BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 82R-537-MW
MERRILL, LYNCH, PIERCE,	)	
FENNER & SMITH, INC.	)	

Appearances:

For Appellant: Richard E. V. Harris
Attorney at Law

For Respondent: David M. Hinman
Counsel

O P I N I O N

This appeal is made pursuant to section 26078 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Merrill, Lynch, Pierce, Fenner & Smith, Inc., for refund of franchise tax in the amounts of $145,672.19, $160,603.56, and $182,317.08 for the income years 1972, 1973, and 1974, 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.

This appeal originally involved four separate issues. Two of those were conceded by appellant, for the purposes of this appeal, at the hearing in this matter. The two remaining issues are: 1) whether the Franchise Tax Board (FTB) has met its burden of proving that the statutory formula does not fairly reflect appellant's business activity in this state, and, if so, whether FTB's modification of the sales factor of the apportionment formula was reasonable; and 2) whether interest income arising from margin account contracts made by California customers with appellant's New York office is includible in the California numerator of the sales factor and, if so, whether actual figures supplied by the taxpayer or estimates prepared by the FTB should be used in the computation.

Appellant was incorporated in Delaware, headquartered in New York, and operated 20 branch offices in California. With its affiliates, it conducted a single worldwide unitary financial services business.

In some of its securities transactions, appellant acted as a broker, buying and selling securities in the open market for customers. It earned commission income, which did not include the cost of the underlying securities, from this activity. Appellant also traded in securities as a principal or underwriter. In these situations, it purchased the securities for its own account and attempted to remarket them. Appellant used its gross receipts (which included the underlying cost of the security) from all of these principal transactions in the computation of its California sales factor, as required by sections 25134 and 25120, subdivision (e). Most of appellant's securities transactions as principal were conducted in New York, so they were included in the denominator of the sales factor, but not in the California numerator. Most of appellant's sales in California were brokerage sales, so only the commission income was includible as gross receipts in the numerator of the sales factor. The FTB determined that this resulted in overweighting appellant's sales as principal and underweighting brokerage sales. The sales factor was adjusted by the FTB by using gross profits to reflect the principal and underwriting transactions, rather than gross receipts. This made the denominator smaller, which resulted in a larger California sales factor.

Taxpayers engaged in a unitary business must allocate and apportion their net income in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (hereafter referred to as UDITPA), which is contained in sections 25120-25139. Generally speaking, UDITPA requires that a' taxpayer's unitary "business income" be apportioned by means of a three-factor formula composed of property, payroll, and

sales factors. (Rev. & Tax. Code, § 25128.) 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 term "sales" means "all gross receipts of the taxpayer" other than those related to items of "nonbusiness income' that are specifically allocable to a particular state under sections 25123-25127. (Rev. & Tax. Code, § 25120, subd. (e).)

The allocation and apportionment provisions of UDITPA may, however, occasionally produce inequitable results when applied to unusual factual situations. In such cases, discretionary adjustments to UDITPA's standard procedures may be made as provided in section 25137, which states:

> If the allocation and apportio'nment 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;
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> (b) The exclusion of any one or more of the factors;
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> (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.

The special allocation and apportionment methods authorized by section 25137 may not be employed unless the party invoking that section first proves that UDITPA's standard provisions do not fairly represent the extent of the taxpayer's business activity in California. (Appeals of Pacific Telephone and Telegraph Company, Cal. St. Bd. of Equal., May 4, 1978.)

The FTB acknowledges that the standard method under UDITPA requires the use of business income gross receipts to compute the sales factor, but contends that it is authorized by section 25137 to substitute gross profits with regard to appellant's principal and underwriting transactions because the

standard method does not fairly represent the extent of appellant's business activity in California. The appellant argues that the FTB has not met its burden of proof under section 25137 to justify adjusting the statutory method and, even if FTB has met that burden, it has not shown that its formula creates an equitable allocation and apportionment of appellant's income. Therefore, appellant concludes it must be allowed to use the statutory standard of gross receipts in computing its sales factor.

