

NOTICES OF PROPOSED RULEMAKING

Unless exempted by A.R.S. § 41-1005, each agency shall begin the rulemaking process by first submitting to the Secretary of State's Office a Notice of Rulemaking Docket Opening followed by a Notice of Proposed Rulemaking that contains the preamble and the full text of the rules. The Secretary of State's Office publishes each Notice in the next available issue of the *Register* according to the schedule of deadlines for *Register* publication. Due to time restraints, the Secretary of State's Office will no longer edit the text of proposed rules. We will continue to make numbering and labeling changes as necessary.

Under the Administrative Procedure Act (A.R.S. § 41-1001 et seq.), an agency must allow at least 30 days to elapse after the publication of the Notice of Proposed Rulemaking in the *Register* before beginning any proceedings for adoption, amendment, or repeal of any rule. A.R.S. §§ 41-1013 and 41-1022.

NOTICE OF PROPOSED RULEMAKING

TITLE 15. REVENUE

CHAPTER 2. DEPARTMENT OF REVENUE INCOME AND WITHHOLDING TAX SECTION SUBCHAPTER D. CORPORATIONS

PREAMBLE

<u>1. Sections Affected</u>	<u>Rulemaking Action</u>
R15-2D-101	Amend
R15-2D-401	Amend
R15-2D-403	Amend
R15-2D-404	Amend
R15-2D-405	Amend
R15-2D-501	Amend
R15-2D-502	Amend
R15-2D-503	Amend
R15-2D-504	Amend
R15-2D-505	Amend
R15-2D-506	Amend
R15-2D-507	Amend
R15-2D-508	Amend
R15-2D-601	Amend
R15-2D-602	Amend
R15-2D-603	Amend
R15-2D-604	Amend
R15-2D-605	Amend
R15-2D-606	Amend
R15-2D-607	Amend
R15-2D-701	Amend
R15-2D-702	Amend
R15-2D-703	Amend
R15-2D-704	Amend
R15-2D-705	Amend
R15-2D-801	Amend
R15-2D-803	Amend
R15-2D-804	Amend
R15-2D-805	Amend
R15-2D-806	Amend
R15-2D-807	Amend
R15-2D-901	Amend

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R15-2D-902	Amend
R15-2D-903	Amend

2. The specific authority for the rulemaking, including both the authorizing statute (general) and the statutes the rules are implementing (specific):

Authorizing statute: A.R.S. § 42-1005

Implementing statutes: A.R.S. §§ 43-941, 43-942, 43-947, 43-1131 through 43-1150

3. List of all previous notices appearing in the Register addressing the proposed rules:

Notice of Rulemaking Docket Opening: 6 A.A.R. 3118, August 18, 2000

4. The name and address of agency personnel with whom persons may communicate regarding the rulemaking:

Name: James Bilski, Tax Analyst

Address: Tax Research & Analysis Section
Arizona Department of Revenue
1600 West Monroe
Phoenix, Arizona 85007

Telephone: (602) 542-4672

Fax: (602) 542-4680

E-Mail: bilskij@revenue.state.az.us

5. An explanation of the rule, including the agency's reasons for initiating the rule:

These rules deal with the division of income by multistate businesses for corporate income tax purposes. As a result of legislative changes and the 5-year review of Title 15, Chapter 2, the Department is proposing to amend the rules to conform to current statutes, remove language that is obsolete or that is repetitive of statute, rearrange the rules in a more logical manner and conform to current rulemaking guidelines.

In addition, R15-2D-403 and a substantial portion of the rules in Articles 5 through 9 were originally taken from uniform regulations prepared by the Multi-State Tax Commission (MTC). The MTC was the originator of the Uniform Division of Income for Tax Purposes Act (UDITPA). MTC designed the regulations so that any UDITPA state could adopt the proposal with minimal change. A.R.S. § 43-1149 requires that UDITPA be construed to effectuate its general purpose to make uniform the law of those states that enact it. The majority of the changes to R15-2D-403 and the rules in Articles 5 through 9 are to conform the rules to the current MTC regulations and to add MTC examples that were not included in the rules when they were originally adopted by the Department in 1986. Due to A.R.S. § 43-1149 and in order to avoid confusion, the Department is keeping changes to the actual language that was taken from the MTC to a minimum.

6. Reference to any study that the agency proposes to rely on and its evaluation of or justification for the proposed rule and where the public may obtain or review the study, all data underlying each study, any analysis of the study and other supporting material:

None

7. A showing of good cause why the rule is necessary to promote a statewide interest if the rule will diminish a previous grant of authority of a political subdivision of this state:

Not applicable

8. The preliminary summary of the economic, small business, and consumer impact:

It is expected that the benefits of the rules will be greater than the costs. The amendment of these rules will benefit the public by making the rules conform to current statute, removing language that is obsolete or that is repetitive of statute, rearranging the rules in a more logical manner and conforming to current rulemaking guidelines, which will make the rules more accurate as well as clearer and easier to understand. In addition, the MTC examples will provide additional guidance for taxpayers and will help to insure that whenever possible Arizona's method for apportioning or allocating multistate income will be similar to that used by other states that have adopted UDITPA. The Department will incur the costs associated with the rulemaking process. Taxpayers are not expected to incur any expense in the amendment of these rules.

