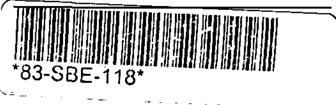
83-SBE-118

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 $146.23, $11,715.37, $12,549.52, and $5,929.68 for the income years ended October 31, 1968, 1969, 1970, and 1971, respectively.

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
>
> (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:
>
> (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

(Continued on next page)

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 8051 (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

(Continued)

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 oppasite 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.

Appeal of Dresser kndustries, 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 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

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: Kendall E. Kinyon
Supervising Counsel

William D. Dexter, General Counsel of the Multistate Tax Commission, filed an amicus brief on behalf of the Commission urging that a rehearing be granted.

OPINION ON PETITION FOR REHEARING

On June 29, 1982, we reversed 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. On July 21, 1982, the Franchise Tax Board filed a timely petition for rehearing pursuant to section 26077 of the Revenue and Taxation Code.

The question presented by this appeal is whether, in computing the sales factor of appellant's apportionment formula, respondent Franchise Tax Board properly applied the "throw back" rule to sales of pumps that were manufactured in California by the appellant and sold and shipped to customers located in various foreign countries in which appellant itself did not do business or file income tax returns. In each of these countries, one of appellant's wholly owned, unitary sales subsidiaries solicited sales of appellant's pumps on a commission basis, and in some of these countries the sales subsidiary's local activities and presence extended substantially beyond the mere solicitation of sales. In the countries where the activities of the sales subsidiaries were confined essentially to solicitation, one or more of appellant's unitary non-sales subsidiaries had substantial local activities and connections.

Respondent's application of the "throw back" rule in this case was based on the theory that appellant itself, as a separate corporate entity, was not "taxable" in the foreign countries in which some of its pump customers were located. While respondent and appellant both agreed that "taxability," for this purpose, was to be determined under United States jurisdictional standards, they disagreed on whether those standards should include the application of Public Law 86-272's jurisdictional limitations to foreign commerce. */ Because of the manner in which this issue was originally argued, it appeared to us that respondent's sole reason for contending that appellant was not "taxable" in the foreign countries was based on its belief that regulation 25122, subdivision (c), requires the use of the same standards, including Public Law 86-272, to determine both a sister state's and a foreign country's jurisdiction to tax, regardless of

*/ Appellant's objection to the application of Public Law 86-272 to foreign commerce distinguishes this appeal from our decision in the Appeal of The Learner Co. et al., decided September 30, 1980. Although that decision did apply Public Law 86-272 principles to foreign commerce, we were careful to note in the opinion that the taxpayer had not questioned the applicability of the Public Law to such commerce. Thus, since the issue was not raised in the case, Learner did not "hold" that Public Law 86-272 is applicable to foreign commerce. Dresser, on the other hand, has raised this issue, and we reiterate our original holding that the limitations of Public Law 86-272 are inapplicable to foreign commerce.

whether the taxpayer's activities are in interstate or foreign commerce. Thus, when we concluded that the regulation does not require identical treatment of interstate and foreign commerce, the sole asserted basis for respondent's position disappeared.

In its petition for rehearing, respondent argues that we incorrectly concluded that its whole case depended on the application of Public Law 86-272. It now contends that, even if Public Law 86-272 is not applicable, constitutional jurisdiction to tax the appellant was lacking because of our factual determination that appellant "did not do business" in the countries in question. At the outset, we should state that this factual "determination" was taken almost verbatim from undisputed statements of fact by both parties in their original briefs. We did not construe these statements as a stipulation by the parties that appellant thereby was immune from tax under basic U.S. jurisdictional standards, and we certainly had no intention, in our original opinion, of implying our own agreement with that legal conclusion. On the contrary, our view throughout these proceedings has been that appellant would be subject to a properly apportioned income tax in these foreign countries under basic U.S. constitutional standards.

The U.S. Supreme Court has stated that the Due Process Clause of the Fourteenth Amendment imposes two requirements for state taxation of income from interstate transactions: a "minimal connection" or "nexus" between the interstate activities and the taxing state, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'! (Exxon Corporation v. Wisconsin Dept. of Revenue, 447 U.S. 207, 219-220 [65 L.Ed.2d 66] (1980), quoting Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436, 437 [63 L.Ed.2d 510] (1980).) The requirement at issue here-is "nexus." Respondent contends-that there was no nexus, because appellant itself, as a separate corporate entity, did not do business in the. foreign countries in question, and because the acts of the sales subsidiaries in these countries cannot be ascribed to appellant for nexus purposes. In support of this position, respondent relies in large part on National Bellas Hess, Inc. v. Dept. of Revenue, 386 U.S. 753 [18 L.Ed.2d 505] (1967), and our decision in the Appeal of John H. Grace Co.', decided by this'board on October 28, 1980. We think those cases are readily distinguishable from the present situation.

In Hess, the question was whether Illinois could require an out-of-state mail order seller to collect Illinois' use tax-from consumers who purchased the seller's products for use in that state, when the seller's only connection with those consumers was through the U.S. mail and by common carrier. The Supreme Court ruled in favor of the seller, declining to repudiate the sharp distinction drawn in earlier cases between "mail order sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier as part of a general interstate business." (National Bellas Hess, Inc. v. Dept. of Revenue, supra, 386 U.S. at 758.) In the Grace appeal, we held that California could not impose Corporation Income Tax liability upon an out-of-state lessor of railroad. cars whose only connection with California was that some of its railroad cars happened to pass into or through California, in interstate commerce, while under the control of the bailees of the appellant's lessees. We noted specifically that the appellant conducted no business in this state, had no agents here, did not solicit leasing customers here, and had no leasing customers in California.

The facts of the present case stand in sharp contrast. Here the record reveals a regular and systematic pattern of local sales solicitation on appellant's behalf in the foreign countries in question. While it is certainly true that this activity was conducted by employees of appe-llant's sales subsidiaries, rather than by appellant's own corporate employees, the Supreme Court's decision in Scripto, Inc. v. Carson, 362 U.S. 207 [4 L.Ed.2d 660] (1960) leaves little-doubt that such a distinction is without'constitutional significance for nexus purposes. Like Hess, the Scripto case involved an out-of-state seller's obligation to collect a use tax. Unlike Hess, however, the Court sustained the tax, because it found that the required nexus was provided by continuous local solicitation activities conducted by ten independent wholesalers or jobbers operating on a commission basis. In discussing the relationship of these individuals to the taxpayer, the Court said:

> True, the "salesmen" are not regular employees of appellant devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. The formal shift in the contractual tagging of the salesman as "independent" neither

> results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida.

(Scripto, Inc. v. Carson, supra, 362 U.S. at 211.

In sum, we believe that appellant's exploitation of foreign markets for the purpose of earning income from sales of its pumps, together with the benefits and protections which the market states provide during the process, is sufficient to satisfy the requisites of due process (see Hartman, "Solicitation" and "Delivery" Under Public Law 86-272: 'An Uncharted Course, 29 Vand. L.Rev. 353, 356 (1976); cf. Miller Bros. Co. v. Maryland, 347 U.S. 340, 347 [98 L.Ed. 744] (1954)), and it makes no difference that appellant chose to conduct its selling activities through unitary sales subsidiaries, even if those subsidiaries may properly be regarded in this context as true "independent contractors."

This conclusion is not affected by older cases such as Irvine Co. v. McColgan, 26 Cal.2d 160 [157 P.2d 847] (1945), which discussed the consequences of business activities conducted through agents and independent contractors in the context of franchise or privilege taxes whose applicability, for constitutional reasons, depended upon whether the taxpayer was doing some local, intrastate business in the taxing state. After Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 [51 L.Ed.2d 326] (1977), which eliminated the constitutional distinction between privilege taxes and net income taxes in the realm of interstate commerce, these older cases may be of little more than historical interest. In any event, even before Complete Auto, a taxpayer engaged wholly in interstate or foreign commerce would have been "taxable," within the meaning of Revenue and Taxation Code section 25122, in any state having the minimal nexus required to justify a net income tax on the earnings from such commerce.

Finally, we turn to the argument presented by the Multistate Tax Commission (MTC), as amicus curiae,. that our original decision produces an unconstitutional result because it conflicts with the non-discrimination provisions of various U.S. treaties with foreign countries. The essence of the MTC's position seems to be that impermissible discrimination will arise if California seeks to tax a foreign corporation engaged in foreign commerce under circumstances where a domestic

corporation engaged in interstate commerce would be protected by Public Law 86-272.

The MTC's argument is difficult to analyze in the abstract, since it appears that the non-discrimination language of the treaties varies, at least to some extent, from treaty to treaty. Moreover, there are many unanswered questions in this area. (See Bischel, Income Tax Treaties, 419-443 (1978).) Under these circumstances, the most we can say is that the MTC goes much too far in asserting that our original decision is "undoubtedly unconstitutional" insofar as it suggested that Public Law 86-272 would not protect a foreign corporation selling goods into California in foreign commerce. The MTC's brief simply provides no authority for that position. Appellant, on the other hand, makes a reasonably persuasive case that the MTC's position might well result in discrimination against interstate commerce by immunizing foreign commerce from all state income taxation whenever the foreign corporation's activities do not exceed, in any state, the solicitation standard contained in Public Law 86-272. Even if a domestic corporation is protected by Public Law 86-272 in some states, it will usually be taxable- on its income in at least one state. Wee, e.g., Deseret Pharmaceutical Co., Inc. . State Tax Commission, 579 P.2d 1322 (Utah Sup. Ct. 1978).)

For the-above reasons, we conclude that adequate cause has not been shown for granting a rehearing. Accordingly, respondent's petition for rehearing will be'denied.

Appeal of Dresser Industries, Inc.

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 petition of the Franchise Tax Board for rehearing of the appeal of Dresser Industries, Inc., from the action of the Franchise Tax Board in denying its claims 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, be and the same is hereby denied, and that our order of June 29, 1982, be and the same is hereby affirmed.

Done at Sacramento, California, this 26th day Of October , 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

a

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9