BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
SAFEWAY STORES, INCORPORATED)

Appearances:

For Appellant: William D. McKee, Attorney at Law

For Respondent: F. Edward" Caine, Associate Tax Counsel

O P I N I O N

These appeals were made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Safeway Stores, Incorporated, to proposed assessments of additional franchise tax in the amounts of $174,978.54, $30,793.02 and $96,039.34 for the income years 1947, 1949 and 1950, respectively, and, pursuant to Section 26077 of the Revenue and Taxation Code, from the action of the Franchise Tax Board in denying the claims of Safeway Stores, Incorporated, for refund of franchise tax in the amounts of $126,398.86 and $35,952.76 for the income years 1948 and 1949, respectively. Since the filing of these appeals, the Appellant has paid the proposed assessments of additional tax, in accordance with Section 26078 of the Revenue and Taxation Code, the appeal from the action of the Franchise Tax Board on those proposed assessments will be treated as from the denial of claims for refund.

Appellant is a Maryland corporation qualified to do business in California. During the years 1947 through 1950 it operated, directly or through subsidiary corporations, a chain of more than two thousand retail food markets and related meat, grocery, produce and egg warehouses in twenty-three states, the District of Columbia and the five western provinces of Canada. In connection with its food store business, Appellant, either directly or through subsidiaries, also conducted large scale purchasing, manufacturing and processing operations throughout the United States and Canada. In addition, Appellant, either directly or through subsidiaries, maintained approximately thirty-five organizations which provided the entire Safeway organization with services in such fields as accounting, financing, advertising and law. Some of the subsidiaries did business only within California, some did business both within and without California, and some did business only without California.

Appeals of Safeway Stores, Incorporated

The entire business of Appellant and its subsidiaries was highly integrated. All offices, stores, warehouses and plants performing similar functions were operated in a similar manner and under the same policies. All retail operations were known under the name "Safeway," which was widely advertised in the United States and Canada, were conducted in stores of similar design and promoted the same "sponsored brands" (brand names of Safeway products).

The principal executive offices of the Safeway organization were located at Oakland, California. From these offices the entire business was managed, directed and controlled. At the top of the executive structure at Oakland, with ultimate responsibility for all operations and policies, was the President of Appellant and a group of executives known as the "President's Staff," consisting of approximately eight employees of Appellant. General responsibility for distribution activities was exercised directly by Appellant's President. General responsibility for each of the various supply and service companies was exercised by individual members of the "President's Staff." In determining policy and in directing the day-to-day operations, no distinction was made between the portions of the business conducted in the United States and the portions conducted in Canada, nor between the portions conducted by Appellant itself and the portions conducted by subsidiary corporations.

During the period in question, Appellant received dividends from several of its subsidiaries, including two of its Canadian subsidiaries, Canada Safeway Limited and MacDonald's Consolidated Limited. Prior to this period none of the subsidiary corporations had paid any dividends to Appellant. Canada Safeway Limited owned retail food stores located in Canada and also operated milk plants and bakeries supplying its retail operations. MacDonald's Gonsolidated Limited operated warehouses in Canada. Appellant itself did no business in Canada,

In the period between 1943 and 1945, Appellant acquired nine meat packing subsidiaries for the purpose of assuring the retail stores an adequate meat supply. These corporations, like all of the others previously referred to, were conducted as part of the unitary business of the Safeway organization. The operations of eight of these subsidiaries were unprofitable and Appellant advanced to them substantial sums of money. Within the period here in question, Appellant caused the meat packing subsidiaries to be liquidated and their assets sold. It incurred losses on its investment in the stock of eight of these subsidiaries and on the loans which it made to them.

During the years in question, Appellant had an average of twenty-seven stores in Maryland, the State of its incorporation, and average annual sales there of $18,500,000. In the same

period, it had an average of approximately six hundred stores in California and average annual sales here of $322,226,462. Its average California payroll was 36.37 percent of its total payroll and the average value of its property in California was 26.50 percent of the total value of its property.

