BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DRESSER INDUSTRIES, INC.)

For Appellant: Frank M. Keesling
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Kendall Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Dresser Industries, Inc., for refund of franchise tax in the amounts of $346.23, $11,715.37, $12,549.52, and $5,929.68 for the income years ended October 31, 1968, 1969, 1970, and 1971, respectively.

Appeal of Dresser Industries, Inc.

The question presented is whether, in computing the sales factor of appellant's apportionment formula, respondent properly applied the "throw-back" rule to various sales of products which were manufactured in California and sold and shipped to customers located in foreign countries.

Appellant and its subsidiaries are engaged in a multinational unitary business which is one of the world's leading suppliers of high technology products and services to energy, natural resource, and industrial markets. Through its Pacific Pumps Division, appellant operates a plant in Huntington Park, California, which manufactures process, turbo, and boiler-feed pumps. During the years in question, some of these pumps were sold by appellant in foreign countries in which it did business, and some were sold in other foreign countries by appellant's wholly owned sales subsidiaries operating on a commission basis. Appellant's agreements with these subsidiaries provided that they would act as the exclusive sales representative for appellant's products in their respective territories, but the record does not reveal whether these corporations also acted as sales representatives for other principals. All export sales of pumps, whether made directly by appellant or through its sales subsidiaries, were consummated by the direct shipment of pumps from California to the foreign customers.

Respondent's application of the "throw back" rule in this case involves three different factual situations:

1. Appellant did business and filed income tax returns in some foreign jurisdictions. The "throw back" rule has not been applied to the sales of pumps to customers in these jurisdictions.

2. In certain other countries where appellant itself did not do business, one or the other of its sales subsidiaries did do business in those countries, and had substantial payroll and property investments there. In addition to soliciting orders, the subsidiaries delivered pumps, serviced them, made repairs, and engaged in other activities in connection with the sale of pumps and other products manufactured by appellant. Respondent has applied the "throw back" rule to pump shipments to these countries, on the grounds that appellant itself was not

subject to income tax in these countries under United States jurisdictional standards.

3. In still other countries where appellant did not do business, one or more of appellant's unitary nonsales subsidiaries actively did business, but the activities of the sales subsidiaries were limited to the taking of orders by salesmen, and these orders were filled by the shipment of pumps from California. These pump sales have likewise been "thrown back" to California, on the theory that if P.L. 86-272 were applicable to foreign commerce, these countries would not have jurisdiction to tax appellant's income.

As a result of the application of the "throw back" rule to the second and third situations described above, respondent increased the numerator of appellant's sales factor by the amount of pump sales "thrown back" to California, causing a greater share of appellant's unitary business income to be apportioned to California. Appellant paid the additional tax resulting from respondent's action, filed timely claims for refund, and has appealed from respondent's denial of its claims.

A taxpayer who derives income from sources both within and without California is required to measure its franchise tax liability by its net income derived from or attributable to California sources in accordance with the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in Revenue and Taxation Code sections 25120-25139. (Rev. & Tax. Code, § 25101.) As required by section 25128, a taxpayer's business income must 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.

Section 25134 defines the sales factor as "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." For purposes of determining whether sales of tangible personal property are in this state, section 25135 sets forth the following rules:

Sales of tangible personal property are in this state if:

> (a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or
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> (b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser. (Emphasis added.)

The underscored language in subdivision (b) contains the "throw back" rule whose application is at issue in this case. Respondent has invoked the rule on the theory that appellant itself was not "taxable in the state[s] of the purchaser[s]" of its pumps. It appears that respondent's only reason for reaching this conclusion is its view that uniformity in the interpretation of UDITPA's statutes and regulations requires the application of P.L. 86-272's jurisdictional limitations to the taxation of income from both interstate and foreign commerce. At least, that is the only argument respondent has offered in defense of its determination in this case. Thus, if we conclude that P.L. 86-272 need not be considered in determining whether appellant was taxable in the foreign countries in question, respondent's action cannot be sustained.

UDITPA defines the term "state" to include not only a state of the United States but also any foreign country. (Rev. & Tax. Code, § 25120, subd. (f).) For purposes of allocating and apportioning income under UDITPA, a taxpayer is "taxable" in another "state" if

> (a) in that state it is subject to 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) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not. (Rev. & Tax. Code, § 25122.) (Emphasis added.)

Since appellant does not contend that it was actually subject to any of these taxes in the foreign countries in question, our sole concern is whether any of those countries had jurisdiction to subject appellant to a net income tax.

