BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DONALD M. DRAKE COMPANY)

For Appellant: Brian A. Steenson
Attorney at Law

Garthe Brown
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 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Donald M. Drake Company against proposed assessments of additional franchise tax in the amounts of $11,428.00, $5,532.00, $190.00 and $11,450.00 for the income years 1967, 1968, 1969, and 1970, respectively.

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Several of the issues raised by the briefs .in this appeal have been abandoned or conceded. Specifically, appellant Donald M. Drake Company now agrees that .it operated as a unitary business, subject to the provisions of the Uniform Division of Income for Tax Purposes Act,1/ throughout the years on appeal.. Respondent concedes that income from certain sales of equipment and real property, which occurred in 1966 and 1968, respectively, should be excluded from appellant's 1967 business income. A further concession by respondent, relating to appellant's sales factor, will be described below.. The issues which remain for our decision concern the proper method of computing the business income and apportionment factors of a corporation participating in long-term construction projects as a joint venturer, where the joint ventures have adopted the completed-contract method of accounting.

Appellant, an Oregon corporation, is a general contractor qualified to do business in Nevada, Idaho, California, Washington and Oregon. During the appeal years it was engaged in several construction projects in the latter three states. At least two of its projects in California and one in Oregon were conducted as joint ventures by appellant and other companies. Each of these joint ventures had begun work on its construction project in or before 1968, and each finished its project sometime in 1970.

Unlike appellant's other construction projects, the three joint ventures in question elected to report their income for tax purposes on the completed-contract method of accounting. Under this method, which is a

1/ Revenue and Taxation Code sections 25120 through 25139, hereinafter referred to as the "Uniform Act" or the "Act." Unless otherwise noted, all statutory citations in this opinion are to the Revenue and Taxation Code.

modification of strict accrual accounting, receipts from and expenses of long-term contracts should be recorded in the business' books of account in the year they are received or accrued. (See American Institute of Accountants, Accounting Research Bulletin No. 45 (1955), Para. 12, cited in Herwitz, Accounting for Long-Term Construction Projects: A Lawyer's Approach, 70 Harv. L. Rev. 449, 451-453 (1957).) For tax purposes, however, receipts are not included in gross income,-and expenses are not allowed as deductions, until the year the contract to which they relate is completed. (Treas. Reg. § 1.451-3(d); Cal. Admin. Code, tit. 18, reg. 24661(c), subd. (2)(B); see generally 2 Mertens, Law of Federal Income Taxation, § 12.134.)

In January 1968 respondent issued Franchise Tax Board Guideline Letter Number 1064 (CCH Cal. Tax. Rep., Para. 203-801), instructing contractors how to apportion their income when one or more of their construction projects is on the completed-contract method of accounting.. The guideline indicates that the yearly payroll, property, and sales of such projects (or the taxpayer's allocated share in the case of a partnership or joint venture) are to be included in the taxpayer's apportionment factors each year the project is in progress. However, income from the project is neither recognized nor apportioned until the year the project is finished. In that year the taxpayer's business income from the project is computed separately from its other business income and apportioned to this state by a special formula. The special formula in effect allocates a portion of the project's business income to each year the project was in progress, then apportions the business income attributed to each year by the taxpayer's apportionment percentage as previously determined for that year.

Appellant did not follow the guideline letter in filling out its California franchise tax returns for the years at issue. Respondent noticed this during an audit and adjusted the returns accordingly, which led to this appeal.

Before turning to the specific issues raised by appellant, it will be helpful to review some of the considerations which will guide our decision. Revenue and Taxation Code sections 25101 and 2.5121 require taxpayers subject to the Uniform Act to allocate and apportion their income in accordance with its provisions. The first step in any case involving the Uniform Act, therefore, is to determine how those provisions apply to that particular case. Revenue and Taxation Code.section 25138 indicates that the purpose of the Uniform Act is to provide a system of income allocation and apportionment which will be applied uniformly in each of the adopting jurisdictions, and directs that the Act should be construed so as to carry out that purpose.

