BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appsal of )
)
BROWNING MANUFACTURING CO., ET AL. )

For Appellant: J. Gordon Hansen
Attorney at Law

For Respondent: 'Crawford H. Thomas
Chief Counsel

John D. Schell
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 Browning Manufacturing Co., for itself and as successor in interest to Browning Industries, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Browning Manufacturing Co.

| Income Year Ended | Taxable Year Ended | Amount |
|---|---|---|
| March 31, 1963 | March 31, 1963 | $ 1,402.21 |
| March 31, 1963 | March 31, 1964 | 1,402.21 |
| March 31, 1964 | March 31, 1964 | 3,927.07 |
| March 31, 1964 | March 31, 1965 | 5,329.28 |
| December 31, 1964 | December 31, 1965 | 9,631.86 |
| December 31, 1965 | December 31, 1966 | 19,447.87 |
| December 31, 1966 | December 31, 1967 | 17,585.48 |

Browning Manufacturing Co., successor in interest to Browning Industries, Inc.

| Income Year Ended | Taxable Year Ended | Amount |
|---|---|---|
| December 31, 1962 | December 31, 1962 | $4,357.68 |
| December 31, 1962 | December 31, 1963 | 4,357.68 |
| December 31, 1963 | December 31, 1963 | 632.76 |
| December 31, 1963 | December 31, 1964 | 4,990.44 |

The principal issue is whether appellant Browning Manufacturing Co. was engaged in a single unitary business with several affiliated corporations during the years on appeal.

Browning Arms Company (Arms) is a Utah corporation which does business in Utah and Missouri. It does not do business in California. For many years the principal business of Arms has been the sale of high quality sporting firearms, but during the years on appeal Arms also sold fiber glass, archery equipment, pole vaulting poles and fishing rods.. Arms sells all of its products to independent dealers in the United States, and because of the outstanding reputation acquired by Browning firearms, Arms was able prior-to 1966 to sell its products solely on the basis of national advertising and catalogs. Beginning in 1966 Arms made *use* of a small sales force.

Although Arms designs and sells Browning firearms, it does not *manufacture* them,. All Browning firearms are manufactured in Belgium by Fabrique Nationale d'Armes de Guerre (FN), a Belgian corporation in which Arms has a very minor *stock* interest. FM is one of the world's largest small arms manufacturers, and nearly 1/3 of its sales are to Browning affiliates. FN devotes a separate plant exclusively to the production of Browning firearms:, and the production process is supervised by a full time staff of Arms employees who enforce Arms' rigid standards of quality control. Browning firearms sold in the United States are imported into this country by Browning Industries, Inc. (Industries), a wholly owned subsidiary of Arms. All Browning firearms imported by Industries are sold to Arms in order to minimize the effect of the federal exise tax on the *first* sale of imported firearms.

During 1962 and 1963 Arms acquired all of the stock of Gordon Plastics *Arrow Co.*, a California corporation engaged in the manufacture of fiber glass arrow shafts. After acquiring complete ownership in 1963,

Arms changed the name of the corporation to Browning Manufacturing Company (appellant). In July of 1962 *Industries* purchased some of the assets of Elko Products, a California corporation manufacturing fiber glass fishing rods, vaulting poles, and archery bows. Industries continued to manufacture fiber glass products in California until July 31, 1964, when it transferred its California assets to appellant and withdrew from the state.

Since 1964 appellant has manufactured fiber glass arrow shafts, fishing rods, *vaulting* poles, and archery bows.. During 1962 and 1963 appellant apparently manufactured only arrow shafts and it sold its entire production to Arms. Subsequent to the transfer of assets from Industries in 1964, appellant has sold all of its arrow shafts, under the Micro-Flite label, directly to independent concerns who use them in making completed arrows which are then sold under the name of the independent firm. These arrow shafts represented approximately 20% of appellant's total sales in the years after 1963. Nearly all of appellant's production of other products during 1964-1966 was sold to Arms at prices negotiated between the two companies. The percentage of appellant's sales to Arms for each of the appeal years is shown in the following table:

| Year | Appellant's Total Sales | Appellant's Intercompany Sales to Arms | Percentage of Sales to Arms |
|---|---|---|---|
| 1962 | $ 16,866 | $ 16,866 | 100% |
| 1963 | 166,099 | 166,099 | 100 |
| 1964 | 925,958 | 750,253 | 81.0 |
| 1965 | 986,388 | 643,883 | 65.1 |
| 1966 | 1,482,080 | 1,132,043 | 76.4 |