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9. The name and address of agency personnel with whom persons may communicate regarding the accuracy of the economic, small business, and consumer impact statement:

Name: James Bilski, Tax Analyst
Address: Tax Research & Analysis Section
Arizona Department of Revenue
1600 West Monroe
Phoenix, Arizona 85007
Telephone: (602) 542-4672
Fax: (602) 542-4680
E-Mail: bilskij@revenue.state.az.us

10. The time, place, and nature of the proceedings for the adoption, amendment, or repeal of the rule or, if no proceeding is scheduled, where, when, and how persons may request an oral proceeding on the proposed rule:

The Department has not scheduled any oral proceedings. Written comments on the proposed rules or preliminary economic, small business, and consumer impact statements may be submitted to the person listed in paragraphs #4 and #9. Pursuant to A.R.S. § 41-1023(C), the Department will schedule oral proceedings if 1 or more individuals file written requests for oral proceedings within 30 days after the publication of this notice.

A person may submit written comments regarding the proposed rules by submitting the comments no later than 5:00 p.m., January 8, 2001, to the person listed in paragraphs #4 and #9.

11. Any other matters prescribed by statute that are applicable to the specific agency or to any specific rule or class of rules:

Not applicable

12. Incorporations by reference and their location in the rules:

None

13. The full text of the rules follows:

TITLE 15. REVENUE

**CHAPTER 2. DEPARTMENT OF REVENUE
INCOME AND WITHHOLDING TAX SECTION
SUBCHAPTER D. CORPORATIONS**

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ARTICLE 1. GENERAL

R15-2D-101. Definitions

In addition to the definitions provided in A.R.S. §§ 43-104, 43-1101, and 43-1131, the following definitions apply to this Subchapter:

- ~~A.~~ "Taxpayer" shall mean any person subject to a tax imposed by Title 43, Arizona Revised Statutes, but in no case shall it include the United States, this state, counties, cities, towns, school districts or other political subdivisions or units of this state or federal government. "Person" includes individuals, fiduciaries, partnerships, and corporations. "Allocation" means the assignment of nonbusiness income to a particular state.
- ~~B.~~ "Apportionment" ~~means~~ refers to the division of business income between states by the use of a formula containing apportionment factors. ~~If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from activities within this state shall be determined by apportionment.~~
- ~~C.~~ "Allocation" refers to the assignment of non-business income to a particular state. Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its non-business income or loss within or without this state in accordance with A.R.S. § 43-1135 through 43-1138. "Arizona affiliated group" has the same meaning as prescribed in A.R.S. § 43-947(I).
- ~~D.~~ "Business activity" ~~means~~ refers to the transactions and activity occurring in the regular course of a particular taxpayer's unitary trade or business of a taxpayer.
- ~~E.~~ "Combined report". ~~If a particular unitary trade or business is carried on by a taxpayer and 1 or more affiliated taxpayers united by a bond of direct or indirect ownership or control of more than fifty percent (50%) and a part of the business is conducted in Arizona by 1 or more of the members of the group, the business income attributable to such member or members shall be apportioned by multiplying the group's unitary business income by the average of the property, payroll and sales factors. Those factors are determined by dividing the Arizona property, payroll and sales figures by the total property, payroll and sales figures of all the members of the unitary group. The property, payroll and sales factors are to be determined in accordance with the rules described in R15-2D-601 through R15-2D-806. The extent of the unitary business or group is limited to that business which is subject to the tax imposed by and computed pursuant to the Internal Revenue Code, except as provided in A.R.S. § 43-1132.~~

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“Combined return” means a return filed by a group of commonly owned corporations or businesses that constitute a unitary business. However, a combined return shall not include either a foreign corporation that is not itself subject to a tax imposed by A.R.S. Title 43, or an insurance company that is exempt under A.R.S. § 43-1201. The group’s business income is combined together and apportioned to Arizona by means of one combined apportionment formula.

“Consolidated return” means a corporate income tax return filed by an Arizona affiliated group pursuant to A.R.S. § 43-947. The return includes the same corporations that are included in the consolidated federal income tax return.

“Employee” means any officer of a corporation; or any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee.

“Sales” means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business and includes all gross receipts of the taxpayer not allocated under A.R.S. §§ 43-1134 through 43-1138.

“Unitary business” means an entity, group of entities, or component parts of an entity whose basic operations are substantially integrated and interdependent. The determination of whether an entity, group of entities, or component parts of an entity constitute a unitary business is made under R15-2D-401.

ARTICLE 4. MULTISTATE DIVISION OF INCOME

R15-2D-401. Unitary Business and Combined Returns

A. ~~An entity or group of entities is not a unitary business for apportionment purposes unless there is actual substantial interdependence and integration of the basic operations of the business carried on in more than 1 taxing jurisdiction. The potential to operate a component as part of the unitary business is not dispositive. Two or more businesses of a single taxpayer. A taxpayer may have more than 1 “trade or business”. In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.~~

B. ~~1. Single unitary trade or business and a combined report. The determination of whether the activities of the taxpayer constitute a single trade or business or more than 1 trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single unitary business if there is evidence to indicate that the basic operations of the components under consideration are integrated and interdependent. The following definition of a single unitary business is based on economic substance and not form. Therefore, a unitary business may consist of part of a corporation, 1 corporation, or many corporations. If the unitary business consists of more than 1 corporation, the Department shall require a combined return report by the entities comprising the unitary business is required by the Department. Components of the combined report must reconcile accounting periods and systems if they are not compatible. See R15-2D-101(E) and R15-2D-401 (B) for methods of filing a combined report and reconciling incompatible accounting periods. The entities comprising the unitary business must be united by a bond of direct or indirect ownership or control of more than fifty percent (50%) of the voting stock of a subsidiary corporation. There must be common management of the component parts or entities. At least some part of the unitary business must be conducted in Arizona.~~

C. ~~The main fundamental reason for defining a business as unitary is that its components in various states are so tied together at the basic operational level that it is truly difficult to determine the state in which profits are actually earned. Centralized top-level management, financing, accounting, insurance and benefit programs, or overhead functions by a home office are not sufficient characteristics in themselves for a business to be unitary without further analysis of the basic operations of component businesses.~~