As a preliminary point, throughout the briefing and at the oral hearing in this matter, the parties disagreed over the standard which must be met by the FTB to carry its burden of proof. The taxpayer argued that the FTB must show that the 'formula as a whole" fails fairly to represent the business activity of the taxpayer in this state. The FTB interpreted this as meaning that they had to show that each of the three formula factors was distorted; and it initially argued that it only needed to show distortion in the sales factor since it was only "making a slight modification in the formula so that it fairly reflects sales activity within the state ...." (Resp. Reply Br. at 6.) In a later brief, however, the FTB revised its position, stating, "This grossly distortive sales factor skews the result of the formula as a whole, so that it, in turn, fails to reasonably reflect the extent of appellant's business activity within this state.. (Resp. Supp. Reply Br. at 4-5.)

Given this last statement of the FTB, and similar statments made at the hearing, we believe that there is really little disagreement between the parties as to the standard that should apply. Both now appear to accept that it is the fairness of the reflection of business activity by the formula as a whole which is determinative for purposes of section 25137, regardless of whether the adjustment sought is separate accounting, adjustment of a single factor, or any other of the acceptable alternatives under that section. The only possible disagreement we can see still existing is whether it must be shown that all three factors are distortive or whether it is sufficient to show that only one factor is distortive,

Business activity encompasses more than simply the ultimate revenue-generating items which are reflected in the sales factor. It also includes the activities of employees, as reflected in the payroll factor, and the use and availability of real and tangible and intangible personal property, as reflected in the property factor. These three factors are used to balance each other, each reflecting a different type of contribution to the business activity and income of the unitary business as a whole. (See Appeal of The Babcock and Wilcox

Company, Cal. St. Bd. of Equal., Jan. 11, 1978.) Distortion in one factor, therefore, does not necessarily result in unfair reflection of the business activity in the state; the other two factors may well mitigate the distortive effect of the third, so that, ultimately, the taxpayer's business activity in the state is fairly represented through the combination of the three factors in the apportionment formula.2/ However, it is also possible that one factor may be so distortive that the other two do not mitigate its effect on the formula as a whole. Therefore, whether distortion must be shown in all or just one of the factors will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination.

The FTB asserts that it has proven that the sales factor is sufficiently distortive to prevent the formula as a whole from fairly representing the extent of appellant's business activity in California. We must disagree.

The FTB argues that the principal and underwriting transactions are virtually identical to brokerage transactions, but that appellant has treated them differently. Neither contention is true. While in both types of transactions appellant is selling securities, there the similarity ends and numerous distinctions begin. Furthermore, in computing the sales factor, appellant has included income from both types of transactions on a consistent basis gross receipts as required by the statute. The FTB's argument that the alleged "gross dispropor-

2/ See Container Corp. v. Franchise Tax Board, 463 U.S. 159, 183 [77 L.Ed.2d 545] (1983), where the United States Supreme Court, in discussing the taxpayer's allegation that there was such distortion in the payroll factor that the income apportioned to California was "out of all appropriate proportion to the business transacted by the appellant in that State" (Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 135 [75 L.Ed. 879] (1931)), stated:

> the three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in Hans Rees' Sons, Inc.

tion is totally unjustified by any difference in the activity required to perform the respective types of transactions" (Resp. Br. at 13) does nothing to prove distortion because it simply assumes distortion as a given. In addition, the employee activities to which it refers are not intended to be reflected in the sales factor, but are ordinarily reflected in the payroll factor.