Since the allocation and apportionment provisions of the Uniform Act are phrased in general terms, however, they may occasionally lead to inequitable results when applied to unusual factual situations. In such cases Revenue and Taxation Code section 25137 authorizes the use of reasonable allocation and apportionment methods different from those of the Uniform Act.[2/] It must be emphasized, however, that section 25137 comes into play

2/ 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:
>
> (a) Separate accounting;
>
> (b) The exclusion of any one or more of the factors;
>
> (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

only in exceptional circumstances, that is, only where the Act's provisions "do not fairly represent the extent of the. taxpayer's business activity in this state." (See Amoco Production Co. v. Armhold, 213 Kan. 636 [518 P.2d 453] (1974).) Moreover, in order to insure that the Act is applied as uniformly as possible, the party who seeks to use extraordinary apportionment methods bears the burden of proving that such exceptional circumstances are present. (Appeal of New York Football Giants, Cal. St. Bd. of Equal., decided this day.)

In this case, the initial question is whether the inclusion of appellant's share of the joint ventures' property, payroll and sales in its apportionment factors for the years 1967, 1968 and 1969, as required by respondent's guideline letter, was proper. Appellant agrees that those items may be passed through from a joint venture to a joint venturer, but objects to the timing of the pass-through. In its opinion the items should not be included in its apportionment factors until 1970, the year the joint ventures finished their construction projects, since the joint ventures were on the'completed-contract method of accounting.

Appellant first suggests that deferral-of the pass-through until 1970 is required by the terms of the Uniform Act, and that respondent therefore bears the burden of justifying its position under section 25137. We disagree. Revenue and Taxation Code section 25129 defines "property factor" to include the average value of the taxpayer's pkoperty owned or rented and used "during the income year." Similarly, section 25132 defines "payroll factor" to include amounts paid as compensation 'during the income year," and section 25134 defines "sales factor" in terms of sales "during the income year." The general rule of the Uniform Act, therefore, is that a taxpayer's apportionment factors for any income year will reflect the items of property, payroll and sales which relate to its business activity in that particular year.

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A taxpayer's use of completed-contract accounting does not require an exception to the general rule for determining its apportionment factors. Completed-contract accounting is no more than a device for- determining in what year profit or loss will be recognized, and items of receipt and expense are generally not ignored in pre-completion years simply because the profit or loss they produce is deferred. (See Anderson Brothers Corp. v. Commissioner, 296 F.2d 627 (5th Cir. 1961).) Inclusion of a completed-contract project's property, payroll and sales in the taxpayer's apportionment factors. for pre-completion years therefore. does not violate. the principles of completed-contract accounting. Nor does it amount to an. unauthorized change of accounting methods, since the project's profit or loss will still not be recognized or apportioned until. the year of! completion.

Furthermore, an exception to the general rule is not required in this case by the fact that items of property, payroll and sales which are connected with the production of nonbusiness income and not with the production of business income are generally excluded from the taxpayer's apportionment factors.. (See Cal. Admin. Code, tit. 18, regs. 25129, subd. (a) [property factor]; 25132-25133, subd. (a) (5) [payroll factor]; 25134, subd. (a) [sales factor].) Although income from completed-contracts projects is not recognized in pre-completion years, it does not follow that such' projects are necessarily- engaged in the production of nonbusiness income. Rather, if the taxpayer's business. is unitary, the completed-contract projects will presumably depend upon or contribute to the taxpayer's other unitary business projects (see Edison California Stores v. McColgan, 30 Cal. 2d.472, 481 [183 P.2d 161 (1947)] and help to produce apportionable business income from those other projects. Accordingly, the property, payroll and sales of completed-contract projects do not necessarily. come within the exclusion for items relating to nonbusiness income..

Appellant argues however, that the general rule for determining apportionment factors is unworkable when applied to completed-contract taxpayers. It bases this argument in part on Revenue and Taxation Code section 25121, which requires taxpayers who have income from business activity which is "taxable" both within and without California to allocate and apportion their net income in accordance with the Uniform Act. Appellant contends that a taxpayer whose entire business was on the completed-contract method of accounting would not be subject to the Act in years when it completed no contracts since it would have no taxable income in those years, Revenue and Taxation Code section 25101, however, applies the Uniform Act to every taxpayer subject to the Bank and Corporation Tax Law, which includes every taxpayer doing business in California except those expressly exempted by statute. (Rev. & Tax. Code, § 23151.) Such taxpayers must therefore allocate and apportion their income in accordance with the Uniform Act in every year they do business in California, regardless of whether or not their income will be taxable in that year.

Finally, appellant asserts that it was unable to obtain data from the joint ventures during pre-completion years concerning their property, payroll and sales.[3/] It argues that the general rule for determining apportionment factors is therefore unworkable, since it required appellant to report on its tax returns information it did not possess. We find it hard to believe, however, that it would have been impossible

3/ In computing the proposed assessments in question, respondent determined appellant's sales factor in part by estimating each joint venture's yearly receipts. Appellant objected that the estimate was improper because it relied on data which did not become available until a later year. Respondent now concedes that the use of estimated receipts was erroneous, and has agreed to recompute the sales factor using appellant's share of any payments actually received or accrued by the joint ventures in each year.

or even inordinately difficult for appellant to obtain the necessary information from the joint ventures in which it was participating. No showing of any actual impossibility or difficulty has been made. Absent 'such a showing, we must reject appellant's contention.

For these reasons we construe the Uniform Act to require a taxpayer to include items of property, payroll and sales in its apportionment factors in the year to which they relate, if they would otherwise be includable, regardless of'whether the taxpayer is on the completed-contract method of accounting. On this, point, respondent's guideline letter merely applies the statutory rules to a particular factual situation. In order to overcome respondent's determination, therefore, appellant must prove that the Act's provisions, as applied in the guideline letter, do not fairly represent the extent of its business activity in this state, so that the extraordinary measures allowed by section 25137 may be invoked.

Appellant has not met its burden of proof. The three joint ventures in question were concededly part of appellant's unitary business operations. As We indicated above, they therefore presumably depended on or contributed to the earning of apportionable business income by appellant's other unitary projects. Insofar as we can ascertain from the record, inclusion of the joint ventures' property, payroll and sales in appellant's yearly apportionment factors accurately reflects the extent to which the joint ventures contributed to the earning of such income. Moreover, appellant concedes that the property, payroll and sales of its other unitary projects are includable in its yearly apportionment factors, since the other projects had not adopted the completed-contract method of accounting. We see no reason why a different rule should apply to the joint ventures in question. It is the taxpayer's business activity within and without California, not the taxpayer's accounting method, which should determine the taxpayer's apportionment percentage for each income year.

Since respondent's computation of appellant's apportionment factors complied with the provisions of the Uniform Act, and since appellant has failed to prove that extraordinary methods should have been used, we sustain respondent's action on this point.

The second issue in this case concerns the proper method of apportioning appellant's business income in 1970. As indicated above, appellant's business income from the joint ventures was recognized and subject to formula apportionment in that year. Pursuant to its guideline letter, respondent segregated that income from appellant's other 1970 business income and apportioned it by a special formula. Appellant contends that use of a special formula is not authorized by the Uniform Act, and that its business income from the joint ventures should have been apportioned in a lump sum along with its business income from other sources.

No question of statutory construction is involved here. The parties apparently agree that Revenue and Taxation Code section 25128 requires all the taxpayer's business income to be apportioned in a lump sum by one formula.[4/] Respondent argues, however, that discretionary use of a reasonable special formula is allowed under the circumstances of this case by section 25137. The issue presented, therefore, is whether respondent has met its burden of proving that the standard statutory formula does not fairly represent the extent of appellant's business activity in this state.

4/ Section 25128 provides:

> All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is, the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

In the previous portion of this appeal, we held that the Uniform Act requires taxpayers to include items of property, payroll and sales in their apportionment factors in the year to which the items relate. It follows that business income from the joint ventures would be apportioned by factors which relate to appellant's business activity in the year of completion, if the income were apportioned by the standard formula in that year. This would not reflect the fact that income from the joint ventures, although recognized and apportioned in the year of completion, was actually earned at least partially through business activity in a prior year or years.

Respondent's special formula cures this distortion by attributing part of the business income from completed-contract projects to each year the project is in progress. The income attributed to each year is then apportioned by the taxpayer's apportionment percentage for that year, reflecting the fact that the income was earned through business activity carried on in each year the project was in progress. For these reasons we conclude that respondent has met its burden of proof, and sustain the use of the special formula for taxpayers who have business income from completed-contract projects.

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,

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'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 protests of Donald M. Drake Company against proposed assessments of additional franchise tax in the amounts of $11,428.00, $5,532.00, $190.00 and $11,450.00 for the income years 1967, 1968, 1969, and 1970, respectively, be and the same is hereby modified to reflect the concessions described in the attached opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 3rd day of February, 19 77 by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Executive Secretary