETE THE INFORMATION REQUESTED BELOW FOR EACH ENTITY AND MAIL THE QUESTIONNAIRE TO:

New Mexico Taxation and Revenue Department
Albuquerque Audit Bureau
P.O. Box 8485
Albuquerque, New Mexico 87198-8485
Attention: ______________________
Phone: (505) 841-6353 Fax: (505) 841-6361

PART I: GENERAL INFORMATION ***DATE*** **____ / ____ / ____.**

1. Company name and DBA:

2. Company address:

3. Telephone number: ( )

4. Type of entity:

5. State and date of incorporation:

6. Federal Employer Identification Number (FEIN):

NM Identification Number (CRS):

NM Corporation Commission Identification Number (SCC):

7. Describe the nature of the company's business activities:

BUSINESS ACTIVITY QUESTIONNAIRE

8. Has the company or its affiliates filed federal income tax returns?

□ YES □ NO

If yes, please complete:

NAME (DBA)	FEIN	TYPE OF RETURN (ex: Sub S or C)	TAX YEARS FILED

9.Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group?

□ YES □ NO

If yes, please provide the name and federal employer identification number of the parent corporation and attach an organizational chart of the affiliated group:

NAME	FEIN

10 Has the company or an affiliate ever been registered in New Mexico?

□ YES □ NO

If yes, please provide the name and federal employer identification number of the entities:

NAME	FEIN

11. Has the company or an affiliate ever filed any type of returns in New Mexico?

□ YES □ NO

If yes, please complete:

NAME	CRS ID NUMBER	TAX YEARS FILED	TYPE OF RETURNS

BUSINESS ACTIVITY QUESTIONNAIRE

12. Has the company or an affiliate ever maintained a bank account in New Mexico?

□ YES □ NO

If yes, where and for what years:

PART II: GENERAL OPERATIONS

Please give detailed answers in the spaces indicated. If the space is inadequate, please submit separate detailed explanations. If a document answers the question, please submit a copy of the document.

1. Does the company derive income in, into or from the transaction of any business in New Mexico?

□ YES □ NO

If yes, describe the source of income:

DATE ACTIVITIES BEGAN:

2. Does the company and/or affiliate have employees that perform activities in New Mexico?

□ YES □ NO

If yes, please provide the frequency and time periods of performance.

3. Does the company and/or affiliate have representatives that perform activities in New Mexico?

□ YES □ NO

If yes, describe the activities of the representatives within New Mexico, including the frequency and time periods of performance.

DATE ACTIVITIES BEGAN:

BUSINESS ACTIVITY QUESTIONNAIRE

4. **Does the company and/or affiliate solicit business through:**

   ❑ telephone / telemarketing
   ❑ mail order / catalog / publications
   ❑ independent representative
   ❑ sales personnel
   ❑ dealership(s)
   ❑ other: ______________________________

5. **Does the company and/or affiliate have an office (in home or otherwise), agency, warehouse or any other place of business in New Mexico?**

   ❑ YES ❑ NO

   If yes, where?

   ____

   Date activities began:

   ____

6. **Does the company and/or affiliate, own, rent or lease real or tangible personal property located or being used in this state?**

   ❑ YES ❑ NO

   If yes, please describe:

DATE ACTIVITIES BEGAN:

7. **Does the company and/or affiliate lease or rent to others (present or past) any tangible personal property or real estate (motor vehicles, office space, industrial equipment, etc.) located and/or used in New Mexico?**

   ❑ YES ❑ NO

   If yes, please describe:

DATE ACTIVITIES BEGAN:

8. **Does the company and/or affiliate own, lease, sell or grant intangible rights or license for use in New Mexico?**

   ❑ YES ❑ NO

   If yes, please describe:

DATE ACTIVITIES BEGAN:

BUSINESS ACTIVITY QUESTIONNAIRE

9. **Does the company and/or affiliate have a security interest, in any real or personal property located in this state?**
□ YES □ NO
If yes, please explain:

DATE ACTIVITIES BEGAN:

10. **Does the company and/or affiliate sell services for use in New Mexico?**
□ YES □ NO
If yes, please describe in detail what services:

DATE ACTIVITIES BEGAN:

11. **Does the company and/or affiliate engage in any advertising (cooperative or otherwise) in this state?**
□ YES, Date activity began: ____ □ NO

12. **Do you have exclusive representatives (broker, agent, contractor, etc.) performing services within this state?**
□ YES, Date activity began: ____ □ NO

13. **Does the company have any franchise operations or rights in New Mexico?**
□ YES, Date activity began: ____ □ NO

14. **Does the company submit bids to potential customers in New Mexico, in which the company offers to sell goods or services based upon conditions specified therein?**
□ YES, Date activity began: ____ □ NO

15. **How are deliveries made into New Mexico?**
□ common carrier (shipping contract)
□ common carrier (FOB destination)
□ your vehicles (owned or leased)
□ other _________________________________

16. **When shipments are made into New Mexico, where does risk of loss and title pass? Please provide sample copies of your invoices.**

DATE ACTIVITIES BEGAN:

BUSINESS ACTIVITY QUESTIONNAIRE

17. Are deliveries to customers into New Mexico always made from an out of state location?

□ YES □ NO

If no, please explain.

DATE ACTIVITIES BEGAN:

18. Do you maintain any written contractual agreements with anyone in New Mexico?

□ YES □ NO

If yes, provide a copy of the agreement(s).

19. Have you collected and/or paid any type of tax for New Mexico?

□ YES □ NO

If yes, please explain.

DATE ACTIVITIES BEGAN:

20. How can customers place orders with your company?

Please explain.

21. Do you, your employees or your representatives conduct research and development in New Mexico?

□ YES □ NO

If yes, please explain.

DATE ACTIVITIES BEGAN:

22. Do you provide customer assistance or service programs for New Mexico customers? □ YES □ NO

If yes, please explain.

BUSINESS ACTIVITY QUESTIONNAIRE

DATE ACTIVITIES BEGAN:

23. **Do you provide grants, awards or rebate programs to New Mexico customers?**
❑ YES ❑ NO
If yes, please explain.

DATE ACTIVITIES BEGAN:

24. **Do any of your representatives or employees reside in the state?**
❑ YES ❑ NO

25. **How does the company compensate their representatives or employees (commission, salary, expense allowance etc.)? Do they receive commissions or other incentives based on New Mexico sales?**

DATE ACTIVITIES BEGAN:

26. **Do you have a standard form of written agreement with your New Mexico representatives or employees?**
❑ YES ❑ NO
If yes, please include a copy for our review.

27. **How did you establish your client base in New Mexico?**

DATE ACTIVITIES BEGAN:

28. **How are you maintaining your client base in New Mexico?**

DATE ACTIVITIES BEGAN:

BUSINESS ACTIVITY QUESTIONNAIRE

PART III: CLIENT LIST

Please list your five largest New Mexico customers. Include addresses and telephone numbers.

Name	
Address	
City/State/Zip	
Telephone Number	
Contact:	

Name	
Address	
City/State/Zip	
Telephone Number	
Contact:	

Name	
Address	
City/State/Zip	
Telephone Number	
Contact:	

Name	
Address	
City/State/Zip	
Telephone Number	
Contact:	

Name	
Address	
City/State/Zip	
Telephone Number	
Contact:	

BUSINESS ACTIVITY QUESTIONNAIRE

PART IV: COMPETITOR LIST

Please list your five largest competitors in and around New Mexico. Include addresses and telephone numbers.

Name	Address

ADDITIONAL COMMENTS:

ENCLOSE A COPY OF YOUR ANNUAL REPORT, FEDERAL FORM 10K AND A LIST OF YOUR AFFILIATES.

PART V: SIGNATURE AND VERIFICATION

I declare that the information furnished in response to this questionnaire is to the best of my knowledge and belief, true, correct and complete.

SIGNATURE OF OFFICER OR AUTHORIZED REPRESENTATIVE OF TAXPAYER

Signature ______________________________

Title ______________________ Date ______________

- OR -

SIGNATURE OF PARTNER OR OWNER

Signature ______________________________

Title ______________________ Date ______________

Taxation & Revenue Department Audit & Compliance Division
Taxpayer: _________________ NM ID # ______________

DIVIDEND INCOME ANALYSIS – Part I

Please complete the following in its entirety for each source of dividend income from each subsidiary and from each investment portfolio maintained for the taxable year in question. Dividend income received from subsidiaries or other ownership interests of more than 5% requires completion the DIVIDEND INCOME ANALYSIS – Part II.

Dividend Type	**YE _____** **Amount**	Was the source of capital used to purchase or acquire the dividend paying assets derived from the business operations of the corporation? If "no", please explain.	Was any portion of the dividend income utilized in the overall operations of the corporation? If "no", please explain the intended use of the payments.	Have the dividend paying assets ever been used for general credit purposes of the corporation? If "yes", please explain.
	$			
Total Dividends:				

Taxation & Revenue Department   Audit & Compliance Division
Taxpayer: _________________   NM ID # ______________

DIVIDEND INCOME ANALYSIS – Part II

Please complete the following in its entirety to show the sources of dividend income and the nature of the business for the taxable year in question for each payor corporation in which your interest income amount is more than $2,500 and your percentage of ownership is more than 5%.

Dividend Payor Name: ________________   Tax Year Ended: ________

Dividend Income Amount: $______________

1. What was your percentage of ownership in the dividend payor?

2. What was the source of capital used to generate the dividend income: funds generated from in business; borrowing; or stock?

3. Are there common officers and/or directors between you and the dividend payor?

4. Did any of the following transactions, activities or services exist between you and the payor? If "yes" please explain.

a) Sales?

b) Financing, lines-of-credit, or loan guarantees?

c) Rental of property?

d) Utilization of trademarks, slogans or shield devices in marketing or daily operations?

e) Planning or coordination of marketing and/or advertising?

f) Provision of accounting services; tax return or regulatory report preparation; or data processing?

g) Coordination of insurance, employee benefit plans, or legal services?

h) Common use and transfers of personnel or personnel training?

i) Common use of office, selling, storage, manufacturing, R&D or transportation facilities?

j) Common formulas, processes or procedures developed or used?

k) Centralized purchasing of inventories, supplies or capital items?

Taxpayer: __________________ NM ID # _______________

INTEREST INCOME ANALYSIS – Part I

Please complete the following in its entirety for each source of interest income and provide a statement of changes in financial position for the taxable year in question. Interest income received on accounts from loans or sales to entities in which you owned more than 5% requires completion the INTEREST INCOME ANALYSIS – Part II.

Interest Type	**YE _____** **Amount**	Was the source of capital used to purchase or acquire the interest bearing assets derived from the business operations of the corporation? If "no", please explain.	Was any portion of the interest income utilized in the overall operations of the corporation? If "no", please explain the intended use of the interest and principal.	Have the interest bearing assets ever been used for general credit purposes of the corporation? If "yes", please explain.
Accounts Receivable	$			
Notes Receivable				
Loans to Ownership Interests > 5%				
Loans to Stockholders				
Mortgage & Real Estate Loans				
Installment Sales				
Certificates of Deposit				
U.S. Securities				
Other :				
Total Interest:				

Taxation & Revenue Department   Audit & Compliance Division
Taxpayer: __________________   NM ID # ______________

INTEREST INCOME ANALYSIS – Part II

Please complete the following in its entirety to show the sources of interest income and the nature of the business for the taxable year in question for each payor corporation in which your interest income amount is more than $2,500 and your percentage of ownership is more than 5%.

Interest Payor Name: ________________   Tax Year Ended: ________

Interest Income Amount: $______________

1) What was your percentage of ownership in the interest payor?

2) What was the source of capital used to generate the interest income: funds generated from in business; borrowing; or stock?

3) Are there common officers and/or directors between you and the interest payor?

4) Did any of the following transactions, activities or services exit between you and the payor? If "yes" please explain.

a) Sales?

b) Financing, lines-of-credit, or loan guarantees?

c) Rental of property?

d) Utilization of trademarks, slogans or shield devices in marketing or day to day operations?

e) Planning or coordination of marketing and/or advertising?

f) Provision of accounting services; tax return or regulatory report preparation; or data processing?

g) Coordination of insurance, employee benefit plans, or legal services?

h) Common use and transfers of personnel or personnel training?

i) Common use of office, selling, storage, manufacturing, R&D or transportation facilities?

j) Common formulas, processes or procedures developed or used?

k) Centralized purchasing of inventories, supplies or capital items?

Taxpayer: __________________ NM ID # ______________

NET GAIN / (LOSS) ANALYSIS – Part I

Please complete the following in its entirety for each source of net gain / (loss) for the taxable year in question. Please also submit copies of the Federal Schedule D, Form 4797 and supporting schedule for the taxable year. If the answers are not the same for each gain / (loss) within each category type below, answer questions separately for each gain / (loss). Gain / (Loss) derived from the sale of stock, other ownership interest or interest-bearing assets of another business in which you owned of more than 5% requires completion the NET GAIN /(LOSS) ANALYSIS – Part II.

