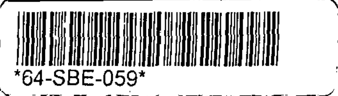

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THE SWEETS COMPANY OF AMERICA, INC.)

For Appellant: Joseph T. Hand, Treasurer

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of The Sweets Company of America, Inc., against proposed assessments of additional franchise tax in the amounts of $3,055.86, $6,312.17, $9,579.12 and $8,406.84 for the income years 1957, 1958, 1959 and 1960, respectively.

Appellant is a foreign corporation, qualified to da business and doing business within this state. Its main office and principal manufacturing plant are located in New Jersey, with a branch office and a manufacturing plant in Los Angeles, California. Appellant is engaged in the business of producinq and selling candy. The candy is sold primarily through independent food and candy brokers,

Appellant employs four district 'sales managers, one of whom operates in California and several other states. Each -district sales manager maintains close contact with the brokers through whom sales are made, He advises the brokers about promotional campaigns, checks their records, travels with their salesmen to check on their activities and to advise, if necessary, and generally acts as a liaison between appellant and the brokers.

All orders from brokers operating in California are received at appellant's Los Angeles office and are processed

by employees located there. All, or substantially all, of the activity in connection with the orders is performed at that office, The orders are filled, to the extent possible, from goods manufactured in California or stored here.

In addition, appellant made certain sales directly to California customers, primarily syndicates, chains and vending companies, from its main office in New Jersey, These sales were not made through brokers and the western district safes manager devoted none of his time to these accounts. The sales were handled by appellant's eastern division and were not solicited in California or processed in the Los Angeles office. Sales of this kind totaled $196,129, $177,204 and $258,765 for the income years 1958, 1959 and 1960, respectively.

In 1957, appellant incorporated Rockwood Chocolate Co., Inc., which manufactured candy in New York, and Sweetwood. Realty Corp., which owned the realty occupied by Rockwood. Rockwood suffered losses in the years here involved and Sweetwood's income was very minor,

Appellant filed a franchise tax return for 1957, using a three-factor formula to compute its California income. This formula attributed no sales to California. For the years 1958 through 1960, its returns were filed on a separate accounting basis,

Respondent determined that appellant was conducting a unitary business by itself in 1957 and with its subsidiaries thereafter. To ascertain the California net income, respondent applied the usual three-factor allocation formula of property, payroll and sales, Book values of property were used in the property factor, For purposes of the payroll factor, respondent considered as California payroll the wages of employees working here plus a portion of the salaries of executives representing time spent in California. As applied by respondent, the sales factor reflected as California sales a%% sales which were made to customers located here. Since this appeal was fifed, respondent Baas conceded that the operations of the subsidiaries were a part of the unitary business in 1957.

Appellant's first contention is that separate accounting should be used to determine the income attributable to California, even though it agrees that the business was unitary in character. It argues that the percentage of profit on sales

in California is lower than elsewhere and that the formula used, by respondent thus produces distortions, This is the same argument that was answered in John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214, 224 [238 P.2d 569], appeal dismissed, 343 U.S. 939 [96 L. Ed. 1345], where the court said that the propriety of using a formula

> ... does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein-the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors employed in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process.

The California Supreme Court has recently reaffirmed its position that the formula method, rather than separate accounting, must be employed to allocate the income of a unitary business. (Superior Oil Co, v. Franchise Tax Board,* 60 Cal. 2d ____ [134 Cal. Rptr. 545, 386 P.2d 33 3; Honolulu Oil co. v. Franchise Tax Board,* 60 Cal., 2d [34 Cal. Rptr. 552, 386 P.2d 40].)

Next, appellant argues that if a formula is to be used, the property factor should be eliminated, It is well established , however , that the Franchise Tax Board has authority and discretion to use any or all of the factors specified in the controlling statute, section 25101 of the Revenue and Taxation Code. (Pacific Fruit Express Co. v. McColgan, 67 Cal. App. 2d 93 [153 P.2d 607]; El Dorado Oil Works v. McColgan, 34 Cal, 2d 73% [215 P.2d 4].) The fairness of using the three factors of property, payroll and sales has been declared settled. (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16].)

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*Advance Report Citations: 60 A.C. 361 and 60 A.C. 373.

Appeal of The Sweets Company of America, Inc.

Appellant's objection to the property factor is based on a contention that a large part of the physical assets of the business have been depreciated on the books to a small fraction of their original cost and actual value, while the assets of the same nature located in California are comparatively new. In place of the book values used by respondent for purposes of the property factor, appellant urges the use of insured values for buildings and equipment, assessed values for land,, and book values for inventories,

Undoubtedly, it would be most desirable to include the properties at their fair market values, There is no assurance, however, that this aim would be achieved by using assessed values, which may vary widely from state to state, or by using insured values, which may also vary widely. As we said in Appeal of Sudden & Christenson, Inc., Cal. St. Bd. of Equal., Jan. 5, 1961:

> 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.)

Appellant also claims that respondent was wrong in assigning to California for purposes of the sales factor, all of the sales to California customers.

The authority and discretion reposed in the Franchise Tax Board to prescribe the allocation formula necessarily carries with it the authority and discretion not only to select the factors but also to determine the composition and application of each factor. Respondent's regulations provide in part that:

> The sales or gross receipts factor generally shall be apportioned in accordance with employee' sales activity of the taxpayer within and without the State.... Promotional activities of an

> employee are given some weight in the sales factor. (Cal. Admin. Code, tit. 18, reg. 25101, subd. (a).)

According to recognized authorities in the field of income allocation, the purpose of *the safes* factor is to balance the other factors of property and payroll and to give recognition to the activities of the taxpayer in obtaining customers and markets. (Final Report of the Committee on Tax Situs and Allocation, 1951 Proceedings of the National Tax Association, pp. 456, 463; Altman & Keesling, Allocation of Income in State Taxation (2d ed. 1950) p. 126.) As stated by Altman & Keesling:

> With this exception, [that sales should not be apportioned to states or countries where.. the taxpayer is engaged in neither inter nor intrastate activities] sales should, so far. as possible, be apportioned to the state where the markets are found, from which the business is received, or where the customers are located. (Op. cit. p. 128.)

With respect to the sales made to California customers through brokers, appellant has failed to show that there was any significant activity by its own employees outside of this state, The district sales manager contacted and worked closely with the brokers here, all *of the* orders received from the brokers were processed by employees at the Los Angeles office and, so *far* as we can ascertain from the record, substantially, all of the orders were filled from goods manufactured *or* stored here. Under these circumstances, we cannot find that the Franchise Tax Board abused its discretion by assigning these sales to California.

Until this appeal was filed, respondent apparently had no information regarding the direct sales to California customers. According to information subsequently presented by appellant, and not disputed by respondent, these sales were not made through brokers but directly from the main office in New Jersey and they were handled by appellant's eastern

division, They were not solicited in California or processed in the Los Angeles office and the western district sales manager devoted none of his time to them. Since it appears that no significant activities in connection with these safes occurred in California, we believe that the principles followed by respondent, as incorporated in the previously quoted language of its regulations, require that they be considered as out of state sales in the sales factor.

Appellant has also questioned respondent's assignment to California of a portion of the compensation of executives for purposes of the payroll factor. No details have been submitted by appellant, however, and we must therefore assume that the determination was correct.

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 on the protests of The Sweets Company of America, Inc., against proposed assessments of additional franchise tax in the amounts of $3,055.86, $6,312.17, $9,579.12 and $8,406.84 for the income years 1957, 1958, 1959 and 1960, respectively, be modified by adjusting the sales factor in accordance with the opinion of the board. and by treating appellant and its subsidiaries as engaged in a unitary business for the income pear 1957. In all other respects the action of the Franchise Tax Board is sustain&d,

Done at Sacramento, California, this 23d day of June, 1964, by the State Board of Equalization,

Paul R. Leake, Chairman

Alan Cranston, Member

Geo. R. Reilly, Member

John W. Lynch, Member

Richard Nevins, Member

ATTEST: [signature], Secretary