BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HAMMOND INSTRUMENT COMPANY)

Appearances:

For Appellant: W. L. Lahey, its Assistant Secretary; Oliver C. Heywood, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chaster 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Hammond Instrument Company to a proposed assessment of additional tax in the amount of $174.69 for the taxable year ended March 31, 1939.

The Appellant is a manufacturer of electric organs and clocks whose principal place of business and manufacturing establishment are located in the State of Illinois. During the income year in question Appellant maintained an office in this State, had property and employees located here, and made sales to California purchasers in the amount of $93,907.22. Orders were taken here by Appellant's representatives, sent to Chicago for acceptance and the merchandise was delivered to the carrier f.o.b. Chicago and consigned to the buyer in California. In its return for the taxable year beginning April 2, 1938, California property and payroll were reflected in the three-factor apportionment formula applied by Appeilant under Section 10 of the Act for the purpose of allocating an appropriate share of its net income to this State, but none of its sales was regarded as a California sale. Upon audit ofhe Appellant's return, the Commissioner treated the sales in question as sales made in this State and, accordingly, determined that the Appellant had derived a somewhat larger portion of its net income from business done here than had been reported on its return, The proposed assessment based on this determination is the subject matter of the present controversy

It is the position of the Appellant that the action of the Commissioner results in the allocation to California of a larger portion of its income than is attributable as a matter of law and fact to its activities here, Several grounds are presented by Appellant in support of this position.

It argues, at the outset, that the sales in question were not California sales, the orders having been accepted and title to the merchandise having passed tc the buyer outside this State, and that to include them in the allocation formula as such would not only violate the terms of the statute, but would also result in the taxation of income attributable solely to activities carried

on outside this State. The Commissioner, on the other hand, contends that his method of allocation is fairly calculated to assign to California that part of Appellant's net income derived from its activities here and is warranted by the tax act.

Section 10 of the Bank and Corporation Franchise Tax Act, as in effect in the taxable year in question, read as follows:

> ". . . . The portion of net income derived from business done within this State, shall be determined by an allocation on the basis of sales, purchases, expenses of manufacture, 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 is at once apparent that the statute does not command the employment of a rigid formula, but contemplates rather the use of any "method of allocation" as is fairly calculated to assign to the State that portion of the net income "of the taxpayer reasonably attributable to it." Butler Bros. v. McColgan, 315 U.S. 501. Nor does the statute make any attempt to define the term "sales" or to distinguish specifically between "California sales" on the one hand, and "out of State sales" on the other. Section 10 is addressed in broad terms to the problem of determining where income is earned. It recognizes "sales" as a factor in the production of income, and authorizes the use of that factor, togethar with others, such as property and payroll, which, if used alone for the purpose of allocating income would often produce results having little relation to the economic realities. See Hans Rees & Sons v. North Carolina, 283 U.S. 123.

In the light of these considerations it is clear that the economic characteristics of a sale should dominate in fixing its situs for purposes of the allocation formula, if proper weight is to be given to its contribution to the process of earning income. In the instant case, prospective buyers and the seller, through a local establishment of the seller, came together in California, the seller demonstrated its electric organs to those buyers here, negotiations were conducted and orders placed here, the purchase price was paid here and to this State the goods were ultimately destined. Certainly, legal incidences, such as the final acceptanc of orders or the passage of title, which can be shifted from place to place at the will of the parties to the sale should not be permitted to obscure the substance of the transaction. We conclude, therefore, that Respondent's allocation of the sales in question to California was not inconsistent with the language or purposes of Section 10 of the statute as in effect in the year 1939. See California Packing Corporation v. State Tax Commission of Utah, 97 Utah 367, 93 Pac. 2d 463; Commonwealth v. Quaker Oats Co., 350 Pa. 253, 38 Atl. 2d 325; International Harvester Co. v. Evatt, 329 U.S. 416.

To Appellant's contention that prior to the amendment to Section 10 in 1939 providing that "Income derived from or attributable to sources within this State includes ... income from any activities carried on in this State, regardless of whether carried on in interstate, intrastate or foreign commerce," income derived from interstate commerce was wholly exempted from tax, we need refer only to the decision of the Supreme Court of California in Matson Navigation Co. v. State Board of Equalization, 3 Cal. 2d 1; affirmed 297 U.S. 441, wherein it was said of that Section in a case arising under the Act as enacted in 1939:

> ". . . reasonably and properly construed, there is nothing in the section which even by implication excludes from the measure of the tax imposed ... income from interstate or foreign commerce which is reasonably attributable to business done within this 'State." 3 Cal.2d 8.

Finally, Appellant asserts that the Commissioner's action results in the taxation of income not properly attributable to activities here in that the inclusion in the allocation formula of the sales in controversy as "California sales" involves the treatment of the full sales price of such sales as income derived from activities in California, whereas in fact such sales price included the costs of materials, manufacture, transportation and executive operations, all of which arose outside of California. This argument overlooks the fact that sales are but one factor in the formula and that equal weight is given to each of the other factors of payroll and property. In the instant case, the latter have a situs almost entirely outside California and their use in the formula results in the allocation to sources outside this State of income attributable to the matters cited by Appellant.

The Commissioner's determination is entitled to a presumption of correctness and beyond the assertions made and above considered, the Appellant has not offered us clear and cogent evidence that the action of the Commissioner results in the taxation of extra-territorial values that is required under the decisions in Butler Bros. v. McColgan, 315 U.S. 501 and Norfolk and Western Ry. Co. v. North Carolina, 297 U.S. 682. That action must, accordingly, 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; pursuant to Chapter 13, Statutes of 1929, as amended, that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Hammond Instrument Company to a proposed assessment of additional tax in the amount of $174.69 for the taxable year ended March 31, 1939, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of January, 1948, by the State Board of Equalization.

Wm. G. Bonelli, Chairman
J. H. Quinn, Member
Jerrold L. Seawell, Member

ATTEST: Dixwell L. Pierce, Secretary