BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MATSON NAVIGATION CO., THE OCEANIC)
STEAMSHIP COMPANY, AND MATSON TERMINALS, INC.)

Appearances:

For Appellants: Gregory A. Harrison, Attorney of Brobeck, Phleger & Harrison; F. A. Bailey, Vice-President and General Manager of Matson Navigation Co.

For Respondent: Chas, J. McColgan, Franchise Tax Commissioner

O P I N I O N

'These are appeals pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protests of Matson Navigation Co., The Oceanic Steamship Company and Matson Terminals, Inc. to a proposed assessment of an additional tax of $19,637.71 for the year 1931 based upon their returns for the calendar year ended December 31, 1930.

It appears that the Appellants are corporations incorporated under the laws of this State, and, in addition to being engaged in business of a purely local character, are engaged largely in the business of transporting persons and property by vessels operating between ports on the Pacific Coast, including ports in California, and ports in Hawaii, the South Seas, Australia and New Zealand.

In their return for the year ended December 31, 1930, the Appellants did not report as subject to the franchise tax, imposed by the Act, any portion of their income from their business done in interstate or foreign commerce. The Commissioner, however, allocated to business done in this State that portion of Appellants' income from their business done in interstate and foreign commerce which the amount or business originating in this State bore to the total business done, and upon the basis of such allocation proposed the additional assessment in question.

Appellants contend that the Act cannot and should not be construed as imposing a tax measured by income derived from business done in interstate or foreign commerce, even though such a tax were within the power of the state to impose. In support of this contention, Appellants argue that nowhere does the Act specifically provide that income from business done in interstate or foreign commerce shall be included in the measure

of the tax but on the contrary, the Act provides that the tax shall be measured only by income from local or intrastate business.

We are unable to find any provision in the Act from which it can be inferred that the measure of the tax is confined solely to income from purely local or intrastate business. Although it is true that the Act does not specifically provide that income from business done in interstate or foreign commerce shall be included in the measure of the tax, we do not believe that such a specific provision is necessary to include such income, if the language used is sufficiently broad to include it and if it is not specifically excluded.

Section 4 of the Act as it read in 1931 provided that "every financial, mercantile, manufacturing and business corporation doing business within the limits of this State of the classes referred to in subdivision 2(a) of Section 16 of Article XXII of the Constitution of this State, shall annually pay to the State for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income.

Under this section, considered alone, it would seem that if a corporation of the classes mentioned does any business in this State, the tax should be measured by its entire net income, regardless of the source from which that income is derived, whether from purely local business or from business done in interstate or foreign commerce.

However, Section 10 of the Act, after stating that if the entire business of the corporation is done within this State, the tax shall be measured by its entire net income, provides that in case the entire business of the corporation is not done within this State, the tax shall, in order to avoid double taxation, be measured by that portion of the net income reasonably attributable to business done within this State.

Although, Section 10, in the interests of avoiding double taxation, limits the provisions of Section 4 of the Act to the extent of excluding from the measure of the tax, income derived from business done outside the state, there is nothing in this section from which it could be inferred that that portion of the income from business done in interstate or foreign commerce which is reasonably attributable to business done in this State should be excluded from the measure of the tax.

The Appellants argue that insofar as they are engaged in business in interstate or foreign commerce, they are not doing business within this State. This argument is manifestly unsound, It is apparent that even business done in interstate or foreign commerce must be done somewhere and it must be done either entirely within the state, entirely without the state or partly within and partly without the state. There are no other alternatives, Thus Appellants' argument would be valid.

only if their business done in interstate or foreign commerce were transacted wholly without the state. The very fact that Appellants are engaged in interstate commerce between this State and other states, and in foreign commerce between this State and foreign countries, would seem to exclude the possibility that all of such business is done entirely without the state, Furthermore, as a matter of fact, Appellants, as an incident to the conduct of their transportation business, engage in numerous activities here, such as the maintenance of offices for the sale of tickets and for the receipt of orders, and the loading and unloading of passengers and freight, etc. These activities, we think, clearly constitute doing business in this State.

