BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JOHN H. GRACE COMPANY)

For Appellant: Vernon T. Squires and
Michael F. Csar
Attorneys at Law

For Respondent: Bruce W. Walker
Chief Counsel

Kathleen M. Morris
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 John H. Grace Company against a proposed assessment of corporation income tax and penalty in the total amount of $562.50 for the income year 1974.

Appellant is an Illinois corporation having its principal place of business in that state. Appellant's business consists of leasing railroad cars to industrial companies who then arrange for railroad companies to transport their products in these cars in interstate commerce. The lessee companies pay appellant a flat monthly rental charge. Appellant conducts no business in California, has no agents in California, does not solicit leasing customers in California, and does not have any leasing customers in this state. The arrangements between appellant's lessees and the various railroads which haul 'the lessees' products are of no concern to appellant. Appellant does' not charge its lessees a rent based upon the mileage traveled by the leased cars. The only contact appellant has with'this state is that some of the railroad cars it leases to interstate shippers happen to pass into or through California in interstate commerce pursuant to arrangements between the interstate shippers and the various railroads.

During 1974 appellant was subject to the private car tax. (Rev, & Tax. Code, §§ 11201-11702.) The private car tax, which is in lieu of all other state, county, municipal or district ad valorem taxes upon private cars, is collected by the state and deposited in the general fund.. (Rev. & Tax. Code, §§ 11252 & 11701.)1/ During the appeal year the average number of appellant's railroad cars per day in California was 9.07. Based upon this average daily presence, the assessed tax was $621.

1/ Appellant suggests that since it pays a state property tax on its cars, it is inappropriate for it to be subjected to a second state tax on the income produced by the same cars. We understand appellant's argument to raise the issue of unconstitutional double taxation. For reasons set forth in this opinion, we cannot reach this troublesome question. (But see Weber v. County of Santa Barbara, 15 Cal. 2d 82, 87 [98 P.2d 49? (1940)] where it was held that the simultaneous'imposition of the local property tax on property and of the state personal income tax measured by the income from such property does no violence to the constitutional inhibition against double taxation.; see also Burhans v. County of Kern, 170 Cal. App. 2d 218, 227 [338 P.2d 546] (1959).)

Upon learning that appellant had cars in the state during 1974, respondent advised appellant that it was subject to the corporate income tax since it owned railroad cars that produced income in this state, and requested that appellant file a return. Appellant refused, contending that California lacked sufficient nexus to establish jurisdiction for asserting a corporate income tax. Thereafter, respondent estimated appellant's net income attributable to California to be $5,000 and issued the proposed assessment of corporate income tax and penalty in issue. It is from this action that appellant appeals.

The sole issue for determination is whether appellant is subject to the California corporation income tax.

Section 23501 of the Revenue and Taxation Code provides, in pertinent part:

> There shall be imposed upon every corporation for each taxable year, a tax ... upon its net income derived from sources within this state. . . ..

The phrase "income derived from sources within this state" is defined by section 23040 of the Revenue and Taxation Code which states:

> Income derived from or attributable to sources within this State includes income from tangible or intangible property located or having a situs in this State and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate or foreign commerce.

Appellant first argues that sections 23501 and 23040, by their own terms, do not apply to the factual situation presented by this appeal. If it is determined that the statutes apply, appellant argues that such application would violate both the due process and commerce clauses of the federal constitution.

The adoption of Proposition 5 by the voters on June 6, 1978, adding section 3.5 to article III of the

California Constitution.?? precludes our determining that the statutory provisions involved are unconstitutional or unenforceable. Furthermore, this board has a well established policy of abstention from deciding constitutional questions in an appeal involving proposed assessments of tax. (See, e.g., Appeal of Maryland Cup Corp., Cal. St. Bd. of Equal., March 23, 1970.) This policy is based upon the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of an adverse decision in a case of this type, and our belief that such review should be available for questions of constitutional importance.

However, the fact that we cannot decide the constitutional issue does not mean that we can ignore existing constitutional limitations when interpreting the applicable statutes. Since the Legislature intended the taxing statutes to reach only to the limits permitted by the Constitution, our application of the statutes to the facts presented is restricted by existing constitutional limitations. (See Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L. Ed. 991] (1942); Luckenbach Steamship Co. v. Franchise Tax Board, 219 Cal. App. 2d

2/ Section 3.5 of article III provides:

> **An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power:**
>
> **(a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that** such **statute is unconstitutional;**
>
> (b) **To** declare a statute unconstitutional:
>
> (c) **To declare a statute unenforceable, or to refuse to enforce a** statute on **the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of** such statute is prohibited by federal law or federal regulations.

710 [33 Cal. Rptr. 544] (1963); see also Matson Navigation Co. v. State Board of Equalization, 3 Cal. 2d 1 [43 P.2d 805] (1935).)

