



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
PACIFIC TELEPHONE AND)
TELEGRAPH COMPANY)

Appearances:

For Appellant: **Toni Rembe**
Attorney at Law

For Respondent: Kendall Kinyon
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pacific Telephone and Telegraph Company against proposed assessments of **additional** franchise tax in the amounts of **\$4,453,195.72** and **\$3,395,416.96** for the income years 1961 and 1963, respectively, and pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Pacific Telephone and Telegraph Company for refund of franchise tax in the amounts of **\$3,817,753.71**, **\$4,064,969.00**, **\$3,241,009.00**, and **\$2,211,460.00** for the income years 1967, 1968, 1969, and 1970, respectively.

Appeals of Pacific Telephone
and Telegraph Company

Appellant Pacific Telephone and Telegraph Company (hereafter Pacific) is a California corporation whose principal office is located in San Francisco. At all relevant times, Pacific was a member of the integrated nationwide group of telephone companies known as The Bell System. Along with their common parent, The American Telephone and Telegraph Company (hereafter American), these companies were and are engaged in a unitary communications business for California franchise tax purposes, and the franchise tax liability of each company doing business in this state has been determined on the basis of a combined report reflecting the unitary net income of the entire multicorporate group.

This case involves two separate appeals that have been consolidated for purposes of hearing and decision. Because the issue presented by each appeal is complex, we will discuss each one separately.

I

For the income years 1961 and 1963, did the gain Pacific realized from its sales of Pacific Northwest Bell Telephone Company stock constitute unitary income apportionable by formula or **nonunitary** income specifically allocable to **California**?

Until **July 1, 1961**, Pacific conducted The Bell System's communications business in California, Oregon, Washington, and Northern Idaho. For some years prior to that date, Pacific's management had felt that the company's operations had grown too large and too complex for effective management. Between 1945 and 1960, Pacific's investment in telephone plant increased more than fivefold from **\$662,000,000** to **\$3,402,000,000**, and its work force increased from approximately 25,000 to 70,000. The most dramatic growth apparently occurred in California, where, by 1960, the company's plant investment and operating revenues exceed **d** its overall 1957 plant investment and operating **revenues** for all four states. Not only was Pacific by **far** the largest operating company in The Bell System, **but** studies by management had also concluded that, absent some reorganization of this segment of the unitary business, Pacific could be expected to have approximately 125,000 employees and **\$5,000,000,000** invested in telephone plant by 1965.

Pacific's first response to the burgeoning growth of its business came in the early **1950's**, when

Appeals of Pacific Telephone
and Telegraph Company

day-to-day operations in the Washington-Idaho area and in Oregon were placed under the direct control of two vice president-general managers located in Seattle and Portland. Each general manager was assisted by a full supporting staff responsible for various local functions (accounting, billing, disbursement, maintenance, etc.), and by an Advisory Council of local business leaders who provided advice relating to local matters and conditions. A further separation of California and Pacific Northwest operations took place in January 1960, when operations in Washington, Oregon, and Idaho were unified in a newly created division known as "Pacific Telephone-Northwest, a division of the Pacific Telephone and Telegraph Company." The division president reported directly to Pacific's president and board of directors, and had virtually complete responsibility for business operations in the Pacific Northwest, except for financing and a few other matters. Assisting him were the two area vice president-general managers and the previously established Advisory Councils.

Studies concerning the feasibility of separately incorporating the Pacific Northwest operations began in 1958. Pacific's primary planning objectives were:

- (1) To reduce the **size** of its business operations to permit more effective management of California operations;
- (2) To bring top-level management closer to the local financial and operational problems present in the Pacific Northwest;
- (3) To ease the administrative burden of local regulatory matters; and
- (4) To divest Pacific of direct control of, and financial responsibility for, operations in the Pacific Northwest.

