ADOPTED 12/12/95 95-SBE-016

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 93A-0719
Fluor Corporation	)	
	)	

Representing the Parties:

For Appellant: Thomas H. Morrow
Vice President - Tax

For Respondent: Michael E. Brownell, Counsel

Counsel for Board of Equalization: Tommy Leung,
Staff Counsel

O P I N I O N

This appeal is made pursuant to section 19045 (formerly section 25666)[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Fluor Corporation against a proposed assessment of additional franchise tax in the amount of $274,978 for the income year ended October 31, 1985.

[1] Unless otherwise specified, all section references hereinafter are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The issues presented in this appeal are whether respondent's recomputation of appellant's sales factor, using the standard three-factor formula and including gross receipts from the sale of business assets located within and without California, is correct, and whether the party seeking to apply the section 25137 regulations must make a preliminary showing of distortion.

Appellant is a multinational corporation which does business within and without this state. It files a California franchise tax return on a world-wide combined reporting basis. During the appeal year, appellant and two of its subsidiaries made significant sales of some of their business assets. In November 1984, Fluor Oil & Gas sold oil and gas properties located throughout the world (but not in California) for $144,898,522; in July 1985, appellant sold its headquarters buildings located in Irvine, California, for $334,567,830; in October 1985 Daniel International Corporation sold a group of buildings constituting its operating center in South Carolina for $49,353,776. The gross proceeds from these sales totaled $528,820,128.

Appellant included the net income from these sales in its apportionable business income on its California franchise tax return and reported it on an installment basis, but did not include the gross proceeds in the computation of its sales factor. Consequently, respondent (also referred to as FTB herein) issued a notice of proposed assessment, including the $528,820,128 of gross proceeds in the denominator of appellant's sales factor and $334,567,830 (from the sale of appellant's Irvine buildings) in the numerator of the sales factor. Appellant protested, to no avail, and this appeal followed.

If a taxpayer has income from sources both within and without California, it is required to allocate and apportion its net income in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act ("UDITPA")[2] and its California franchise tax liability is measured solely by the net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) When a taxpayer conducts a single unitary business both within and without this state, its business income is divided between states by means of an apportionment formula to determine that portion which has its source in California. (Cal. Code Regs., tit. 18, §§ 25101 and 25121.) A taxpayer's business income is apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.) The numerators of the respective factors are comprised of the taxpayer's property, payroll, and sales in California; the denominators consist of the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, and 25134.)

However, when the application of the standard UDITPA apportionment formula outlined above results in distortion, and thereby fails to fairly reflect the extent of the taxpayer's business in this state, an

[2] Rev. & Tax. Code, §§ 25120-25139.

alternate method may be utilized. (See Rev. & Tax. Code, § 25137; UDITPA § 18, [1 All St.] St. Tax Guide 2d (CCH) ¶ 10-000.) But section 25137 cannot be invoked unless the party seeking to use it proves that application of the general provisions of UDITPA would lead to an unfair representation of the extent of the taxpayer's activities in this state. (See *Appeal of Dart Container Corp. of California*, 92-SBE-021, July 30, 1992; *Appeal of Merrill, Lynch, Pierce, Fenner and Smith, Inc.*, 89-SBE-017, June 2, 1989.) A rough approximation under the general UDITPA standards is all that is required. (See *Appeal of Merrill, Lynch, Pierce, Fenner and Smith, Inc.*, supra.)

Appellant agrees that section 25134 states the standard formula for calculating the sales factor.[3] However, it contends that such a formula does not fairly represent the extent of the taxpayer's business activities in California and, thus, an alternative method must be used. (See Rev. & Tax. Code, § 25137.) Appellant points out that the regulations promulgated under section 25137 provide that alternative methods may be used "where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results . . . ." (See Cal. Code Regs., tit. 18, § 25137.) Specifically, appellant refers to subdivision (c) of regulation section 25137, which states:

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.

Appellant claims its method of reporting the asset sales was in conformity with this regulation. (See generally FTB LR 413, Jan. 15, 1979.)

