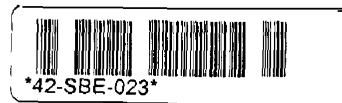

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHICAGO PNEUMATIC TOOL COMPANY)

Appearances:

For Appellant: Herbert E. White, Attorney at Law

For Respondent: Harrison Harkins, Assistant 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 protest of Chicago Pneumatic Tool Company to his proposed assessment of an additional tax for the taxable year ended December 31, 1937, in the amount of $835.14.

The Appellant is a corporation domiciled in the State of Massachusetts, and is a wholly-owned subsidiary of a New Jersey corporation which bears the same name and which will be hereinafter referred to as "the parent." The Appellant is engaged exclusively in the business of selling, chiefly in the western and southern states, and most of its sales consist of products manufactured by the parent. The latter is engaged in manufacturing at plants located in Cleveland, Ohio; Detroit, Michigan; and Franklin, Pennsylvania, at each one of which it manufactures a different type of product, and it also engages in extensive selling operations, chiefly in the eastern and midwestern states. It appears that the sales of the two corporations, other than the sales of the parent to the Appellant, consist almost exclusively of sales to ultimate consumers rather than to dealers,

The Appellant filed a return for the year 1936 disclosing gross sales of $2,351,442.45, and a net income of $3,845.93, of which 18.7 per cent was represented as being allocable to California according to the mathematical average of the percentages which the amount of Appellant's sales, payroll and tangible property in California bore to the corresponding items within and without the State. During the same period the domestic sales of the parent, other than those to Appellant, aggregated $4,469,843.53, on which it derived a net profit of $778,259.85.

On the ground that the prices charged Appellant by the parent did not allow an adequate margin of gross profit, and that therefore its accounts did not properly reflect its net

income, the Commissioner treated the Appellant and the parent a: together constituting but a single enterprise, and allocated to California in accordance with the above-mentioned formula a proportionate amount of the aggregate of the net incomes of both corporations, as disclosed by their respective books of account. This computation produced a figure of $21,597.65, which the Commissioner has treated as the income of the Appellant derived from business done in California, and upon which he has based the proposed assessment. It should be pointed out in this connection that the Commissioner does not assert any right to measure the tax by the income of the parent, but has taken the position that a portion of the income disclosed by the accounts of the parent was actually attributable to the operations of the Appellant in California, and was in fact income of the Appellant. He also contends that the procedure followed by him was specifically authorized by the provisions of Section 14 of the Act, as that section read prior to its amendment in 1937. The first paragraph of this Section gave the Commissioner authority, in the case of two or more corporations owned or controlled by the same interests, to apportion gross income or deductions among such corporations if necessary to prevent the evasion of taxes or clearly to reflect the income of any of such corporations. The second paragraph, so far as material here, provided that in the case of a corporatic owned or controlled by another corporation and acquiring or disposing of the products of the latter in such a way "as to create a loss or improper net income the Commissioner, in order to prevent evasion of taxes or clearly to reflect the income of such a corporation, may require a report consolidated with the owning and/or controlling corporation . . . and may determi the amount which shall be deemed to be the entire net income allocable to this State of the business of such corporation . . ." having regard "to the fair profits which, but for any agreement arrangement or understanding, might or could have been obtained from dealing in such products . . ."

The Appellant maintains that its accounts accurately reflected its income, and that there was no arrangement between itself and its parent whereby it was deprived of the fair profits it might otherwise have obtained, and that therefore the procedure followed by the Commissioner was not authorized by Section 14 or by any other provision of the Act. In view of the specific provisions of Section 14, the mathematical accurac of Appellant's books of accounts, as well as the absence of any intent to evade taxes, is immaterial, but the decisive question is whether the net income as computed by the Commissioner is in excess of the fair profits reasonably attributable to the operations of the Appellant.

Although in the case of an enterprise whose activities extend over several states the portion of the total net income derived from the business done in a particular state may not be fixed solely by the application of an allocation formula regardless of whatever other evidence may be submitted, Hans Rees' Sons v. N. Carolina, 283 U. S. 123, it is established that a manufacturing or mercantile enterprise may ordinarily be treate as a unitary business and that the apportionment of the aggregate income therefrom in accordance with a formula such as

that which was applied here may not be regarded as reaching income from business carried on outside the state in the absence of proof that it produces such a result. This rule has been applied both when the enterprise was carried on by a single corporation (Hans Rees' Sons v. N. Carolina, supra; Underwood Typewriter Co. v. Chamberlain 254 U. S. 113; Bass Ratcliff & Gretton v. State Tax Cd., 266 U. S. 271; Butler Bros. v. McColgan, 62 S. Ct. 701), and when it was carried on by several foreign corporations, only one of which was doing business within the state. In re Morton Salt Co., 150 Kan. 650, 95 P. (2d) 335. In Butler Bros. v. McColgan, supra, the Supreme Court gave its approval to the identical formula used by the Commissioner here, stating that the three factors of property, payroll and sales "may properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income.'" The court further held that the result produced by the formula was not impeached by its wide divergence from the figures disclosed by the company's accounting records, even though the latter admittedly followed recognized accounting principles,

The Appellant has attempted to meet the burden of proof thus imposed on it by establishing the propriety of the charges made to it by the parent and by explaining why its own operations were virtually profitless, whereas those of the parent resulted in substantial net income. According to Appellant's evidence, the gross sales of itself and the parent are allocable as follows

	Appellant	Parent
Cost of goods sold	72.44%	60.84%
Direct selling expense	21.79%	12.82%
General & administrative expense	5.70%	10.87%
Net profit	.07%	15047%
	100.00	100.00

The propriety of the charges for direct selling expenses, aggregating $528,670, is said to be proven by the fact that this entire amount, except for $62,486 charged by the parent for royalties, consists of actual expenditures by the Appellant rather than intercompany charges.

The total of the direct selling expenses is shown to be 21.79% of Appellant's sales, as contrasted with direct selling expenses of the parent equal to 12.827% of its sales, exclusive of sales to Appellant. It is also shown that direct selling expenses in California are equivalent to 19.48% of California sales, as compared to an average ratio of 15.98% for the combined companies. The proprotionately larger selling expenses are said to be the necessary result of-conditions prevailing in the territory served by Appellant, and to account for and to justify to a large extent the negligible net profit reported by Appellant.

The propriety of the cost of goods sold is said to be proven by the fact that the charges made by the parent for its product represent only the cost of manufacture, and include no element of manufacturing profit, and by the further fact that the

parent's sales to wholly independent distributors and its purchases from other manufacturers are made at an average discount from the resale price that is substantially smaller than the average discount allowed to Appellant; The transactions with independent dealers and manufacturers, however, appear to be small in amount and are not shown to have occurred under the same conditions as the parent's sales to Appellant. On the contrary, Appellant's evidence shows that the independent dealers to whom sales were made were located entirely in the eastern and midwestern states, where, according to Appellant's own representations, selling expenses are much less than in the territary served by Appellant.

Moreover, Appellant's representation that it was allowed a discount from the resale price which was fair and equivalent to that which an independent dealer would have secured cannot be reconciled with the fact that the charges and expenses incurred by it were so far in excess of those incurred by the parent that its accounts disclosed only a negligible net profit as compared to the very substantial profit disclosed by the accounts of the parent. It is our opinion that in view of its larger selling expenses, a fair discount from the resale price of goods sold by it must necessarily be greater than it would be if it were selling in the territory served by the parent. On the showing thus far made we regard as immaterial the fact that the product was charged to Appellant at its actual cost. Since a large portion of the manufacturing costs undoubtedly constituted joint costs, which would have been incurred regardless of whether any goods were produced for the Appellant, we are unable to conclude, in the absence of any evidence as to the actual out-of-pocket expenses occassioned by the production for the Appellant, that the latter's sales did not contribute materially to the net profits of the enterprise.

The Appellant has also attempted to explain and to justify the small net profit reported by it on the ground that its sales consisted to a proportionately greater extent than those of the parent of products of the plant at Franklin, Pennsylvania, and that the gross profit on these products was much less than on the products of the other two plants. We do not find this argument persuasive, however. If it be conceded that the gross profit on the Franklin products was less than on the other products, there is nothing to indicate that this circumstance is not offset by relatively smaller selling expenses. It is apparent that the degree of profit resulting from the sales of Franklin products may not be shown by establishing only one of the several elements that determine net profits. See Norfolk & Western Ry. Co. v. Maxwell, 297 U. S. 682.

The Appellant has cited a number of cases in which taxing authroities were denied the right to compute the tax of a subsidiary corporation on-the basis of the combined income of the subsidiary and parent, but an examination of the opinions rendered in these cases discloses that in all of them the facts differed in important respects from those presented herein. In McCrory Co. v. Commissioner, 280 Mass. 273, 182 N.E. 481, there was no statutory provision authorizing the computation of net

income upon this basis, In Curtis Companies, Inc. v. Wisconsin Tax Commission, 214 Wis. 85, 251 N.W. 492, the taxing authorities attempted to invoke a statutory provision applicable "to any corporation conducting its business in such a manner as to benefit the members or shareholders thereof . . . by selling its products at less than the fair price which might be obtained therefor." It was not contended, however, as here, that any of the inter-corporate arrangements were unfair, and relying on this circumstance the court held that the statute was inapplicable. Prcotor & Gamble v. Sherman, 2F (2d) 165, merely held that groundsfor relief were stated by a bill in equity which alleged that the plaintiff was assessed on the theory that it must pay taxes on the property and income of another company.. In People ex rel Studebaker Corp. v. Gilchrist, 244 N.Y. 114, 155 N.E. 68 , the details of the assessment are not given, but it appears that the court was of the opinion that under the method by which the assessment was computed the entire profit resulting from manufacturing in one state and sales in another was attributed to the state of sale, (155 N.E. at 70, 71) whereas here, by the use in the allocation formula of the factors of payroll and property, recognition was given to the activities in the state of manufacture. The court also appears to have been influenced by the fact that the New York statute under which the tax was assessed made no provision, as does the second paragraph of Section 14 of the California statute, for a consolidated return by the subsidiary corporation. (155 N.E. at 70) It is to be noted that subsequent to the assessment involved in the Studebaker case this omission was corrected, and that an assessment made under the amended statute on the basis of the combined income of a New York subsidiary and its foreign parent was sustained in People ex rel. Federal Motor Truck Co. v. Lynch, 264 N.Y. 679, 191 N.E. 623,

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 Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Chicago Pneumatic Tool Company to a proposed assessment of an additional tax in the amount of $835.14 for the taxable year ended December 31, 1937, based upon the income of said company for the year ended December 31, 1936, pursuant to Chapter 13, Statutes of 1929 as amended, be and the same is hereby sustained.

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