After a **number** of reorganization proposals had been considered **and** rejected because of legal obstacles, Pacific's board of directors and shareholders approved a plan in early 1961 that provided for (1) Pacific's transfer of all of its unitary business assets in Washington, Oregon, and Idaho to a newly formed corporation in exchange for stock, debt paper, and the assumption of liabilities relating to the operations in those states, and for (2) Pacific's distribution to its shareholders of all of the new corporation's stock pursuant to one or more pro rata rights offerings.

Appeals of Pacific Telephone
and **Telegraph** Company

When the reorganization plan was submitted to Pacific's shareholders on February 27, 1961, Pacific declared that,, promptly after its acquisition of the new company's stock, it would offer for sale approximately 56 percent of the stock. This figure was selected for two reasons. First, since American owned about 90 percent of Pacific's stock, distribution of 56 percent of the new company's stock was sufficient to transfer majority ownership and control of the new company to American. Second, by selling no more than this, Pacific would obtain the amount of cash it needed to pay off its advances from American but would not have excess cash left over that would have to be invested temporarily at a low return. The plan provided that the balance of the new company's stock would be sold when Pacific needed new capital; and that total disposition of the stock was expected to occur within three years after the reorganization. The prices at which the stock would be offered were not stipulated in the plan, but were left to be determined by Pacific's board at the time of each offering.

Following approval of the reorganization plan by the shareholders and public regulatory bodies, Pacific transferred its assets in ~~the~~ Pacific Northwest to the new company, Pacific **Northwest** Bell Telephone-Company (hereafter Northwest), on June 30, 1961. Pacific received in exchange: (1) **30,450,000** shares of Northwest's common stock; (2) an interest-bearing demand note in the amount of **\$200,000,000**; and (3) Northwest's assumption of liabilities in the amount of about **\$30,000,000**. Pacific ceased doing business in the Pacific Northwest on June 30, 1961, and Northwest commenced operations on July 1 as a member of The Bell System's unitary business. With few exceptions, each of the officers and employees Of the Pacific-Northwest Division commenced employment with Northwest at the same position and in the same location as before. With only one exception, all of Northwest's directors had **served** on one of Pacific's Advisory Councils or as **officers** of the Pacific-Northwest Division.

On September 29, 1961, Pacific distributed to its **shareholders** assignable rights to purchase about 57 percent of the Northwest stock. The rights were exercisable until October 20, 1961, and six rights plus a payment of \$16 were required to purchase one share of Northwest common. As a result of this offering, Pacific sold **17,446,031** Northwest shares for **\$279,136,496**. American purchased about 90 percent of these shares for **\$248,770,240**, and thereby acquired ownership of approximately 51 percent of Northwest's outstanding stock. In

Appeals of Pacific Telephone
and Telegraph Company

June of 1963, Pacific offered the remaining 43 percent of Northwest common to its shareholders on terms substantially similar to the first offering. Management decided to make the offering at that time in order to avoid the necessity of issuing new long-term debentures. Pacific received a total of **\$208,223,504** from this sale, **\$185,558,572** of which came from American. Following this second offering, American owned about 89 **percent** of Northwest's stock, and the rest was owned by Pacific's minority shareholders or their assignees.

In its franchise tax return for the income year 1961, Pacific treated the transfer of assets to Northwest as a transfer to a controlled corporation governed by Revenue and Taxation Code section 24521. Since the transfer was also between members of a combined report group of unitary affiliates, Pacific eliminated from unitary income the **\$200,000,000** of gain arising from the demand note and required to be recognized under section 24521. This gain, along with the amount of liabilities assumed by Northwest, was then subtracted from Pacific's basis in the transferred assets to arrive at its basis in the Northwest stock. When the **first** offering of stock was made in 1961, Pacific treated it as a transaction incident to the reorganization. Accordingly, Pacific eliminated from income the gain realized from the transfer of stock to American, and reported the gain from sales to minority shareholders as unitary income subject to formula apportionment. Pacific reported its gains from the 1963 stock sales in an identical fashion.