Respondent does not dispute appellant's claim that it has satisfied the conditions and circumstances set forth in the above-quoted regulation. However, the respondent does argue that the term "sales" generally includes all gross receipts from transactions or activities in the regular course of the taxpayer's trade or business. (See Rev. & Tax. Code, §§ 25120, subd. (e), 25134, and Cal. Code Regs., tit. 18, § 25134, subd. (a)(1).) Thus, the FTB avers that unless appellant can point to a specific statutory provision excluding the sales at issue, the standard method of calculating the sales factor must be used. Furthermore, respondent contends the alternatives provided by section 25137, and the regulations promulgated thereunder, are not available unless appellant can establish the existence of exceptional circumstances (i.e., the general statutory formula does not fairly reflect the extent of the taxpayer's business activities in California). (See *Appeal of Triangle Publications, Inc.*, Cal. St. Bd. of Equal., June 27, 1984; *Appeal of Donald M. Drake Company*, Cal. St. Bd. of Equal., Feb. 3,

[3] "The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year." (Rev. & Tax. Code, § 25134.) " 'Sales' means all gross receipts of the taxpayer not allocated under [s]ections 25123 through 25127 . . . ." (Rev. & Tax. Code, § 25120, subd. (e).)

1977; *Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., Feb. 3, 1977.) Moreover, respondent continues, the party wishing to deviate from the general statutory formula bears the burden of proving that exceptional circumstances exist. (See *Appeal of Triangle Publications, Inc.*, supra.)

Appellant rejects this argument - - it feels exceptional circumstances are already prescribed in regulation section 25137 and once a taxpayer qualifies thereunder, no further proof is required. (See *Appeal of The Proctor & Gamble Manufacturing Company, et al.*, 89-SBE-028, Sept. 26, 1989; *Appeal of Union Carbide Corporation*, Cal. St. Bd. of Equal., April 5, 1984.) In addition, appellant claims respondent, by refusing to apply subdivision (c) of regulation section 25137, is ignoring its own rules and regulations, which are binding upon both the government and the taxpayer. (See *Appeal of Union Carbide Corporation*, supra; *Pacific National Bank v. Commissioner*, 91 F.2d 103 (9th Cir. 1937).) Respondent has expressed concern throughout the course of this appeal that, read together, this board's opinions in *Triangle Publications* and *Union Carbide* would "whipsaw" the state - - i.e., if respondent wished to impose the alternate methods of apportionment prescribed in the section 25137 regulations, it would always have to make a preliminary showing of distortion, even where a specific regulation existed that was directly applicable to the situation (see *Appeal of Triangle Publications*, supra), whereas if the taxpayer wished to apply the alternate methods provided in the section 25137 regulations, it would merely have to satisfy the requirements of the relevant regulation section (see *Appeal of Union Carbide*, supra).

In an area where uniformity and harmony are sought,[4] fragmentation and discord appear to be the norm. Our examination of the issues involved in this appeal reveal an obvious tension between the standard UDITPA apportionment formula, section 25137, and the special apportionment methods contained in the regulations promulgated under section 25137. On the one hand, section 25137, and the cases interpreting it, establish that the standard UDITPA formula is *the* method to use in apportioning business income unless application thereof results in distortion; on the other hand, the section 25137 regulations apparently permit the use of special methods or formulas with distortion assumed to exist if the standard formula were used in the situations covered by the regulations. Decisions rendered by some other states, which have adopted UDITPA either in part or in whole, as well as opinions issued by this board in the past,[5] have only served to muddy the waters. We hope to resolve the problem with this opinion.

In Montana, the party seeking to depart from the standard apportionment formula apparently has a lower burden of proof than the one prescribed in *Hans Rees' Sons, Inc. v. North Carolina*, 283

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[4] "[UDITPA] shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it." (Rev. & Tax. Code, § 25138; UDITPA § 19, [1 All St.] St. Tax Guide 2d (CCH) ¶ 10-000.)

[5] See e.g., *Appeal of Triangle Publications, Inc.*, supra, *Appeal of Union Carbide Corp.*, supra, and *Appeal of Danny Thomas Productions*, Cal. St. Bd. of Equal., Feb. 3, 1977, all discussed infra.

U.S. 123 [75 L.Ed. 879] (1931). [6] The state of Utah narrowly construes the relief provisions of section 18 of UDITPA, ruling that the party seeking to deviate from the standard formula must prove distortion due to the application of that standard formula.[7] Oregon takes a two-step approach - - not only must

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[6] The *Hans Rees'* Court found that a 250 percent difference between the apportionment ratios used by the state and the taxpayer was sufficient to show distortion.

In constrast, in *Montana Dep't of Revenue v. United Parcel Service, Inc*., 252 Mont. 476 [830 P.2d 1259] (1992), the Department of Revenue (DOR) used the "mileage method" to apportion UPS's sales and said UPS could invoke the relief provision only if it could show distortion. The mileage method was a special rule promulgated by the DOR for freight and passenger carriers. The Montana Supreme Court held that UPS did not need to show that the mileage method "distorted" its income before invoking the relief provision; however, the court did require UPS to make some showing that the method did not fairly represent UPS's business activities in the state. UPS was able to show that the mileage method did not fairly represent its business activities in the state; UPS put forth evidence, but not percentage calculations, to prove that the mileage method did not equitably represent its business activity within the state.

In *American Telephone & Telegraph Co. v. State Tax Appeal Board*, 241 Mont. 440 [787 P.2d 754] (1990), AT&T and two of its affiliates filed separate returns, but were engaged in a unitary business. The taxpayers were requested, and agreed, to file combined corporate license tax returns for the years involved, but excluded gross receipts from the sale of intangible assets (temporary cash investments such as commercial paper, U.S. Treasury instruments, or other readily liquidated investments) from the sales factor; however, the state wanted to include the gain from such sales in the sales factor. The Montana Supreme Court held that although the UDITPA rules would include gross receipts from the sale of intangible assets in the sales factor, the state had authority under Montana's equivalent of section 18 of UDITPA to include only gains from such sales. The court looked at our opinion in *Appeals of Pacific Telephone and Telegraph Co*., Cal. St. Bd. of Equal., May 4, 1978, where we found that inclusion of the gross receipts under UDITPA's normal provisions would not fairly represent the taxpayer's business activities in California, and that section 25137 authorized the FTB to require a departure from the normal rules. However, Montana did not have a regulation for this method of excluding the gross receipts at the time, just a general rule of practice. In reaching its conclusion, the court relied on testimony from two state representatives who stated that it was a universally accepted practice among tax administrators in UDITPA states to not include gross receipts from sales of temporary cash investments in the sales factor; otherwise, substantial distortion would occur. Apparently, the state was able to meet its burden of proof without showing the actual amount of distortion - all that was needed was a showing that to follow the standard formula under similar circumstances would lead to distortion.

[7] In *Deseret Pharmaceutical Co., Inc. v. State Tax Commission*, 579 P.2d 1322 (Utah 1978), the State Tax Commission (STC) deviated from the standard UDITPA formula, saying it was distortive, and based its assessment on all of the taxpayer's income other than those amounts attributable to Texas and Washington. The taxpayer's activities in other states were merely solicitation and not subject to a net income tax as provided under Public Law 86-272, 15 U.S.C. § 381 (the Washington tax was a franchise tax and the Texas tax was a stock tax). Using the standard formula, the taxpayer was able to apportion approximately 40 percent of its income outside of Utah. The Utah Supreme Court held that the relief provisions of UDITPA should be interpreted narrowly and the party seeking to invoke them must prove that an unreasonable result would occur. The court found that the STC sustained its burden of proof and upheld its use of an alternate method.

the party seeking to depart from the standard UDITPA formula prove distortion, it must also show that the alternate method selected is reasonable.[8]

Wisconsin treats the special or alternate methods adopted by its taxing agency as rules of general application, and the taxpayer must show distortion thereunder in order to deviate therefrom.[9]

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[8] In *Twentieth Century-Fox Film Corp. v. Dep't of Revenue*, 299 Ore. 220 [700 P.2d 1035] (1985), the taxpayer filed Oregon corporate excise tax returns using the standard UDITPA three-factor formula. The taxpayer included positive prints of films, which were the only tangible personal property that entered Oregon, in the numerator of the property factor. The DOR adjusted the property factor and included film negatives, which were stored in California, in the numerator of the property factor. The Oregon Tax Court held the DOR could not rely on its own regulation (which was based on California guidelines for the movie industry) to deviate from the standard formula. The Oregon Supreme Court ruled that the DOR's regulations did not create a *per se* exemption from the standard formula for the named industries; the regulations do not prevent a taxpayer from using the standard formula, but they do indicate to the taxpayer that use of the standard formula may not fairly represent the extent of its activities in the state (distortive). The court found that while promulgating administrative rules promotes uniformity, as opposed to an ad hoc application of the relief provisions on a case-by-case basis, the party seeking to depart from the standard formula must prove that the standard formula is distortive and that the proposed alternative method is reasonable. (In this case, the DOR was able to prove distortion and that its alternate method was reasonable.)

In *Crocker Equipment Leasing, Inc. v. Dep't of Revenue*, 314 Ore. 122 [838 P.2d 552] (1992), the taxpayer agreed to file a combined corporate excise tax return with its parent and affiliates. The DOR excluded intangible property from the denominator of the property factor, leading to a higher Oregon apportionment percentage. Oregon law excluded financial organizations from the standard UDITPA formula, and authorized the DOR to promulgate appropriate regulations applicable to these entities. These DOR regulations, which also use a three-factor formula, incorporated the UDITPA method of computing the three factors (which excludes intangibles from the property factor). The taxpayer sought to deviate from the formula contained in this special regulation since tangible personal property only represented approximately three percent of all of its property. The Oregon Supreme Court held that the taxpayer has the burden of proving by a preponderance of the evidence that the general apportionment formula does not fairly represent the extent of its activities in the state (citing Oregon law and *Twentieth Century*). In finding that the taxpayer had met its burden of proof, the court accepted testimony from an expert who stated that to exclude intangibles from the property factor would result in gross distortion.

[9] In *Consolidated Freightways Corp. v. Dep't of Revenue*, 164 Wis.2d 764 [477 N.W.2d 44] (1991), the DOR used a formula contained in its regulations to determine the amount of income the taxpayer earned in Wisconsin. The formula was a two-factor formula used to assess the state's franchise tax on motor carriers. The taxpayer wanted to use a different formula. The Wisconsin Supreme Court held that the state has wide discretion in selecting an apportionment formula and that a formula-produced assessment should only be disturbed when the taxpayer can prove by clear and cogent evidence that the resulting apportionment of income to the state is grossly distorted (citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 [57 L.Ed.2d 197] (1978)).

In *United Parcel Service Co. v. Dep't of Revenue*, [2 Wis.] St. Tax Rptr. (CCH) ¶ 400-074 (Wis. Tax Appeals Comm., Aug. 30 1994), UPS did not use Wisconsin's special rule for apportioning income of interstate air carriers. Instead of using the relative number of arriving and departing aircraft in computing its apportionment ratio as provided in the special rule, UPS used the actual weight of each aircraft departure and arrival. The Wisconsin Tax Appeals Commission held, citing *Consolidated Freightways*, that UPS may not deviate from the special rule because it failed to show by clear and cogent evidence that the special rule caused distortion.

Even the forays made by this board into this murky area have resulted in opinions that have been, at best, difficult to reconcile.[10]

Our analysis of this problem leads us to the conclusion that none of the above-mentioned approaches provides a completely satisfactory solution. In *Moorman*, the United States Supreme Court held that

> [s]tates have wide latitude in the selection of apportionment formulas and . . . a formula-produced assessment will only be disturbed when the taxpayer has proved by "clear and cogent evidence" that the income attributed to the state is in fact "out of all appropriate proportions to the business transacted . . . in that State," or has "led to a grossly distorted result."

Moorman Mfg. Co., supra, 437 U.S. at 274. Consistent with the "wide latitude" accorded to selecting apportionment formulas, we believe that the following conclusions provide a workable and appropriate method for dealing with special formulas.

Clearly, in situations where there is no special formula or method provided in the regulations, the standard UDITPA formula must be applied unless the party seeking to depart from it can prove distortion. (See *Butler Brothers v. McColgan*, 315 U.S. 501, 507 [86 L. Ed. 991] (1942); *McDonnell Douglas Corp. v. Franchise Tax Board*, 69 Cal.2d 506 [446 P.2d 313] (1968).) However, if a relevant special formula is specifically provided for in the section 25137 regulations and the conditions and circumstances delineated in such regulations are satisfied, the method of apportionment prescribed in those regulations shall be the standard by which the parties are to compute the taxpayer's apportionment formula. In other words, once found to be applicable to the particular situation, the section 25137 regulations will control. On the other hand, we also recognize that regardless of how much expertise the FTB may have in a particular industry, regardless of how much time and effort has been expended in developing a regulation, and regardless of the degree of cooperation with industry representatives in that process, it will be inevitable that some situation will arise where use of a special formula under the section 25137 regulations will not be appropriate and a

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[10] For example, in *Union Carbide*, we determined that since the taxpayer satisfied the requisite conditions contained in the FTB's regulations concerning the treatment of non-owned property in the property factor, the taxpayer was entitled to rely on such a regulation and was not required to show distortion under the standard formula as a predicate to using it. In *Triangle Publications*, we concluded that since the FTB failed to show distortion as required by section 25137, it could not use the regulation pertinent in this appeal to compute the taxpayer's sales factor. Furthermore, in *Appeal of Danny Thomas Productions*, Cal. St. Bd. of Equal., Feb. 3, 1977, where the FTB attempted to utilize a special formula applicable to the movie industry and the taxpayer attempted to deviate therefrom, we found that since neither party had established distortion under the standard formula, the standard method would be applicable.

party may wish to object to the use of the special formula. (See e.g., *Appeal of Danny Thomas Productions*, Cal. St. Bd. of Equal., Feb. 3, 1977.)[11] Therefore, we also hold that *any* party wishing to deviate from the method prescribed by the regulation, when found to be applicable, must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state. (See *Moorman Mfg. Co., supra; Butler Brothers v. McColgan*, supra; *McDonnell Douglas Corp. v. Franchise Tax Board*, supra.) This is the analysis we will now use in cases of this nature and, to the extent that opinions such as *Triangle Publications* and *Union Carbide* conflict with the views expressed hereinabove, they will not be followed.[12]

In the instant appeal, we find that appellant has established the existence of the elements required for the application of the special sales factor computation contained in subdivision (c) of regulation section 25137 and that respondent has failed to prove that the application thereof would be distortive. Accordingly, respondent's action in this matter must be reversed.

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[11] In *Appeal of Danny Thomas Productions*, supra, the FTB attempted to apply a special formula, which had existed prior to the enactment of UDITPA in California, to apportion income of independent motion picture producers, but the sales factor in the special formula was the same as the sales factor in the standard formula. (The FTB continued to use this special formula, as well as formulas devised for other specified industries, after the adoption of UDITPA). However, instead of using the industry formula, the taxpayer apportioned its gross receipts according to the location of the viewing audience (a method which the FTB later adopted, but refused to apply retroactively). We found that because neither party established distortion, the standard UDITPA formula had to be utilized; if, after application of the standard formula, distortion was shown, then the FTB could use the pre-UDITPA special industry formula. (UDITPA became operative in California in 1967; the *Danny Thomas* appeal involved the income years ended June 30, 1969, and June 30, 1970.)

[12] We believe that this ruling should resolve respondent's "whipsaw" concerns that we delineated earlier in this opinion.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Fluor Corporation against a proposed assessment of additional franchise tax in the amount of $274,978 for the income year ended October 31, 1985, be and the same is hereby reversed.

Done at Sacramento, California, this 12th day of December, 1995, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Dronenburg, Mr. Sherman, and Mr. Halverson present.

Johan Klehs, , Chairman

Dean F. Andal , Member

Ernest J. Dronenburg, Jr. , Member

Brad Sherman , Member

Rex Halverson* , Member

*For Kathleen Connell, Per Government Code section 7.9.