~~An entity or group of entities is not a unitary business for apportionment purposes unless there is actual substantial interdependence and integration of the basic operations of the business carried on in more than 1 taxing jurisdiction. The potential to operate a component as part of the unitary business is not dispositive. In the manufacturing, producing or mercantile type of business, a substantial transfer of material, products, goods, technological data, processes, machinery, and equipment between the branches, divisions, subsidiaries or affiliates is required for an entity or group of entities to be defined as a unitary business.~~

~~A transfer of over twenty percent (20%) of the total goods annually manufactured, produced or purchased as inventory for processing and/or sale by the transferor, or over twenty percent (20%) of the total goods annually acquired for processing and/or sale by the transferee would be presumptive evidence of a unitary business. A smaller percentage of goods transferred may be indicative of a unitary business depending upon the presence of other characteristics indicating operational integration.~~

~~In a unitary service business, the operations of the various component parts or entities of the business are integrated and interrelated by their involvement with the central office or parent in delivering substantially the same service. The day-to-day operations of these components use the same procedures and technologies which are developed, organized, purchased and/or prescribed by the central office or parent. There usually is an exchange of employees among the component parts and centralized training of employees.~~

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Generally speaking, a conglomerate composed of diverse businesses is not a single unitary business. However, a line or line of business within the conglomerate may be a unitary business if the operations of the components of the line are integrated and interrelated as described herein. The cost of centralized services and functions performed by the parent corporation for diverse subsidiaries may be specifically allocated to the respective subsidiaries.

- D.** ~~The following~~ While common ownership, common management and reconciled accounting systems of components are necessary threshold characteristics for component parts of an entity, an entity, or group of entities for a business to be considered a single unitary business ~~the;~~
1. The entities comprising the unitary business shall be united by a bond of direct or indirect ownership or control by the same interests of more than 50% of the voting stock.
 2. The entities or component parts shall share common management.
 3. The entities or component parts shall have reconciled accounting systems.
- E.** ~~The presence of the~~ these 3 characteristics listed in subsection (D) is not sufficient for a business to be considered unitary without evidence of substantial operational integration. Some of the factors of a single unitary business which indicate basic operational integration are:
1. The same or similar business conducted by components;
 2. Vertical development of a product by components, such as i.e., manufacturing, distribution, and sales;
 3. Horizontal development of a product by components, such as i.e., sales, service, ~~and~~ repair, and financing;
 4. Transfer of materials, goods, products, and technological data and processes; between components;
 5. Sharing of assets by components;
 6. Sharing or exchanging of operational employees by components;
 7. Centralized training of employees;
 8. Centralized mass purchasing of inventory, materials, equipment, and technology; ~~etc.;~~
 9. Centralized development and distribution of technology relating to the on-going day-to-day operations of the components;
 10. Use of common trademark or logo at the basic operational level, centralized advertising with impact at the basic operational level;
 11. Exclusive sales-purchase agreements between components;
 12. Price differentials between components as compared to unrelated businesses;
 13. Sales or leases between components; and
 14. Other contributions between components at the basic operational level.
- F.** All of the ~~above~~ factors listed in subsection (E) need not be present in every unitary business, but factors indicating substantial integration at the basic operational level should be evident.
- G.** In the manufacturing, producing, or mercantile type of business, a substantial transfer of material, products, goods, technological data and processes, or machinery and equipment between the branches, divisions, subsidiaries, or affiliates is required for an entity or group of entities to be defined as a unitary business.
1. A transfer of 20% of the total goods annually manufactured, produced or purchased as inventory for processing or sale, or both, by the transferor, or 20% of the total goods annually acquired for processing or sale, or both, by the transferee would be presumptive evidence of a unitary business.
 2. A smaller percentage of goods transferred may be indicative of a unitary business depending upon the presence of other characteristics indicating operational integration.
- H.** In a unitary service business, the operations of the various component parts or entities of the business are integrated and interrelated by their involvement with the central office or parent in delivering substantially the same service. The day-to-day operations of these components use the same procedures and technologies that are developed, organized, purchased, or prescribed by the central office or parent. There usually is an exchange of employees among the component parts and centralized training of employees.
- I.** A taxpayer may have more than 1 unitary trade or business. In such cases, it is necessary to determine the business income attributable to each separate unitary trade or business. The income of each business is then apportioned using an apportionment formula that considers the in-state and out-of-state factors of the business.
- J.** Generally, a conglomerate composed of diverse businesses is not a single unitary business. However, a line or lines of business within the conglomerate may be a unitary business if the operations of the components of the line are integrated and interrelated. The cost of centralized services and functions performed by the parent corporation for diverse subsidiaries may be specifically allocated to the respective subsidiaries.
- K.** ~~All members of a combined return shall determine income using the same accounting period. Unitary business group; members having different accounting periods.~~
1. If the members of a combined return have different accounting periods, the Utilization of the combined method of apportionment will ordinarily require that unitary income be determined generally on the same accounting period to be used by the ~~for all~~ members shall be determined as follows:-
 - a. If the combined return includes the common parent corporation, Where the members' accounting periods differ, the parent's accounting period is used will be utilized.

