BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
AMERICAN TELEPHONE AND TELEGRAPH COMPANY)

Appearances:

For Appellant: John S. Warren
Attorney at Law

For Respondent: Brian W. Toman
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 American Telephone and Telegraph Company against proposed assessments of additional franchise tax in the amounts of $28,472.40, $31,260.00, $78,350.00, and $99,074.00 for the income years 1967, 1968, 1969, and 1970, respectively. As described more fully below, appellant agreed to and paid a portion of each assessment. Accordingly, the amounts remaining in issue are $19,841.50, $21,765.55, $29,005.90, and $40,604.90 for the income years 1967, 1968, 1969, and 1970, respectively.

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In conjunction with other affiliated and unaffiliated telephone companies, appellant operates a long distance multistate and international telecommunications system. Part of this system is composed of (1) appellant's ownership interest in two trans-oceanic submarine cable routes extending from California to Hawaii, and (2) its leasing from Communications Satellite Corporation (Comsat) of satellite "circuits," which are two-way communications links between earth stations and orbiting satellites in outer space. The question to be resolved is how appellant's interests in these properties should be reflected in the property factor of its apportionment formula.

The two trans-oceanic cables at issue extend from Point Arena and San Luis Obispo, California, to the Island of Oahu, Hawaii. The cables are jointly owned and maintained by appellant and the Hawaiian Telephone Company, an unrelated corporation, with appellant owning a substantial majority interest in each cable. Each cable system consists of three segments:

Segment A: Land and buildings appropriate for the cable landings and for the cable station at the California point. All of this property is solely owned by appellant.

Segment B: Submarine cable connecting the landing points in California and the Hawaii cable stations, together with associated cable station equipment at these points.

Segment C: Land and buildings appropriate for the cable landings and for the cable station equipment at the Hawaiian points.

In filing its returns for the income years 1967-1970, appellant included in the denominator of its property factor its total investment in both cable systems, and included in the numerator its investment in Segment A and in that portion of Segment B located within the territorial limits of California out to the "three-mile limit." Respondent's assessments propose to increase the numerator by one-half of appellant's investment in the portion of the cables lying in the deep ocean, i.e., beyond both the three-mile limit and

the "outer Continental Shelf." 1/ Appellant contends that respondent has no authority to assign tangible property to California when it is never physically present in this state. Respondent's position, however, is that these cables must be assigned to California and Hawaii for property factor purposes in order to prevent some of appellant's income from being attributed to the high seas so as to escape state taxation altogether.

Along with other communications common carriers, appellant rents satellite circuits from Comsat linking a telecommunications satellite with earth stations at Jamesburg, California, and Brewster Flats, Washington. The satellite has a stationary orbit over the Pacific Ocean and thus never passes over California. Since construction of the Jamesburg earth station was not completed until December of 1968, the first year for which appellant paid rental for circuits connecting that station to the satellite was 1969. Consequently, the issue concerning these rental payments relates only to the years 1969 and 1970.

In addition to renting the satellite circuits, appellant also owns an undivided 28.5 percent interest in the Jamesburg and Brewster Flats earth stations, with Comsat and other carriers owning the rest. The rental charges appellant pays Comsat for each circuit out of Jamesburg cover the use of both the Jamesburg facilities and the satellite, but Comsat provides no billing breakdown between the two components. In addition, during 1969 and 1970, Jamesburg and Brewster Flats shared the circuits extending to and from the Pacific satellite, and Comsat's billing to appellant failed to differentiate between the circuits entering into each earth station. Thus, it cannot be determined what rental appellant actually paid for the Jamesburg, California, circuits alone. As well as paying rent to Comsat, appellant, as a part owner of the station, also receives a portion of the rent Comsat receives from other carriers for the use of Jamesburg.

1/ Respondent excluded the outer Continental Shelf area because state taxation laws do not apply there. (See the Submerged Lands Act, 43 U.S.C.A. § 1333; FTB LR 366, Dec. 14, 1973, as modified by FTB LR 396, Aug. 9, 1976.)

In computing its property factor for 1969 and 1970, appellant included all satellite rentals paid to Comsat in the denominator. It did not include any of the Pacific satellite circuit rentals in the numerator, although it did include its investment in the Jamesburg facilities in the numerator. Respondent's assessments propose to increase the numerator by one-half of the Pacific circuit rentals, minus the portion that would be duplicative of the inclusion of appellant's interest in the Jamesburg station. Respondent's theory is that the Pacific circuit rentals must be assigned entirely to California and Washington for property factor purposes in order to prevent some of appellant's income from being attributed to outer space, where it escapes all state taxation.

Appellant's position is that if the numerator is to be increased at all, it should be increased only by the portion of the Pacific circuit rentals reasonably attributable to the use of the Jamesburg facilities in California and not by the portion attributable to the use of the satellite in outer space. Appellant recomputed its property factor on this basis and submitted it to respondent along with its protest against the proposed assessments. Respondent rejected appellant's proposal, however, and affirmed the assessments. Appellant then paid the portion of the assessments that would result under its own recomputation of the property factor.-

Under the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120-25139 of the Revenue and Taxation Code,, taxpayers who have income from business activity which is taxable both within and without California must allocate and apportion their net income as provided in UDITPA. (Rev. & Tax. Code, § 25121.) As required by section 25128, a multistate taxpayer's business income is to be apportioned to this state by means of an equally-weighted three-factor formula composed of the property factor, the payroll factor, and the sales factor. UDITPA's standard property factor is defined in section 25129 as follows:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year, and the denominator of which is the average value of all the taxpayer's

> real and tangible personal property owned or rented and used during the income year. (Emphasis added.)

For purposes of this case, the critical language is the underscored phrase "used in this state." Appellant contends that property which has never been physically located in California, and never will be, cannot be "used in this state" within the contemplation of the statutory definition of the property factor.

Although, as respondent notes, section 25129 does not specifically define the phrase "used in this state," we believe that one would have to stretch the ordinary meaning of this language considerably in order to conclude that the property involved herein falls within it. Perhaps in recognition of the difficulties of sustaining its position under the literal language of section 25129, respondent argues that section 25137 provides independent authority for its action in this case. Because we agree with that contention, it is unnecessary to consider the other arguments respondent has advanced in support of its assessments.

To the extent relied on by respondent, section 25137 provides:

> 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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> * **
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> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Based on prior decisions of this board, respondent acknowledges that it bears the burden of establishing that UDITPA's normal provisions do not fairly represent the extent of appellant's business activity in this state, and that the application of section 25 137 's special relief provisions is therefore permissible. (See Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Danny Thomas Productions, Cal. St. Bd. of Equal., Feb. 3, 1977;

Appeal of The O.K. Earl Corporation, Cal. St. Bd. of Equal., April 6, 1977.) In substance, respondent argues that, insofar as the application of the standard property factor would result in apportioning some of appellant's income to outer space and the high seas, UDITPA's normal provisions "per se" fail to fairly represent the extent of appellant's business activity in California.

The underlying basis for respondent's position is the notion that UDITPA's fundamental purpose is to assure that 100 percent, and no more and no less, of a multistate taxpayer's business income is taxed by the states having jurisdiction to tax it. This view of UDITPA is supported not only by the statements of Professor William J. Pierce, 27/ who was the principal draftsman of the uniform act, but also by the courts of at least four other states which have adopted UDITPA. (See GTE Automatic Electric, Inc v. Allphin, 68 Ill.2d 326 [369 N.E.2d 841] (1977); M. V. Marine Co., et al. v. State Tax Comm., 606 S.W.2d 644 (Mo. 1980); Deseret Pharmaceutical Co., Inc. v. State Tax Comm., 579 P.2d 1322 (Utah 1978); Caterpillar Tractor Co., et al. v. Dept. of Rev., Ore. Tax Rep. (CCH) ¶ 203-314, affd., 289 Ore. 885 [618 P.2d 261] (1980).) In each of these cases, the court sought to avoid an interpretation of UDITPA which would create a gap in the taxation of the taxpayer's income.

27/ Prior to UDITPA's adoption by any state, Professor Pierce commented:

> The uniform act, if adopted in every state having a net income tax or a tax measured by net income, would assure that 100 per cent of income, and no more and no less, would be taxed. . . .
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> * * *
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> In several sections of the uniform act, reference is made to the allocation and apportionment of income on the basis of whether the taxpayer is taxable in another state. As we shall see, the question of allocating and apportioning with reference to this concept of taxability assures that 100 percent of the income of a multistate business theoretically will be taxed by the several states. . . . (Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747, 748-749 (1957).)

Of the cases cited above, the one most comparable to the situation now before us is GTE Automatic Electric. One of the issues in that case was whether the Illinois Department of Revenue could require the taxpayer to include in the numerator of its Illinois sales factor so-called "drop-shipment" sales where both the origin and destination of the sales were outside Illinois and the taxpayer was not taxable either in the state of origin or destination. The Illinois Supreme Court agreed that such sales were not includible in the numerator under a literal reading of UDITPA's definition of the sales factor, but it held that the Illinois counterpart of our section 25137 (section 18 of UDITPA) authorized the Department of Revenue to include these sales in the numerator in order to effectuate the legislative intent of avoiding either an overlap or gap in the taxation of the taxpayer's multistate business income. The court specifically stated that, to the extent the standard sales factor did not apply to these sales, UDITPA's normal apportionment provisions clearly did not fairly reflect the extent of the taxpayer's business activities in Illinois.

In light of this decision, and the others cited above, we believe that section 25137 authorizes respondent to deviate from UDITPA's standard provisions in this case in order to prevent some of appellant's business income from escaping state taxation entirely. To hold otherwise would contravene UDITPA's fundamental purpose to avoid both overtaxation and undertaxation of a multistate taxpayer's business income, and would unduly circumscribe respondent's powers to effectuate an equitable apportionment of a taxpayer's income.

Our holding in this case is not inconsistent with our decision on rehearing in the New York Football Giants appeal, where we refused to allow respondent to make a sales factor adjustment of greater magnitude than the adjustment it seeks in this case. (Appeal of New York Football Giants, Inc., Op. on Rehg., June 28, 1979.) That appeal did not involve a situation where some of the taxpayer's income would escape all state taxation if the normal apportionment provisions were applied. The instant case does involve that problem, and the criteria by which respondent's authority under section 25137 is to be measured are not necessarily the same in both situations. For example, when the possibility of duplicative taxation exists; as it often will

when the various taxing states apply different apportionment formulas to the same taxpayer, it seems entirely appropriate to strictly limit the use of section 25137. But duplicative taxation is not a possibility in this case, and it therefore seems equally appropriate to allow respondent somewhat greater. latitude under section 25137, in order to ensure that the basic purposes of UDITPA are carried out.

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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 HEHEBY 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 American Telephone and Telegraph Company against proposed assessments of additional franchise tax in the amounts of $28,472.40, $31,260.00, $78,350.00, and $99,074.00 for the income years 1967, 1968, 1969, and 1970, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Richard Nevins, Member

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