



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOYCE; INC.)

Appearances:

For Appellant: Dennis J. Barron, Attorney at Law
John Thumann, Assistant Controller
For Respondent: Lawrence C. Counts
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 Joyce, Inc., against proposed assessments of additional franchise tax in the amounts of \$10,688.17, \$8,773.35, and \$10,614.65 for the income years ended November 30, 1959, 1960, and 1961, respectively.

The issues presented are whether appellant was engaged with certain other corporations in a unitary business during those years; and if so, whether a federal statutory provision, Pub. L. No. 86-272 (73 Stat. 555 (1959), 15 U.S.C. §381), precluded respondent from determining appellant's franchise tax liability by combining the unitary net income of appellant and the other corporations and allocating a portion of the income to California according to the ratio of the California property, payroll and sales of all the corporations to their total property, payroll and sales.

Appellant, a California corporation, commenced doing business in 1932, manufacturing and selling women's shoes and footwear. During the years in question it had its principal office in Cincinnati, Ohio, and had two manufacturing plants,

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a principal one in Columbus, Ohio, and one in Madison, Indiana. Other than certain leasehold improvements in California, appellant's sole contact with California was through the presence of two sales representatives who solicited but could not accept orders from merchants. All orders were forwarded to Cincinnati for approval and filled by shipment from outside of California.

For many years prior to 1955, United States Shoe Corporation, an Ohio corporation engaged in manufacturing and selling women's shoes and footwear, was totally unrelated to appellant. In 1955, U. S. Shoe acquired 94.8 percent of appellant's stock. The percentage increased to 97.95 percent, 99.26 percent and 99.34 percent, respectively, for the years on appeal. U. S. Shoe had its principal place of business in Cincinnati, Ohio, and had eight manufacturing plants, all located outside California. Its sole contact with California was by means of sales representatives who operated in the same manner as appellant's representatives. U. S. Shoe's five sales representatives were different persons than appellant's representatives.

United States Box Company is an Ohio corporation wholly owned by U. S. Shoe. During the years in question, it manufactured boxes in its own plant. It had no property, office, nor employees in California.

Imperial Adhesives, Inc. , another Ohio corporation wholly owned by U. S. Shoe, was organized in 1960 to manufacture adhesives for use by shoe and furniture manufacturers and solvent processors. It had no property, office, nor employees in California.

U. S. Shoe sold to appellant leather, other raw materials and finished products for total amounts of \$86,011, \$194,006, \$1,043,122, during the respective years at issue. This represented 2.68 percent, 5.52 percent, and 23.26 percent, for the respective years, of appellant's purchases, or an average of 10.49 percent. This was an average of .0096 percent of U. S. Shoe's sales for the three years. By purchasing raw materials from U. S. Shoe, appellant was able to obtain the advantage of U. S. Shoe's quantity discount purchasing.

Appellant's sales to U. S. Shoe for the pertinent years, in the amounts of \$108,219, \$548,480, and \$50,060,

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consisted exclusively of finished products and averaged 2.57 percent of appellant's sales and 1.09 percent of U. S. Shoe's purchases for the three years.

U. S. Box sold boxes exclusively to appellant and U. S. Shoe.

In 1961, Imperial's first year of manufacturing, more than one-half of Imperial's sales of adhesives were made to U. S. Shoe; namely, \$128,585 out of total sales of \$206,657.. Imperial also sold some adhesives directly to appellant.

After U. S. Shoe acquired appellant's stock, appellant and U. S. Shoe continued to have separate manufacturing plants and to sell separate lines of ladies' shoes and footwear. They retained separate purchasing, styling, advertising, pattern and production departments and separate sales and office forces. There was no shifting of personnel between the corporations.

All corporations but Imperial shared U. S. Shoe's offices in Cincinnati, Ohio. Accounting records of all four corporations were retained there and tax returns prepared there. All corporations were represented by the same legal counsel and independent accounting firm. While the makeup of each corporation's board of directors varied to a degree, there was some interlocking of directors and the secretary-treasurer of each corporation was the same individual.

While appellant was generally successful prior to 1955, it sustained operating losses in some of the years just prior to U. S. Shoe's acquisition of its stock so that in 1955, appellant had a net operating loss carryover in excess of \$400,000.

Appellant filed separate returns for the income years under appeal, computing its income attributable to California by the usual three-factor formula consisting of tangible property, payroll and sales. Respondent determined that appellant, U. S. Shoe, U. S. Box and Imperial were engaged in a unitary business. Respondent then regarded as income includible in the measure of appellant's tax, the combined net income attributable to sources within this state. It computed this California income by using in the three-factor formula the factors of all of the corporations, including as California

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factors both appellant's and U. S. Shoe's payroll and sales in this state and appellant's property in this state.

Section 25101 of the Revenue and Taxation Code provides that where income of a taxpayer is derived from sources both within and without the state, the portion of the income attributable to California for tax purposes must be determined by an allocation based on sales, payroll, property or other factors or such other method as is fairly calculated to determine the California income.

If a unitary business exists, the unitary income attributable to California must be determined by a reasonable formula method rather than by separate accounting.. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed. 991].) In accordance with one test developed by the California Supreme Court, commonly owned corporations are engaged in a unitary business if the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state. (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 163; Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33]; Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40].) The California Supreme Court decisions indicate a broadening application of the unitary business concept, The court has yet to draw the line where the various portions of a business are separate rather than unitary.

Applying this test to the four corporations involved in this present appeal, we find considerable contribution and dependency. Although appellant and U. S. Shoe sold different lines of shoes and footwear, appellant was virtually entirely owned by U. S. Shoe. The parent, U.S. Shoe, served as a substantial supply source of raw materials for appellant, thereby passing on to appellant considerable savings on purchases because of U. S. Shoe's volume discount purchasing. Appellant contributed substantially to the benefit of U. S. Shoe, one of U. S. Shoe's wholly owned subsidiaries, by serving as a market for box sales, It also purchased adhesives from Imperial and sold finished products to U. S. Shoe,

The four corporations were further linked together by partial interlocking directorates, Three of the four

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corporations shared the same head office. The same person served as an officer of appellant and U. S. Shoe,

Accordingly, based upon the existing court decisions, we conclude that the four corporations were engaged in a unitary business.

Appellant asserts that in its separate accounting it would not understate its net income since this was the only net income which, for federal income tax purposes, could be offset against the available net operating loss carry-over. Appellant's good faith and good intentions are not questioned. However, inasmuch as appellant's business was part of a unitary system, separate accounting of appellant's business did not truly reflect appellant's net income, (Edison California Stores, Inc. v. McColgan, supra, 30 Cal. 2d 472 [183 P.2d 16].)

While appellant operated as part of a unitary business and a formula method of allocation was therefore required, we still must determine whether respondent, by its method of applying a formula, made a reasonable determination as to the amount of appellant's income attributable to California and includible in the measure of the franchise tax.

Power to apply formula allocation pursuant to section 25101 of the Revenue and Taxation Code is not authority to tax a group of corporations as a unit or to include all of the California income in the measure of the tax of one of the corporations. The power is given to ascertain the income of a particular taxpayer within this state. (Edison California Stores, Inc. v. McColgan, supra.) Accordingly, when two or more entities conduct a portion of a unitary business in the state, it is necessary, after the portion of the income from the unitary business attributable to the state is determined, to make a further apportionment between the entities of the group to determine the tax liability of each. In many instances the apportionment between the taxpayers within the state is unimportant since the tax in total amount is the same, and the persons in control of the unitary business are not economically affected by the method of, or lack of, that apportionment. One instance, however, where the further apportionment is important is where the taxpayers fall into different tax categories. (Aitman and Keesling, Allocation of Income in State Taxation, (2d ed. 1950) pp: 175-177.)

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Pursuant to Pub. L. No. 86-272, no state has the power to impose a tax on or measured by income derived within the state by any person if the only business activities within the state are the solicitation of orders for sales of tangible personal property, which orders are sent outside the state for approval or rejection and if approved, are filled by shipment or delivery from a point outside the state. Specifically excluded by this federal statute from this immunity are corporations incorporated in the state where the activity occurs. Accordingly, the net income which appellant as part of the unitary group derived from sources within this state was includible in the measure of tax, whereas the net income of U.S. Shoe derived from sources within this state was not includible.

Inasmuch as U. S. Shoe, in addition to appellant, solicited orders in California, a portion of the unitary income attributable to sources within this state constituted income of U. S. Shoe which was not includible in the measure of tax. The apportionment of the California income between appellant and U. S. Shoe was not made by respondent.

We conclude that respondent must allocate to appellant and include in the measure of tax only a reasonable portion of the unitary net income which respondent has determined is attributable to California sources. This allocation should be made on the basis of appellant's property, payroll and sales within California, in a manner designed to reasonably reflect the contribution of those factors to the total unitary net 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,