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- b. ~~If the combined return does not include the~~ ~~Where there is no common parent corporation,~~ ~~the income of the group's members shall be determined generally on the basis of the accounting period of a the member that has a presence in filing an Arizona~~ ~~shall be used~~ ~~return who is expected to have, on a recurring basis, the greater (or greatest) liability for Arizona income tax.~~ ~~The same group member's accounting period shall be used consistently from year to year.~~
2. Each member of the combined return that uses an accounting period that is different from the common accounting period determined in subsection (K)(1), shall use one of the following methods to determine the income to be included in the common accounting period:
- a. ~~Determine~~ ~~In complying with this requirement, any particular member, in determining the proper income to be included in the appropriate accounting period, may reflect income and related deductions using as may (or may not) be allocable to Arizona in accordance with the actual book or accounting entries for the relevant period.~~
- b. ~~Determine~~ ~~On the other hand, the member may determine~~ income based on the number of months falling within the required common accounting period. For example, if 1 member utilizes a calendar year, and the common accounting period ends October 31, 1981, the member will include 2/12 of the income for the year ended December 31, 1980, and 10/12 of the income for the year ended December 31, 1981. Estimates may be necessary where this proration method involves a member's year ~~that which~~ ends subsequent to the common accounting period.

R15-2D-403. Taxable in Another State-~~In General~~

- A. ~~The taxpayer is shall be~~ subject to the allocation and apportionment provisions of A.R.S. §§ 43-1131 through 43-1148 Title 43, Article 4 of the Arizona Revised Statutes if it has income from business activity that is taxable both within and without this state. A taxpayer's income from business activity is taxable without this state if the such taxpayer, by reason of such business activity (~~that is, the transactions and activity occurring in the regular course of a particular trade or business~~), is taxable in another state.
1. A taxpayer ~~is shall be~~ taxable within another state if it meets either 1 of the 2 tests specified in A.R.S. § 43-1133:
- a. ~~If by reason of business activity in another state the taxpayer is subject to 1 of the types of taxes specified, namely: A net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or~~
- b. ~~If by reason of such business activity another state has jurisdiction to subject the taxpayer to a net income tax, regardless of whether or not the state imposes such a tax on the taxpayer.~~
2. A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of nonbusiness non-business income or business activities relating to a separate trade or business.
- B. ~~Taxable in another state: when a corporation is "Subject to" a tax.~~ A taxpayer is "subject to" 1 of the taxes specified in A.R.S. § 43-1133(1) subsection (A)(1)(a) if it carries on business activities in a state and that state imposes such a tax thereon. Any taxpayer ~~that which~~ asserts that it is subject to 1 of the taxes specified in A.R.S. § 43-1133(1) in another state shall furnish to the Department of ~~this state~~ upon its request evidence to support that assertion. The Department of ~~this state~~ may request that the evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the laws of the other state; the taxpayer's failure to produce such proof may be taken into account in determining whether the taxpayer in fact is subject ~~in the other state~~ to 1 of the taxes specified in A.R.S. § 43-1133(1) in the other state this regulation.
1. ~~A If the taxpayer that~~ voluntarily files and pays 1 or more of the such taxes specified in A.R.S. § 43-1133(1) when not required to do so by the laws of the other state or pays a minimal fee for qualification, ~~for~~ organization, ~~for~~ the privilege of doing business in that state is not "subject to" 1 of the taxes specified in A.R.S. § 43-1133(1) if:
- a. ~~The taxpayer does~~ Does not ~~actually~~ engage in business activity in that state, or
- b. ~~The taxpayer engages~~ Does ~~actually~~ engage in some business activity, not sufficient for nexus, and the minimum tax bears no relation to the taxpayer's business activity within that state, ~~the taxpayer is not "subject to" 1 of the specified taxes within the meaning of this regulation.~~
2. The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states ~~that which~~ do not impose an income tax, other types of taxes may be imposed as a substitute ~~for an income tax~~. Therefore, only those taxes enumerated which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is "subject to" 1 of the taxes in another state.

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Example 1: State A requires all nonresident corporations that qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of \$50 and a maximum fee of \$500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not “taxable” in State A.

Example 2: The facts are the same as example 1 except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is “subject to” the net income tax of State A and is “taxable” in State A.

Example 3: State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of outstanding capital stock, and surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X, which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is “taxable” in State B.

Example 4: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based on its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A’s corporation franchise tax.

- C. ~~Taxable in another state: When a state has jurisdiction to subject a taxpayer to a net income tax. The 2nd test in A.R.S. § 43-1133 subsection (A)(1)(b) applies if the taxpayer’s business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of such business activity. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C.A. §§ 381-384.~~

R15-2D-404. Apportionment Formula

- A.** All business income of each trade or business of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in A.R.S. § 43-1139. The elements of the apportionment formula are the property factor, the payroll factor and the sales factor of the trade or business of the taxpayer.
- B.** A unitary business that files a combined return shall use an apportionment formula that combines the property, payroll, and sales figures of all of the unitary group members before calculating the factors.
- C.** An Arizona affiliated group that files a consolidated return shall use an apportionment formula that combines the property, payroll, and sales figures of all of the members of the Arizona affiliated group before calculating the factors.
- D.** This Section does not apply to a taxpayer engaged in air commerce that apportions its income in accordance with A.R.S. § 43-1139(B).

R15-2D-405. Intercompany Eliminations

Members of a combined or consolidated group shall eliminate intercompany amounts included in the group’s income, expense, and apportionment factors when Unitary business income; eliminations; intercompany transactions. Elimination of income and deduction items arising from transactions between members of the group must be done whenever necessary to avoid distortion of the group’s Arizona taxable income income, the denominators used by all members of the group in calculating apportionment factors, or the numerators used by any particular member of the group in calculating its apportionment factors.

ARTICLE 5. BUSINESS AND NONBUSINESS INCOME

R15-2D-501. General

- A.** ~~Business and non-business income defined. “Business income” is income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations. Parts or components of the taxpayer’s regular trade or business operations are limited to that business which is subject to the tax imposed by and computed pursuant to the Internal Revenue Code, except as provided in A.R.S. § 43-1132. In essence, all income from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration, the income of the taxpayer is business income unless clearly classifiable classified as nonbusiness non-business income.~~
- B.** ~~“Non-business income” means all income other than business income.~~

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€ The classification of income by the labels ~~occasionally used~~, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, or nonoperating income, ~~etc.~~, is of no aid in determining whether income is business or ~~nonbusiness non-business~~ income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “~~nonbusiness income~~” “~~non-business income~~” is the identification of the transactions and activity which are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of a particular trade or business of the taxpayer ~~the taxpayer’s unitary business as a whole constitute the taxpayer’s trade or business and~~ shall be transactions and activity arising in the regular course of, and shall constitute integral parts of, a trade or business.

R15-2D-502. Rents From Real and Tangible Personal Property

~~Rents from real and tangible personal property.~~ Rental income from real and tangible personal property is business income if the property with respect to which the rental income was received is used in the taxpayer’s trade or business or is incidental attendant thereto and therefore is includable ~~includible~~ in the property factor ~~under R15-2-1140.~~

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

Example 2: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example 3: The taxpayer operates a multistate chain of men’s clothing stores. The taxpayer purchases a 5-story office building for use in connection with its trade or business. It uses the street floor as 1 of its retail stores and the 2nd and 3rd floors for its general corporate headquarters. The remaining 2 floors are leased to others. The rental of the 2 floors is incidental to the operation of the taxpayer’s trade or business. The rental income is business income.

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

Example 5: The taxpayer operates a multistate chain of men’s clothing stores. The taxpayer invests in a 20-story office building and uses the street floor as 1 of its retail stores and the 2nd floor for its general corporate headquarters. The remaining 18 floors are leased to others. The rental of the 18 floors is not incidental to but rather is separate from the operation of the taxpayer’s trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example 6: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example 7: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a 5-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

R15-2D-503. Gains or Losses From Sales of Assets

Gain ~~Gains or losses from sales of assets.~~ gain or loss from the sale, exchange, or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer’s trade or business. However, if such property was utilized for the production of ~~nonbusiness non-business~~ income or otherwise was removed from the property factor, in accordance with Article 6, for a substantial period of time ~~before the year of its sale, exchange, or other disposition, the gain or loss will constitute nonbusiness non-business income. Five years or more shall be considered a substantial period of time.~~

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

Example 2: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example 3: Same as example 2 except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example 4: Same as example 2 except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

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

R15-2D-504. Interest

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

Example 1: The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

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

Example 3: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business income.

Example 4: The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example 5: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

Example 6: In January, the taxpayer sold all of the stock of a subsidiary for \$20,000,000. The funds are placed in an interest-bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.

R15-2D-505. Dividends

~~Dividends:~~ Dividends ~~are shall be~~ business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations.

Example 1: The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are business income.

Example 2: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example 3: The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example 4: The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for those agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example 5: The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

Example 6: The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

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R15-2D-506. Royalties

~~Royalties.~~ Patent and copyright royalties ~~and other royalties and licensing fees~~ are business income where the patent or copyright with respect to which the royalties ~~and other royalties and licensing fees~~ were received arose out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is related to such trade or business operations. Other royalties and licensing fees are business income if the property or licensing agreements that generated the income arose out of or was created in the regular course of the taxpayer's trade or business operations or the purpose for acquiring and holding the property or license agreement is related to or incidental to such trade or business operations.

Example 1: The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example 2: The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.

Example 3: The same as example 2, except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

R15-2D-507. Proration of Deductions

~~A. Proration of deductions.~~ In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of ~~nonbusiness non-business~~ income. In some cases an allowable deduction may be applicable to the business incomes of more than 1 trade or business ~~or and/or~~ to several items of ~~nonbusiness non-business~~ income. In such cases the deduction shall be prorated among such trades or businesses and such items of ~~nonbusiness non-business~~ income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

~~B. Consistency and uniformity in reporting.~~

- ~~1. Year-to-year consistency.~~ In filing returns with this state, if the taxpayer departs from or modifies the manner of prorating any such deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.
- ~~2. State-to-state uniformity.~~ If the returns or reports filed by a taxpayer with all states to which the taxpayer reports are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this state the nature and extent of the variance.

R15-2D-508. Consistency and Uniformity in Reporting

~~Consistency and uniformity in reporting.~~

~~A.1. Year-to-year consistency.~~ In filing returns with this state, if the taxpayer departs from or modifies the manner in which income has been classified as business income or ~~nonbusiness non-business~~ income, or the manner of prorating any related deduction, in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

~~B.2. State-to-state uniformity.~~ If the returns or reports filed by a taxpayer for all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as business or ~~nonbusiness non-business~~ income, or in the application or proration of any related deduction, the taxpayer shall disclose ~~in its return to this state~~ the nature and extent of the variance upon request by the Department.

ARTICLE 6. PROPERTY FACTOR

R15-2D-601. General

~~A. Property factor. In General.~~ The property factor, as defined in A.R.S. § 43-1140, ~~of the apportionment formula~~ for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of ~~the such~~ trade or business. The term "real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency.

~~B. Property used in connection with the production of nonbusiness non-business income shall be excluded from the property factor.~~

~~C. Property used both in the regular course of taxpayer's trade or business and in the production of nonbusiness non-business income shall be included in the factor only to the extent the property is used in the regular course of taxpayer's trade or business. The method of determining that portion of the value to be included in the factor will depend upon the facts of each case.~~

~~D. The property factor shall include the average value of property includable in the factor.~~

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~~**B.** Property factor: denominator. The denominator of the property factor is the average value of all of the taxpayer's real and tangible personal property owned or rented and used during the tax period. The term "all of the taxpayer's real and tangible personal property" is limited to all of the property owned or rented by the unitary business, which business is subject to the tax imposed by and computed pursuant to the Internal Revenue Code, except as provided in A.R.S. § 43-1132.~~

R15-2D-602. Property Used for the Production of Business Income

A. Property factor: Property used for the production of business income. Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer.

B. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor.

C. Property or equipment under construction during the tax period, (except inventorable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor.

D. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness non-business income, its sale, or the lapse of an extended period of time (normally, 5 years) during which the property is held for sale.

Example 1: Taxpayer closed its manufacturing plant in State X and held the property for sale. The property remained vacant until its sale 1 year later. The value of the manufacturing plant is included in the property factor until the plant is sold.

Example 2: Same as example 1 except that the property was rented until the plant was sold. The plant is included in the property factor until the plant is sold.

Example 3: Taxpayer closed its manufacturing plant and leased the building under a 5-year lease. The plant is included in the property factor until the commencement of the lease.

Example 4: The taxpayer operates a chain of retail grocery stores. Taxpayer closed Store A, which was then remodeled into 3 small retail stores such as a dress shop, dry cleaning, and barber shop, which were leased to unrelated parties. The property is removed from the property factor on the date on which the remodeling of Store A commenced.

R15-2D-603. Property Factor Numerator

~~Property factor: numerator.~~ The numerator of the property factor shall include the average value of the real and tangible personal property owned or rented by the taxpayer and used in this state during the tax period in the regular course of the trade or business of the taxpayer.

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

2. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination.

3. The value of mobile or movable property such as construction equipment, trucks or leased electronic equipment that ~~which~~ are located within and without this state during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the state during the tax period.

4. An automobile assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the automobile is licensed.

R15-2D-604. Valuation of Owned Property

A. Property owned by the taxpayer shall be valued at its original cost. Generally ~~As a general rule,~~ "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, or other similar event etc. ~~However, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes.~~

Example 1: The taxpayer acquired a factory building in this state at a cost of \$500,000 and, 18 months later, expended \$100,000 for major remodeling of the building. Taxpayer filed its return for the current taxable year on the calendar-year basis. A depreciation deduction in the amount of \$22,000 was claimed with respect to the building on the return for the current taxable year. The value of the building includable in the numerator and the denominator of the property factor is \$600,000; the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

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Example 2: During the current taxable year, Corporation X merged into Corporation Y in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, Corporation X owned a factory that it built 5 years earlier at a cost of \$1,000,000. Corporation X has been depreciating the factory at the rate of 2% per year, and its basis in Corporation X's hands, at the time of the merger was \$900,000. Since the property is acquired by Corporation Y in a transaction in which, under the Internal Revenue Code, its basis in Corporation Y's hands is the same as its basis in Corporation X's, Corporation Y includes the property in its property factor at Corporation X's original cost, without adjustment for depreciation, that is \$1,000,000.

Example 3: Corporation Y acquires the assets of Corporation X in a liquidation by which Corporation Y is entitled to use its stock cost as the basis of the Corporation X assets under Internal Revenue Code § 334(b)(2). Under these circumstances, Corporation Y's cost of the assets is the purchased price of the Corporation X stock, prorated over the Corporation X assets.

- B.** If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.
- C.** Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.
- D.** Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes.

R15-2D-605. Valuation of Rented Property

- A.** ~~Property factor: valuation of rented property.~~ Property rented by the taxpayer is valued at 8 times its net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for such property, less the aggregate annual subrental rates paid by subtenants of the taxpayer. Subrents are not deducted when the subrents constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the taxpayer when it is producing such income; accordingly, there is no reduction in its value. If the adjustment for subrents produces a negative or clearly inaccurate value of rented property, see the special provisions in R15-2D-902.

Example 1: The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Because the subrents are business income they are not deducted from rent paid by the taxpayer for the food market.

Example 2: The taxpayer rents a 5-story office building primarily for use in its multistate business, uses 3 floors for its offices and subleases 2 floors to various other businesses and persons such as professional people and shops. The rental of the 2 floors is incidental to the operation of the taxpayer's trade or business. Because the subrents are business income, they are not deducted from the rent paid by the taxpayer.

Example 3: The taxpayer rents a 20-story office building and uses the lower 2 stories for its general corporation headquarters. The remaining 18 floors are subleased to others. The rental of the 18 floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Because the subrents are nonbusiness income they are to be deducted from the rent paid by the taxpayer.

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

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

Example 2: Same facts as in example 1 except that the lease would have terminated on August 31. In this case, the annualized rent is \$20,000 (\$2,500 x 8).

- 3. Rent shall not be annualized because of the uncertain duration when the rental term is on a month-to-month basis.
- C.** "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:
 - 1. Any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or as a percentage of sales, profits or otherwise.

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

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

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

Example 2: A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was \$1,000 of which \$700 was for the use of storage space and \$300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is \$700.

D.3. "Annual rent" does not include:

1. Incidental incidental day-to-day expenses such as hotel or motel accommodations; and daily rental of automobiles; etc.; and
2. Royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration conveyed or credited to a holder of an interest in property that constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental or otherwise.

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

R15-2D-606. Averaging of Monthly Property Values

The As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, the Department may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

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

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

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

The average monthly value of the taxpayer's property includable in the property factor for the income year is \$10,000 (120,000 divided by 12).

2. Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of such property.

R15-2D-607. Consistency in Reporting

A. Property factor: consistency and uniformity in reporting.

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

B.2. State-to-state uniformity: If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion or inclusion of property in the property factor, the taxpayer shall disclose ~~in its return to this state~~ the nature and extent of the variance upon request by the Department.