In further support of their contention that the Act cannot or should not be construed as including income derived from business done in interstate or foreign commerce in the measure of the tax, Appellants present an argument based upon the fact that the Act makes no distinction between domestic and foreign corporations but imposes the tax, and specifies the income which shall be used as a measure of the tax, in terms applicable alike to both domestic and foreign corporation From this fact, Appellants draw the inference that if the Act be construed to impose a tax upon domestic corporations, such as Appellants, which are doing business in this State, measured by income derived from business done in interstate or foreign commerce, the Act must also be construed to impose a tax upon foreign corporations doing business here, measured by income derived from business done in interstate or foreign commerce.' But, Appellants argue, it is beyond the power of the state to impose a tax upon foreign corporations measured by income derived from business done in interstate or foreign commerce. Furthermore, Appellants maintain that the provisions of the Act imposing the tax and providing for the measure of the tax cannot be severed and held valid with respect to domestic corporations if they are invalid with respect to foreign corporations. Accordingly, Appellants conclude that if the Act is construed as imposing the tax upon domestic corporations measured by income derived from interstate or foreign commerce, the entire Act is rendered unconstitutional,

This argument, we believe is based upon a misunderstanding of the Act and upon a misconception of the power of the state to impose a franchise tax upon foreign corporations doing business in this State.

It is true that it has been held that the state may not impose a franchise tax, whether measured by net income or otherwise, upon foreign corporations doing business within the state, if the foreign corporation's business is exclusively interstate in character and if it does no local business whatsoever, (Alpha Portland Cement Co. vs. Massachusetts, 268 U.S. 203, 45 Supp. Ct. 477; Anglo - Chilean Nitrate Sales Co. vs. Alabama, 53 Supp. Ct. 373; People vs. Pacific Alaska Steamship Co. 182 Cal. 202). Presumably, a similar rule is applicable to foreign corporations whose business is exclusively of a foreign commerce character.

However, although the Act, as Appellants argue, does not distinguish in so many words between domestic and foreign corporations, and even though the Act be construed as imposing a tax upon domestic corporations measured by income for busines done in interstate or foreign commerce, it does not follow that the Act must be accorded a similar construction with respect to foreign corporations engaged exclusively in interstate or foreign commerce. Under the provisions of Section 4 of the Act, quoted above, the tax is imposed upon financial, mercantile, manufacturing and business corporations doing business in this State of the classes referred to in subdivision 2(a) of Section 16 of Article XIII of the Constitution. Subdivision 2(a) of Section 16 of Article XIII as it read prior to the amendments adopted by the people on June 27, 1933 (as amended, Section 16 does not contain a subdivision numbered 2(a)) refers only to those financial, mercantile, manufacturing and business corporations doing business within the limits of this State which are subject to be taxed pursuant to subdivision (d) of Section 14 of Article XIII. Section 14(d) it is to be noted, provides that with certain exceptions; s&h as the franchises of public utility corporations, all franchises shall be taxed at their full cash value. It was pursuant to this section that franchises of general corporations were taxed prior to the adoption of Section 16 of Article XIII and the enactment of the Bank and Corporation Franchise Tax Act.

Foreign corporations engaged exclusively in interstate or foreign commerce, not being subject to a franchise tax were thus not subject to be taxed pursuant to Section 14(d) (see People vs. Alaska Pacific Steamship Co., supra, expressly so. holding) and thus by the very terms of the Act, itself, are not subject to the tax imposed by the Act. Consequently, Appellants' argument to the effect that if the Act is to be construed as including in the measure of the tax income of domestic corporations derived from business done in interstate or foreign commerce, it must also be construed in a similar fashion with respect to foreign corporations is unsound insofar as foreign corporations engaged exclusively in interstate or foreign commerce are concerned.

A different situation is presented with respect to foreign corporations doing some local or intrastate business here. Undoubtedly, such corporations were subject to be taxed pursuant to Section 14(d) of Article XIII and; consequently, are subject the tax imposed by the Act. Thus, if the Act is construed as including in the measure of the tax on domestic corporations a portion of their income derived from business done in interstate or foreign commerce, it must also be construed, inasmuch as no distinction is made between domestic and foreign corporations subject to the Act, as providing that a portion of the income derived from interstate or foreign commerce shall be included in the measure of the tax on foreign corporations doing local or intrastate business here.

But contrary to Appellants' statements, we believe it is entirely within the power of the state to impose a franchise tax upon foreign corporations doing local or intrastate business here, and to measure that tax by income properly attributable to business done within the state, regardless of whether the business is intrastate business or whether it is of an interstate or foreign commerce character.

It has been held that a franchise tax measured by net income is not to be regarded as a tax upon income, and, consequently, there may be included in the measure of the tax, income, such as income from tax exempt bonds, which cannot be taxed directly (Flint vs. Stone Tracy Co. 220 U. S. 107, 31 Sup, Ct. 343; Pacific Co. vs. Johnson, 212 Cal. 148,285 U. S. 480). Thus it would seem arguable that if a corporation exercises a franchise granted by the state, the state may tax the franchise and include in the measure of the tax, income derived from interstate or foreign commerce business, even though such income could not be taxed directly. However, it has been held that a tax imposed upon net income including income derived from transactions -in interstate or foreign commerce does not amount to burdening interstate or foreign commerce, -and is valid (U, S. Glue Co. vs. Oak Creek, 247 U. S. 321, 38 Sup, Ct. 499; Peck & Co. vs. Lowe, 247 U. S. 165,38 Sup. Ct, 432). Clearly, it would seem that a franchise tax'measured by net income does not burden interstate or foreign commerce if a tax levied directly upon net income does not have that effect.

But Appellants argue that the principles applicable to a state's power to' impose franchise taxes measured by net income are entirely different from the principles applicable to a state's power to-impose taxes upon net income. Although there are. differences, the principal difference, we believe, is that a franchise tax, as pointed out above, may be measured by income which cannot be taxed directly.

It is true that in Alpha Portland Cement Co. vs. Massachusetts, supra, it was held that a franchise tax, measured by net income, could not be imposed upon a foreign corporation engaged exclusively in interstate commerce, whereas in view of the decisions in U. S. Glue Co. vs. Oak Creek; and Peck & Co, vs. Lowe, supra, to the effect that a tax on income is not a burden upon interstate or foreign commerce, and in view of the decision in Shaffer vs. Carter, 252 U. S.37, 40 Sup. Ct. 221, to the effect that the net income of a non-resident from business done in the state may be taxed, it would seem arguable that a state could impose a tax directly upon the net income of a foreign corporation from business done in the state, even though the business was exclusively interstate in character. This possible difference in a state's power to impose franchise taxes measured by net income and direct net income taxes is explainable, we think, on the grounds that a foreign corporation engaged exclusively in interstate commerce, although doing business within the state and therefor subject to a direct net income tax, cannot be regarded as exercising a franchise or privilege granted by

the state upon which a franchise tax can be imposed.

This difference does not hold true, we believe, with respect to foreign corporations doing some local or intrastate business in the state. If the foreign corporation does some local or intrastate business and thereby exercises a franchise or privilege granted by the state, the state may require the corporation to pay for that privilege a tax measured by its net income attributable to business done in the state, regardless of whether the income is derived from intrastate business or from business done in interstate or foreign-commerce. The cases of Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 41 Sup. Ct. 45; and Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271, 45 Sup. Ct. 82, squarely support this conclusion.

The following language of the court in the Underwood case completely refutes Appellants' argument:

> "A tax is not obnoxious to the commerce clause merely because imposed upon property used in interstate commerce, even if it takes the form of a tax for the privilege of exercising its franchise within the State. Postal Telegraph Cable Co. v. Adams, 155 U. S. 688,695. This tax is based upon the net profits earned within the State. That a tax measured by net profits is valid, although these profits may have been derived in part, or indeed mainly, from interstate commerce is settled. U. S. Glue Co. v. Oak Creek, 247 U. S. 321; Shaffer vs. Carter,' 252 U. S. 37, 57; compare Peck & Co. vs. Lowe, 247 U. S. 165. Whether it be deemed a property tax or a franchise tax, it is not obnoxious to the commerce clause."

Since it is within the power of the state to impose a franchise tax measured by income from business done within the state, whether done in interstate or foreign commerce; upon all the foreign corporations which are subject to the Act, it follows that the Act may be construed as including in the measure of the tax upon domestic corporations that portion of their income derived from business done in interstate or foreign commerce which is attirubtable to business done in California without thereby rendering the Act unconstitutional for the reasons asserted by Appellants.

What we have said in answer to Appellant's second argument; in support of its contention that the Act cannot and should not be construed as providing that income from business done in interstate or foreign commerce should be included in the measure of the tax, largely disposes of Appellant's third argument in support of this contention. This argument is to the effect that if the Act be construed in a manner contrary to that contended for by Appellants, foreign corporations would be permitted to transact business in California on more favorable conditions than domestic corporations and the Act would thereby violate

Section 15 of Article XII of the Constitution which provides:

> "No corporation organized outside the limits of this State shall be allowed to transact business within this State on more favorable conditions than are prescribed by law to similar corporations organized under the laws of this State,"

It appears that Appellants in addition to being engaged in interstate or foreign commerce are also engaged in some purely local or intrastate business. As we have seen, foreign corporations doing some local business here may be required to pay a franchise tax measured by income attributable to business done in this State even though of an interstate or foreign commer character. According to Appellants' own argument, the Act must be construed as being applicable alike to both foreign and domestice corporations. It follows that the Act cannot be regarded as permitting foreign corporations "similar" to Appellants, i.e., corporations doing some local or intrastate business here, to transact business here on more favorable conditions than Appellants.

It may be argued, however, that the same construction of the Act which would justify the proposed assessment in question would result in construing the Act as being applicable to domestic corporations engaged exclusively in interstate or foreign commerce, If so, it might be argued that the Act permits foreigr corporations engaged exclusively in interstate or foreign commerce to transact business here on more favorable conditions than similar domestic corporations since such foreign corporatior cannot be subjected to a franchise tax.

However, we are of the opinion that Section 15 of Article XII, when properly construed, does not prohibit the state from taxing domestic corporations simply because it cannot under the Constitution or laws of the United States also tax similar foreign corporations. This point, we think, was settled in Smith vs. Lewis, 211 Cal. 294, holding that the fact that the state is powerless to impose a license tax on a foreign corporation engaged in interstate commerce does not render a license tax on a domestic corporation a violation of Section 15 of Article XII, (see also Roger J. Traynor, the Bank and Corporation Franchise Tax Act, ch. 20 of Ballantine's California Corporation Laws, p. 713, n. 76).

Appellants also assert in support of their contention regarding the application of the tax to income derived from business done in interstate or foreign commerce that, at the time the Act was in the course of passage through the Legislature they were definitely assured by various state officials that income from transportation of persons and property upon the high seas in interstate and foreign commerce would not be included in the measure of the tax. With all due respect to the officials to whom Appellants have reference, we are of the opinion that the Act, as passed by the Legislature and approved by the Governor, does not exclude from the measure of the tax income attributable

to business done in this State, simply because it may have been derived from the transportation of persons and property upon the high seas in interstate and foreign commerce. Unquestionably of course, it is the Commissioner's duty to administer the Act, as finally passed by the Legislature, rather than in accordance with any "understanding" of the kind referred to by Appellants.

In further support of their contention, Appellants urge upon us that the predecessor of the Commissioner thattho propose additional assessment in question, consistently abided by the "understanding" above referred to, and did not require Appellant: to pay a tax measured by any portion of their income from their transportation business. However, Appellants do not offer any reasons, other than those above considered and disposed of, for holding that the preceding Commissioner acted correctly in so doing. Obviously, the fact that a particular Commissioner fails properly to administer the Act by reason of an erroneous interpretation of the Act, or for other reasons, does not preclude either a subsequent Commissioner or this Board from adopting and enforcing a correct interpretation.

As a second contention, Appellants maintain that even though the Act be construed to justify the assessment in question, the assessment is invalid for the reason that it is beyond the power of the state to impose a franchise tax upon Appellants, measured by any portion of their income from their transportation busines: done in interstate or foreign commerce.

But if it is within the power of the state to impose a franchise tax upon foreign corporations doing some local business here, measured by income from business done in this State, including income from business done in interstate or foreign commerce, it is clearly within the power of the state to impose a franchise tax, similarly measured, upon domestic corporations doing some local business here.

For that matter, it would seem that even though Appellants were engaged exclusively in business of an interstate or foreign commerce character, they must be regarded; inasmuch as they were incorporated under the laws of this State, as possessing franchis granted by this State, and for the privilege of exercising those franchises could be required to pay a tax measured at least by income from business done in this State and possibly by their entire net income. See Cream of Wheat Co. vs. County of Grand Forks, 253 U. S. 325, 40 Sup. Ct. 558, in which a franchise tax upon a domestic corporation measured by the entire value of the franchise was sustained, even though the business of the corporation was conducted entirely without the state and even though it has no tangible real or personal property within the state of incorporation. See also the following cases, holding that the state may impose a franchise tax on a domestic corporation, measured by total capital stock instead-of merely by capital employed within the state: Kansas City, Fort Scott & Memphis Ry. vs. Botkin, 240 U. S. 227, 36 Sup. Ct. 261; Kansas City, Memphis & Birmingham Ry. Co. vs. Stiles, 242 U. S. 111, 37 Sup. Ct. 58; and Roberts and Schaefer Co. vs. Emmerson, 271 U. S. 50, 46 Sup. Ct. 375.

Furthermore, it is to be noted that the tax imposed upon public utilities pursuant to Section 14 of Article XIII of the Constitution, measured by gross receipts, including a portion of gross receipts from business done in interstate *commerce,* has been sustained on the theory that the tax was in lieu of a property tax which the state could constitutionally impose (Pullman Co. vs. Richardson, 185 Cal. 484, affirmed 261 U. S. 33 The tax imposed by the Act is in lieu of the tax imposed pursuan to Section 14(d) of Article XIII (See Section 16 of Article XIII as it read prior to the amendments adopted by the people on June 27, 1933.) Inasmuch as the tax imposed pursuant to Section 14(d) has been held to be a property tax upon the so called "corporate excess" of the corporations subject to the tax (Mille & Lux vs. Richardson, 182 Cal. 115, and Schwab vs. Richardson), it would seem that the tax imposed should be held valid, even though measured by net income from business done in interstate o foreign commerce for the reason that it is in lieu of a property tax which the state could constitutionally impose upon Appellant (See Schwab vs. Richardson, supra, holding that Appellant, The Oceanic Steamship Company was subject to the tax imposed pursuan to Section 14(d)).

As a third contention, Appellants maintain that even though the Act can be construed as requiring that a portion of their income from their transportation business should be included in the measure of the tax and even though the Act when so construed is constitutional, the Commissioner has included in the measure of the tax a far greater portion of their income from their transportation business than the Act contemplated should be included.

As noted above, the Act provides in Section 10 that in case the entire business of a corporation is not done within the state, the tax shall be measured by that portion thereof which is derived from business done within the state. This section further provides that the portion of net income derived from business done within the state

> "shall be determined by an allocation upon the basis of-sales,'purchases, expenses of manufacturer, payroll, value and situs of tangible property, or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the State the portion of net income reasonably attributable to the business done within this State and to avoid subjecting the taxpayer to double taxation."

It appears that the Commissioner allocated to income from business done in the state that portion of Appellants' income from its transportation business done within and without the state which the amount of the business originating in this State bore to the total business done. By this means, the Commissioner determined that approximately 22,277 of Appellants' net income from their transportation business was attributable to business dome in California. Appellants argue that the method of allocati

employed by the Commissioner does not fairly apportion to the state that portion of their net income from their transportation business which is reasonably attributable to business done in the state. Appellants suggest that if any of their net income from their transportation business is to be allocated to business done in this State, only that portion of such income should be so allocated which the number of miles traversed by their vessels in this State bears to the total number of miles traverse by their vessles. If this formula were employed, the net income attributable to business done in California would not exceed one-half of one percent of the total net income from Appellants' transportation business.

The objection to Appellants' formula is that it emphasizes the actual transportation of passengers and property to the total disregard of other activities of Appellants which, though incidental to the actual transportation of passengers and property, are, nevertheless, and; necessarily, must be, performed by Appellants, Obviously, in order to transport passengers and property, Appellants must obtain passengers and property to transport. Furthermore, Appellants must maintain facilities for the- loading and unloading of property and for the embarking and disembarking of passengers transported, These factors are completely disregarded by Appellants' formula. Under that formula, the same percentage of income is attributed to California as would be attributed to California if Appellants' vessels simply entered California ports and if none of their business originated or terminated here, and if no offices or other facilities were maintained here,

In view of the above, it seems clear that the Commissioner's formula more nearly allocates to the state that portion of the net income of Appellants' transportation business which is reasonably attributable to business done within this State than does Appellants' formula. Furthermore, it is to be observed that if the other states, and the territories and foreign countries, in which Appellants do business had franchise tax acts similar to our Act and should employ the formula employed by the Commissioner for the purpose of determining the amount of net income attributable to business done in such states, territories and foreign countries, respectively, the result would be that the full amount of Appellants' net income from their transportation business would be allocated between this State and such other states and territories and foreign countries without in any way subjecting Appellants to double taxation.

For the above reasons, we are of the opinion that the method employed by the Commissioner is a method of allocation fairly calculated to assign to the state that portion of Appellants' net income from their transportation business which is reasonably attributable to business done within this State and which avoids subjecting the Appellants to double taxation.

In view of this conclusion and in view of our conclusions regarding the construction of the Act and the power of the state

to impose franchise taxes upon domestic corporations, measured by income from business done in interstate or foreign commerce, it follows that the action of the Commissioner in overruling Appellants' protest to his proposed assessmsnt of the additional tax in question must be sustained,

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, that the action of Charles J. McColgan, Franchise Tax Commissioner, in overruling the protest of Matson Navigation Co., The Oceanic Steamship Company and Matson Terminals, Inc, against proposed assessments of additional taxes under Chapter 13, Statutes of 1929, as amended, be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of February, 1934, by the State Board of Equalization,

R. E, Collins, Chairman
Fred E. Stewart, Member
Jno, C. Corbett, Member
H. G. Cattell, Member

ATTEST : Dixwell L. Pierce, Secretary