It is respondent's position that appellant's railroad cars, which are used to ship merchandise into and through California, are employed in this state to produce income. Respondent argues that although appellant is not directly engaged in transporting goods, obtaining, instead, a profit from leasing the cars, such income is derived from the use of appellant's property which is "located" in California within the meaning of section 23040. Respondent then concludes that appellant's cars acquired an in-state situs, and its income from the leases of its cars is "derived from sources within this state" under section 23501. In reaching this conclusion, respondent relies upon the economic presence theory posited by the court in American Refrigerator Transit Co. v. State Tax Commission, 238 Ore. 340 [395 P.2d 127] (1964). (See also, Oklahoma Tax Commission v. American Refrigerator Transit Co., 349 P.2d 746 (Okla. 1959); and Commissioner of Revenue v. Pacific Fruit Express Co., 227 Ark. 8 [296 S.W.2d 676] (1956).)

Appellant counters with the argument that the taxing statute does not apply to it because none of its income is from a California source. It is appellant's position that none of its business activities, which consist of leasing railroad cars, occur in California. Appellant also maintains that the presence of its railroad cars in California, which are under the control of its lessees' bailees, is too attenuated to satisfy the statutory nexus requirement. The authorities cited in support of appellant's position are Kentucky Tax Commissioner v. American Refrigerator Transit Co., 294 S.W. 2d 554 (Ky. 1956) and Redwine v. American Refrigerator Transit Co., 91 Ga.App. 522 [86 S.E.2d 336] (1955).

Although the cases cited by the parties are factually similar to this appeal, we find them of little assistance. With the exception of the Oregon case relied upon by respondent, all of the cases can be distinguished on the basis of the specific statute involved or by the courts' reliance on local cases which were factually inapposite. Even the Oregon case has been criticized as interpreting controlling Supreme Court authorities as a carte blanche for aggressive state tax administrators. (Lohr-Schmidt, Developing Jurisdictional Standards for State Taxation of Multistate

Corporate Net Income, 22 Hastings L. J. 1035, 1043 (1971).) This comment was generated by the Oregon Supreme Court's acceptance of the theory that the taxpayer's mere economic presence, as opposed to physical presence, within the taxing state constituted a sufficient nexus to validate the tax under the due process clause.

In the 16 years since the Oregon case was decided, no United States Supreme Court case has adopted the economic presence theory, and one case has suggested that some physical presence on behalf of the taxpayer is required. (See National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753 [18 L. Ed. 2d 505] (1967).) Accordingly, we decline to follow the lead of the Oregon Supreme Court by accepting mere economic presence as constituting sufficient statutory nexus to support the corporate income tax.

In view of the volume of judicial and nonjudicial writing upon the subject before us, there is little to be gained from another detailed analysis of the many cases and commentaries considering the existence of sufficient connection or nexus to support state taxation of interstate commerce. It is sufficient to say, in accordance with Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 [3 L. Ed. 2d 421] (1959) and its progeny, that no barrier exists to prevent the taxation of income derived wholly in furtherance of interstate commerce so long as the corporation's in-state business activities have some regular, systematic and substantial connection with, and physical presence within, the taxing state. The controlling test which the United States Supreme Court has repeatedly noted as underlying minimally sufficient nexus is whether by the practical operation of the tax the state has exerted its taxing power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society. (Northwestern States Portland Cement Co. v. Minnesota, supra, 358 U.S. at 465; accord Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 [85 L. Ed. 267] (1940).) In order to subject the foreign corporation to taxation, however, the benefits and protections afforded by the state must be substantial and enduring rather than insignificant and transitory. (See generally, Beaman, Paying Taxes to Other States (1963) p. 1-7.)

With this analysis in mind, we turn to the question whether California, pursuant to section 23501 and 23040 of the Revenue and Taxation Code, can subject appellant to the corporation income tax.

Appellant's sole business activity is leasing railroad cars. Since appellant conducts no business in California, has no agents in this state, does not solicit leasing customers here, and does not have any leasing customers in California, it is readily apparent that appellant conducts no "activities" within this state as contemplated by section 23040 of the Revenue and Taxation Code.

Furthermore, the minimal quantity of appellant's property present in this state was here under the control of the bailees of appellant's lessees, and not under the direction or control of appellant. The presence of any of appellant's railroad cars in California was entirely fortuitous. After the income producing relationship was established by entering into a lease and delivering the transitory property to the lessee, all of which occurred outside California, the receipt of income in Illinois from the lease of that transitory property during the time it was within this state under the possession and control of the bailee of appellant's lessee did not constitute the receipt of "income from tangible property ... located or having a situs in this State" as contemplated by section 23040.3/

In short, there is simply nothing that this state does or provides which has a sufficient connection with appellant's income or property for which it can legitimately assert its corporation income tax against appellant. Accordingly, respondent's action in this matter must be reversed.

3/ Presumably, appellant's lessees are subjected to a properly apportioned franchise or income tax for their endeavors in California. Therefore, California is being paid for the only benefits and protections it provides.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of John H. Grace Company against a proposed assessment of corporation income tax and penalty in the total amount of $562.50 for the income year 1974, be and the same is hereby reversed.

Done at Sacramento, California, this 28th day of October, 1980, by the State Board of Equalization, with Members Nevins, Reilly, Dronenburg and Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

George R. Reilly, Member

William M. Bennett, Member

_____, Member