Commencing in 1937 and continuing through the period in question, Appellant annually reported to the Franchise Tax Board or its predecessor the combined net income of the entire multi-corporate business. In each report Appellant allocated a portion of the combined net income to California sources by use of the usual three-factor formula. Attached schedules showed a break-down of the California income and tax of each corporation doing business within this State, as computed by Appellant. Cividends received by Appellant from its subsidiaries during the period in question were not included in reported income. Liquidation losses on meat packing subsidiaries were adjusted to reflect the amounts by which prior operating losses of those subsidiaries had offset operating income of other members of the affiliated group. Asso adjusted they were deducted by Appellant in its computation of the combined net income subject to allocation.

In recomputing the income of Appellant and its affiliated corporations for purposes of the assessments here in question, the Franchise Tax Board allowed the claimed deductions of liquidation losses from the combined allocable income, but added all intercompany dividend income to Appellant's non-allocable California income. In the Notices of Action upon Appellant% protests the Franchise Tax Board reduced the intercompany dividend income by allowing dividend deductions computed under Section 8(h) of the Act. Liquidation losses which had previously been allowed as deductions from unitary income were added back and in lieu thereof were allowed, as recomputed by the Franchise Tax Board after adjustment on account of prior operating losses, as deductions from non-allocable California income.

In the claims for refund filed after receipt of the Notices of Action, Appellant takes the position that if intercompany dividends are taxable in California as non-unitary income from intangibles, then on the same reasoning intercompany worthless stock and bad debt losses should be deductible in full from California income as non-unitary losses from intangibles. The Franchise Tax Board denied the claims on the ground that they were barred by the statute of limitations. It now, however, concedes that they were timely, with the exception of the claim for the year 1949, to the extent it relates to losses from worthless stocks. Appellant in turn concedes that this portion of its claim for 1949 was not timely.

There are three basic questions presented for our decision. They are:

1. Whether dividends received from wholly owned subsidiaries were taxable to Appellant.

2. If any of the dividends were taxable, whether the Franchise Tax Board correctly computed the dividend deductions allowable under Section 8(h) of the Bank and Corporation Franchise Tax Act.

3. To what extent losses resulting from the liquidation of the subsidiary corporations were deductible by Appellant.

TAXATION OF INTERCOMPANY DIVIDENDS

Appellant contends that where the income of a group of affiliated corporations engaged in a single unitary business is combined and apportioned among the places in which the business is conducted, intercompany dividends must be completely eliminated. In the alternative, it contends that the dividends should be included in the combined income to be allocated within and without the State. Essentially similar contentions were considered by this Board in the Appeal of Dohrmann Commercial Co., decided February 29, 1956 (2 CCH Cal. Tax Cas. Par. 200-504, 2 P-H State & Local Tax Serv. Cal. Par, 13152), and we concluded that the Bank and Corporation Franchise Tax Law required all dividends from stock having a situs in California to be included in the measure of the tax, except to the extent they were deductible under Section 8(h) of the Act. The cornerstone of our decision was Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, in which the court held that the allocation of income on the basis of a combined report does not disregard corporate entities;

Appellant argues that our conclusions in Dohrmann, supra, are without application here because the Franchise Tax Board, by addressing its assessments only to Appellant, elected to tax the entire group of corporations as one entity. This position may be assumed to be correct if the combined reports filed by Appellant constituted true consolidated returns on behalf of all the corporations in the group and the group was in fact taxed as one entity. (Edison California Stores, Inc. v. McColgan, supra; Keesling and Warren, The Unitary Concept in the Allocation of Income, 12 Hastings L. J. 42, p. 60.)