After examining Pacific's returns, respondent agreed with Pacific's treatment of the gain arising from the transfer of assets to Northwest, and with its computation of its basis in the Northwest stock. But respondent disagreed with Pacific's treatment of the gain from the sales of stock. On the theory that the Northwest shares were nonunitary assets in Pacific's hands, respondent determined **that all** of the gain (totalling **\$142,503,937**) from the **stock** sales constituted nonunitary income which California, as the state of Pacific's commercial domicile, may tax in its entirety. That determination led to the deficiency assessments now before us.

Under Revenue and Taxation Code section 25101, as it read during the years in question, the tax **liability** of a corporation with income from sources both within and without the state must be measured by the income from California sources. If the taxpayer is engaged in a

Appeals of Pacific Telephone
and Telegraph Company

unitary business with affiliated corporations, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 161 (1947)], and John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dismissed 343 U.S. 939 196 L. Ed. 1345] (1952).)

For the years before us, the rule for determining whether income from property constitutes apportionable unitary income is set forth in subdivision (d) of regulation 25101:

Income from property, which is not a part of or connected with the unitary business, is excluded from the income of the unitary business which is allocated by formula. Income from intangible personal property which is not a part of or connected with the unitary business, is allocated according to **situs....** (Cal. Admin. Code, tit. 18, reg. 25101, **subd.** (d) (1), in effect for income years beginning before January 1, 1967.)

By implication, income from property which is connected with or a part of the unitary business constitutes apportionable unitary income. (Appeal of W. J. Voit Rubber Corp., 1 St. Bd. of Equal., May 12, 1964.) The question, therefore, is whether the nature of the connection between the Northwest stock and the unitary business requires inclusion of the gains in unitary income.

In a number of previous cases, we have held that **income from intangibles** was unitary income where the acquisition, management, and disposition of the intangibles **constituted** integral parts of the taxpayer's regular **business** operations. (Appeal of Marcus-Lesoinc, Inc., Cal. St. Bd. of Equal., July 7, 1942; Appeal of Houghton Mifflin Co., Cal. St. Bd. of Equal., March 28, 1946; Appeal of International Business Machines Corp., Cal. St. Bd. of Equal., Oct. 7 1954; Appeal of National Cylinder Gas Co., Cal. St. Bd. of Equal., Feb. 5, 1957. Cf. Appeal of Capital Southwest Corp., Cal. St. Bd. of Equal., Jan. 16, 1973; Appeal of General Dynamics Corp.... Cal. St. Bd. of Equal., June 3, 1975 opinion on denial of rehearing, Sept. 17, 1975.) **Conversely**, in other cases, where we found that the income came from investments in

Appeals of Pacific Telephone
and Telegraph Company

intangibles not connected with the unitary business, we held that the income was nonunitary. (E.g., Appeal of American Airlines, Inc., Cal. St. Bd. of Equal., Dec. 18, 1952; Appeal of Fibreboard Products, Inc., Cal. St. Bd. of Equal., Feb. 17, 1959; Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961. See Appeal of General Dynamics Corp., supra.) Pacific's income from the Northwest stock does not fit neatly into either category, since it was neither operating income nor income from an investment made in customary fashion for typical investment purposes, but under the particular facts presented, we believe it is more appropriate to classify these gains as unitary income.

As we view this case, what occurred was simply a change in the form of The Bell System's unitary business. Control of a portion of the business was passed from one member of the corporate group to another, and the employees, assets, and business operations of that part of the business continued unchanged and remained within the unitary group. Under these circumstances, we believe respondent erred in, **splitting** the reorganization into two parts: a unitary transfer of assets to Northwest, and nonunitary sales of stock by Pacific. The stock sales were as much an integral part of the reorganization plan as the transfer of assets to Northwest, and they should not, in our opinion, be treated as any less unitary. The reorganization effected here was a single, integrated transaction which must be viewed as a whole; its various steps, therefore, ^{1/} should not be treated separately for tax purposes. (Commissioner v. Court Holding Co., 324 U.S. 331 [89 L. Ed. 981] (1945); Appeal of Chris-Craft Industries, Inc., Cal. St. Bd. of Equal., March 26, 1968.)

