BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WARNER BROS. PICTURES, INC.)

"For Appellant: H. R. Kelly
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Peter S. Pierson
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 Warner Bros. Pictures, Inc., against proposed assessments of additional franchise tax in the amounts of $278,739.02 and $23,039.05 for the income years ended August 31, 1956 and 1959, respectively.

Appellant Warner Bros. Pictures, Inc., is a Delaware corporation. Its commercial domicile has always been located in New York City, except for the period from December 1, 1958, to June 30, 1960, when it was situated in California; Appellant produces motion pictures and then leases them to two wholly owned subsidiaries, Warner Bros. Pictures Distributing Corp. and Warner Bros. Pictures International Corp. (hereafter referred to as International), which distribute the films on a world wide basis through the use of licenses. The commercial domiciles of the above two subsidiaries followed the locations of the commercial domicile of appellant. A number of other sub-, sidiaries of appellant operated in the motion picture, television, and recording fields during the years In question.

On March 1, 1956, appellant contracted to sell 750 motion pictures to P.R.M. Inc., for television use. The negotiations preceding this agreement took place at appellant's offices in New York City; however, the contract was executed in Dover, Delaware. The films had been produced during the period from 1918 through 1949, and 700 of them were in storage in Fort Lee, New Jersey, while the remainder were held in Burbank, California. Delivery was made at the above storage locations, and the $21,000,000 purchase price was paid by P.R.M. Inc., partially in Dover, Delaware, partially in Fort Lee, New Jersey, and the balance in Boston, Massachusetts.

Appellant did not include the $21,000,000 in the computation of unitary business income subject to apportionment, in the combined report filed by appellant and its subsidiaries for the income year ended August 31, 1956. Whether the film sale proceeds should have been so included, as respondent contends, is the first issue of this case.

During the period when appellant's and International's commercial domiciles were located in California;. International received a dividend of $120,630 from another subsidiary of appellant, Warner Bros. First National Pictures, Inc. (East), and appellant received a dividend in the amount of $1,500,000 from International. After reviewing the combined report submitted by appellant and its subsidiaries for the income year ended August 31, 1959, the Franchise Tax Board determined that the claimed dividend deductions should be recomputed in accordance with the formula used in Appeals of Safeway Stores, Inc., Cal. St. Bd. of Equal,, decided March 2, 1962. This resulted in a reduction in the amounts of the dividend deductions allowed with respect to the above two inter-, company dividends. Whether respondent's determination was correct is the second issue of this case.

When a taxpayer derives income from sources both within and without California, its tax shall be measured by the net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If a business is unitary, as is appellant's, the income derived from or attributable to California must be computed by formula allocation rather than by the separate accounting method. (Butler Brs. v. McColgan,, 17 Cal. 2d 664 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed. 991]; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16].)

With respect to the first issue, appellant contends that the exclusion of the film sale proceeds from the computation of unitary business income subject to apportionment was justified because its use of the films had ceased long before their sale. Appellant also argues that the film sale was not within the scope of its unitary business which was concerned with leasing or licensing motion pictures, but not with selling them. Alternatively appellant contends that even if the income at issue is unitary business income, it is exempt from California taxation under the following provision of section 25101 which was in effect during the year in question:

> 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 domicile.

Appellant argues that it was not doing business in Delaware, New Jersey, or Massachusetts, the states most closely connected with the film sale, and therefore all the sale proceeds must be allocated to New York, appellant's commercial domicile during the year of the sale.

In Appeal of Paramount Pictures Corp., Cal. St. Bd. of Equal., decided January 6, 1969, we considered a fact situation, primary issue, and contentions, very similar to those presented in the instant case. We concluded that the proceeds from the sale of the films should have been included in the taxpayer's computation of unitary business income, and stated in part:

> ... we do not think that these facts are sufficient to establish that the films were not integral parts of or connected with the unitary business. The films were developed and maintained through the resources of and in furtherance of that business. Their cost was very probably amortized in reduction of unitary business income. Appellant retained ownership of the films until their sale and throughout the period preceding their sale the films continued to be valuable assets of the unitary business. This value was maintained by the possibility that a change in demand would justify reissuance, and by future television

> use which became foreseeable at least by the late 1940's. Under these circumstances the income realized from the film sale cannot be excluded from unitary business income under subdivision (d) of regulation 25101. 1/
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> Appellant'next contends that the business activity of selling the films for television exhibition was not within the scope of appellant's unitary business,.... Under the more recent test, a business is unitary when operation 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, supra, 30 Cal. 2d 472 [183 P.2d 163.) Appellant's film production and theater distribution business benefited from the sale of the films. because it received the proceeds. (See RKO Teleradio Pictures, Inc. v. Franchise Tax Board 246 Cal. App. 2d 812 [55 Cal. Rptr. 299].) Also, it is certainly clear that the production and probably the theater distribution of the films contributed to their sale for television use. This dependence and contribution is sufficient basis for holding that appellant's film sale activity was part of its unitary film production and distribution business,

In reference to the taxpayer's argument in the Paramount case that the provision of section 25101, quoted above, allocates all of the income in question to New York, the taxpayer's principle place of business, we stated in part:

1/ Subdivision (d) of regulation 25101, title 18, California Administrative Code, states in part:

