

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
J. F. SHEA CO., INC. ) No. 87A-1007-MW  
)

Appearances:

For Appellant: Frederick A. Richman  
Attorney at Law

For Respondent: Paul J. Petrozzi  
Counsel

O P I N I O N

This appeal is made pursuant to section 25666<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of J. F. Shea Co., Inc., against proposed assessments of additional franchise tax in the amounts of \$180,707 and \$88,488 for the income years 1980 and 1981, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appeal of J. F. Shea Co., Inc.

The sole issue in this appeal is whether the Franchise Tax Board (**FTB**) correctly recomputed appellant's unitary business income./

Appellant acquired Malta Properties, Inc. (Malta), in 1980 and acquired Anderson Cottonwood Concrete Products, Inc. (**ACCP**), in 1981. It is undisputed that appellant and its subsidiaries were engaged in a unitary construction business during the appeal years.

For both its 1980 and 1981 income years, appellant had business income from long-term construction contracts which it reported using the completed contract method of accounting as prescribed by regulation 25137-2 (Cal. Code Regs., tit. 18, reg. **25137-2.**) Neither of appellant's subsidiaries had income from long-term construction contracts for the appeal years. Appellant and its subsidiaries filed combined reports that showed net unitary business income of \$120,810 for 1980 and **\$6,799,171** for 1981. For each year, the combined group computed and paid a single tax based on the group's California net business and nonbusiness income.

After an audit, the FTB issued proposed assessments to appellant for 1980 and 1981 based on the **FTB's** recalculation of the business income of appellant and its subsidiaries. It appears that the FTB also used the procedure in regulation 25137-2 to calculate the California long-term contract income and the California "other business income" of the group, but instead of adding these two amounts to produce a total net California business income figure., it first apportioned the long-term contract income among the corporations and then separately apportioned the other business income among the corporations. Then, for each corporation, it added the apportioned long-term contract income to the apportioned other business income to determine the business income of each corporation. This resulted in a net business income amount for appellant and net business loss amounts for the subsidiaries. The net business income amount attributed by the FTB to appellant exceeded the total of the California net business income for the entire unitary group.

The taxpayer argues that, since it is clearly engaged in a unitary business and entitled to file a combined report, it should not have to pay tax on business income in an amount

2/ Appellant has apparently conceded several issues which were included in the original notices of proposed assessment. The amounts attributable to the only remaining issue are approximately \$8,988 for 1980 and \$39,178 for 1981.

Appeal of J. F. Shea Co., Inc.

greater than the combined business income of the unitary group which is apportioned to this state. Its position appears to be that all of the group's California business income, both long-term contract income and other business income (or loss), should be combined, resulting in a total California net business income amount which may then be subject to intrastate apportionment. Appellant points out, however, that the intrastate apportionment should not be necessary since its situation did not fall within either of the two categories enumerated on the combined report form which make a unitary group ineligible to compute a single tax for the group.

The rationale of the FTB is somewhat vague. Much of its argument is addressed to appellant's alleged disregard of the separate corporate existence of the unitary affiliates, a position which the taxpayer denies it is taking. The FTB takes the position that, even though appellant and its subsidiaries are engaged in a unitary business, business losses of one corporation cannot be combined with, and offset against, business income of another corporation. It attempts to justify this position on the basis that appellant uses the completed-contract method of accounting for long-term contracts.

The FTB says that it must treat appellant separately from its subsidiaries because appellant reports some of its income on the completed-contracted method of accounting and thus "falls into a different tax category from the other members of the unitary group." (Resp. Post. Hrg. Br. at 4.) The "different tax category" language upon which the FTB appears to rest its case comes from this board's opinion in the Appeal of Joyce, Inc., decided November 23, 1966. We reject the FTB's reasoning for a number of reasons.

First, the "different tax category" language of Joyce was taken from the Altman and Keesling book, Allocation of Income in State Taxation, (2d ed. 1950) at pages 176 through 177. The example given by Altman and Keesling on page 177 of the "different tax category" situation is "if one [taxpayer] were an individual and the others were corporations." Appellant's use of the completed-contract method of accounting for the portion of its income attributable to long-term construction contracts is not at all similar to either the Altman and Keesling example or to the Joyce situation, where one of the unitary corporations was not taxable by California due to P.L. 86-272 [15 U.S.C.A. §§381-384]. Furthermore, reading the rest of Altman and Keesling's paragraph on page 177 makes it clear that the authors did not contemplate any sort of separate treatment for California corporations in different tax categories, but simply a further intrastate apportionment by formula of the California business income. Secondly, this

board specifically overruled its holding in Joyce in the Appeal of Finnigan Corporation, Opinion on Petition for Rehearing, decided January 24, 1990. Even if the principle espoused by the FTB could somehow legitimately be derived from Joyce, which we do not believe, the analysis used in that opinion is no longer authoritative.

Lastly, and perhaps most importantly, the position taken by the FTB misstates and violates fundamental principles of the unitary business and combined report concepts. The FTB states that "each entity must be treated separately," and "each entity must have its income and tax determined separately." (Resp. Post Hrg. Br. at 4.) We agree, as does the appellant, that the separate identities of corporations engaged in a unitary business and filing a combined report may not be ignored. However, the FTB, in its insistence that the corporations be treated as separate entities, merely repeats a rubric without providing any basis for concluding that such treatment requires the result it propounds. Long-term construction contract income is simply a type of business income. The fact that the income is reported using the completed-contract method does not affect its characterization as business income. (Cf. Appeal of Triangle Publication, Inc., Cal. St. Bd. of Equal., June 27, 1984 (installment reporting did not affect business income characterization).) The FTB has cited no authority which would support its segregation of one type of business income from the rest.

At the hearing in this matter and in its post-hearing brief, FTB raised another objection to including the long-term construction contract income as part of the unitary group's business income. It argues that none of the long-term construction contract income attributable to activities during years preceding the acquisitions of Malta and ACCP may be assigned to those corporations because they were not part of the unitary group when the activities occurred.<sup>3/</sup> This argument is very similar to one that FTB made, and we rejected, in the recent Appeal of The Signal Companies, Inc., decided by this board on January 24, 1990. In that appeal, the FTB argued that the appellant there could not deduct on its combined report certain properly accrued business losses of one of its recently acquired subsidiaries because the transactions that produced the losses occurred before the subsidiary was

<sup>3/</sup> This statement by FTB is confusing since it appears that the FTB, after determining the total California completed-contract income for each year, apportioned (assigned?) some of that income to Malta and ACCP.

Appeal of J. F. Shea Co., Inc.

acquired. As in this appeal, the FTB in Signal presented "no authority whatsoever in support of its conclusion and we certainly [could] find none, either legal or logical." (Appeal of The Signal Companies, Inc., supra.) We agreed with the appellant in Signal that if the loss tracing proposed by the FTB were to be done, consistency would require that items of income would also need to be traced and that such a procedure was hardly likely to "be workable or even palatable for the FTB." Although the FTB appears to find income and loss tracing palatable in this particular instance, we find that it is not required and continue to believe that, carried to its logical conclusion, it would be unworkable in almost all instances.

We conclude that the FTB's method of computing appellant's California taxable income was in error. To be consistent with long-established unitary principles, all of the business income of the unitary group, including that from long-term construction contracts, must be combined to determine net California business income of the group. Normal intrastate apportionment may then be used to apportion the net business income among the members of the unitary group, if necessary.

Based on the foregoing, the action of the FTB must be modified to reflect appellant's concessions and the foregoing opinion.