During these five years, sales of appellant's products ranged between .7% and 5.18% of Arms' total sales. Like all other products sold by Arms, those manufactured for it by appellant were sold under the Browning trade-name. Some *or* all of appellant's *products, however,* carried the additional trade name Silaflex, which apparently was acquired in the purchase of assets from Elko Products. Arms' profit margins on the resale of appellant's products were those generally prevailing in the fiber glass industry but were lower than the margins on Arms' other products.

Except for the arrow shafts, all of appellant's products not sold to Arms were sold to Browning Arms

Company of Canada, Ltd. (Canco). Sales to Canco constituted approximately 5% of appellant's total sales. Canco does in Canada what Arms and Industries do in the United States--i.e. it imports and sells Browning firearms and the other products which bear the Browning name. Arms owns 70% of Canco's stock; FN owns the other 30%.

As is usually the case with a group of related corporations, the Browning companies have had common officers and directors. Arms and Industries had identical boards of directors during the appeal years; Canco and Arms had identical officers. Appellant at all times had at least one director in common with both Arms and Industries and for two of the appeal years the president of Arms was also the president of appellant. . In 1965 and 1966 appellant's president was a director of Arms.

During all the years in issue, Arms appears to have exercised close supervision over appellant's significant business decisions. Close communication between the two companies was maintained by means of a leased line telephone network. Appellant's employees prepared monthly balance sheets and profit and loss statements, all of which were forwarded to Arms for review by its treasurer. Major expenditures by appellant required prior consultation with and approval by the management of Arms. A single outside accounting firm provided auditing services for Arms, Industries, and appellant, and this same firm prepared all tax returns for these companies for 1963 and 1964. Appellant's own treasurer prepared appellant's returns for both 1965 and 1966.

In each appeal year appellant received financing from its affiliates. As of December 31, 1966, appellant owed Arms and Industries a total of $543,000. This total consisted of cash advances from Arms of $140,000 and of $403,000 in manufacturing assets transferred from Industries to appellant in 1964. Appellant never paid interest on these intercompany loans, but the Internal Revenue Service imputed interest at the rate of 5% after auditing the books of the companies.

Appellant filed a separate California franchise tax return for each year in question, and Industries did the same for the years that it did business in California. All of these returns treated the business of each corporation as a unitary business and allocated to California

a portion of the corporation's net income. Respondent determined that appellant and Industries were not each conducting a unitary business but were, along with Arms, engaged in a single unitary business. As a result of that determination, respondent recomputed the amount of net income attributable to California sources on the basis of the combined operations of the three corporations and issued the additional assessments in question. While this appeal was pending, the parties agreed that Canco would have to be included as part of any single unitary business involving Arms, Industries, and appellant. Respondent has informed us that including Canco in the unitary group results in a net reduction of $1,100.69 in the proposed additional assessments.

It is axiomatic now that when a corporate taxpayer is engaged in a unitary business with affiliated corporations, its California tax liability is to be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16]; John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569], appeal dismissed, 343 U.S. 939 [96 L. Ed. 1345].) It is equally fundamental that the existence of a unitary business is established if either of two tests is satisfied: (1) the three unities test of Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd 315 U.S. 501 [86 L. Ed. 991], or (2) the dependency and contribution test of Edison California Stores, Inc. v. McColgan, supra.

In this case the following factors indicate the existence of a unitary business under the established tests: (1) common ownership of the Browning corporations, (2) interlocking officers and directors, (3) the parent company's control over the major policy decisions of appellant (and probably of the other subsidiaries as well), (4) common use of a valuable trade name affixed to the products manufactured, imported, and sold by the various corporations, (5) substantial intercompany transfers of goods, and (6) substantial intercompany loans. When one adds that all products bearing the Browning name, including the fiberglass goods manufactured by appellant and Industries, were sold to retail sporting goods dealers by means of a common distribution system (and were almost certainly commonly advertised), it is apparent that there is sufficient evidence of interdependence among the four companies to support respondent's conclusion that they were all engaged in a single unitary business.

Appellant denies that it was a part of the integrated business conducted by Arms, Industries, and Canco. In support of its contention, appellant argues that it was engaged in a distinct, fiber glass manufacturing business that did not contribute to the income of the firearms business conducted entirely outside of California by the other three companies.. Appellant admits that its own business derived some benefits from the firearms business, but it contends that the converse is not true.. Since appellant's relationship to the other companies.. allegedly was wholly one-sided in appellant's favor, appellant says there was no "unity of use," thus precluding a finding of a single unitary business.

Although the issue thus posed by appellant is rather intriguing, we need not decide it since appellant has failed to establish the factual predicate on which it is based. There is no proof that appellant's California operations contributed nothing to the income of the other companies; On the contrary, the intercompany connections heretofore mentioned strongly indicate that appellant's products contributed to the overall income by allowing the advertising and selling costs of all Browning products to be spread over a broader base. In addition Arms and Canto-clearly realized gross income from the sale of appellant's products. The manufacturing and selling business involving those three corporations constituted a typical unitary business subject to formula allocation. (John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569], appeal dismissed, 343 U.S. 939 [96 L. Ed. 1345].)

Appellant's second major contention is that the standard apportionment formula produces an unconstitutional result under the due *process* clause of the Fourteenth Amendment. In order to prevail *on* this issue, appellant must prove by clear and convincing evidence that the formula is intrinsically arbitrary or produces an unreasonable result. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd 315 U.S. 501 [86 L. Ed. 991]; McDonnell Douglas Corp. v. Franchise. Tax Board, 69 Cal, 2d 506 [72 Cal. Rptr. 465; 446 P.2d 313]) The only evidence offered to meet this heavy burden is a chart showing that the percentage of income allocated to California in each year is somewhat larger than the percentage of California sales made by the combined companies. In our opinion appellant has not met its burden of proof. We are no-t convinced that California's contribution to the overall income is measurable solely by the amount of

California sales. Even if it could be so measured, however, the disparity between California sales and California income, i's not so great as to establish that the income allocated to California is out of all appropriate proportion to the business transacted in this state by appellant and Industriesi (Cf. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 [75 L. Ed. 879].)

Finally, appellant argues that the formula should contain some allowance for FN's property and payroll attributable to the manufacture of Browning firearms, the principal income-generating products of the unitary group. In support of its position, appellant relies on McDonnell Douglas Corp. v. Franchise Tax Board, 69 Cal, 2d 506 [72 Cal. Rptr. 465; 446 P.2d 313], which held that the property factor there used by the Franchise Tax Board was improper because it excluded government-owned property used by the taxpayer in manufacturing airplanes for the government during World, War II. We believe that McDonnell Douglas's readily distinguishable from the appeal before us. Since McDonnell Douglas had derived income Prom its exclusive use of government-owned property, the formula had to give weight to this property because it constituted one of the "essential elements responsible for the earning of'the [taxpayer's] income." (See 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].) In the situation before'us, however, the property and payroll employed in manufacturing Browning firearms produced income only for FN. The income of the Browning companies' came from the resale of imported firearms produced by an unrelated corporation; the Browning companies derived no income from the manufacture of firearm's,. Thus, since none of the unitary income from the firearms business constituted "manufacturing profit," the apportionment formula need not give any weight to the factors which produced this "manufacturing profit." The result would be different, of course, if FN were a part of the unitary group (it is not, because unity of ownership is lacking), but in that case the formula would have to include the income and sales of FN, as well as the property and payroll, attributable to the production of Browning firearms.

## 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 protest of Browning Manufacturing Co. against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Browning Manufacturing Co.

| Income Year Ended | Taxable Year Ended | Amount |
|---|---|---|
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| December 31, 1963 | December 31, 1964 | 4,990.44 |

be and the same is hereby modified to include Browning Arms Company of- Canada, Ltd. in the unitary business; In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 14th day of September, 1972, by the State Board of Equalization,

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary