BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHESTER A. AND MARY E. JOHNSON)

For Appellants: Robert A. Petersen
Certified Public Accountant

For Respondent: Jacqueline W. Martins
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Chester A. and Mary E. Johnson against a proposed assessment of additional personal income tax in the amount of **$3,064.70** for the year 1972.

During the year in issue, appellants, the owners of Turlock Pet Foods (hereinafter referred to as "Turlock"), then a sole proprietorship, were residents of Australia. Turlock did business in both California and Iowa, and was managed by Mr. Johnson (hereinafter referred to as "appellant-husband") from Australia. On their California joint nonresident personal income tax return, appellants determined their taxable income attributable to California sources by employing a formula provided by Internal Revenue Code section 911(b), which allows a taxpayer, engaged in a trade or business in which both personal services and capital are material income-producing factors, to exclude from gross personal income up to 30 percent of his share of the net profits of such trade or business as personal services rendered by the taxpayer.

In 1974, respondent issued its notice of proposed assessment notifying appellants that use of Internal Revenue Code section 911(b) was improper for purposes of calculating their California income tax liability, and that, to determine the portion of-their proprietorship income attributable to California sources, they were required to use the standard three-factor formula of property, payroll, and sales. (See former Cal. Admin. Code, tit. 18, reg. 17951-17954(d), subd. (4), in effect for the year in question, but repealed Aug. 8, 1976.) Respondent, in determining appellants' California taxable income by the latter formula, did not include in the denominator of the payroll factor any amount to reflect the value of appellant-husband's personal services to Turlock. During the protest proceedings, respondent proposed, for purposes of settlement, that if appellants could provide acceptable documentation as to the value of appellant-husband's personal services to Turlock during the year in issue, it would include that value, as an imputed wage, in the denominator of the payroll factor.

Appellants responded to respondent's settlement proposal by indicating that their best estimate as to the value of appellant-husband's personal services to Turlock in 1972 was $60,000. This estimate was apparently based upon his draws and salaries paid in years subsequent to the year in issue and after Turlock had been incorporated. Appellants, however, argued that the $60,000 value they had attributed to appellant-husband's personal services should be excluded from

apportionable income and that only the remainder of Turlock's net profits should be subject to apportionment under the three-factor formula. Consequently, appellants contended, their original determination of their California income had resulted in an overpayment of tax, and they requested that their letter in response to respondent's proposal be recorded as a claim for refund. Appellants' letter has been so recorded. and respondent has withheld action on the claim pending the outcome of this appeal. In the alternative, appellants maintained that use of Internal Revenue Code section 911(b) as an alternative to the three-factor formula was proper. After considering appellants' contentions, respondent affirmed its proposed assessment.

Revenue and Taxation Code section 17951 states that the gross income of nonresidents "includes only the gross income from sources within this State.." In addition, section 17954 provides, with regard to nonresidents, that "[g]ross income from sources within and without this State shall be allocated and apportioned under rules and regulations prescribed by the Franchise Tax Board." During the year in issue, respondent's regulations provided, in pertinent part:

> (3) If the business, trade or profession carried on within this State is an integral part of a unitary business carried on both within and without the State, or if the part within the State is so connected with the part without the State that the taxable income from the part within the State cannot be accurately determined independently of'the part without the State, the gross income from the entire business, trade or profession must be reported.
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> The taxable income from sources within this State subject to the tax imposed by the law should be determined by subtracting from gross income the deductions allowed by the law (See Articles 6 and 7 of Chapter 3 (Sec. 17201 and following) and the regulations thereunder) and by apportioning the remaining income to

sources within and without the State in the manner described in (4) below.

(4) Every nonresident who conducts a business, trade or profession within and without the State of the character described in (3) above, should accompany his return with a schedule or statement showing: (a) the total value of real and tangible personal property, (i) within the State, (ii) within and without the State: (b) the total wages, salaries and other compensation for personal services performed (i) within the State, (ii) within and without the State: (c) the total gross sales, or charges for personal services performed (i) within the State, (ii) within and without the State. ...

Generally, the amount of taxable income from a business, trade or profession of the character described in (3) above, which is derived from sources within the State may be determined by taking that portion of the total net income equal to the average percentage of items (a)(i), (b)(i) and (c)(i) to items (a)(ii), (b)(ii) and (c)(ii) respectively, as shown by the schedule or statement accompanying the return.

If a nonresident taxpayer believes that the taxable income from sources within this State cannot properly be determined by the above method, he may, for the purpose of his return, employ another method. He should, nevertheless, file the above schedule or statement and should also file a schedule or statement explaining in detail the method used. (Former Cal. Admin. Code, tit. 18, reg. 17951-17954(d), subds. (3) and (4), repealed Aug. 8, 1976.) (Emphasis added.)

Appellants contend that the above emphasized portion of former regulation 17951-17954(d), subdivision (4), permitted them to employ an alternative method of calculating their taxable income attributable to California sources since they believed that the standard three-factor formula did not properly determine their

California taxable income. Respondent, on the other hand, argues that it is not bound to accept any such alternative submitted by a taxpayer and that it may require a taxpayer to determine his California taxable income through use of the three-factor formula.

We cannot agree with appellants' contention that their subjective belief that the standard three-factor formula does not properly determine the proper amount of their California taxable income is sufficient to permit them to adopt an alternative method to calculate such income. Such an interpretation would permit every taxpayer subject to the regulation's provisions to employ an alternative method of determining his California taxable income whether or not his subjective belief that application of the three-factor formula leads to an improper calculation was reasonable. Respondent would then find itself in the position of having to ascertain if the multitude of variously adopted alternatives properly determined their authors' California taxable income. Respondent's regulation cannot be interpreted to have intended to impose such an administrative burden.

As previously noted, respondent expressed a willingness to include in the denominator of the payroll factor an imputed wage to reflect the value of appellant-husband's personal services to Turlock during the year in issue. Despite numerous opportunities to do so, however, appellants failed to produce any evidence from which such a valuation could be made. It is well established that the burden is on the taxpayer to present competent and credible evidence as to the issues in dispute. (Cf. Banks v. Commissioner, 322 F.2d 530 (8th Cir. 1963); Estate of Albert Rand, 28 T.C. 1002 (1957).) Appellants' failure or refusal to produce any such evidence bears heavily against them. (Halle v. Commissioner, 175 F.2d 500 (2d Cir. 1949), cert. den., 338 U.S. 949 [94 L.Ed. 586] (1950); Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) Under these circumstances, we must sustain respondent's determination that appellants improperly employed an alternative method of calculating their California taxable income as well as its action in denying appellants the inclusion in the payroll factor denominator of an imputed wage reflecting the value of appellant-husband's personal services to Turlock during the year in issue.

Appellants:. final argument is that the value of appellant-husband's service, performed in Australia for Turlock should be excluded from the gross income of the business for the purposes of former regulation 17951-17954(d). During the year in issue, respondent's regulations provided that taxable income from California sources was to be determined by subtracting from gross income the deductions allowed by sections 17201-17266, inclusive, of the Revenue and Taxation Code and the regulations thereunder,. and by apportioning the remaining income to sources within and without California using the standard three-factor formula unless use of an alternative apportionment formula was proper. (Former Cal. Admin. Code, tit. 18, reg. 17951-17954(d), subds. (3) and (4), repealed Aug. 8, 1976.) Appellants' contention that the value of a sole proprietor's services to his sole proprietorship should be deducted from the gross income of the business is not supported either by the above referenced code sections or the regulations promulgated pursuant thereto. Furthermore, it runs counter to subdivision (3) of former regulation 17951 - 17954(d) which provided that "the gross income from-the entire [unitary] business ... be reported."

Appellants contend that current regulation 17951-17954(d), subdivision (6), implies that such an exclusion is proper. This regulation, however, is inapplicable to any years prior to January 1, 1976, and therefore is irrelevant to the instant appeal. In any event, that regulation, which provides, in part, that 60 percent of the net income of a nonresident sole proprietor engaged in certain professions shall be deemed compensation paid to an employee for inclusion in the payroll factor, would not support appellants' position even had it been in effect for the year in issue. As it pertains to sole proprietors, it is relevant only for those individuals engaged in professions in which capital is not a material income producing factor. Capital is a material income producing factor in appellants' pet food business.

Appeal of Chester A. and Mary E. Johnson.

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 18595 of the Revenue and Taxatioh Code, that the action of the Franchise Tax- Board on the protest of Chester A. and Mary E. Johnson against a proposed, assessment of additional personal income tax in the amount of $3,064.70 for the year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of July , 1981, by the State Board of Equalization. with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly I Member

William ?I. Bennett, Member

Richard Nevins, Member

, Member