Gain / (Loss) From the sale or other disposition of:	**YE _____** **Amount**	Were the assets which generated the gain / (loss) originally purchased , developed, or constructed by the corporation?	If the assets were purchased, was the source of capital used to acquire the assets derived from the business operations of the corporation? If "no", please explain.	Was the net gain from the sale or other disposition of the assets utilized in the overall operations of the corporation? If "no", please explain	Prior to their sale, were the assets used in the regular operations of the corporation? If "no", please explain	Have any of the assets ever been used for general credit purposes by the corporation?
Stock owned In other corporations.	$					
Interest bearing assets.						
Rental property.						
Royalty assets						
Physical assets used in the regular business operations.						
Other:						
Total :						

Taxpayer: __________________ NM ID # ______________

NET GAIN / (LOSS) ANALYSIS – Part II

Please complete the following in its entirety to show disposition of stock, other ownership interests and interest bearing assets of businesses of which you owned more than 5% for the taxable year in question. A concise statement explaining the purpose for acquiring each the asset and the nature of the business or businesses of each business whose stock, interest or asset was disposed of is required on a supplement page if the gain /(loss) amount is more than $2,500 and your percentage of ownership in the business was more than 5%.

Name/Type Asset: ________________ Tax Year Ended: ________

Gain / (Loss) Amount: $______________

1. What was your percentage of ownership in the business?

2. What was the source of capital to acquire the asset: funds generated in business; borrowing; or stocks?

3. Are there common officers and/or directors between you and the business?

4. Did any of the following transactions, activities or services exit between you and the business? If "yes" please explain.

    a. Sales?

    b. Financing, lines-of-credit, or loan guarantees?

    c. Rental of property?

    d. Utilization of trademarks, slogans or shield devices in marketing or day to day operations?

    e. Planning or coordination of marketing and/or advertising?

    f. Provision of accounting services; tax return or regulatory report preparation; or data processing?

    g. Coordination of insurance, employee benefit plans, or legal services?

    h. Common use and transfers of personnel or personnel training?

    i. Common use of office, selling, storage, manufacturing, R&D or transportation facilities?

    j. Common formulas, processes or procedures developed or used?

    k. Centralized purchasing of inventories, supplies or capital items?

Taxation & Revenue Department   Audit & Compliance Division
Taxpayer: _________________   NM ID # ______________

RENTAL INCOME ANALYSIS – Part I

Please complete the following in its entirety for each source of rental income:

1. Identify the lessee and fully describe the rental property and its physical location.

2. Do you have an ownership interest of more than 5% of the lessee? If "yes", please complete Part II.

3. Was the rental property previously occupied by you or used in your business and later converted for rental to others? If "yes", please explain.

4. Was this property purchased, manufactured, acquired or leased by you for use as rental property? If "yes", please explain.

5. Was the source of capital used to purchase or acquire these rental assets derived from the business operations of the Corporation? If "no", please explain.

6. Was the rental income utilized in the overall operations of the Corporation? If "no", please explain.

7. Have the rental assets ever been used as security or otherwise pledged to obtain credit for the Corporation?

8. Please complete the below net rental income (loss) schedule for each source of rental income for the taxable years in question:

	YE______	**YE______**	**YE______**
Gross Rental Income			
Less Related Expenses:			
Depreciation			
Repairs			
Interest			
Property Taxes			
Other			
Total Related Expenses:			
Net Rental Income (Loss):			

Taxation & Revenue Department   Audit & Compliance Division
Taxpayer: ___________________   NM ID # ______________

RENTAL INCOME ANALYSIS – Part II

Please complete the following in its entirety for each lease which you have an ownership interest in the property of more than 5%. A concise statement explaining the business or businesses of the lessee corporation is required on a supplemental page if the rental income or (loss) is more the $2,500 and your percentage of ownership is more than 5%.

Lessee Name: ________________   Tax Year Ended: ________

Rental Income/(Loss) Amount: $______________

1. What was your percentage of ownership in the rental property?

2. Are there common officers and/or directors between you and the lessee?

3. Did any of the following transactions, activities or services exit between you and the lessee? If "yes" please explain.

a) Sales?

b) Financing, lines-of-credit, or loan guarantees?

c) Utilization of trademarks, slogans or shield devices in marketing or day to day operations?

d) Planning or coordination of marketing and/or advertising?

e) Provision of accounting services; tax return or regulatory report preparation; or data processing?

f) Coordination of insurance, employee benefit plans, or legal services?

g) Common use and transfers of personnel or personnel training?

h) Common use of office, selling, storage, manufacturing, R&D or transportation facilities?

i) Common formulas, processes or procedures developed or used?

j) Centralized purchasing of inventories, supplies or capital items?

Taxpayer: ___________________ NM ID # ______________

ROYALTY INCOME ANALYSIS – Part II

Please complete the following in its entirety for each source of royalty income for the taxable year in question. Royalty income received from an ownership interest of more than 5% requires completion the ROYALTY INCOME ANALYSIS – Part II.

Royalty Type	**YE _____** **Amount**	Were the assets which generated the royalty income purchased or were they developed by the corporation?	If the royalty assets were purchased, was the source of capital used to purchase the royalty generating assets derived from the business operations of the corporation? If "no", please explain.	Was the royalty income utilized in the overall operations of the corporation? If "no", please explain.	Have the royalty generating assets ever been used as security or otherwise to obtain credit for the corporation?
Forests & Timber	$				
Minerals & Mining					
Oil & Natural Gas					
Copyrights					
Patents					
Processes					
Equipment					
Other :					
Total Royalty:					

Taxpayer: __________________ NM ID # ______________

ROYALTY INCOME ANALYSIS – Part II

Please complete the following in its entirety to show the sources of royalty income received from ownership interest of more than 5% for the taxable year in question. A concise statement explaining the business or businesses of each payor corporation is required on a supplement page if the royalty income amount is more than $2,500 and your percentage of ownership is more than 5%.

Royalty Payor Name: ________________ Tax Year Ended: ________

Royalty Income Amount: $______________

1) What was your percentage of ownership in the royalty payor?

2) Are there common officers and/or directors between you and the royalty payor?

3) Did any of the following transactions, activities or services exit between you and the payor? If "yes" please explain.

a) Sales?

b) Financing, lines-of-credit, or loan guarantees?

c) Rental of property?

d) Utilization of trademarks, slogans or shield devices in marketing or day to day operations?

e) Planning or coordination of marketing and/or advertising?

f) Provision of accounting services; tax return or regulatory report preparation; or data processing?

g) Coordination of insurance, employee benefit plans, or legal services?

h) Common use and transfers of personnel or personnel training?

i) Common use of office, selling, storage, manufacturing, R&D or transportation facilities?

j) Common formulas, processes or procedures developed or used?

k) Centralized purchasing of inventories, supplies or capital items?

CORPORATE INCOME TAX AUDIT MANUAL

Section 8000

Appendix B – General Review Procedures for Income Taxes

PREFACE

The general review procedures for income taxes presented in this appendix are to be used on all income tax audits which are performed by auditors who are not the Corporate Income Tax Audit Unit.

Since taxpayer situations are diverse there may be times when it is impractical to follow a procedure or procedures outlined in this appendix, therefore the auditor should specify which procedure(s) was not used and the reason for not using the procedure. In other cases the auditor may find additional steps and documentation are required. If this should occur the auditor should refer to the specific procedures in the CITM and document and explain the additional procedures used.

The auditor may find that certain workpapers and procedures used in auditing the Gross Receipts and Compensating, and Withholding taxes will work in auditing corporate income taxes and the auditor is encouraged to utilize such procedures and workpapers so long as they are properly documented.

PROCEDURES

1. Determine how is the taxpayer filing.

    - Review the Programs screen in GenTax under the FEIN (or CRS number) for background information, such as the status (C Corporation, S Corporation, Partnership, sole proprietorship or individual).

2. Determine if the taxpayer is filing and reporting income tax.

    - Obtain copies of the returns in GenTax (both from scanned copies and from microfilm with 14 digits.)
    - If CIT or PTE returns, compare New Mexico sales from Schedules CIT-A or PTE-A to the monthly CRS-1s and reconcile any differences.

3.Trace significant numbers from the state returns to the federal tax returns.

4. Research your taxpayer and obtain all the information you can about your taxpayer. (i.e. Form 10Ks, annual reports, Google.com, Yahoo.com, etc.) Determine the taxpayer’s primary and secondary businesses.

Appendix C – Significant New Mexico D&Os and Rulings

K-Mart Corporation vs. Taxation & Revenue Department – Supreme Court of New Mexico – 2006

Xerox Corporation vs. Taxation & Revenue Department – D&O – December 2003.

Conoco, Inc. and Intel Corporation v. Taxation and Revenue Department of the State of New Mexico – Supreme Court of New Mexico – 1996

Kewanee Industries, Inc. v. State of New Mexico – Supreme Court of New Mexico – 1993

NCR Corporation v. Taxation and Revenue Department – Court of Appeals of New Mexico – 1993

F.W. Woolworth Co. v. Taxation and Revenue Department of New Mexico – Supreme Court of the United States – 1982

Tipperary Corporation v. New Mexico Bureau of Revenue – Court of Appeals of New Mexico – 1979

McVean & Barlow, Inc. v. New Mexico Bureau of Revenue – Court of Appeals of New Mexico – 1975