BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THE BABCOCK AND WILCOX COMPANY)

Appearances:

For Appellant: Robert A. Petersen
Certified Public Accountant

For Respondent: Paul J. Petrozzi
Counsel

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 protest of The Babcock and Wilcox Company against proposed assessments of additional franchise tax in the amounts of $16,392 and $7,364 for the income years 1967 and 1968, respectively.

Appeal of The Babcock and Wilcox Company

Appellant is a large multinational corporation incorporated in New Jersey. Together with its affiliates and subsidiaries, appellant is engaged in the design, manufacture, and sale of products which may be classified broadly as steam generating systems and associated equipment, refractory products, and automated machines and machine tools. It is conceded that appellant is engaged in a single unitary business with its affiliates and subsidiaries. Accordingly, appellant filed a combined report including its worldwide operations, and determined the California portion of its unitary business income by means of the standard three-factor apportionment formula comprised of property, payroll and sales.

The issue for determination is whether the sales of large steam generating systems, assembled in California by appellant from subunits fabricated by it outside of California, should be included in the numerator of appellant's California sales factor.

The steam generating systems produce steam which operates turbines for the generation of electricity. The systems in question are extremely large structures which, together with their supporting equipment, may cover an area as large as a city block. They are generally several stories high. The system components are also large, heavy units often weighing several tons. These steam generating systems are not products that are manufactured for inventory and sold from the shelf. Appellant contracts to provide a completed system which includes the planning, design, engineering and modeling of the system: manufacture of the components; and subassembly. To this point, all the work occurs outside California. The subassemblies are then transported to the California location, usually by railroad car. Once in California the subassemblies are erected by appellant on previously prepared and constructed footings and support structures. Thereafter, appellant performs final testing. When the system is satisfactory, it is turned over to the purchaser. Appellant remains at risk on the contract until the purchaser accepts the unit. Generally, 30 percent of the selling price of the steam generating systems relates to costs associated with the installation and testing of the system at the site of the purchaser.

Respondent determined that the sales of the steam generator systems were sales of tangible personal property and should be included in the numerator of the sales factor as sales in California pursuant to section 25135 of the Revenue and Taxation Code. Section 25135

provides in pertinent part that sales of tangible personal property are in this state if "[t]he property is delivered or shipped to a purchaser ... within this state regardless of the f.o.b. point or other conditions of the sale."

It is appellant's position that the sales of steam generating systems are sales of other than tangible personal property, and, therefore, subject to section 25136, not section 25135. Appellant asserts that sections 25135 and 25136 are the only two provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) dealing with the determination of the sales factor, and are mutually exclusive. Thus, appellant argues, if the sales are not sales of tangible personal property, their attribution must be controlled by section 25136 since they are excluded from the ambit of section 25135. Section 25136 provides that sales of other than tangible personal property are in this state if:

> (a) The income-producing activity is performed in this state; or
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> (b) The income-producing activity is performed both in and outside this stnte and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Since, according to appellant, the sales are of other than tangible personal property and a greater proportion of the costs result from activities performed outside California, in accordance with section 25136, none of the sales are attributable to California.

As appellant correctly points out, a resolution of the issue in this appeal involves classification Of the property sold in order to correctly compute the Sales factor. Unfortunately, in its argument appellant has not attempted to classify the particular property in issue, merely being satisfied to assert that the large steam generating systems are something "other than tangible personal property." Thus, we must look to the statutes and cases for assistance, The California Civil Code divides property into real property, which consists of land and that which is affixed or appurtenant thereto, and personal property, which consists of all property which is not real property. (Cal. Civ. Code, §§ 657, 658 & 663.) Personal property may be either tangible or intangible. (See Italiani v. Metro-Goldwyn-Mayer Corp.,

45 Cal. App. 2d 464 [114 P.2d 370] (1941).) Similarly, the Revenue and Taxation Code defines real property, in part, as interests in land and improvements, and defines personal property as all property except real property. (Rev. & Tax. Code, §§ 104, 106.) Improvements include buildings, structures and fixtures erected on or affixed to the land. (Rev. & Tax. Code, § 105.) The definitions contained in the Revenue and Taxation Code apply to the Bank and Corporation Tax Law. (San Diego Trust and Savings Bank v. San Diego County, 16 Cal. 2d 142, 147 [105 P.2d 94] (1940); Jameson Petroleum Co. v. State, 11 Cal. App. 2d 677, 680 [54 P.2d 776] (1936).) Thus, it would appear from the statutes that the property in question must be either tangible personal property or fixtures and, therefore, realty, since we do not understand that appellant is arguing that a structure as large as a city block is intangible personal property.

