BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
M. SELLER COMPANY)

Appearances:

For Appellant: Albert A. Rosenshine, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel

OPINION

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 M, Seller Company to his proposed assessments of additional tax in the amounts of $719.03 and $1,003.12 for the taxable years ended December 31, 1938, and December 31, 1939, respectively.

Appellant, an Oregon corporation with its principal office in San Francisco, California, is engaged in the import and export business. Branch offices in Portland, Oregon, and in San Francisco carry on the business of the Appellant, which, prior to 1929, was conducted by separate corporate entities. The San Francisco office now conducts Appellant's operations in California, Arizona, Nevada, New Mexico and the Territory of Hawaii, and the Portland office conducts Appellant's operations in the Pacific Northwest, Alaska and Canada. Each office operates entirely independently of the other.

By contract, separate accounting records are maintained at each of the branch offices by Seller-Lowengart Company, the parent corporation of Appellant. All purchases are also made through Seller-Lowsngart Company. Each branch places its orders with that Company, which purchases the merchandise from the manufacturer with instructions to deliver it to the branch that has issued the order. The cost is billed by the manufacturer to Seller-Lowengart Company, which rebills the branch to which the goods were delivered. Seller-Lowengart Company receives from each branch a stipulated amount based upon its purchases for the managerial, financial and accounting services performed.

For the income years ended December 31, 1937, and December 31, 1938, Appellant filed its franchise tax returns reporting only the net income of the San Francisco office, and using the allocation formula method to allocate to

California a portion of such net income. The Commissioner refused to accept this method of accounting as properly assigning to California income derived from sources within this State, and deficiency assessments were proposed using the allocation formula method to allocate to California a portion of Appellant's entire net income received from both its California and Oregon branches. The Appellant contends that absolute separability exists in the operations of its San Francisco and Portland branches and that its separate accounting method fairly assigns to California the portion of its net income reasonably attributable to business done within this State.

The Appellant's position, in our opinion, is foreclosed by Butler Brothers v. McColgan, 315 U.S. 501. In that case, as here, each branch conducted its own operations within a specified territory and a system of separate accounting following recognized accounting principles was employed. The purchasing activities of the Seller-Lowengart Company on behalf of Appellant are extremely similar to those of the central purchasing division of Butler Brothers and, like that firm, Appellant realizes advantages to its entire business from its method of centralized purchasing.

The Commissioner's determination that the business activities of Appellant are parts of an integral whole, each part adding value to the other, is, we believe, adequately supported by the Butler Brothers case. Its offices are engaged in the same type of activity. In addition, both offices purchase all their merchandise from and are managed and controlled by the same parent corporation. There can be no doubt but that the sales volume of the California branch increased income in California and elsewhere by reducing the unit purchasing cost without a proportionate increase in administrative and overhead expense.

The burden of proof placed upon the taxpayer by the Butler Brothers decision has not been met by Appellant. It has not shown by clear and cogent evidence that the Commissioner's formula of apportionment results in extraterritorial values being taxed. As the Court stated in that decision, it does not impeach the integrity of the taxpayer's accounting system to say that it does not prove Appellant's assertion that extraterritorial values are being taxed. Appellant has not submitted any computations or other evidence in support of its claim that the formula method apportioned to California income in excess of that having its source here. As in the Butler Brothers case, Appellant "has not shown the precise sources of its net income ..." and as there stated "if factors which are responsible for that net income are present in other States but not present in California, they have not been revealed." 315 U.S. 501, 509. The action of the Commissioner in departing from Appellant's separate accounting system and determining its net income from California sources by applying the apportionment formula to its entire net income must, therefore, be upheld.

During the income year 1937, Appellant received interest

income from accounts receivable in the amount of $15,743.92, and incurred interest expense in the amount of $45,500.90, all of which was paid to Seller-Lowengart Company. Of the total interest received, $8,791.26 was received from Seller-Lowengart Company, and in determining the deficiency, the Commissioner treated this portion of interest received as an offset to the extent of interest paid. Interest paid in excess of interest received from Seller-Lowengart Company was considered an expense of the unitary business and was deducted from Appellant's gross income before application of the allocation formula, The remaining portion of interest income which was derived from customers' accounts in the amount of $6,952.66, was considered intangible income assignable entirely to California, the domocile of Appellant. Similar treatment was afforded interest income and expense for the income year 1938.

Appellant contends that if the $6,952.66 interest income is assignable in its entirety to California, interest expense in excess of interest income is deductible in full from California income after allocation, or that if income expense is to be allocated, interest income must also be allocated.

It is our opinion that the Commissioner properly deducted the interest expense from gross income in arriving at the base against which the allocation formula was applied inasmuch as such expense was incurred in furthering the regular business operations of a unitary business. See Holly Sugar Co. v. Johnson, 18 Cal. (2d) 218. We believe, however, for the reasons set forth in our opinion in the Appeal of Marcus-Lesoine, Inc. (July 7, 1942), that the Commissioner should have considered the interest income derived from customers' accounts as income received in the course of the unitary business and that he erred in assigning that interest income to California.

ORDER

Pursuant to the views set forth 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 protests of M. Seller Company to proposed assessments of additional tax in the amounts of $719.03 and $1,003.12 for the taxable years ended December 31, 1938, and December 31, 1939, respectively, be and the same is hereby modified as follows: Said Commissioner is hereby directed to consider the interest income derived from customers' accounts for the income years 1937 and 1938 as income from unitary business of said M. Seller Company and, accordingly, as income subject to allocation, rather than to assign said interest income entirely to California; in all other respects the action of said Commissioner is hereby sustained.

Done at Sacramento, California, this 22nd day of August, 1946, by the State Board of Equalization.

George R. Reilly, Member
Wm. G. Bonelli, Member
J. H. Quinn, Member

ATTEST: Dixwell L. Pierce, Secretary