83-SBE-249

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ROBERT E. McKEE, INC.)

For Appellants: Thomas A. Lance
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert E. McKee, Inc., against proposed assessments of additional franchise tax in the amounts of $57,026.16, $24,988.83, $22,682.65, and $6,792.80 for the income years ended October 31, 1969, October 31, 1971, October 31, 1972, and January 31, 1973, respectively.

The issues for determination in this case are:' (1) whether appellant and its divisions were engaged in a unitary business for state income tax purposes, so that formula apportionment was properly used to determine appellant's California franchise tax liability; and (2) whether respondent properly applied its guideline for use of the special apportionment formula for construction contracts reported'by the completed-contract method of accounting.

Appellant is a general construction contracting corporation, incorporated in Nevada and headquartered in El Paso, Texas. During the appeal years, it maintained operating divisions in Georgia, Texas, and California. Throughout the years at issue, appellant was engaged in numerous construction projects in California and other states.

On its California franchise tax returns for the years at issue, appellant used separate accounting, reporting as California income only that income reported separately by the California divisions. In addition, appellant used the completed-contract method of accounting to report its income for tax purposes. This method requires the corporation to record receipts from and expenses of long-term contracts in the year they are received or accrued, but the receipts and expenses are not included in determining income for tax purposes until the year that the contract to which they relate is completed. (See Appeal of Donald M. Drake Company, Cal. St. Bd. of Equal., Feb. 3, 1977, and citations listed therein.)

Respondent determined that appellant was operating a single unitary business within and without California and recomputed appellant's California source income by means of a special apportionment formula for contractors using the completed-contract method of accounting. The taxpayer protested the resulting assessment, contending that it was not a unitary business and raising objections to respondent's use of the special formula. Respondent's affirmation of its assessment gave rise to this appeal.

When a taxpayer derives income from sources both within and without California, its state franchise tax liability is measured by its net income derived from or attributable'to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business, the income attributable to California sources must be determined by applying an apportionment. formula to the total income derived'from its combined unitary operations. (Butler Brothers v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) Only if the business within California is truly separate from the business outside the state, so that the segregation of income may be made clearly and accurately, may the separate accounting method-properly be used. (Butler Brothers v. McColgan, supra, 17 Cal.2d at 667-668.)

The California Supreme Court has determined that a business is unitary when there are: (i) unity of ownership; (ii) unity of operation as evidenced by central purchasing, advertising, accounting., and management divisions; and (iii) unity of use in a centralized executive force and general system of operation. (Butler Brothers v. McColgan, supra, 17 Cal.2d at 678.) The court has also held that a unitary business exists when the operation of the business within California depends upon or contributes to the operation of the business outside the state. (Edison California Stores, Inc. v. McColgan, 30, Cal.2d 472, 481 [183 P.2d 161 (1947).) The-existence of a unitary business may be established if either the three unities test or the contribution or dependency test is satisfied. (Appeal of Revere Copper and Brass, Inc., Cal. St. Bd. of Equal., July 26, 1977; Appeal of Browning Manufacturing Co., et al., Cal. St. Bd. of Equal., Sept. 14, 1972; Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Respondent's determination that appellant is engaged in a unitary business is presumptively correct, and the burden to show that such determination is erroneous is upon appellant. (Appeal of Cox Hobbies, Inc., Cal. St. Bd. of Equal., Nov. 18, 1980; Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.)

Appellant and its divisions were connected by a common and controlling ownership, an integrated executive force, the exercise of central managerial control, inter-company financing, and centralized accounting, insurance, computer, and data processing services. In numerous prior cases these unitary features have been found, in the aggregate, to satisfy the three unities test and to demonstrate a degree of mutual dependency or contribution sufficient to establish the existence of a unitary business. Wee, e.g., Chase Brass and Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970); Superior Oil-Co. v. Franchise Tax Board, 60 Cal.2d

406 [386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 [386 P.2d 40] (1963); Appeal of Credit Bureau Central, Inc., Cal. St. Bd. of Equal., Feb. 2, 1981; Appeal of Arkla Industries, Inc., Cal. St. Bd. of Equal., Aug. 16, 1977; Appeal of Automated Building Components, Inc., Cal. St. Bd. of Equal., June 22, 1976; Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975.) Although appellant contends that it was nof engaged in a unitary business, it has presented no factual evidence to support its position. Such unsupported assertions are insufficient to overcome the presumptive correctness of respondent's determination. (Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of Cox Hobbies Inc., supra.)