^{1/} It would, theoretically be possible, of course, to **treat** the reorganization as a nonunitary transaction in its entirety. This result could be reached by **recharacterizing** the transfer of assets to Northwest as nonunitary. However, while the several steps in the reorganization would at least be treated consistently under this view, we do not believe that a mere rearrangement of the unitary business should be characterized as anything other than a unitary transaction.

Appeals of Pacific Telephone
- and Telegraph Company

Respondent argues that, in the case of a taxpayer not **engaged** in the business of dealing or investing in intangibles, income from stock is nonunitary unless the acquisition, retention, and disposition of the stock were "'inextricably entwined" with the taxpayer's unitary business. (Appeal of General Dynamics Corp., supra.) The sales **of stock** were not inextricably entwined with the earlier asset transfer, respondent says, because the sales of stock in 1963 were not made pursuant to a binding commitment to sell any particular amount of stock, at any particular time, at any particular price. As support for this position, respondent relies on Commissioner v. Gordon, 391 U.S. 83 [20 L. Ed. 2d 448] (1968), which held that, for purposes of section 355 of the Internal Revenue Code, the 1961 distribution was not a step in a plan of total divestiture of the Northwest stock. The basis for this holding was that, although Pacific had made a commitment to its shareholders to distribute 56 percent of the Northwest stock immediately after acquiring it, it had not made a promise to distribute the rest of the stock at any particular time or price.

In Gordon, the Supreme Court was concerned with **specific, detailed** statutory requirements governing the circumstances under which certain distributions of securities will not result in recognized gain or loss to the distributee shareholders. That is not the situation confronting us here. We are concerned with Pacific's tax liability, not with that of its shareholders, and there are no detailed statutory provisions which must be satisfied in order to classify this reorganization as a unitary transaction. It is sufficient for our purposes that a specific plan to restructure the form of unitary business was adopted and carried out, and we see no reason, under unitary theory, to split this reorganization into unitary and nonunitary parts.

One additional matter requires consideration. At the oral hearing, we asked the parties to submit additional briefs discussing the effect, if any, of Revenue and Taxation Code section 23040 on the disposition of **this** issue. That section states:

Income derived from or attributable to sources within this State includes income from tangible or intangible property located or having a **situs** in this State and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate or foreign commerce.

Appeals of Pacific Telephone
and Telegraph Company

In Fibreboard Paper Products Corp. v. Franchise Tax Board, 268 Cal. App. 2d 363 [74 Cal. Rptr. 46] (1968), the court construed section 23040 to require specific allocation to California of income from certain securities owned by a taxpayer engaged in a unitary business and having a California commercial domicile. The court's theory was that since the intangibles had a **situs** in California under the doctrine of mobilia sequuntur personam, the income from them was derived from a **California** source and therefore had to be included in the measure of **Fibreboard's** franchise tax liability. The court specifically stated that section 23040 mandated this result even though the securities had been held for unitary purposes, viz., as a reserve against certain potential uninsured losses of the unitary business, and to meet the estimated federal and state tax liabilities of the unitary business.

In its post-hearing brief, respondent argues that, since Pacific's legal and commercial domiciles are in California, section 23040 requires that the gains from the sales of the Northwest stock be specifically allocated to this state, regardless of whether the sales are classified as unitary or nonunitary transactions. To our knowledge, respondent has not previously contended that section 23040 has such broad scope. Indeed, this construction of the statute appears to be at odds with California's prior administrative practice of uniformly applying the unitary business concept without regard to the domicile of the particular taxpayer involved. (E.g., compare Appeal of Tri-State Livestock Credit Corp., Cal. St. Bd. of Equal., April 4, 1960, and Appeal of Interstate Finance Co., Cal. St. Bd. of Equal., Aug. 9, 1961, with Appeal of Capital Southwest Corp., supra; and compare Appeal of American Airlines, Inc., supra, with Appeal of Fibreboard Products, Inc., supra.)

