BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
NEW HOME SEWING MACHINE COMPANY)

Appearances:

For Appellant: Norman J. Laboe
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of New Home Sewing Machine Company against proposed assessments of additional franchise tax in the amounts of $5,955.09, $5,642.21, $3,781.42, and $5,568.53, for the income years ended March 31, 1973, March 31, 1974, March 31, 1975, and March 31, 1976, respectively.

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Two questions are presented by this appeal: (1) whether appellant, its Japanese parent, and subsidiaries of the two were engaged in a single unitary business, and (2) if so, whether respondent properly determined that appellant must file a combined report which includes the foreign corporations of the unitary group and use formula apportionment to compute its income derived from or attributable to California sources.

Appellant, an Illinois corporation with its headquarters and commercial domicile in New Jersey,, is a wholly owned subsidiary of a Japanese corporation, Janome Sswing Machine Company, Ltd, (Janome). During the years on appeal, appellant imported, distributed, and serviced sewing machines and sewing machine parts manufactured by Janome and Janome's manufacturing subsidiaries. Appellant (and Janome's other sales subsidiaries) purchased sewing machines and parts exclusively from Janome and its manufacturing subsidiaries. The manufacturing corporations in the Janome group sold almost all of their products to Janome's sales subsidiaries.

For its income years ended in 1973, 1974, and 1975, appellant filed its California franchise tax returns on a separate accounting basis. Respondent determined, however, that appellant, Cocicar, Inc. (appellant's wholly owned subsidiary), Janome, and Janome's foreign subsidiaries were engaged in a single unitary business, requiring the Eiling of a combined report. 'This determination was based on controlling ownership, substantial intercompany product and service flow, interlocking officers and directors, and some intercompany financing.

When a taxpayer derives income from sources both within and without California, its tax liability' is measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer' is engaged in a unitary business with affiliated corporations, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated corporations. (See Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) A unitary business exists when, there is unity of ownership, unity of operation, and unity of use (Butler Bros. v. McColgan, 17 Cal.2d 664, 678 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942)) or when the operation of the business within California contributes to or is dependent upon the operation of the business outside this state. (Edison

California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.)

Appellant states that the corporations involved do not constitute a unitary business. No evidence or argument is presented, however, to support appellant's conclusion. Such unsupported assertions are insufficient to overcome the presumptive correctness of respondent's determination. (Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.) We must conclude, therefore, that respondent's determination of unity was correct.

For the years on appeal, appellant's income derived from or attributable to California sources must be determined in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120 through 25139 of the Revenue and Taxation Code. (Rev. & Tax. Code, § 25101.) Generally speaking, UDITPA requires that the business income of the unitary business be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor and the denominator of which is three. (Rev. & Tax. Code, § 25128.) The numerators of the respective factors are composed of the taxpayer's property, payroll, and sales in California; the denominators consist of the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, and 25134.) Methods other than the standard three-factor formula may be used only in exceptional circumstances where UDITPA's provisions do not fairly represent the extent of the taxpayer's business activity in this state. (Rev. & Tax. Code, § 25137.) The party seeking to deviate from the standard formula bears the burden of proving that such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

Appellant argues that separate accounting must be used in this case because there is no basis in the Revenue and Taxation Code for computing the worldwide combined income of the unitary group. Its contention is based on provisions in the code which limit certain deductions to United States-based activities or corporations. Applying these provisions, appellant states, would disallow thousands of dollars of ordinary and necessary business expense deductions to Janome and its non-U.S. subsidiaries merely because they do business outside the United States.

We find appellant's argument unconvincing for several reasons. First, as appellant itself acknowledges, respondent has never construed the code provisions to deny deductions to foreign corporations when computing combined worldwide income. Respondent merely uses the income statements prepared by the corporations themselves to determine income and expense of the foreign corporations. Secondly, there is no allegation that respondent has denied any appropriate deductions to the specific non-U.S. corporations involved in this appeal. Finally, even if the code provisions were construed to deny certain deductions to the non-U.S. corporations, appellant has cited no authority which would prohibit different treatinent of U.S. and non-U.S. corporations where the income of the non-U.S. corporations is not being taxed, but is merely included in the apportionment base.

Appellant also argues that because California income is measured in dollars and the financial records of the non-U.S. corporations ate properly kept using other currencies (e.g., yen), there is no single unit of measure with which to establish the net income of the unitary group. Because of fluctuations in exchange rates, appellant states, a transaction using one currency will always result in "income" different from the same transaction entered into using some other currency, and an income figure derived from the combination of income reports using different currencies will always be erroneous. Once again, appellant has failed to show specifically how this affects its own unitary group. More generally, no showing has been made that any variations which might occur due to currency fluctuations prevent the apportionment method from fairly representing the extent of a taxpayer's business activity in this state. Appellant's mere allegations of distortion, based on separate accounting principles, are insufficient to persuade us that a combined report and formula apportionment should not be used. (See Container Corp. of America v. Franchise Tax Board, 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), prob. juris. noted, May 3, 1982, -- U.S. -- (Dock. No. 81-523); Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.)

In both of the arguments above, appellant seems to be trying to establish that the inclusion of the foreign affiliates in the unitary group is unauthorized and improper. Both the California courts and this board, however, have held that so long as the business is unitary, inclusion of foreign affiliates is entirely proper. (Container Corp. of America v. Franchise Tax Board, supra;

Appeal of Ii ikkoman International, Inc., supra; Appeal of Beecham, Inc., March 2, 1977.)

A variety of constitutional objections to respondent's use of combined reporting and formula apportionment are also raised. These same objections were raised in Appeal of Shachihata, Inc., U.S.A., supra. As we pointed out in that appeal (and in other appeals cited therein), this board has a well-established policy of abstention from deciding constitutional questions in an appeal involving proposed assessments of additional tax. This policy is based upon the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of a decision in an appeal of this type, and our belief that such review should be available for questions of constitutional importance. This policy properly applies in the present appeal. We do note, however, that constitutional objections substantially the same as several of those raised by appellant were considered in Container Corp. of America v. Franchise Tax Board, supra, and rejected.

We find that appellant has failed to show any error in respondent's determination of unity and also has failed to show that the allocation and apportionment provisions of UDITPA did not fairly reflect the extent of its business activity in California. Respondent's action, therefore, is sustained.

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ORDER

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 25567 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of New Home Sewing Machine Company against proposed assessments of additional franchise tax in the amounts of $5,955.09, $5,642.21, $3,781.42, and $5,568.53, for the income years ended March 31, 1973, March 31, 1974, March 31, 1975, and March 31, 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of August, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member

_____, Member