In General Electric Co. v. State Board of Equalization, 111 Cal. App. 2d 180 [244 P.2d 427] (1952), a case factually quite similar to the instant appeal, the question was whether the sale of a 521-ton turbine generator unit was the sale of tangible personal property or the sale of a fixture. The court found that, although the unit ultimately became a fixture in the hands of the purchaser, it was clearly tangible personal property when sold by the taxpayer; thus, the sale was subject to the sales tax. While the court's determination was for the purpose of applying the retail sales tax, we see no reason to deviate from this determination in the instant case and appellant has offered none. 1/

1/ Appellant also maintains that the sales in question were not sales of real property. However, we note that even if the steam generating systems became real property when affixed to the realty of the purchaser, as they undoubtedly did (see General Electric Co. v. State Board of Equalization, supra, at 185), and were characterized as such in the hands of the seller, appellant would fare no better. Respondent's regulations provide that the gross receipts from the sale of real property are in this state if the real property is located in this state. (Cal. Admin. Code, tit. 18, reg. 25136(d) (2) (A) (Art. 2.5).) Although this regulation was not adopted until 1972, it has not been suggested that it is a change in prior law. (See Cal. Admin. Code, tit. 18, reg. 25136 (e) (2) CA) (Art. 2).)

Appellant emphasizes that it is selling completed systems requiring the performance of many elements, or income-producing activities, specifically designed to customer specifications which, when completed, are guaranteed to perform a unique function involving significant technology indigenous to it. The transactions under consideration involve contracts for completed steam generating systems requiring the performance of many activities including planning, drafting, engineering and many other service functions, as well as the installation and testing in California. Approximately 70 percent of the total production costs are incurred outside California. Since physical performance of the contract involves so many elements, appellant concludes that the ultimate sale must be of something other than tangible personal property. Thus, in accordance with section 25136 which deals with sales of other than tangible personal property, the Sales cannot be assigned to California since a greater proportion of the income-producing activities are performed outside California. Appellant's position is untenable. Taken to its logical conclusion, appellant's argument would prohibit inclusion in the numerator of the sales factor of practically any sale in this state of a product manufactured outside this state. It is hard to imagine any manufactured product which, to a greater or lesser degree, does not involve many elements such as planning, design and engineering in its production. Nevertheless, the existence of such fact does not prevent the finished product from being classified as tangible personal property. (See, e.g., General Electric Co. v. State Board of Equalization, supra, at 186.)

It must be remembered that the sales factor, which is used to balance the property and payroll factors, reflects the importance of the market to multistate businesses. The purpose of the sales factor is to balance the property and payroll factors by giving weight to elements not reflected by those factors and to assist in making a reasonable apportionment of the unitary business income among the states in which the business is conducted. (See generally Altman & Keesling, Allocation of Income in State Taxation (2d ed. 1950) pp. 126-128.) Here, the property and payroll factors, to which appellant has not objected, reflect the contribution to appellant of the manufacturing states where the bulk of the planning, engineering and other service functions occur and serve to reduce the amount of income apportioned to California. (Cf. Appeal of Citadel Industries, Inc., et al., Cal. St. Bd. of Equal., June 28, 1966, affd. on rehearing, Sept. 1, 1966; Appeal of Pratt & Whitney Co., Inc., Cal. St.

Bd. of Equal., May 24, 1961.) To apply appellant's theory would improperly increase the contribution appellant derives from its operations in the manufacturing states while decreasing the contribution of California as the market state.

Appellant cites Prairie Tank & Construction Co. v. Department of Revenue, 49 Ill. App. 3d 291 [364 N.E. 2d 963] (1977) in support of its position that it was selling something other than tangible personal property. However, appellant's reliance is misplaced. In Prairie Tank, the taxpayer constructed specially designed and engineered storage tanks for its customers. The court held that, in accordance with the taxpayer's contention, the Illinois use tax did not apply to the tangible personal property transferred incidental to the taxpayer's design and engineering skills. Whether the storage tanks constituted something other than tangible personal property was neither contended by the taxpayer, nor considered by the court.

We conclude that the sales of the steam generating systems were sales of tangible personal property and that respondent properly included the sales in the numerator of the sales factor.

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* protest of The Babcock and Wilcox Company against proposed assessments of additional franchise tax in the amounts of $16,392 and $7,364 for the income years 1967 and 1968, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of January, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member