BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

THE UPJOHN COMPANY

Appearances:

For Appellant: Devlin & Devlin & Diepenbrock, Attorneys at Law

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

O P I N I O N

This appeal is made pursuant to Section 27 of the Bank and Corporation Franchise Tax Act (Chapter 13 Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in denying the claims of The Upjohn Company for refunds of tax in the amounts of $3,015.27, $3,170.89, $3,363.26 and $3,005.26 for the taxable years ended December 31, 1937, J-938, 1939 and 1940, respectively.

Appellant, a Michigan corporation, was engaged during the years in question in the manufacture and sale of pharmaceutical products, Its principal office, manufacturing establishment and research facilities were located in Michigan. Its products were sold through nine branch offices, one of which was located in California, and through del credere agents whose relation to it is that of a factor. The agents made saies on behalf of Appellant from inventories owned by Appellant but in their possession. The California office controlled the sales in California, Idaho, Ore&on, Nevada, Utah and Washington and in parts of Arizona, Montana and Wyoming. In practically ail instances, a salesman operating under the California office was assigned to a particular territory, e.g., a state or portion of a state, and spent all his time in that territory except when receiving sales or other instructions at the branch office. The orders solicited by the salesmen operating under the California office were subject to acceptance by that office and, if accepted, were filled with goods shipped to the purchasers from inventories maintained in California.

The Appellant paid its franchise tax for the taxable years 1937 to 1940, measured by what it then believed to be the California portion of its income for the years 1936 to 1939, respectively. The California income was ascertained through the use of an allocation formula based upon the average of ratios of (a) California property, (b) California payroll and (c) California sales to (a) total property, (b) total payroll and (c) total sales,

respectively. Thereafter, Appellant filed its claims for refund for those years, urging that this allocation formula apportioned to California income in excess of that actually attributable to this State. Appellant now contends that the formula used in allocating its income under Section 10 of the Bank and Corporation Franchise Tax Act should include the following factors: (a) property, (b) payroll, (c) cost of manufacturing and (d) cost of selling, or, in the alternative, (a) property and (b) payroll.

Section 10 of the Act, as applicable to the taxable years 1937 and 1938, provided as follows:

> "If the entire business of the bank or corporation is done within this State the tax shall be according to or measured by its entire net income; and 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 manufacturer, 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."

The Section as amended in 1939 and applicable to the taxable years 1939 and 1940 provided as follows:

> When the income of the bank or corporation is derived from or attributable to sources both within and without the State, the tax shall be measured by the net income derived from or attributable to sources within this State. Such income 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 any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State. Income from business carried on partly within and partly without this State shall be allocated in such a manner as is fairly calculated to apportion such income among the States or countries in which such business is conducted. Income attributable to isolated or occasional transactions in States or countries in which the taxpayer is not doing business shall be allocated to the State in which the taxpayer has its principal place of business or commercial domicil. Income derived from or attributable to sources within this State includes income from

> "tangible or intangible property located or having a situs in this State and income from any activities carried on ih this State, regardless of whether carried on ih intrastate, interstate of foreign commerce."

The Appellant argues that its activities may be divided into research activity, manufacturing activity and selling activity, and that the inclusion of the sales factor with the property and payroll factors in the allocation formula results in the selling activity being represented twice (in the payroll factor and in the sales factor), while the research and manufacturing activities are represented but once (in the payroll factor). It is urged, accordingly, that a manufacturing expense factor and a selling expense factor be substituted for the sales factor to balance the allocation formula and thereby reflect more accurately the California income.

The factors selected for an allocation formula must, of course, reflect business functions essential to the profitable conduct of the enterprise. People ex rel. Alpha Portland Cement Co. v. Knapp, 230 N. Y. 48, 129 N. E. 202. An allocation formula, however, need not include as many functional factors as there are corresponding functions in the business. Thus, allocation of the income of a manufacturing business en the basis of a property factor alone has been upheld, despite the fact that income was earned through other business functions such as manufacturing and selling. Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113; State ex rel. Maxwell v. Kent-Coffey Mfg. Co., 204 N. C. 365, 168 S. E. 397; Baldwin Tool Works v. Blue, 240 Fed. 202; Ford Motor Co. v. State 65 N.D. 316, 258 N. W. 596. A single gross receipts factor applied to a manufacturing business has also been approved. F. Burkhart Manufacturing Co. v. Coale, 345 Mo. 1131, 139 s. IV. 2d 502. A two factor formula of property and sales has been upheld. United States Glue Co, v. Town of Oak Creek, 247 U. S. 321; United States Rubber Products, Inc. v. South Carolina Tax Commission, 189 S.C. 386, 1 S. E. 2d 153. Finally, a three factor formula of property, payroll and sales has met with judicial approval. Turco Paint and Varnish Co. v. Kalodner, 320 Pa. 421, 184 Atl. 37; Commonwealth v. Ford Motor Co., 350 Pa. 236, 38 Atl. 2d 329; Commonweal-t.h v. Quaker Oats Co., 350 Pa. 253, 38 Atl. 2d 325; California Packing Corp. v. State Tax Commission, 97 Utah 367, 93 P. 2d 463. In view of these authorities it is clearly apparent that the application of an allocation formula to the income of a manufacturing business is not to be held invalid merely because the formula does not include the factors of manufacturing expense and selling expense.

Appellant's position that the method of allocation applied must be such as is fairly calculated to assign to the State the portion of its income reasonably attributable to its business operations here is undoubtedly correct. We are not in accord with its contention, however, at least as applied to this case, that under Section 10 of the Act ". . . proof that an allocation formula will tend to apportion more income to the State than in fact arose therein, will render such allocation factor

null and void, even in the absence of proof that such allocation formula did in fact apportion more income to the State than arose there." An allocation-formula might on its face be so inherently arbitrary that it could not be said to be fairly calculated to assign to a state the portion of a corporation's net income reasonably attributable to its operations there. Such a determination certainly could not be made at this time, however, as respects the application of a property, payroll and sales formula to the income of an ordinary manufacturing business. Appellant is now attacking the method of apportionment used in the preparation of its return and adhered to by the Commissioner in denying its refund claim based on another method. Its situation, in our opinion, falls squarely within the principle of Butler Brothers v. McColgan, 315 U. S. 501,507, that "One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extra-territorial values being taxed."

Appellant has not attempted to show any peculiar circumstances respecting the operation of its business or wherein its manufacturing and selling operations differed from such operations carried on by other corporations so as to make the application Of the property, payroll and saies allocation formula, upheld in the authorities above cited, inappropriate so far as its business is concerned. Its contention made in the abstract, that selling activity is reported twice'in the three factor formula (in payroll and sales) while manufacturing activity is reported but once (in payroll) fails to take into account the fact that its manufacturing plan, fixtures, machinery and equipment, raw materials, work in progress and plant inventories of finished products are represented in the property factor-and, being located outside California, result in the assigning of a considerable portion of its income to other states. We are of the opinion, accordingly, that Appellant has not established the invalidity of the application of the property, payroll and sales formula in the determination of the California portion of its income.

The Appellant has not raised any question respecting the inclusion of any particular items in either the numerator or denominator of the fractions representing the property and payroll factors of the allocation formula. In the case of the sales factor, however, it now contends that the fraction as reported by it on its returns for the years in question is incorrect in that there is included in the numerator as California sales all sales involving deliveries from the stocks maintained at the California branch office. The Commissioner has conceded that as respects the income years 1938 and 1939, which are governed by Section 10 of the Act as amended in 1939, there should be included as California sales only those sales solicited in this State and those unsolicited sales in other states, the orders for which were filled from inventories maintained in California. The Appellant is apparently in agreement with this general principle, but urges that it should also be applied to the income years 1936 and 1937.

We believe the Appellant's position in this regard to be correct. That the Appellant was deriving income from the other states in which its salesmen solicited orders and that the sales resulting from that activity are attributable to those states is established by West Publishing Co. v. McColgan, 27 Cal. 2d 705, aff'd 328 U. S. 823. The only basis for applying different rules to the two periods is the 1939 amendment to Section 10. Prior to the operative date of that amendment the basis for allocation was business done within and without the State, thereafter the basis was the deriving of income from sources within and without the State.

The Commissioner's Office Ruling F T 10, No. 1 (Modified) of October 10, 1941, under which his concession was made as respects the income years 1938 and 1939 provides, in part, as follows:

> "No taxpayer shall be entitled to allocate income outside of California, for income years prior to 1938, unless it was engaged in intrastate business in some state or country outside of California. If a taxpayer was engaged in intrastate business outside of this State, during that period, it is entitled to allocate all income derived from sources without the State to the state or country of its source, regardless of whether taxpayer is engaged in intrastate business in that particular state or country."

The Appellant was doing intrastate business outside California in 1936 and 1937. It was authorized, accordingly, under this Ruling to allocate a portion of its income to the other Western states in which its salesmen operated irrespective of whether its business in those states constituted interstate or intrastate commerce. The Commissioner has not advanced any reason why the income from the California activity should be measured any differently for the income years 1936 and 1937 than for 1938 and 1939. Under his concession as respects the income years 1938 and 1939, the Office Ruling above quoted and the West Publishing Co. case, there should be included in the sales factor as California sales for the income years 1936 and 1937, as well as for the income years 1938 and 1939, only those sales solicited in California and those unsolicited sales in other states, the orders for which were filled from inventories maintained in California.

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 denying the claims of The Upjohn Company for refunds of tax in the amounts of

$3,015.27, $3,170.89, $3,363.26 and $3,005.26 for the taxable years ended December 31, 1937, 1938, 1939 and 1940, respectively, be and the same is hereby modified; said Commissioner is hereby directed to redetermine the net income attributable to this State of said Upjohn Company for each of the income years 1936, 1937, 1938 and 1939 by including in the sales factor of the allocation formula as California sales for each of those years only those sales solicited in California and those unsolicited sales in other states, the orders for which were filled from inventories maintained in California to recompute the tax upon the basis of such net income as so determined and to refund to said Upjohn Company the excess of the amount of tax paid by it for each of the taxable years 1937, 1938, 1939 and 1940 over the amount of tax as so recomputed for each of said taxable years; in all other respects the action of the said Commissioner is hereby sustained.

Done at Sacramento, California, this 20th day of May, 1948, by the State Board of Equalization.

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

ATTEST: Dixwell L. Pierce, Secretary