BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of Bechtel Power Corporation, Bechtel Corporation, Sequoia Ventures, Inc., Bechtel Group, Inc., and Fremont Investors, Inc.	)))))	Nos. 91R-1084, 93R-1225, and 96R-0822

Representing the Parties:

For Appellant: James R. Bridges, Attorney

For Respondent: Alison M. Clark, Counsel

O P I N I O N

These appeals are made pursuant to Section 19324, subdivision (a), of the Revenue and Taxation Code[1] from the action of the Franchise Tax Board in denying the claims for refund of franchise tax as follows:

Appellants	Income Years Ended	Claims For Refund
Bechtel Power Corporation	12/31/78	$359,139
91R-1084	12/31/79	433,437
	12/31/80	572,460
Bechtel Corporation	12/31/78	158,848
93R-1225	12/31/79	249,013

[1] Unless otherwise specified, all Section references are to Sections in the Revenue and Taxation Code as in effect for the income years at issue.

	12/31/80	205,829
Sequoia Ventures, Inc.	12/31/78	202,539
96R-0822	12/31/79	122,001
	12/31/81	3,517
	12/31/82	3,397
	12/31/83	4,876
Bechtel Group, Inc.	12/31/81	1,158,350
96R-0822	12/31/82	1,175,059
	12/31/83	1,151,993
Fremont Investors, Inc.	12/31/81	1,846
96R-0822	12/31/82	93,407
	12/31/83	69,126

In this case of first impression, we must decide whether the costs of client furnished materials under a cost-plus contract should be included in the California sales factor of a contractor doing business within and without California.

During the years at issue, appellants were engaged in a unitary engineering and construction business. Many of appellants' contracts were "cost-plus" contracts under which the customer agreed to pay the actual costs of materials and payroll plus an additional fee for services. In performing these contracts, appellants provided a full range of services including design, preparation of specifications, evaluation of proposals, negotiation, inspection, and testing. Appellants purchased materials under a cost-plus contract in one of three ways:

1. With their own funds and billed the customer for reimbursement;
2. With money advanced by the customer or deposited into a bank account by the customer over which appellants had signature authority. Appellants received the materials and the supplier invoices in their own name; or
3. Either as the customer's agent, or the customer issued its own purchase order for the materials. The supplier invoices were paid directly by the client after appellants' approval. Materials obtained in this fashion are considered "client furnished materials."

The parties agree that the funds expended under #1 and #2 are included in the denominator of the sales factor. With respect to #3, appellants argue that because the sales factor is intended to represent the taxpayer's activities it should include the total value of its contract. Respondent argues that appellants merely act as agents when using client furnished materials and therefore should only be allowed to include the fee for their services in determining the sales factor. We disagree and reverse respondent's action denying appellants' claims.

The Uniform Division of Income for Tax Purposes Act (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." (Rev. & Tax. Code, § 25120, subd. (e); Cal. Code Regs., tit. 18, § 25134, subd. (a).) Most significantly, the regulations indicate that "[i]n the case of cost-plus fixed fee contracts, such as the operation of a government-owned plant for a fee, 'sales' includes the entire reimbursed cost, plus the fee." (Cal. Code Regs., tit. 18, § 25134, emphasis added.)

We emphasize that this case does not involve the computation of appellants' total income to be taxed, but rather the composition of the formula which determines how that income is to be apportioned to California. This distinction is critical because we must determine which computation of the sales factor leads to a better measure of economic activity in California. Stating the matter broadly, whereas the mechanical, precise application of black-letter law is quite important in determining the amount of income to be taxed, apportionment of that income has been recognized by the United States Supreme Court to be a more general, "reasonable sense" inquiry. (Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 169 (1983).)

In Appeal of North American Aviation, Inc., decided on October 7, 1952, the Board rejected the taxpayer's attempt to double count the same receipts for purposes of the sales factor:

> Appellant's position...loses sight of the fact,...that the amount of its sales is material in the present controversy, not from the standpoint of [the law of sales] or from the standpoint of proper accounting, but solely as a measure of Appellant's activity within and without California.

(Appeal of North American Aviation, supra; see also McDonnell Douglas Corp. v. Franchise Tax Board (1968) 69 C.2d 506, 511, fn. 4.)

In McDonnell Douglas Corp. v. Franchise Tax Board, supra, the taxpayer built aircraft at its own factories and also at factories owned by the Federal Government. In upholding the taxpayer's argument that the state's failure to include the value of the government facilities in its property factor was arbitrary and unreasonable, the court stated:

> With respect to each of [the] contracts[,] the use of the plant - whether owned by the plaintiff or provided by the government - was essential to the performance of the contract and the consequent production of income.

(McDonnell Douglas Corp., supra, at p. 514.)

Appellants rely on this language in support of their position that legal technicalities, such as whether a "sale has in fact occurred, should not determine the composition of the sales factor for purposes of the apportionment factor.

We do find that the McDonnell Douglas case illustrates the general premise set forth in this Board's opinion in Appeal of North American Aviation, supra, and the premise upon which we rely in rendering our decision today. Specifically, we find that the level of income producing business activity to be represented by the sales factor is best represented by inclusion of the full amount of the cost-plus contract.

Appellants' income producing business activity and the taxable income produced by that activity, is the same regardless of whether procurement was from the appellant's account or from its client's account. Including the entire reimbursed cost in appellants' sales factor, as mandated by the regulations, and excluding costs of client furnished materials from the sales factor was not only inconsistent but clearly resulted in an incorrect measurement of appellants' business activity in California.

Respondent argues that appellants actually sold the services necessary for a construction project and did not sell materials; under such a services contract, only the fees are included in gross receipts. (Cal. Code Regs., tit. 18, § 25134, subd. (a)(1)(c).) Respondent appears to focus on the party who bears the risk of loss for the materials and the monies advanced on behalf of the customer as the distinguishing factors in the first two scenarios. In essence, respondent suggests that there must be a "sale" of goods or similar legal transfer for the related funds to be included in appellants' sales factor. (See Coulter Electronics, Inc. v. Dept. of Rev. of the State of Florida (1978) 365 So.2d 806.)

Under respondent's approach, the resolution of the issue depends on the legal consequences of appellants' contractual arrangements with its clients under the law of sales and

contracts. This approach completely ignores the nature and extent of the business activity at issue--cost-plus contracts and client furnished materials.

We believe such a narrow interpretation and application of the law is neither required nor appropriate. To the contrary, the three factor apportionment formula should be interpreted and applied in a manner which comports with the basic purpose of apportionment--to treat as derived from California sources the portion of income which fairly represents the extent of the taxpayer's business activity in California. (Container Corporation of America v. Franchise Tax Board, supra.)

Treating the three procurement scenarios differently would, in essence, open a trap for the unwary and a planning opportunity for the well advised. Taxpayers would be able to use the choice of procurement options as a legal method of tax avoidance. We think such an opportunity for manipulation is not in the long-term interest of the tax system, particularly in light of our view that the underlying economic activity of the three procurement methods is identical. There may be circumstances involving cost-plus-fixed-fee contracts in which the taxpayer does not have discretion to choose the specifications and the seller of the goods to be acquired. In such cases a purchase of goods in the customer's names using customer funds may not be the economic equivalent of reimbursement under Reg. §24134(a)(1)(B).

We find that the sales factor is intended to represent the taxpayer's activities and therefore should include client furnished materials in the total value of the contracts.

Based on the aforementioned facts and applicable legal authorities, respondent's action is hereby reversed.

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 action of the Franchise Tax Board in denying of the claims for refund of the Bechtel Power Corporation in the amounts of $359,139.00, $433,437.00 and $572,460.00 for the years 1978, 1979 and 1980, respectively; of Bechtel Corporation in the amounts of $158,848, $249,013.00 and $205,829.00 for the years 1978, 1979 and 1980, respectively; of Bechtel Group, Inc. in the amounts of $1,158,350.00, $1,175,059.00 and $1,151,993.00 for the years 1981, 1982 and 1983, respectively; of Freemont Investors, Inc., in the amounts of $1,846.00, $93,407.00 and $69,126.00 for the years 1981, 1982 and 1983, respectively; and of Sequoia Ventures, Inc. in the amounts of $202,539.00, $122,001.00, $3,517.00, $3,397.00, and $4,876.00 for the years 1978, 1979, 1981, 1982 and 1983, respectively; be and the same is reversed.

Done at Sacramento, California, this 19th day of March 1997, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Andal and Mr. Chiang** present, Mr. Halverson* and Mr. Klehs not participating.

Ernest J. Dronenburg, Jr., Chairman

Dean F. Andal, Member

_____, Member

_____, Member

_____, Member

*For Kathleen Connell, per Government Code section 7.9.
**Acting Member, 4th District.