> (d) Income From Property. (1) Non-unitary Income. Income from property, which is not a part of or connected with the unitary business, is excluded from the income of the unitary business which is allocated by formula.,

> . . . Appellant's proposed interpretation in effect uses the separate accounting method to compute the income which had its source in New Jersey. The result is nonrecognition of the fact that the operations of appellant's business in various states contributed to the income realized upon the film sale.
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> We think that when a unitary business is involved the provision of section 25101 at issue must be construed to apply only 'after unitary business income has been computed and tentatively allocated among the various relevant states', If at that time some of this unitary business income has been allocated to a state only because of isolated or occasional transactions there which were reflected in the factors of the allocation formula, and the taxpayer is not doing business in that state, then such income will instead be allocated to the state in which the taxpayer has its principal place of business or commercial domicile. This interpretation does not frustrate the purpose of formula allocation of unitary business income.

We think that the reasoning and conclusions in the Appeal of Paramount Pictures Corp., supra, are equally applicable to the instant case. Therefore we conclude that the film sale proceeds should have been included in the computation of unitary business income subject to apportionment.

The second issue of this case is concerned with the correctness of the Franchise Tax Board's computation of the dividend deductions applicable to the intercompany dividends received by appellant and International. Sections 24401 and 24402 of the Revenue and Taxation Code provide:,

> 24401. In addition to the deductions provided in Article 1, there shall be allowed as deductions in computing taxable income the items specified in this article.
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> 24402. Dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 or Chapter 3 of this part upon the taxpayer declaring the dividends.

Respondent's computation was based upon a formula designed to calculate the amount of each affiliated payor corporation's unitary income which was included in the measure of the California tax. We first approved this formula in Appeals of Safeway Stores, Inc., supra, and reaffirmed it in Appeal of Max Factor & Co., Cal. St. Bd. of Equal., decided April 24, 1967.

Appellant first contends that the intercompany dividends at issue are totally exempt from taxation. This argument is based on appellant's assumption that the corporations in question were required to file a combined report under section 25102 of the Revenue and Taxation Code. *Appellant contends that the effect of this statute is to tax a group of corporations as if they were one entity, and therefore concludes that in order to avoid double taxation intercompany dividends must be eliminated.

However, appellant's basic assumption is erroneous. The combined report filing requirement in question was part of the procedure involved in formula allocation of unitary business income. It is well settled that the authority for this requirement flowsfrom the general statute which authorizes such formula allocation, section 25101 of the Revenue and Taxation Code, rather than from section 25102. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal, 2d 472 [183 P.2d 16]; Appeal of AMP Inc., Cal. St. Bd. of Equal., Jan. 6, 1969; Appeal of Max Factor & Co., supra; Appeals of Safeway Stores, Inc., supra; Appeals of Elier Co. and Elier Co. of Calif., Cal, St. Bd. of Equal., Dec. 16, 1958; Appeal of St. Regis Paper Co., Cal. St. Bd. of Equal., Dec. 16, 1958; Appeal of Bostitch-Western, Inc., Cal. St. Bd. of Equal., Nov. 17, 1948.)

Also, the function of formula allocation of unitary business income is not to disregard the various taxable entities involved and combine them as one unit, but rather it is to ascertain the true income of the business attributable to sources within California. (Edison California Stores, Inc. v. McColgan, supra; Appeal of Household Finance Corp., Cal. St. Bd. of Equal., Nov. 20, 1968.) When two or more corporate entities each conduct a portion of the unitary business in this state, their separate entities are respected and a further allocation is made among them to determine the true income of each. (Appeal of Household Finance Corp., supra. See also Appeal of Joyce, Inc., Cal. St. Bd. of Equal., Nov. 23, 1966; Appeal of Oakland Aircraft

Engine Service, Inc.', Cal. St. Bd. of Equal., Oct. 5, 1965; Appeals of Kaiser-Frazer Sales Corp. and Kaiser Motors Corp., Cal. St. Bd. of Equal., Nov. 7, 1958.) This intrastate allocation is incorporated into the dividend deduction computation formula used by respondent. (See Appeals of Safeway Stores, Inc., supra.) Consequently, we cannot agree with appellant's argument that the intercompany dividends must be totally exempted from taxation.

Appellant next suggests an alternative method for computation of the dividend deductions in question. The basic feature of this method is that the amount of the payor corporation's unitary business income which was included in the measure of the California tax is calculated by taking the same percentage of that corporation's unitary business income as the percentage which was used to allocate a portion of the combined unitary business income of all of the affiliated corporations to California. This suggested method of computation is identical to the method proposed by the taxpayer in Appeals of Safeway Stores, Inc., supra. In that case we rejected the taxpayer's proposal and approved the formula used by respondent, which we stated "removes the possibility of double taxation and represents an acceptable solution to a complex and difficult problem." We think that this choice is equally appropriate in the instant case.

We must conclude that the Franchise Tax Board was correct in its determination that the dividend deductions in question should be recomputed in accordance with the formula used in Appeals of Safeway Stores Inc., supra.

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,

Appeal of Warner Bros. Pictures, Inc,

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 protest of Warner Bros. Pictures, Inc., against proposed assessments of additional franchise tax in the amounts of $278,739.02 and $23,039.05 for the income years ended August 31, 1956 and 1959, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of May, 1969, by the State Board of Equalization.

Leon W. Lynch, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary