BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DANNY THOMAS PRODUCTIONS)

Appearances:

For Appellant: Kenneth Ziffren
Attorney at Law

For Respondent: **James C.** Stewart
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 Danny Thomas Productions against proposed assessments of additional franchise tax in the amounts of **$6,017.59** and $280.64 for the income years ended June 30, 1969, and June 30,' 1970, respectively.

Appellant is a California corporation engaged in the business of producing television films, including anthologies and television series. In general appellant

hires all of the personnel and facilities necessary to produce films, and contracts with a national television network to whom it delivers the films for a negotiated price. During the term of its agreement with appellant, the network has the right to broadcast each film twice on national television. After these network broadcasts, appellant is free to exhibit the films again in domestic territories, and it has at all times the right to exhibit them outside the United States. Domestic exhibition of films subsequent to network telecasting generally takes one of two forms. Under "network stripping" the films of a television series are repeated five times a week, with the network usually having the right to telecast each film at least five times. Under the form known as "domestic syndication," either appellant or a distributor enters into agreements with individual television stations giving those stations the right to exhibit appellant's films a number of times on a once-a-week basis.

For the years in question, appellant was required to allocate and apportion its net income in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (hereinafter referred to as "UDITPA"), which is contained in sections 2.5120-25139 of the Revenue and Taxation Code. Generally speaking, UDITPA requires that a taxpayer's business income 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.) Appellant apportioned its income by means of such a formula, in accordance with its interpretation of UDITPA's basic requirements. Upon auditing appellant's returns, however, respondent objected to the formula appellant had devised. As more fully explained below, respondent's principal objection was that appellant's sales factor attributed an inadequate amount of film rentals to California.

The sales factor is defined as "a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year." (Rev. & Tax. Code, § 25134.) The rules for determining whether sales are

in this state are set forth in section 25135, 1/ which applies to sales of tangible personal property, and in section 25136, 2/ which applies to all other sales. After deciding that films are tangible personal property, appellant assigned its film rentals on the basis of its interpretation of the "destination test" contained in

1/ "25135. Sales of tangible personal property. Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States Government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the state of the purchaser."

2/ "25136. Other sales. Sales, other than sales of tangible personal property, are in this state if:

(a) The income-producing activity is performed in this state; or

(b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance."

subdivision (a) of section 25135.[3] For purposes of determining where a film was 'delivered to a purchaser," appellant decided that the location of each television station was determinative in the case of a syndicated program, and that the places where a program is received (in accordance with published 'rate card values") were determinative in the case of a network program.[4] The net effect of these calculations was that ten percent of appellant's total film rentals was attributed to California in each income year under appeal.

For income years beginning prior to the effective date of UDITPA (January 1, 1967), appellant was required to apportion its income in accordance with a special formula that respondent had devised for independent motion picture producers. This special formula apparently differed from the standard formula applied to manufacturing and merchandising businesses in several respects, but the sales factor was the standard one that

3/ Although one could infer from the language of sections 25135 and 25136 that all transactions involving tangible personal property are governed by section 25135, the regulations implementing those two sections indicate that section 25135 applies only to "sales" involving transfers of title, and that section 25136 applies to the rental, leasing, or licensing the use of tangible personal property. Therefore, a determination that films are tangible perspnal property does not compel the conclusion that section 2.5135 controls the allocation of appellant's film rentals. On the contrary, it seems to us that section 25136 would be the applicable statute. (See Cal. Admin. Code, tit. 18, regs. 25135 and 25136 (art. 2); see also Boren, Equitable Apportionment: Administrative Discretion and Uniformity in the Division Of Corporate Income for State Tax Purposes, 49 So. Cal. L. Rev. 991, 1041-1045 (1976).)

4/ Even if it were correct to apply section 25135 in this case, the network itself would seem to be the "purchaser" of network programming in the literal sense of that word. Consequently, appellant's attempted use of the viewing audience (as measured by rate card values) as the "purchaser" represents a deviation from section 25135 that could only be justified as a special rule under section 25137. As we view this case, therefore, the method of apportionment appellant seeks is no less dependent on the applicability of section 25137 than is the formula respondent used in assessing the deficiencies. (See footnote 5, infra, and accompanying text.)

attributed sales according to the situs of the selling activities engaged in by the taxpayer's employees. Under this soliciation rule all of appellant's sales were attributed to California since all of its employee sales activities were performed in this state.

Because of the many changes in existing allocation and apportionment procedures required by UDITPA, respondent prepared a pamphlet entitled "Comments Regarding Application of the Uniform Division of Income for Tax Purposes Act,' (CCH Cal. Tax Rep. ¶ 203-548), and distributed it to all affected taxpayers in January 1967. In the comment regarding Revenue' and Taxation Code section 25137, respondent instructed appellant and all other taxpayers then using special apportionment formulas that they were to continue using their pre-UDITPA formulas. Respondent adopted this course of action in order to give itself time to determine how UDITPA should be applied to the 28 'special industries' that it had identified over the years. When appellant refused to continue using its special pre-UDITPA formula and attempted to use a new formula based on its own interpretation of UDITPA, respondent advised appellant that the special pre-UDITPA formula was to be used without modification until a new formula was developed, and it adjusted appellant's returns accordingly. These adjustments, principally in the sales factor, gave rise to the deficiencies in question.

In January 1974, while these deficiencies were still under protest, respondent adopted a new apportionment formula for appellant's industry that approved a sales factor virtually identical to the one appellant had devised on its own initiative. Nevertheless, since the new formula was specifically made applicable only to income years beginning after December 31, 1972, respondent refused to apply it retroactively to the years in question, and it therefore denied appellant's protest. This appeal followed.

Appellant contends that it was entitled to use section 25135's "destination test" because respondent does not have authority to require the use of pre-UDITPA formulas after UDITPA's effective date. Respondent argues, on the other hand, that UDITPA's general relief

provision (section 25137 of the Revenue and Taxation Code.). 5/ gives it the same broad powers. that it had. under prior, law to employ any method to effect an. equitable apportionment of the taxpayer's income. This position was also expressed in the previously mentioned pamphlet of comments on UDITPA, wherein respondent said:, with respect to section: 25137:

> This section specifies that in appropriate cases other allocation. and apportionment methods may be used. In general the apportionment formulas which have been developed for specialized businesses will be continued since they fairly represent the extent of the taxpayer's business, activity in this State-. The various factors used in such specialized apportionment formulas, however,. will. usually be modified so as to reflect the; provisions of the Uniform Act. For example, payrolls will be assigned as provided in the Uniform Act and the. property factor will be determined. under the provisions of the, Uniform-Act.. (Emphasis added.) (CCH Cal. Tax Rep., ¶ 2.0 3-548.)

5/ "25137. Other apportionment me.thods.. If the allocation and apportionment provisions of this: act do not fairly represent the extent of' the taxpayer's business activity in this. state, the: taxpayer may petition for or the Franchise, Tax. Board may require, in respect to all or any part of the taxpayer's business activity; if reasonable:

(a) Separate accounting:

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more. additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

In the Appeal of New York Football Giants, Inc., also decided today, we considered at some length the question of when a taxpayer may use, or may be compelled by the Franchise Tax Board to use, a special apportionment formula that differs from UDITPA's normally applicable provisions. We held in that case that the special procedures authorized by section 25137 may not be employed in any situation unless the party invoking that section first proves that UDITPA's basic provisions "do not fairly represent the extent of the taxpayer's business activity in this state." In the present controversy, each party has sought to apply a special rule of its own choosing,[6] but neither has proved that UDITPA's basic three-factor formula reaches an unfair or unreasonable result. Since UDITPA made a number of substantial changes in prior law, we will not assume that a special formula will still be necessary in every case where pre-UDITPA law required the use of such a formula. As this case now stands, therefore, it has not been established that there is any need to apply a special formula to appellant's business operations.

Because no justification has been shown for deviating from UDITPA's normal apportionment formula, respondent is directed to recompute appellant's tax liability in accordance with that formula. If both parties find, however, that this formula does not fairly represent the extent of appellant's business activity in this state, then respondent is authorized to apply its special pre-UDITPA formula, pursuant to the discretion vested in it, by section 25137, to effect an equitable apportionment of appellant's income.

6/ Although appellant has consistently maintained that it followed UDITPA's requirements when it filed the returns in question, we have characterized appellant's use of the "destination test" as a special rule because (1) we believe section 25136, not section 25135, is the applicable basic provision of UDITPA, and (2) even if section 25135 is applicable, appellant has misapplied that section's destination test. See footnotes 3 and 4, supra.

Appeal of Danny Thomas Productions

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT I-S '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 Danny Thomas Productions against proposed assessments of additional franchise tax-in the amounts of $6,017. 59 and $280.64 for the income -years ended June 30, 1969, and -June 30, 1970, respectively-, be and the 'same is hereby modified in accordance with the attached opinion.

Done at Sacramento, California, this 3rd day of February , 1977, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Executive Secretary