For the years in question, respondent's regulation 25122, subdivision (c), sets forth the following rules for determining jurisdiction to tax net income:

> The second test in Section 25122(b) applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. 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. §§ 381-385. In the case of any "state," as defined in Section 25120 (f), other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that state. . . . (Cal. Admin. Code, tit. 18, reg. 25122, subd. (c) (art.2).)

Both parties agree that United States jurisdictional standards should be used to determine whether a foreign country has jurisdiction to tax the appellant. (Contra, Scott & Williams, Inc. v. Bd. of Taxation, 372 A.2d 1305 (N.H. 1977).) They disagree, however, on whether P.L. 86-272 has any application to the facts of this case. Appellant argues that it does not, because P.L. 86-272 does not apply to foreign commerce. Although respondent recognizes that the Congress limited the immunity of P.L. 86-272 to interstate commerce,* it contends that subdivi-

* P.L. 86-272 provides, in pertinent part:

> No State, or political subdivision thereof, shall have power to impose, . . . a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person . . . are either, or both, of the following:
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> (1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by

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sion (c) of regulation 25122 requires not only that the same uniform standards be applied to determine both a sister state's and a foreign country's jurisdiction to tax, but also that the jurisdictional limitations of P.L. 86-272 be applied regardless of whether the taxpayer's business activities are in interstate or foreign commerce. We believe respondent has misconstrued the regulation.

The notion that regulation 25122 eliminates the basic distinction between interstate and foreign commerce is supported neither by the language of the regulation nor by the principle of uniformity, upon which respondent so heavily relies. The regulation states simply that jurisdiction to tax is not present when a state is "prohibited" by P.L. 86-272 from imposing a net income tax. No such prohibition exists, however, when the income sought to be taxed is derived from foreign commerce. If, for example, appellant were a Canadian corporation which had sales representatives in California who merely solicited orders for pumps from California customers, and the orders were approved in Canada and filled by shipments from a Canadian factory, P.L. 86-272 would not prevent California from levying a net income tax on the appellant. Nothing in subdivision (c) of regulation 25122 requires the conclusion that California's jurisdiction to tax should be limited by P.L. 86-272 in such a case. Indeed, if such a limitation were read into the regulation, it would appear to be in conflict with the rule that the reach of the California franchise tax is coextensive with the state's constitutional power to tax. (See Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed 991] (1942); Matson Navigation Co. v. State Board of Equalization, 3 Cal.2d 1 [43 P.2d 805] (1935), affd., 297 U.S. 441 [80 L.Ed 791] (1936); Luckenback S.S. Co. v. Franchise Tax Board, 219 Cal.App.2d 710 [33 Cal.Rptr. 544] (1963).)

Respondent fares no better with its reliance on the principle of uniformity. There is no lack of uniformity simply because different jurisdictional standards are applied to different classes of commerce, so long as those standards are applied consistently to both foreign and domestic "states." Furthermore, although respondent has suggested that its interpretation of regulation 25122 must be followed in order for California to be in conformity with the other UDITPA states which have adopted the same

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shipment or delivery from a point outside the State; . . . (Pub. L. No. 86-272, 73 Stat. 555 (1959), 15 U.S.C. § 381.) (Emphasis added.)

regulation, it has cited no authority from such states in support of its interpretation.

Since subdivision (c) of regulation 25122 does not authorize the application of P.L. 86-272 to foreign commerce with a California destination, both logic and uniformity compel the same result where, as here, the stream of commerce flows in the opposite direction. Accordingly, we hold that respondent erred in ruling that the jurisdictional limitations of P.L. 86-272 must be considered in determining whether the foreign countries in question had jurisdiction to tax the appellant under United States jurisdictional standards. Since respondent has not argued that these countries lacked jurisdiction to tax the appellant for any other reason, we conclude that appellant was "taxable" in those countries. Appellant's foreign pump sales, therefore, should not have been "thrown back" to California for sales factor purposes, but should, instead, have been assigned to their respective foreign destinations under the general rule of Revenue and Taxation Code section 25135, subdivision (a).

In light of our disposition of the jurisdictional issue, it is unnecessary to consider appellant's other major argument that, even if the foreign countries lacked jurisdiction to tax appellant itself, the sales in question should nevertheless have been assigned to their destinations, since other members of appellant's combined report group were taxable in those countries. Accordingly, we express no opinion on the continuing validity of our decision in the Appeal of Joyce, Inc., decided by this board on November 23, 1966.

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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 HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Dresser Industries, Inc., for refund of franchise tax in the amounts of $346.23, $11,715.37, $12,549.52 and $5,929.68 for the income years ended October 31, 1968, 1969, 1970 and 1971, be and the same is hereby reversed.

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.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member