ARTICLE 7. PAYROLL FACTOR

R15-2D-701. General

A. The payroll factor, as defined in A.R.S. § 43-1143, of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

1. The total amount "paid" to employees shall be determined upon the basis of the taxpayer's accounting method.
 - a. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid.

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b. Notwithstanding the taxpayer's method of accounting, ~~at the election of the taxpayer,~~ compensation paid to employees may, at the election of the taxpayer, be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under ~~that such~~ method for unemployment compensation purposes.

2. The compensation of any employee ~~for on account of~~ activities ~~that which~~ are connected with the production of non-business ~~non-business~~ income shall be excluded from the factor.

Example 1: The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of those wages is included in the payroll factor.

Example 2: The taxpayer owns various securities that it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of Mr. X, an employee. The salary paid to Mr. X is excluded from the payroll factor.

~~3.2. The term "compensation" shall mean wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded.~~

4. Only amounts paid directly to employees are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the ~~federal~~ Internal Revenue Code. In the case of employees not subject to the Internal Revenue Code, such as those employed in foreign countries, the determination of whether such benefits or services would constitute income to the employees shall be made as though such employees were subject to the Internal Revenue Code.

3. The term "employee" shall mean:

a. ~~Any officer of a corporation; or~~

b. ~~Any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee.~~

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

R15-2D-702. Payroll Factor Denominator

~~Payroll factor: denominator.~~ The denominator of the payroll factor is the total compensation paid everywhere during the tax period ~~by the unitary business, which business is limited to that subject to the tax imposed by and computed pursuant to the Internal Revenue Code during the tax period, except as provided in A.R.S. § 43-1132. Therefore Accordingly,~~ compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation ~~not taxable~~ is included in the denominator of the payroll factor.

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

R15-2D-703. Payroll Factor Numerator

~~Payroll factor: numerator.~~ The numerator of the payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The tests in A.R.S. § 43-1144 to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act. Accordingly, if compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report such compensation under such method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation purposes constitute compensation paid in this state except for compensation excluded under this Article. The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes.

R15-2D-704. Compensation Paid in this State: Definitions

~~A.~~ For the purpose of determining whether compensation ~~Compensation~~ is paid in this state under A.R.S. § 43-1144, the following definitions apply if any 1 of the following tests applied consecutively, are met:

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

2. ~~The employee's service is performed both within and without the state, but the service performed without the state is incidental to the employee's service within the state.~~

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1. “Incidental” The word “incidental” means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.
 3. ~~If the employee’s services are performed both within and without this state, the employee’s compensation shall be attributed to this state:~~
 - a. ~~If the employee’s base of operations is in this state; or~~
 - b. ~~If there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or~~
 - e. ~~If the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee’s residence is in this state.~~
- ~~B. 2. The term “Place place from which the service is directed or controlled” means refers to the place from which the power to direct or control is exercised by the taxpayer.~~
- ~~C. 3. The term “Base base of operations” is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points.~~

R15-2D-705. Consistency in Reporting

A. ~~Consistency and uniformity in reporting:~~

1. ~~Year-to-year consistency:~~ In filing returns with this state, if the taxpayer departs from or modifies the treatment of compensation paid used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.
- ~~B.2. State-to-state uniformity:~~ If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the treatment of compensation paid, the taxpayer shall disclose ~~in its return to this state~~ the nature and extent of the variance upon request by the Department.

ARTICLE 8. SALES FACTOR

R15-2D-801. General

A. ~~The term “sales” shall mean all gross receipts of the taxpayer not allocated pursuant to R15-2-1134 through R15-2-1138. Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, the term “sales” means all gross receipts derived by the taxpayer from a transactions and activity in the regular course of such unitary trade or business, which business is limited to that business subject to the tax imposed by and computed pursuant to the Internal Revenue Code. The following are provisions rules for determining “sales” in various situations:~~

1. In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, “sales” includes all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) shall be included as part of such receipts if such taxes are passed on to the buyer or included as part of the selling price of the product.
 2. In the case of cost-plus-fixed-fee contracts, such as the operation of government-owned plant for a fee, “sales” includes the entire reimbursed cost plus the fee.
 3. In the case of a taxpayer engaged in providing services, such as the operation of an advertising agency, or the performance of equipment service contracts or research and development contracts, “sales” includes the gross receipts from the performance of such services including fees, commissions ~~commission~~, and similar items.
 4. In the case of a taxpayer engaged in renting real or tangible property, “sales” includes the gross receipts from the rental, lease, or licensing the use of the property.
 5. In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, “sales” includes the gross receipts therefrom.
 6. If a taxpayer derives receipts from the sale of equipment used in its business, such receipts constitute “sales.” For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor.
- B.7. In some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer’s trade or business. See R15-2D-903.

R15-2D-803. Sales Factor Numerator

~~Sales factor numerator.~~ 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 the place where the accounting records are maintained or the location of the contract or other evidence of indebtedness.

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R15-2D-804. Sales of Tangible Personal Property Delivered or Shipped to a Purchaser in this State

A. Sales of tangible personal property in this state:

1. ~~Gross receipts from sales of tangible personal property (except sales to the United States Government) are in this state:~~
 - a. ~~If the property is delivered or shipped to a purchaser within this state regardless of the f.o.b. point or other conditions of sale; or~~
 - b. ~~If the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the taxpayer is not taxable in the state of the purchaser.~~
2. Property shall be deemed to be delivered or shipped to a purchaser within this state if the recipient is located in this state, even though the property is ordered from outside this state.

