BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85A-527-GO
LIPPS, INC.)

For Appellant: Robert Kahn
Director

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Lipps, Inc., against proposed assessments of additional franchise tax in the amounts of 52,752 and $2,243 for the income years ended June 30, 1979, and June 30, 1980, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The primary issue presented is whether certain workers in Mexico are employees of appellant for purposes of determining the payroll factor in order to apportion its income within and without this state pursuant to section 25128. If we should find that the Mexican workers are not its employees, appellant asks that we, nevertheless, utilize the special apportionment formula of section 23137.

Lipps, Inc. (hereinafter "Lipps"), appellant herein, a closely-held California corporation that manufactures magnetic tape heads, maintains an office and a plant in California which carries on research and development. On June 20, 1973, appellant's board of directors conducted a special meeting for the purpose of reviewing "a proposed Production Agreement to be entered into with Cal-Pacifico [an unrelated corporation, hereinafter sometimes referred to as "CAL"] for the purpose of establishing plant facilities for this corporation in La Mesa, Mexico.. (App. Br., Ex. I.) The minutes of that meeting indicated that appellant's board unanimously adopted the following resolution reflecting the above proposed agreement:

> RESOLVED FURTHER, that this corporation enter into a Production Agreement with Cal-Pacific0 for the purpose of Cal-Pacifico providing labor and facilities in connection with the assembly of component parts into sub-assemblies, assemblies and products for this corporation. A true and correct copy of said agreement is attached hereto, marked Exhibit 'A' and by this reference made a part hereof. (Resp. Bt., Rx. I.)

The Production Agreement referred to in the resolution, signed on behalf of appellant on June 22, 1973, provided, in part, as follows:

> Whereas, CAL is engaged in a service business and
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> Whereas, LIPPS is engaged in manufactur inq and assembling; and
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> Whereas, LIPPS is desirous of securing certain services provided by CAL in the general nature of providing labor and facilities for the purpose of assembling various

component parts into sub-assemblies, assemblies and products in the Republic of Mexico and

Whereas, CAL can provide such service together with other services as hereinafter described:

Now, therefore, the parties hereto agree more particularly as follows: LABOR. It is agreed that CAL will provide to LIPPS, from facilities available to CAL in the Republic of Mexico, an adequate plant facility, selected by CAL and approved by LIPPS, together with a minimum labor force of 20 employees on a regular full-time basis for a forty-eight (48) hour week. Said employees shall be screened and hired by CAL for the purpose of assembling the various component parts of LIPPS into sub-assemblies, assemblies and finished products, as follows: 'sub-assemblies for magnetic heads and other electronic packages.'

* * *

Employees of CAL shall not be deemed employees of LIPPS and it is further understood that all matters relating to good personnel practices involving any employees, particularly those relating to wage increases' bonuses, incentives, shift premiums, wage differentials, gifts and parties, are the sole responsibility of CAL. Discussions on these matters initiated by LIPPS must be held only with bona fide principals of CAL and not the employees of CAL or their unions.

* * *

It is further understood and agreed that LIPPS will provide all of the necessary machinery and/or capital equipment necessary for the assembly of its products at the facilities in Mexico, including the training and technical supervision of the employees of CAL assigned to LIPPS.

* * *

LIPPS now owns certain production equipment as shown attached to the Lease Agreement.

> All capital equipment required by LIPPS covered under the Lease Agreement has been leased to CAL for the express purpose of assembling LIPPS product in Mexico. (Resp. Br., Ex. II.)

Accordingly, pursuant to this agreement, appellant sent its unfinished products to Mexico for assembly by the workers engaged by Cal-Pacifico. During the years at issue, appellant used the standard three-factor formula to apportion income to this state. (Rev. & Tax. Code, § 25128.) In computing the payroll factor (Rev. & Tax. Code, § 25132), appellant included the wages paid to Cal-Pacifico on behalf of the Mexican workers as part of its own payroll factor. (Resp. Br. at 3.) This, of course, had the effect of reducing the amount of business income that was apportioned to this state.

On audit, respondent determined that the wages paid Cal-Pacific0 for the Mexican workers should be eliminated from the payroll factor since those workers were not the employees of appellant. (Resp. Br. at 3.) On appeal, appellant argues that the Mexican workers were its employees for payroll factor purposes. In the alternative, appellant argues, if we should find that the Mexican workers were, in fact, not its employees, the special facts of this appeal warrant allowing a recomputation of income apportioned to California by using a "substitute factor" or "fourth factor" under the authority of section 25137. (App. Ltr., May 21, 1984, at 4.)

Section 25128 provides that "[a]ll business income shall 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." Section 25132, in turn, defines the payroll factor as "a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year." And title 18 of the California Administrative Code, section 25132, subdivision (a)(3), provides, in relevant part:

> The term 'compensation' means wages, salaries, commissions and any other form of remuneration paid to employees for personal services. Payments made to an independent

> contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor. [Emphasis added.]

What appears to be indisputable in this record and dispositive of this issue is the fact that appellant paid Cal-Pacifico and Cal-Pacifico, in turn, paid the Mexican workers. (See attachments to App. Ltr., Aug. 7, 1984,) As indicated above, only amounts paid directly to "employees" are included in the payroll factor. Accordingly, pursuant to the regulation cited above, the amount paid to such workers is clearly not includable in appellant's payroll factor.

Moreover, even under the common law definitions of employee and independent contractor, the Mexican workers cannot be said to be appellant's employees. (See Empire Star Mines Co. v. Cal. Emp. Com., 28 Cal.2d 33, 43, [168 P.2d 686](1946).) As indicated in Empire Star Mines Co., the most important factor with respect to employment status is the right to control the manner and means of accomplishing the results desired. The Production Agreement provides that the subject workers were to be considered the employees of Cal-Pacifico and not appellant. Cal-Pacifico and not appellant was required to screen and hire all workers. The Production Agreement further provides that "all matters relating to good personnel practices involving any employees" were to be the sole responsibility of Cal-Pacific0 and that any discussions in these matters initiated by appellant must be held with principals of Cal-Pacifico and not the employees of Cal-Pacifico. (Resp. Br., Ex. II-B.) While no specific reference was made either in the Production Agreement or in other documents in the record, everyday control of the Mexican workers clearly resided with Cal-Pacifico and not with appellant. While appellant might argue it "taught" the Mexican workers how to make magnetic tape heads, there is nothing in the record to document this claim. Based on the record presented, we must find that Cal-Pacifico controlled the Mexican workers and, as a consequence, the workers were its employees and not those of appellant.

As indicated above, appellant also argues that it should be allowed to use an alternative allocation as provided in section 25137. The party seeking to utilize section 25737 must bear the burden of proving that exceptional circumstances are present. (Appeal of

New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.) As appellant has not shown such exceptional circumstances, we must find there is no basis for utilizing section 25137.

For the reasons cited above, respondent's action must be sustained.

Appeal of Lipps, Inc.

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 Lipps, Inc., against proposed assessments of additional franchise tax in the amounts of $2,752 and $2,243 for the income years ended June 30, 1979, and June 30, 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of March , 1987 by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker* , Member

, Member

*For Gray Davis, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATIOON

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No, 85A-527-GO
LIPPS, INC.)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition-filed March 18, 1937, by Lipps, Inc. for rehearing of its appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby denied and that our order of March 3, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 7th day of May, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9