We cannot accept the proposition that section 23040 requires specific allocation of all income from intangibles owned by a corporation domiciled in California. The principal difficulty with this interpretation of section 23040 is that, under the language of that section, there is no apparent basis for limiting the application of this rule to intangibles. If the income from all California-sited intangibles must be specifically allocated to this state, then a similar result would seem to be required for income arising from California-sited real and tangible personal property, even though such property is used in the owner's unitary business or held for sale or rent to customers in the ordinary course of a unitary

Appeals of Pacific Telephone
and Telegraph Company.

business. Obviously, this interpretation of section 23040 would wreak havoc with the apportionment provisions of section 25101 in a great many cases, and it is inconceivable to us that section 23040 was intended to have such far-reaching effects.

In our opinion the very most that could be required by section 23040 is the specific allocation of nonunitary income.^{2/} Even that, however, may be overstating the original purpose of the language now appearing in that statute. In 1939 this language was inserted into section 10 of the Bank and Corporation Franchise Tax Act, the predecessor of current section 25101. Some 20 years later, in a case involving patent royalties, we stated that the language in question "merely defined the sources of income for purposes of [section 10] and did not purport to limit the manner in which the amount of income attributable to such sources was to be determined."

Appeal of St. Regis Paper Co., Cal. St. Bd. of Equal., Dec. 16, 1958.) We went on to hold that the royalties were unitary income subject to formula apportionment in the same manner as the unitary income attributable to the appellant's business activities and to its use of tangible property.

Whatever the **true** purpose of section 23040, we do not believe that it overrides the apportionment of unitary income required by section 25101. To hold otherwise would mean that foreign and domestic corporations, otherwise similarly situated, would be taxed differently on their unitary business income. Under California's long-standing method of corporate taxation, the propriety of that result is dubious at best. (See Pacific Telephone and Telegraph Co. v. Franchise Tax Board, 7 Cal. 3d 544 [102 Cal. Rptr. 782; 498 P.2d 1030] (1972); cf. Matson Navigation Co. v. State Board of Equalization, 3 Cal. 2d 1, 11 [43 P.2d 805] (1935), affd. 297 U.S. 441 [80 L. Ed. 7911 (1936)].)

2/ Despite some dictum to the contrary in the court's opinion, the holding of Fibreboard Paper Products Corp. v. Franchise Tax Board, supra, **is** not inconsistent with **this view**, since the income specifically allocated in that case was investment income which had historically been regarded as nonunitary income.

Appeals of Pacific Telephone
and Telegraph Company

For the reasons stated above, we hold that Pacific's gain on its sales of Northwest stock was unitary income subject to apportionment by formula. Accordingly, respondent's action on this issue will be reversed.

II

For the income years 1967-1970, should the sales factor include the gross receipts from the sale or redemption of certain interest-bearing and discount securities?

A number of Bell System companies, including Pacific, maintain "pools" of working capital. During each of the years in question, the aggregate value of these pools approximated one billion dollars. Pooled funds not needed currently in the business are typically invested in various types of short-term securities, and the gross receipts we are concerned ^{3/}with here arise from the turnover of these investments. For convenience, the following discussion will focus primarily on American's pool of funds, which is by far the largest pool maintained by any Bell System affiliate.

Under the **standard** license contracts between American and each of its operating telephone companies, American is required to provide a broad range of financial assistance to its subsidiaries. In order to fulfill this obligation, American maintains a large pool of funds at its New York headquarters. From time to time, as the cash needs of its subsidiaries dictate, American transfers funds to them in the form of loans, advances, and stock investments. **The subsidiaries use these funds to**

3/ Pacific's refund claims are based primarily on **including** the **gross receipts** from these investments in the sales factor. A portion of the claims, however, is based on **inclusion** of certain other receipts in the factor. Although the refund claims were denied in their entirety, it now appears that respondent objects only to including the receipts from the short-term securities. Accordingly, respondent's action will be reversed to the extent that Pacific's claims are based on the following categories of receipts set forth in Exhibit A of Pacific's Supplemental Statement: Dividends, Interest on U.S. Obligations, Other Interest, Gross Rents, Gross Royalties, and Other Income.

Appeals of Pacific Telephone
and Telegraph Company

pay taxes, dividends and interest, to provide for capital needs, and to meet legal liquidity and credit rating requirements. Borrowing and repayment arrangements are flexible, permitting the operating companies to borrow one day and repay the next. Repayments by the subsidiaries come from cash accumulations in the ordinary course of business, or from the proceeds of their security issues.

American derives the funds for its pool from dividends and license fees paid by its subsidiaries, and from public offerings of its own stock and debt instruments. Pending their use in the unitary business, the funds are invested in short-term, interest-bearing and discount securities such as U.S. Treasury bills, other obligations of federal, state and local governments, bank certificates of deposit, and various types of commercial paper. As a general rule, these investments are held to maturity, but some are sold each year to meet unscheduled cash needs of the unitary business. The pool is managed by a **full** time special staff of American's treasury department in New York, and the securities themselves are held in New York depositories.

For the income years 1967, 1968, 1969, and 1970, respectively, the members of The Bell System had gross receipts of \$8.561 billion, \$9.164 billion, \$9.047 billion, and \$9.492 billion from nonintercompany sales and redemptions of interest-bearing and discount securities. American's total receipts from such transactions were: 1967-\$6.430 billion; **1968-\$7.051 billion; 1969-\$5.907 billion; 1970-\$5.953 billion.** If one adds the comparable receipts that were realized by Western Electric Company, which also maintained a pool of funds in New York, the total gross receipts from New York-based investment activities were: **1967-\$8.217 billion; 1968-\$8.785 billion; 1969-\$8.188 billion; 1970-\$8.511 billion.** The income (interest, gains and losses) directly generated by the investment activities of all Bell System affiliates was approximately \$54 million a year, which was less than two percent of total unitary business income.

In its original returns for the years in issue, Pacific excluded the gross receipts from short-term investments from the sales factor. As originally reported, total gross receipts from other unitary business operations were as follows: **1967-\$14.75 billion; 1968-\$15 billion; 1969-\$16.5 billion; 1970-\$18 billion.** Pacific subsequently decided that it should have included the investment receipts in the sales factor, and it therefore

Appeals of Pacific Telephone
and Telegraph **Company**

filed the refund claims now before us. Respondent denied the claims, on the ground that including these receipts in the factor would not fairly represent the extent of Pacific's business activity in this state (see Rev. & Tax. Code, § 25137), and Pacific has appealed.

For income years beginning after December 31, 1966, Pacific's net income must be allocated and apportioned in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (hereafter referred to as UDITPA), which is contained in sections 25120-25139 of the Revenue and Taxation Code. Generally speaking, UDITPA requires that a taxpayer's unitary "business income" be apportioned by means of a **three-**factor formula composed of property, payroll, and sales. (Rev. & Tax. Code, § 25128.) The sales factor is defined 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." (Rev. & Tax. Code, § 25134.) The term "sales" means **"all** gross receipts of the taxpayer" other than those related to items of "nonbusiness income" that are specifically allocable to a particular state under sections 25123-25127. (Rev. & Tax. Code, § 25120, **subd.** (e).)

Since the parties agree that the income generated by the working capital investment **activities** is business income, except for a very few items, ^{4/} it would seem to follow that the gross receipts from these activities come within the literal definition of "sales" that are **includible** in the sales factor. If this is so, and Pacific says it is, then the denominator of the factor must contain all of the investment receipts, and the numerator must contain the portion of the receipts which arises from sales "in this state." (Rev. & Tax. Code, § 25134.) Under section 25136, which applies to all sales other than those of tangible personal property, **sales** are "in this **state**" if:

^{4/} The exceptional items are gains from certain sales of stock referred to in the footnotes of respondent's Exhibit D. Pacific and respondent have agreed, for purposes of this appeal, that these gains were nonbusiness income and that the gross receipts from these sales should be excluded from the sales factor.

Appeals of Pacific Telephone
_ and Telegraph Company

(a) The income-producing activity is performed in this state; or

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

It would appear that the income-producing activity associated with each pool of funds is performed exclusively in the state where that particular pool is located. Therefore, all of the investment receipts from Pacific's California-based pool are includible in the numerator, while none of the receipts from the much larger New York pools are includible. This is the result sought by Pacific.

Except for questioning whether receipts from the sale **or redemption** of debt securities should be considered "sales" for purposes of the sales factor, respondent does not dispute Pacific's analysis of the relevant UDITPA provisions. Its principal attack comes, instead, from another direction. Relying on section 25137, which permits **deviation** from **UDITPA's** normal allocation and apportionment provisions when they "do not fairly represent the extent of the taxpayer's business activity in this state," respondent argues that including all of the investment receipts in the sales factor would result in an unreasonable apportionment of the income from The Bell System's communications business. While it objects to the inclusion of total gross investment receipts, respondent does concede that the interest or yield generated by the debt securities should be reflected in the sales factor. What we must decide, therefore, is whether section 2.5137 permits respondent to exclude the return of capital element of the investment receipts.

In a number of recent cases, we have held that the special allocation and apportionment methods authorized by **section** 25137 may not be employed unless the party invoking that section first proves that **UDITPA's** standard provisions do not fairly represent the extent of the taxpayer's business activity in California. (See, e.g., Appeal of Donald M. Drake Co., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Danny Thomas Products, Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Revere Copper and Brass, Inc., Cal. St. Bd. of Equal., July 26, 1977.) The underlying reason for this policy is, of

Appeals of Pacific Telephone
and Telegraph Company

course, to foster uniformity among UDITPA jurisdictions by requiring that **UDITPA's** normal rules be applied unless there is a clear showing that they work unfairly or unreasonably in a particular situation. Respondent points out, however, that public utilities were specifically excluded from coverage under the original version of UDITPA adopted by the National Conference of Commissioners on Uniform State Laws. Because of that exclusion, respondent argues that it has greater discretion to modify the normal rules for Pacific since uniformity is not a compelling consideration. In spite of the position taken by the NCCUSL, however, our Legislature decided to extend **UDITPA's** umbrella to public utilities by deleting the exclusionary language from California's version of the statute. This decision by the Legislature indicates to us that a utility ought to be treated like any other taxpayer subject to UDITPA, which means, in this case, that respondent cannot employ section 25137 against Pacific without making the same showing it would be required to make if Pacific were engaged in a mercantile or manufacturing business.

In attempting to meet its burden of proof, respondent contends that the formula is seriously distorted by including in the **sales** factor an enormous volume of receipts which would be attributed almost entirely to one state (New York). The record reveals that if the investment receipts were to be combined with the gross receipts from other business activities, they would constitute, on average, approximately 36 percent of the combined total during each appeal year. The receipts from the New York-based investment activities would average 34 percent of total receipts, ranging from a low of 32 percent in 1970 to a high of 37 percent in 1968. (American's investment receipts alone would average more than 25 percent of total receipts, ranging from 22 percent in 1970 to 29 percent in 1968.) Thus, because of this one activity alone, section 25136 would treat approximately ~~one-third~~ of The Bell System's total "Sales" as having taken place in New York. Moreover, when this sales ~~factor~~ of one-third is multiplied by the weight given to it in the standard apportionment formula (~~one-third~~), the inclusion of the investment receipts causes the formula to assign to New York at least one-ninth (or about 11%) of The Bell System's entire business activities. In respondent's opinion, the standard formula clearly reaches an unreasonable result because, on the basis of the investment-management activities of a few employees,

Appeals of Pacific Telephone
and Telegraph **Company**

it assigns great weight to an incidental aspect of the **unitary** communications business that directly produces only minor amounts of business income. For the reasons expressed below, we conclude that respondent has met its burden.

In analyzing a problem concerning the composition of one of the factors, it is appropriate to begin by focusing on the role which that factor plays in the formula. Generally speaking, the sales factor should reflect the markets for the taxpayer's goods or services since its purpose is to balance the property and payroll factors by giving weight to elements of the business not reflected **by** those factors. (See generally Altman and Keesling, Allocation of Income in State Taxation (2d ed. 1950), pp. 126-128; see also Appeal of The Babcock and Wilcox Co., Cal. St. Rd. of Equal., Jan. 11, 1978.) Where, as here, we are asked to decide whether certain receipts belong in the factor, we believe that the relevant inquiry is whether including those receipts would tend to accomplish the sales factor's basic function.

In this case; we think the answer to that question is clear. The inclusion of this enormous volume of investment receipts **substantially** overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all the other states, including California, which supply the markets for the communications services provided by Pacific and its affiliates. Moreover, we are unable to accept, even for a moment, the notion that more than 11 percent of The Bell System's entire unitary business activities should be attributed to any single state solely because it is the center of **working** capital investment activities that are clearly only an incidental part of one of America's largest, and most widespread, businesses. We conclude, therefore, that **UDITPA's** normal provisions "do not fairly represent the extent of the taxpayer's business activity in this state," and that respondent is authorized, under section 25137, to require a deviation from the normal rules. However, since section 25137 specifically requires that all special rules be "reasonable", we now turn to Pacific's contention that it is not reasonable for respondent to exclude the entire return of capital element of the investment receipts.

Pacific bases its argument on the proposition that the pools of working capital, particularly the one maintained by American, play a central role in the **finan-**

Appeals of Pacific Telephone
and Telegraph Company

cial operations of the unitary business and in the production of unitary income. Since the pools constitute such an important part of the business, Pacific argues, a reasonable formula must give weight to them, and it believes that they will not be adequately reflected unless the capital element is included, at least to some extent, in the sales factor.

There is no question that the existence of the pools is very important to The Bell System's business, just as working capital is important to any other business. We have serious doubts, however, whether the turnover of assets in those pools has any value to the unitary business beyond the income that it generates directly. In any event, as respondent points out, the contribution made by the pools is reflected in the payroll factor, which includes the payroll attributable to the employees who manage the pools, and in the sales factor, which respondent has conceded should include the income element of the investment receipts. Whether this constitutes adequate or "reasonable" reflection of the working capital pools is, of course, the sort of subjective question which rarely lends itself to an indisputable conclusion. Under the facts of this case, however, we are not persuaded that reasonableness necessarily requires that the capital element of the investment receipts be included in the sales factor.

Accordingly, respondent's action on Pacific's refund claims will be modified to reflect the several concessions noted in our opinion.

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,

Appeals of Pacific Telephone
and Telegraph Company

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 Pacific Telephone and Telegraph Company against proposed assessments of additional franchise tax in the amounts of **\$4,453,195.72** and **\$3,395,416.96** for the income years 1961 and 1963, respectively, be and the **same** is hereby reversed. It is further ordered, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Pacific Telephone and Telegraph Company for refund of franchise tax in the amounts of **\$3,817,753.71**, **\$4,064,969.00**, **\$3,241,009.00**, and **\$2,211,460.00** for the income years 1967, 1968, 1969, and 1970, respectively, be and the same is hereby modified in accordance with the concessions of the parties.

Done at Sacramento, California, this **4th** day
of May , 1978, by the State Board of Equalization.

Scott P. Kelly , Chairman
William K. Kelly , Member
William K. Kelly , Member
_____, Member
_____, Member