Authority to allocate the income of a unitary business, whether the integral parts of the business were or were not separately incorporated, was derived from the general provisions of the Bank and Corporation Franchise Tax Act relating to the ascertainment of income attributable to activities within the

State. (Edison California Stores, Inc. v. McColgan, supra.) The authority to use a consolidated return as a basis for the taxation of a group of affiliated corporations as a unit, on the other hand, rested upon specific statutory provisions. Since 1937, the year in which Appellant commenced reporting the combined income of its affiliated group of corporations for allocation purposes, the privilege of filing consolidated returns was limited by Section 13-1/2 of the Act to groups of affiliated railroad corporations. Although Section 14 of the Act authorized the Commissioner (now the Franchise Tax Board) to tax an affiliated group of corporations as a unit, this provision was applicable only if all of the corporations in the group were taxable as doing business within the State. (Bay Cities Transportation Co. v. Johnson, 8 Cal. 2d 706; Edison California Stores, Inc. v. McColgan, supra.) Thus Appellant never had the option of making a consolidated return and Respondent was without authority to require it. Absent such authority, Respondent could not "elect" to tax Appellant and its affiliated corporations on a consolidated basis. We conclude, accordingly, that the assessments in question did not constitute such an election.

Appellant next contends that the situs of the stock of Canada Safeway Limited and MacDonald's Consolidated Limited was in Canada and that the dividends on that stock were therefore not includible in the measure of the California tax. The basis of its argument is that the Canadian subsidiaries were integral parts of the unitary business and were simply the instrumentalities by and through which Appellant conducted that business in Canada.

Appellant leans heavily on Holly Sugar Corp. v. Johnson, 18 Cal. 2d 218, as support for its position. There the facts were that a New York corporation doing a substantial part of its business in California, but with its principal office in Colorado, acquired 70% of the shares of a California corporation engaged in the same type of business wholly within this State, for the purpose of controlling the policies and operations of the domestic corporation. The court held that by economic integration with the owning corporation's operations within California the shares of stock had become sufficiently localized to acquire a business situs here. Since Appellant did not do business in Canada, the decision is distinguishable and, in the light of other California authorities, hereinafter mentioned, does not sustain Appellant's position.

Appellant has also directed our attention to several decisions in other jurisdictions, with particular reference to Kentucky Tax Comm'r v. Fourth Ave. Amusement Co., 170 S.W. 2d 42, and Stanley Works v. Hackett, 190 Atl. 743. In those decisions the courts have, under local statutes applied what Appellant describes as the "ultimate source doctrine." Under that doctrine corporate entities were apparently disregarded and dividends

received by a parent corporation from a subsidiary corporation were treated as business income attributable to the place where the subsidiary conducted its business. Whatever its merits, this theory has not been followed by our courts.

In Miller v. McColgan, 17 Cal. 2d 432; Southern Pacific Co. v. McColgan, 60 Cal. App. 2d 48, and Pacific Western Oil Corp. v. Franchise Tax Board, 136 Cal. App. 2d 794, dividend income was regarded as having its source in the shares of corporate stock of the declaring corporation and to be taxable at the situs of the stock. In Southern Pacific Co. v. McColgan, supra, the situs of stock which was integrally connected with and used to further the multi-state business of the corporate stockholder was held to be at the commercial domicile of the stockholder, that is, the place from which the business was directed and controlled and where a major part of the business was conducted.

The commercial domicile of Appellant was in California. It was from the executive offices here that the entire unitary business was managed and controlled. It was here that the shares of stock in the Canadian subsidiaries were used to control the policies and operations of those corporations as a part of the unitary enterprise. In our opinion, the shares of stock had a situs here and the dividends were properly attributed to this State.

DIVIDEND DEDUCTIONS

During the period here in question Section 8(h) of the Bank and Corporation Act (now Section 24402 of the Revenue and Taxation Code) read as follows:

> In computing "net income" the following deductions shall be allowed:
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> * * *
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> Dividends received during the income year declared from income which has been included in the measure of the tax imposed by this act upon the bank or corporation declaring the dividends, or from income which has been taxed under the provisions of the Corporation Income Tax Act to the corporation declaring the dividends.

Since the Canadian subsidiaries did no business in California and had no California allocation factors, there has been no tax imposed upon those corporations by this State. Section 8(h) by its terms was, accordingly, without application to the dividends declared by the Canadian Subsidiaries and received by Appellant. It must be recognized, however, that formula

allocation of the combined income of a unitary business will not ordinarily coincide with the distribution of earnings and profits by separate accounting. If under the formula allocation a larger portion of the combined income of a group of affiliated corporations engaged in a single unitary business is attributable to California than the aggregate of the income attributable to this State by the separate accounts of each member of the group, an adjustment to intercompany dividend income may be required to avoid double taxation of the same income.

We have no doubt that Respondent's statutory authority to apportion for purposes of taxation the net income of multistate unitary business is sufficiently broad to encompass any adjustments to such income necessary to avoid double taxation by this State in accord with the underlying purpose of Section 8(h). For purposes of this discussion, accordingly, we shall refer to all deductions from dividend income as though they had been computed under Section 8(h).

Since this appeal has been filed the Franchise Tax Board has revised its method of computing Section 8(h) deductions and has redetermined the dividend deductions allowable to Appellant. The method now proposed would allow a deduction for each dividend in the proportion that the earnings and profits of each payor attributable to California bears to its total earnings and profits. Where, as here, the income of the corporation declaring the dividend is included for purposes of allocation in the combined income of a group of affiliated corporations, the denominator of the ratio is nevertheless determined from the payor's separate accounting records, which reflect the total book earnings and profits from which the dividend was paid. In determining the numerator there is included that portion of the California income attributable to the California factors of the payor, if any, adjusted for excesses or deficits arising from its actual receipt of more or less of the total California income than the amount attributable to it by its California factors. The following example furnished by the Franchise Tax Board illustrates the actual computations to be made in the application of this method to affiliated corporations.

	Parent	Sub.-1	Sub. 4	Sub. -3	Sub-4	Total
California factors	0	0	10%	6%	9%	25%
Total factors	30%	25%	10%	20%	15%	100%
Unitary income	400,000	300,000	80,000	160,000	60,000	1,000,000
Apportionment of total unitary income (item 2 x-item 3 total)	300,000	250,000	100,000	200,000	150,000	1,000,000
Excess of item 3 over item 4	100,000	50,000	(20,000)	(40,000)	(90,000)	0
Apportionment of California Unitary income (Item 1 x total of item 3)	0	0	100,000	60,000	90,000	'250,000
Limitation (item 6 x item 3) (item)			80,000	48,000	36,000	
Excess California income			20,000	12,000	54,000	86,000
Apportionment of excess (in ratio of excesses at item 5) $\frac{100,000}{150,000}$ x 86,000	57,333					
$\frac{50,000}{150,000}$ x 86,000		28,667				
Unitary income included in the measure of Calif. tax (item 6 minus item 8 plus item 9)	57,333	28,667	80,000	48,000	36,000	250,000

It is Appellant's position that the Section 8(h) deductions should have been computed by the use of the combined allocating percentage, on the basis of which the combined unitary income was actually allocated within and without the State on the combined report. In support of this conclusion it argues that every dollar of unitary income swells the combined income the same as every other dollar and that the application of a combined allocation percentage to the total unitary income assigns that percentage of each dollar to California. This method and the argument

in its support are untenable because they overlook the fact that the interstate apportionment of unitary business income for the purpose of taxation is a means of ascertaining the actual income attributable to the portion of the unitary business conducted within this State (Edison California Stores v. McColgan, supra), rather than a means of apportioning each individual dollar of income of the entire system without regard to its source. Moreover, both ignore the second, and frequently essential, step of the allocation process, which is the apportionment of the aggregate California net income among affiliated corporations doing businesswithin California. (See Keesling and Warren, The Unitary Concept in the Allocation of Income, supra,) In effect, the method urged by Appellant erroneously assumes that the affiliated group of corporations is taxable as a single entity.

As recomputed by the application of the method illustrated herein, the aggregate amount of the dividend deductions allowable to Appellant is substantially larger than the amount previously allowed in the Notices of Action issued by the Franchise Tax Board. In our opinion, the method of computation now utilized by the Franchise Tax Board removes the possibility of double taxation and represents an acceptable solution to a complex and difficult problem.

LIQUIDATION LOSSES

The present position of the Franchise Tax Board with respect to losses resulting from the liquidation of the meat packing subsidiaries is that (1) the bad debt losses are deductible from the combined income, (2) the losses on the stock are assignable to the commercial domicile of Appellant in California, and (3) the stock losses must be reduced to reflect prior operating losses of the liquidated subsidiaries. It is Appellant's contention that (1) if intercompany dividend income is includible in its California non-unitary income, then both the intercompany bad debt losses and the stock losses are deductible from its California income as non-unitary losses, and (2) that the stock losses should not be adjusted because of prior operating losses of the liquidated subsidiaries.

The claimed intercompany bad debt losses arose from a series of advances from Appellant to eight of its meat packing subsidiaries. From time to time the subsidiaries made repayments. The subsidiaries were an integral part of the unitary system and their operations were reflected in the combined reports filed by Appellant. Advances by Appellant were made for the purpose of meeting normal operating expenses of the subsidiaries, thus enabling them to acquire meat for distribution through "Safeway" stores. Assuming, without deciding, the correctness of the Franchise Tax Board's concession that the amounts of the advances

remaining unpaid at the time of liquidation of the subsidiaries constituted losses fully deductible in the year of liquidation, we conclude that they were unitary business losses deductible from the combined allocable business income. (Appeals of M. Seller Co., decided August 26, 1946; Houghton-Mifflin Co., decided March 28, 1946; and Marcus-Lesoine, decided July 7, 1942.)

Both the Franchise Tax Board and Appellant agree, and we concur, that intercompany stock losses should be accorded the same treatment for allocation purposes as are intercompany dividends. For the reasons stated in our discussion of intercompany dividends, we conclude that the stock losses are deductible from Appellant's California income. We shall, accordingly, consider here only the question of the adjustments urged by the Franchise Tax Board to reflect prior operating losses of the liquidated subsidiaries, thereby purportedly giving tax benefits to Appellant and its other subsidiaries doing business in California.

It is the Franchise Tax Board's position that the adjustment of the stock losses to reflect prior operating losses of the liquidated subsidiaries is required to avoid double deductions. In support of this contention it relies entirely upon decisions and regulations concerned with consolidated returns filed under provisions of the Federal laws. As Appellant's combined reports were not the equivalent of consolidated returns, those authorities are without application to the stock losses in question and require no discussion. In view of our conclusion that income derived from stock in the form of intercompany dividends is non-business income, it necessarily follows that intercompany losses on stock must be treated as non-business losses. They are, accordingly, not subject to adjustment because of prior operating losses taken into account in the determination of net unitary business income.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Safeway Stores, Incorporated, for refund of franchise tax in the amounts

of $174,978.54, $126,398.86, $66,745.78 and $96,039.34 for the income years 1947, 1948, 1949 and 1950, respectively, be and the same is hereby modified as follows: The bad debt losses incurred by Appellant on the liquidation of its meat packing subsidiaries are to be allowed as deductions in the determination of net unitary business- income subject to apportionment; the stock losses incurred upon the liquidation of those subsidiaries are, to the extent timely claims relating thereto have been filed, to be allowed as deductions from Appellant's California income without adjustments for prior operating losses deducted in the determination of net unitary business income; and the deduction from intercompany dividends are to be recomputed in accordance with the method set forth in the Opinion on file herein. In all other respects the action of the Franchise Tax Board is sustained.

Done at Pasadena, California, this 2nd day of March, 1962, by the State Board of Equalization.

George R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary