BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MARCUS LESOINE, INC.)

Appearances:

For Appellant: L. C. Marcus, its President; Pierce Coombe Attorney; John W. Burrows, Certified Public Accountant
For Respondent: Frank M. Keesling, Franchise Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protests of Marcus-Lesoine, Inc. to his proposed assessments of additional taxes in the amounts of $441.02, $1,526.69, and $1,027.33, for the taxable years ended December 31, 1934, December 31, 1935, and December 31, 1936, respectively.

Portions of the additional assessments were due to the fact that the Commissioner attributed to the Appellant net income supposed to have been earned by the Marles Lovalon Company and the Lesoine-Marcus Investment Co., partnerships owned and operated by the two stockholders of Appellant, each of whom owned a fifty percent interest in each of the three organizations, and the balance of the assessments resulted from the Commissioner's action in allocating to California the entire amount of Appellant's interest income, Since the hearing in this matter the Commissioner has'recomputed the Appellant's net income for the years in question; arriving at the amounts of $4,735.98, $27,014.18, and $12,096.62, respectively, and in accordance with these revised figures he has consented to the entry by the Board of an order requiring corresponding reductions in the proposed assessments. Except as to the treatment of interest, no objection to the revised figures or to the method of allocation applied thereto has been expressed by the Appellant, so that the only question remaining for decision is the amount of interest income to be allocated to California.

The relevant provisions of the Bank and Corporation Franchise Tax Act are contained in Section 10 of the Act and are as follows:

> ". . . if the entire business of such bank or corporation is not done within this State, the tax shall be according to or measured by that portion thereof which is derived from business done within this State. The portion of net income derived from business done

> "within this State, shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, 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 Appellant, a domestic corporation, is engaged in selling merchandise in California and in other states, and that many of its sales are made under conditional sales contracts. During the years 1933, 1934, and 1935, the Appellant received interest in connection with these contracts in the amounts of $15,023.69, $19,529.47, and $25,931.86, respectively, and it is the Commissioner's position that these amounts, except to the extent that they were offset by the net losses otherwise attributable to California for the years 1933 and 1935, must be included in the measure of the tax. He has, accordingly, in recomputing the measure of Appellant's tax deducted from Appellant's total net income for each year the amount of such interest income for that year, and the following proportions of the resulting figures have been allocated to California: For 1933, 69.4 percent, for 1934, 57.89 percent, and for 1935, 72.69 percent. To the amount thus allocated to California he has added the total amount of the interest income. The only justification offered by him for attributing the entire interest income to California is that the Appellant is a domestic corporation and that therefore the contracts have their situs for taxation in California and the interest on the contracts has its source in California. The Appellant, on the other hand, states that a portion of such interest income was derived from business done in Oregon and Washington, and in this connection explains that some of the contracts covered goods sold by its Oregon and Washington branches from stocks maintained in those statesand that the payments of principal and interest on these contracts were collected by the branch offices and deposited in Oregon and Washington banks,

In our opinion the argument of the Commissioner has no application to the situation where, as here, the acquisition, management and liquidation of the intangibles constitute integral parts of the corporation's regular business operations It is to be observed that the Appellant's conditional sales contracts result directly from its selling activities, and that the collection of both the interest and the stipulated sales price is necessarily the result of the same efforts and expenditures. As already stated, all of these functions are carried on in Oregon and Washington as well as in California. Because it ignores these factors and treats the gross amount of the interest as net income and attributes the same exclusively to California, we regard the method of allocation applied, by the Commissioner as arbitrary and inherently unreasonable, and as a violation of the provision of the act that 'the tax

shall be measured only by that portion of the net income "which is derived from business done within this State."

None of the cases cited by the Commissioner dealing with the allocation of corporate income gives any support to the position he has taken here, In Meyer v. Wells, Fargo & Co., 223 U.S. 298, an Oklahoma tax upon a nonresident express compan equal to three per centum of such portion of its gross receipts as the business done within the state bore to the whole of its business was held invalid on the ground that in addition to its income from its express business the company received "larg sums as income from investments in bonds and land all outside the State of Oklahoma." (Underscoring ours.) People ex rel. Alpha Portland Cement Co. v. Knapp, 230 N.Y. 48, and California Packing Co. v. State Tax Commission, 97 Utah 367, 93 P. (2d) 463, dealt with the application to foreign corporations of franchise taxes measured by net income, and held improper the application of the allocation formula to income received in the form of interest and dividends. The former case involved a statutory requirement that all income from intangibl be included in net income, which was subject to allocation in accordance with a prescribed formula. The intangibles owned by the relator consisted principally of bonds held at the home office outside the state and of stock in a wholly owned subsidiary. It did not appear that the bonds had any connectic with the company's business, either in New York or elsewhere, and the allocation formula reflected neither the situs of the stocks and bonds nor, as regards the stock, the fact that the subsidiary's property and business was located entirely outside the state. The court held the formula invalid in its application to the interest and dividends on the ground that it involved "an artificial and arbitrary augmentation of the value of the local privilege," (230 N.Y. at 58.) *In* the California Packing case the distinction between the interest and dividends and the ordinary business income of the corporation is clear. The opinion of the court affirmatively states (93 P. (2d) at 467) that the Commission included the income from intangibles in the amount subject to allocation upon the theory that such investments were probably made from Profits resulting from the general operations of the company, SO that the income therefrom should be allocated in the same proportion as the other income,

Newport Company v. Tax Commissioner, 219 Wis, 293, 261 N.W. 884, involved a foreign corporation the principal place Of business of which was assumed to be in the State of Wisconsi and which had derived a profit from the sale of stock in a Wisconsin corporation, A portion of the stock had been pledged as collateral outside the state and the remainder had been held in a safe deposit box outside the state. Wisconsin asserted the right to tax the entire amount of this profit on the theory that the stock had acquired a business situs in the state, It was held, however, that the above facts did not, establish a business situs in Wisconsin and that the state was without the constitutional power to tax. Manitowic Gas Co. v. Tax Commissioner, 161 Wis. 111, 152 N.W. 84% held that a state tax imposed upon the income of nonresidents "derived from sources within the State or within its jurisdiction"

was inapplicable to interest received by nonresident bondholder; of a domestic corporation. The court specifically pointed out that "The nonresidents as bondholders owned no property and conducted no business within the State."

On the other hand, an argument essentially similar to that which the Commissioner has advanced here was rejected by the Supreme Court of this State in Holly Sugar Co. v. Johnson, 18 Cal. (2d) 218. In this case it appeared that a foreign corporation, for the specific purpose of furthering its regular business operations, had acquired a majority of the outstanding shares of a California company engaged in the same type of business. The court held that the facts established an "integration of the activities of the two companies into one indivisible, composite whole, each portion giving value to every other portion", and that therefore, notwithstanding the fact that it resulted from the ownership of intangibles, the loss sustained by the foreign corporation on the liquidatior of its subsidiary was required to be included in the income base against which the allocation formula was applied., For the reasons set forth above, we believe that the situation of the Appellant more than fulfills the integration test laid down in this case.

The Commissioner cites Article 10-1 of the regulations issued by him under the Franchise Tax Act, which provides that in the case of domestic corporations the measure of the tax includes all interest on indebtedness. In our opinion, however, the application to the Appellant of this regulation is violative of the provision of Section 10 that the tax shall be measured only by that portion of the net income which is derived from business done within this State, and we are unable accordingly, to regard it as furnishing any justification for the proposed assessment. The act authorizes the Commissioner to prescribe only "such rules and regulations as are reasonable and necessary to-carry out its provisions." (See Section 22.)

O R D E R

Pursuant to the views expressed in the opinion of the Boarc on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the action, of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protests of Marcus-Lesoine, Inc., to proposed assessments of additional taxes in the amounts of $441.02, $1,526.69, and $1,027.33 for the taxable years ended December 31, 1934, December 31, 1935, and December 31, 1936, respectively, be and the same are hereby modified as follows: Said Commissioner is hereby directed to accept as the net income of said corporation for the income years ended December 31, 1933, December 31, 1934, and December 31, 1935, the sums of $4,735.98, $27,014.18, and $12,096.62, respectively, and to allocate-to California 69.4 percent, 57.89 percent, and 72.69 percent, respectively, of such amounts. In all other respects the action of said Commissioner is hereby affirmed.

Done at Sacramento, California, this 7th day of July, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary