61-SBE-006

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
SUDDEN & CHRISTENSON, INC., as)
Successor in Interest to)
Sudden & Christenson)

Appearances:

For Appellant: G. E. Oefinger, Accountant

For Respondent: John S. Warren, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the protest of Sudden & Christenson to a proposed assessment of additional franchise tax in the amount of $3,143.77 for the income year 1941. Sudden & Christenson was dissolved in 1944 and Sudden & Christenson, Inc., assumed liability for all unpaid franchise taxes due from Sudden & Christenson.

Sudden & Christenson was organized in 1903 under the laws of California and thereafter engaged in the shipping and lumber business. In 1914 it purchased 25 shares of stock in the Hoquiam Lumber and Shingle Company under an agreement whereby it could surrender the shares and recover the full purchase price at any time. The price paid for each share was its par value of $1,000. Hoquiam suffered losses in each of the years 1914 through 1917 and had asubstantialdeficit in its surplus account by 1917.

In 1917 Sudden & Christenson became dissatisfied with the manner in which Hoquiam was being operated and sought to surrender its shares.. -1-n the course of negotiations which ensued it instead agreed to put up-additional money for which it was to receive notes and more shares of stock. In May, 1917, Sudden & Christenson thus acquired an additional 465 shares with a book value of $424,744.95, together with notes of Hoquiam in the amount of $174,977.12, for--a_ combined consideration as follows:

Cash	$108,148.36
Nineteen (19) shares of stock in Panama Eastern Lumber Co. at cost	19,000.00
Assumed debts of Hoquiam	4,981.81
	$132,130.17

Concurrently with this transaction Sudden & Christenson transferred to a third party 25 shares of Hoquiam stock, together with notes of Hoquiam with a face value of $8,465.59, for the sum of $7,607.42. In substance, for the sum of $124,522.75, Sudden & Christenson increased its holdings of Hoquiam stock by 440 shares and acquirednotes of Hoquiam with a face value of $166,511.53. It thenceforth held 465 shares. Since Hoquiam had only 500 shares of stock outstanding; -Sudden & Christenson gained almost absolute control.

In 1918 and thereafter, at least through 1923, Hoquiam had substantial profits and surpluses, except for an operating loss in 1921. In the period from 1919 through 1924, Sudden & Christenson acquired Hoquiam's remaining outstanding shares at a cost per share ranging---from $300 in 1919 to $3,360 in 1924.

Between August, 1917, and November, 1920, the notes acquired in May, 1917, were paid in full. Sudden & Christenson recorded its collections on the notes against a designated cost of $108,148.36 in cash and $4,981.81 in assumed debts, indicating a profit on the notes of $53,381.56. However, Federal revenue agents reviewed the firm's Federal income tax return for 1917 and determined that only $37,192.66 should be allocated as the cost of the notes and that the remainder of the consideration given in the 1917 transaction should be allocated as the cost of the 440 shares of Hoquiam stock. The company contested this determination, contending that the entire cost should be allocated to the notes. In the year 1926, the Bureau of Internal Revenue accepted this allocation. The Bureau also determined, however, that the discount on the face value of the notes was income for 1917.

In 1941 Sudden & Christenson disposed of its 500 shares of Hoquiam stock for $3,000.00. In a dispute with the Bureau of Internal Revenue-over its tax-liability for that year, the company contended that the inclusion in 1917 income of the discount on the Hoquiam notes constituted an error of law by the Bureau because income was realized only upon collection of the notes in subsequent years. Based upon this argument the Bureau allowed the company an "equitable offset" of $13,148.28 against its 1941 Federal tax liability. In the settlement, however, both parties adhered to the principle that the stock acquired in 1917 had a zero basis. The Franchise Tax Board, in computing the loss attributable to the sale of the stock, likewise determined that the basis of the shares acquired in 1917 was zero.

Appeal of Sudden & Christenson, Inc.

Another issue in this appeal concerns the operations of Sudden & Christenson and the Christenson Steamship Company, hereinafter referred to as the steamship company, a California corporation which owned and operated three ocean-going vessels. As early as 1939 Sudden & Christenson owned 87-1/2 percent of steamship company stock and before the end of 1941 it had acquired all of the stock. The two companies had three officers in common and maintained their headquarters in the same San Francisco office.

During 1941 and other years Sudden & Christenson acted as agent for the steamship company in Los Angeles, Portland and Seattle, receiving commissions based on gross freight revenue. It also acted as agent for other steamship companies. The commissions it received were billed to the steamship company on exactly the same basis, as to other companies, namely, 5 percent on outgoing cargo, 2-1/2 percent on inbound cargo and a flat husbanding fee if no cargo was involved. In ports where Sudden & Christenson did not maintain an office the steamship company used other agents. Sudden & Christenson in 1941 received approximately 31 percent of its agency commission income from the steamship company. The latter's payments of such commissions to Sudden & Christenson were approximately 64 percent of the total amount paid by it to all agents.

In 1941, in the course of negotiations over the franchise tax liability of the steamship company for the year 1936 it urged that it should be allowed to file combined reports with Sudden & Christenson. This was agreed to by the then Franchise Tax Commissioner and by Sudden & Christenson. A letter of August 1941, from the steamship company stated:

> ". ..It [Sudden & Christenson] acts as traffic agent for Christenson Steamship Company, receiving a commission based on gross freight revenue. The branches of Sudden & Christenson, in Oregon and Washington, as well as the head office at San Francisco, provide all lumber cargoes, handle the loading and discharging of cargo, bill and collect all revenue, pay all crews' wages and operating expenses. The vessels of Christenson Steamship Company are operated under the trade name 'Arrow Line' owned by Sudden & Christenson.
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> "Christenson Steamship Company had no working capital, its operations were entirely financed by Sudden & Christenson, at times to the extent of several hundred thousand dollars. It has never had a bank account, and its books of account are maintained by employees of Sudden & Christenson.

"The officers and directors of Sudden & Christenson are also officers and directors of Christenson steamship Company and receive no compensation from the latter. Christenson Steamship Company has no employees excepting the crews on its vessels. It has, since its organization, been operated as if it were a division of Sudden & Christenson."

Returns on a consolidated basis were thereafter filed for the Year 1941.

The Franchise Tax Board allocated the combined income of the two companies within and without the State through a formula composed of the factors of sales, payroll and property. The wages of personnel connected with the ships and the book value of the ships were assigned within and without the State according to the number of days that the ships were in port here and elsewhere.

The Franchise Tax Board's proposed assessment is challenged by Sudden & Christenson, Inc. (hereafter referred to as "Appellant") as successor to Sudden & Christenson. The grounds of its attack are (1) that the cost basis of the Hoquiam stock should be at least $88,045.38 rather than zero, (2) that the franchise tax due from Sudden & Christenson and the steamship company should not be computed on a consolidated basis and (3) that the three-factor formula in combination with the port-day formula as used in this case is not fairly calculated to determine the companies' net income derived from or attributable to sources within this State.

As to the first issue, the general rule is that where a mixed aggregate of assets is acquired for a lump sum, the cost or other basis should be allocated among the assets (Nathan Blum, 5 T.C. 702, 709). Allocation should be based upon the relative value of each item to the value of the whole (C. D. Johnson Lumber Corporation, 12 T.C. 348, 363). The taxpayer has the burden of establishing the proper basis to be used (Winifrede Land Co., T. C. Memo., Dkt. No. 34402, March 19,1953). Hence it is necessary for the Appellant to establish the relative values of the shares of stock and the notes involved in the 1917 transaction. Book value is not a conclusive indication of fair market value (Bryant Heater-Co. v. Commissioner, 231 Fed. 2d 938).

By 1917 Hoquiam had been operating at a loss for four years and its capital structure was impaired. Sudden & Christenson wanted to dispose of its stock but instead acquired a controlling interest in Hoquiam together with notes which on their face were worth more than the total acquisition price. The notes, particularly under these circumstances, were the preferable part of the bargain because they constituted a prior claim upon the company's dwindling resources, These factors were considerations which convinced Sudden & Christenson in 1917 that the stock had no value and which in 1926 persuaded the Bureau to accede to Sudden & Christenson's contention that the entire purchase price should be allocated to the notes.

It is significant that the Bureau and Sudden & Christenson, in their agreement as to the very year in question, confirmed the original allocation of a zero basis to the stock. Appellant deprecates that agreement as being merely an equitable compromise made in the light of the Bureau's admitted errors with respect to the years 1917 through 1920 when California had no franchise tax. But it appears that the Bureau admitted error only in determining that the difference between the face value of the Hoquiam notes and their allocated cost was income realized in 1917 rather than when the notes were paid. The Bureau, acting upon the original representations of Sudden & Christenson, has consistently treated the Hoquiam stock acquired in 1917 as having a zero basis.

Upon the evidence before us, we find no basis for concluding that the allocation agreed upon by Sudden & Christenson and the Bureau of Internal Revenue for the year 1917, and thereafter confirmed by their agreement for 1941, was erroneous, or that the Franchise Tax Board erred in using the values so agreed upon for State tax purposes.

Whether the franchise taxes due from Sudden & Christenson and the steamship company should be computed on a combined basis depends upon whether or not they may properly be considered to have been engaged in a unitary business. A business is unitary if one portion is dependent upon or contributes to the operation of the other portion (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 481). We have considered the above test met if by reason of the common ownership and the method of operation employed the profits of the business are materially greater (or the losses less) than they would have been had the various parts of the business'been operated without benefit of the connection (see e.g., Appeals of Beatrice Foods Company and Meadow Gold Dairies of California, Inc., Cal. St. Bd. of Equal., November 19, 1958 (CCH, 2 Cal. Tax Cases, Par. 201-181), (P-H, St. & Loc. Tax Serv., Cal., Par. 13,188)).

Applying that test to this situation we believe it is obvious that both companies were engaged in a single unitary business. The steamship company had no shore-based organization of its own, relying instead upon Sudden & Christenson to the extent of having the same officers, the same head office and the same clerical force. If the steamship company had assumed the burden of furnishing these services and facilities for itself there is no doubt that its income would have been materially decreased.

Appellant seeks to distinguish the Edison California Stores case, supra, on the ground that it did not involve two California corporations. This attempted distinction is without merit. It is immaterial whether the corporations are both foreign corporations, both domestic corporations, or a combination. We conclude that the companies were correct in their own belief, now controverted by the successor, that they were engaged in a unitary business.

Having determined that the business was unitary, formula allocation is clearly the proper method by which the income attributable to California should be determined (Butler Brothers v. McColgan, 17 Cal. 2d 664 aff'd, 315 U. S. 501; Edison California Stores, Inc. v. McColgan, supra; John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214). Nor do we see any reason for disturbing the method of allocation used by the Franchise Tax Board.

Appellant contends that there has been an improper combination of the port-day method and the property, payroll, sales formula. The Franchise Tax Board merely used port-days as a means of determining the numerators and denominators to be used in the three-factor allocation formula with respect to the value of the ships and the wages of the ships' personnel. This is the usual and proper method of determining intrastate and extrastate property and payroll of an ocean carrier (Appeal of American President Lines, Inc., Cal. St. Bd. of Equal., December 18, 1952 (CCH, 1 Cal. Tax Cases, Par. 200-193), (P-H, St. & Loc. Tax Serv., Cal., Par. 13,121)).

Appellant asserts that the result reached by formula allocation is inaccurate because (1) the book values of the steamships were used in the property factor though they represented only a small fraction of the fair market values, and (2) certain sums paid for stevedoring services were not included in the payroll factor and apportioned within and without California.

It would be impossible to annually ascertain the fair market value of all property used by enterprises doing business in California; the use of book values is a good practical substitute for fair market values in the formula. (See Altman & Keesling, Allocation of Income in State Taxation, Second Edition, 1950, pp. 114, 115.) Furthermore, the courts have repeatedly held that "rough approximation rather than precision" in formula allocation is sufficient (Illinois Central Railroad Co. v. Minnesota, 309 U. S. 157, 161; International Harvester Co. v. Evatt, 329 U. S. 416; El Dorado Oil Works v. McColgan, 34 Cal. 2d 731).

In so far as the sums paid for stevedoring services are concerned, the Franchise Tax Board states that those sums were paid to independent contractors. Appellant has furnished no information to the contrary. Sums paid to independent contractors cannot properly be included in the formula because the activities of such persons may not be regarded as activities of the taxpayers (Irvine Co. v. McColgan, 26 Cal. 2d 160; El Dorado Oil Works v. McColgan, 34 Cal. 2d 731; Appeal of The Times-Mirror Co., Cal. St. Bd. of Equal., October 27, 1953 (CCH. 1 Cal. Tax Cases, Par. 200-244), (P-H, St. & Loc. Tax Serv., Cal., Par. 13,137)):

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 Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the protest of Sudden & Christenson to a proposed assessment of additional franchise tax in the amount of $3,143.77 for the income year 1941 be and the same is hereby sustained.

Done at Sacramento, California; this 5th day of January, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Alan Cranston, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: Ronald B. Welch, Acting Secretary