In support of appellant's contention that its operation was not unitary, it cites Appeal of Lear Siegler, Inc., decided April 24, 1967, and Appeal of Carl M. Halvorson, Inc. decided March 20, 1963, in which this board held that the taxpayer's businesses were not unitary. We based our opinion in each case primarily upon whether the taxpayer had presented information to refute a reasonable finding by respondent as to the unitary nature of the business. In the instant case, appellant has presented no such evidence at all. We must, therefore, conclude that respondent's determination of unity was correct.

Taxpayers engaged in a unitary business must allocate and apportion their net income in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), contained in sections 25120 through 25139 of the Revenue and Taxation Code. (Rev. & Tax. Code, § 25101.) UDITPA, in general, requires a taxpayer's business income to be apportioned to this state by multiplying the income by a fraction, the numerator of which is the sum of the property factor, the payroll factor, and the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.) The numerators of the respective factors are the taxpayer's property, payroll, and sales in California; the denominators are property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, 25134.) Nonbusiness income is specifically allocated to particular states, generally on the basis of situs or commercial domicile. (Rev. & Tax. Code, §§ 25123-25127.)

The allocation and apportionment provisions of UDITPA may, however, occasionally produce inequitable results when applied to unusual factual situations. In such cases, discretionary adjustments to UDITPA's standard procedures may be made as provided in Revenue and Taxation Code section 25137, which states:

> If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (a) Separate accounting;
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> (b) The exclusion of any one or more of the factors;
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> (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
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> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

This general relief provision authorizes exceptional allocation and apportionment methods only in circumstances where UDITPA's basic provisions "do not fairly represent the extent of the taxpayer's business, activity in this state." (See Kennecott Copper Corp. et al. v. State Tax Commission, 27 Utah 2d 119 [493 P.2d 632], app. dism., 409 U.S. 973 [34 L.Ed.2d 237] (1972); Appeal of The O.K. Earl Corp., Cal. St. Bd. of Equal., April 6, 1977.) Furthermore, the party requesting the application of section 25137 bears the burden of establishing that such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

In January 1968, respondent applied subdivision (d) of section 25137 and promulgated a special formula to apportion the long-term contract income of construction contractors operating unitary businesses who use the completed-contract method of accounting. This formula was issued in Guideline Letter Number 1064 ([1966-1971 Transfer Binder] Cal. St. Tax Rep. (CCH) ¶ 203-801) and applied to taxable years commencing after December 31, 1966. It was incorporated into respondent's regulation 25137, subdivision (f)(1), when that regulation was enacted in November 1974.

The guideline provides that yearly payroll, property, and sales of each long-term project are to be included in the taxpayer's apportionment factors each year the project is in progress. However, income from a long-term project is neither recognized nor apportioned until the year the project is finished. In that year, the taxpayer's business income derived from "other sources"--that is, not from the long-term construction contracts--is apportioned by the normal three-factor formula. The business income from each long-term project completed in that year is computed separately and apportioned to this state by a special formula. First, for each year the project was in progress, a fraction is computed, the denominator of which is the total direct construction costs incurred over the life of the project, and the numerator of which is the direct construction costs incurred in that year. That fraction is multiplied by the normal apportionment percentage previously determined for that year, and the resulting products for all the years that the project was in progress are then totaled. This sum is multiplied by the total income or loss from the project as determined in the year of completion. The product is the amount of income from the contract that is apportioned to this state. The procedure is repeated for each long-term contract completed in that year. (See Cal. Admin. Code, tit. 18, reg. 25137, subds. (f)(l), (D)(iii), (f)(l)(E).)

We sustained the use of this special apportionment formula in the Appeal of Donald M. Drake Company, supra. We found that the requirements of section 25137 were met because the normal apportionment formula did not fairly reflect the extent of business activity in this state of a construction contractor that reported its long-term contract income on the completed-contract method of accounting. Once these exceptional circumstances are found, respondent may use any reasonable method'to equitably apportion income. (Rev. & Tax. Code, § 25137; Appeal of Milwaukee Professional Sports and Services, Inc., Cal. St. Bd. of Equal., June 28, 1979.)

Appellant does not directly object to the use of the special formula, but argues that respondent improperly applied its own guidelines in apportioning appellant's income. It contends that respondent improperly used gross income rather than net income when apportioning the income from long-term construction contracts. This occurred, appellant asserts, because respondent deducted only costs directly attributable to the contracts from the long-term contract income, while general overhead expenses were deducted only from its other business income. Appellant argues that respondent should have apportioned general overhead expenses in proportion to the long-term projects' gross income for each year.

Contrary to appellant's assertion, the guidelines do not require overhead expenses to be allocated in part to the income from construction contracts. Page two-of the guideline letter states, in part:

> Long-term contract methods of accounting apply only to the accounting for income and expenses attributable to long-term contracts. Other income and expense items, for example, from other businesses, and nonbusiness income, not attributable to such contracts must be accounted for separately.
>
> Construction costs may include an equitable portion of indirect expense or overhead. If not apportioned or allocated as construction costs indirect expense or overhead is deductible in determining business income in the year paid or accrued. A taxpayer may not change its method of accounting for indirect expense or overhead without prior approval of the Franchise Tax Board.
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> In the case of a taxpayer using the completed-contract method, business income [from sources other than the long-term contracts] is adjusted to exclude all receipts and construction costs attributable to such contracts whether completed or not completed during the income year.

The first and third paragraphs in the above quotation indicate that overhead expenses are generally not deductible from long-term contract income, while the middle paragraph explains that an equitable percentage of overhead expenses may be included in such income only if the taxpayer had included them in construction costs.

The business records and state tax returns that appellant submitted listed, for each year in question, each long-term project's receipts and direct expenses, and separately, appellant's general and administrative expenses. This apparently conformed to appellant's consistent practice of deducting expenses not incidental and necessary to the performance of long-term contracts as a current-period cost. Appellant's loss of some tax benefit from its overhead expenses is due, therefore, not to any misapplication of the guidelines by respondent, but to appellant's choice of not including an equitable portion of its overhead in construction costs. Appellant has not shown that any of its general overhead or administrative expenses were clearly related to any specific contract, so it would be impossible, in any case, to determine what "equitable portion" should be attributed, to any contract.

Appellant also contends that respondent's calculation of the special apportionment formula distorts its actual profit or loss picture, as finally determined in the year of completion, for its long-term contracts. It also asserts that respondent's calculations result in attributing to the California contracts more than 100 percent of the profit which appellant ultimately determined to be realized from them.

Appellant states that the distortion which it alleges is demonstrated by a $518,102 difference in the income attributable to California for contracts in progress in 1967 when a different method of calculation is used. It proposes, therefore, that its method is a better one to use.

Appellant contends that annual California source income should not be computed.separately for each contract. Instead, appellant proposes that all contracts in progress in a given year be treated as if they were a single contract. Under appellant's method, one would find the sum of direct construction costs incurred in 1967 for all California contracts that were completed in '1969, then divide this amount by the sum of total construction costs for these contracts as determined upon completion, and, finally, multiply this ratio by the total job profits from all of these contracts. This results in a "California source income" figure for 1967 which, appellant argues, "averages yearly profits and losses," and which is a much smaller amount than the 1967 long-term contract income attributed to California by respondent. While we agree with appellant that its method does result in less income being attributed to California for contracts in progress in 1967, we do not find that this impeaches respondent's method in any way.

Revenue and Taxation Code section 25137 requires that any special apportionment method authorized by that section must be reasonable. In the recently decided case of Container Corp. of America v. Franchise Tax Board, the United States Supreme Court reiterated that the burden rests on the taxpayer to show that an apportionment formula is unfair, and to do so, the taxpayer must prove "that the income apportioned to California under the statute is 'out of all appropriate proportions to the business transacted in that State,' [citation]." (Container Corp. of America v. Franchise Tax Board, -- U.S. -- [77 L.Ed.2d 545] (1983).)

Respondent has shown that there is a difference between the results obtained under its method of computation and respondent's, but we fail to see any distortion. The "distortion" of which appellant complains was attributable not to respondent's method of computing its special formula, but largely to the use of separate accounting to determine California income for appellant's fiscal year ended October 31, 1967. Respondent's guideline applied only to income years beginning after December 31, 1966. Since appellant's income year began before that date, separate accounting was used to determine its California income for that income year. This means that 100 percent of the 1967 income from projects located in California was included as California income, but the income from projects located outside California was totally excluded. In any case, appellant's focus on its 1967 income year is inappropriate, since no income was taxed until the contracts were completed in 1969, and appellant has not shown any distortion in the amount of income utlimately taxed in that year after the years 1968 and 1969 were also taken into account.

Appellant has not shown that respondent's method is in any way unreasonable or unfairly represents the extent of appellant's business activity in this state. It also has failed to show that, in 1969, more than 100 percent of the ultimate profit from any contract completed in that year was attributed to California.

For the reasons stated above, we must sustain respondent's action.

Appeal of Robert E. McKee,, Inc.

ORDER

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert E. McKee, Inc., against proposed assessments of additional franchise tax in the amounts of $57,026.16, $24,988.83, $22,682.65, and $6,792.80 for the income years ended October 31, 1969, October 31, 1971, October 31, 1972, and January 31, 1973, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 13th day of December, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr. Member

Richard Nevins, Member

_______________, Member