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

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

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

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

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

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

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

6. ~~If the taxpayer is not taxable in the state of the purchaser, the sale is attributable to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.~~
7. ~~If a taxpayer whose salesman operates from an office located in this state makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a 3rd party to the purchaser, the following rules apply:~~
 - a. ~~If the taxpayer is taxable in the state from which the 3rd party ships the property, then the sale is in that state.~~
 - b. ~~If the taxpayer is not taxable in the state from which the 3rd party ships property, then the sale is in this state.~~

R15-2D-805. Sales of Tangible Personal Property to the United States Government

~~Sales factor:~~ Sales of tangible personal property to the United States Government are not included in the numerator of the sales factor in this state. ~~Gross receipts from sales of tangible personal property to the United States Government are in this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state.~~ For the purposes of this Section regulation, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example 1: A taxpayer contracts with General Services Administration to deliver X number of trucks that are paid for by the United States Government. The sale is a sale to the United States Government.

Example 2: The taxpayer, as a subcontractor to a prime contractor with the National Aeronautics and Space Administration, contracts to build a component of a rocket for \$1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government.

R15-2D-806. Sales Other Than Sales of Tangible Personal Property in This State

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

1. ~~Income-producing activity: Defined.~~ The term “income-producing activity” ~~applies shall apply~~ to each separate item of income and ~~means shall mean~~ the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity shall not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, “income-producing activity” shall include but is not limited to the following:
 - a. The rendering of personal services 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. The mere holding of intangible personal property is not, of itself, an income-producing activity.
2. ~~Costs of performance: Defined.~~ The term “costs of performance” means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.
3. ~~In general. Receipts (other than from sales of tangible personal property) in respect to a particular income-producing activity are in this state if:~~
 - a. ~~The income-producing activity is performed wholly both in this state; or~~
 - b. ~~The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.~~
4. ~~Specific rules.~~ The following are specific provisions ~~rules~~ for determining when receipts from the income-producing activities described below are in this state:
 - a. ~~Real property.~~ Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.
 - b. ~~Tangible personal property.~~ Gross receipts from the rental, lease or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income-producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during that ~~such~~ period.

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

$$\frac{[(10 \times 50) \div (10 \times 365)] \times \text{Total Receipts}}{= \text{Receipts Attributable to This state}}$$

- c. ~~Personal services.~~ Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts for the performance of such services shall be attributable to this state only if the ~~a~~ greater proportion of the services was performed in the state, based on costs of performance. Usually, where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income-producing activity; in such case the gross receipts for the performance of services attributable to this state shall be measured by the ratio which the time spent in performing the ~~such~~ services in this state bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

Example 1: Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

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Example 2: The taxpayer, a public opinion survey corporation, conducted a poll by means of its employees in State X and in this state for the sum of \$9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. The taxpayer expended 200 of the 600 man-hours in this state. The receipts attributable to this state are \$3,000 [(200 ÷ 600) x \$9000].

R15-2D-807. Consistency in Reporting

~~A.~~ Consistency and uniformity in reporting.

~~1. Year-to-year consistency.~~ In filing returns with this state, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the sales factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

~~B.2. State-to-state uniformity.~~ If the returns or reports filed by the taxpayer with all states to which the taxpayer reports under the Uniform Division of Income for Tax Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose ~~in its return to this state~~ the nature and extent of the variance upon request by the Department.

ARTICLE 9. DEPARTURE FROM STANDARD APPORTIONMENT AND ALLOCATION PROVISIONS

R15-2D-901. General

~~A.~~ In general, if the allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- ~~1. Separate accounting;~~
- ~~2. The exclusion of any 1 or more of the factors;~~
- ~~3. The inclusion of 1 or more additional factors which will fairly represent the taxpayer's business activity in this state;~~
~~or~~
- ~~4. The denominator of the apportionment ratio should correspond to the number of factors utilized to fairly represent the taxpayer's business activity in this state. For example, if only 2 factors are used, the denominator is 2.~~
- ~~5. The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.~~

~~B.~~ A.R.S. § 43-1148 ~~This Section~~ permits a departure from the allocation and apportionment provisions only in limited and specific cases. A.R.S. § 43-1148 ~~It~~ may be invoked only in specific cases where unusual fact situations produce incongruous results under the apportionment and allocation provisions contained in A.R.S. Title 43, Chapter 11, Article 4.

~~B.~~ If the departure from the allocation and apportionment provisions referred to in subsection (A) includes a change in the number of factors, the denominator of the apportionment ratio shall be adjusted to reflect the change.

Example 1: If two equally weighted factors are used, the denominator is two.

Example 2: If two factors are used and one of the factors is double weighted, the denominator is three.

R15-2D-902. Special Provisions for the Property Factor

~~Special rules: property factor.~~ The following special provisions ~~rules~~ are established in respect to the property factor of the apportionment formula:

1. If the subrents taken into account in determining the net annual rental rate under R15-2D-605 produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the Department or requested by the taxpayer.

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

Example: The taxpayer rents a 10-story building at an annual rental rate of \$1,000,000. Taxpayer occupies 2 stories and sublets 8 stories for \$1,000,000 a year. The net annual rental rate of the taxpayer shall not be less than 2/10ths of the taxpayer's annual rental rate for the entire year, or \$200,000.

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

R15-2D-903. Special Provisions for the Sales Factor

~~Special rules: sales factor.~~ The following special provisions ~~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, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

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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 the sale of office furniture, business automobiles, or other similar items etc.
3. Where 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 this 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 and income from the sale, licensing or other use of intangible personal property.
Where business income from intangible property cannot readily be 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 shall 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, ~~the such~~ dividends and interest shall be excluded from the denominator of the sales factor.
4. Items of income ~~that which~~ are not subject to taxation by A.R.S. Title 43 or judicial decision shall be excluded from the sales factor. Examples of such items include controlled corporation dividends, gross-up dividends, Subpart F dividends and interest from federal obligations.