The Appeals of Pacific Telephone and Telegraph Company, supra, cited by the FTB as a "case very similar to the instant case" (Resp. Supp. Reply Br. at 3), is readily distinguishable. The securities transactions in Pacific Telephone involved investment by the utility of a pool of working capital funds held available for use in the unitary business. The inclusion in the sales factor of the gross receipts from these transactions resulted in "an incidental part of one of America's largest, and most widespread, businesses" causing the attribution to New York of 11 percent of The Bell System's entire unitary business activities, a result which we concluded showed sufficient distortion of the formula as a whole to warrant modification of the sales factor pursuant to 25137. In contrast, we are not dealing here with an incidental part of appellant's unitary business, but with a fundamental segment of the financial services provided by appellant. More importantly, however, the FTB has made no showing of distortion such as was made in Pacific Telephone.

The FTB's "proof" of distortion appears to be based primarily on comparisons of appellant's sales factor figures with two other sets of figures--those in appellant's annual reports and those computed by the FTB. The FTB finds it "instructive to note how appellant reported to its own stockholders the amounts of its revenues derived from various categories of transactions" (Resp. Br. at 10-11), the implication apparently being that the sales factor should include amounts of income from the various categories of transactions in the same proportions as those shown in appellant's annual reports. Why this should be so we are not told. A difference between the figures derived under two different accounting methods does not prove that one set of figures is distorted, simply because appellant's financial accounting methods use gross profits to report revenue for all types of transactions does not mean that appellant must therefore use those financial accounting methods for tax reporting purposes in contravention of UDITPA's clear requirement of gross receipts. Financial accounting is not designed to reflect relative business activity in the various states in which appellant does business, as are the tax reporting requirements of UDITPA, and it is not surprising that there will be differences in results. (See Butler Bros. v. McColgan,

315 U.S. 501, 507 [86 L.Ed. 9911 (1942).) "There is no necessary inconsistency between the accuracy and fairness of the taxpayer's [internal] accounting and the different result obtained by the [standard] formula method of [apportioning] income. For taxation purposes.the one does not impeach the other." (Edison California Stores v. McColgan, 30 Cal.2d 472, 483 [183 P.2d 161 (1947).) As appel- lant points out, the FTB's argument is very similar to the almost universally discredited argument that, because the separate accounting methods used in the taxpayer's internal accounting records produce a result different from that produced by formula apportionment, the apportionment formula does not properly attribute income. (See, e.g., Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 180-184; Mobil Oil Corp. v. Commissioner, 445 U.S. 425, 438 [63 L.Ed.2d 510] (980); John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214, 224 [238 P.2d 569] (1951).) Just as we would reject such a separate accounting argument, we reject its parallel now urged upon us by the FTB.

The FTB's attempt to impugn appellant's use of the statutory sales factor by showing a difference between the sales factor as computed by appellant pursuant to the statute and as computed by the FTB as it desires it to be computed, and labeling that difference a "gross distortion," is equally unavailing. The FTB's argument appears to be that the principal and'underwriting transactions are "grossly overweighted" in the sales factor as computed under the statute because they make up a larger percentage of sales than they would if computed using appellant's financial accounting methods or FTB's computations based on gross profits. Further, FTB argues, because nearly all the principal and underwriting transactions take place in New York, the denominator is grossly overweighted, and because the transactions in California are primarily brokerage transactions, from which, under the statute, only commissions are includable in the sales factor, the numerator is underweighted.

It appears to us that what the FTB's argument comes down to is that the statutory method results in a bigger denominator and a smaller numerator than would occur under the FTB's method. We fail to find proof of distortion in this. The fact that the statutory formula results in a denominator "from 100 to 400 times larger than it is using respondent's modification" does not justify FTB's conclusion that "the standard formula results in California sales activity being understated by 100 to 400 percent." (Resp. Reply Br. at 1.)

Even if it were appropriate merely to compare the standard apportionment formula with that computed by the FTB,

an idea which we reject, the FTB has not shown that the difference between the numbers rises to the level of distortion such that appellant's business activity in California is unfairly reflected by the standard apportionment formula. The parties have submitted a large number of computations and recomputations of the three factors and of the apportionment formula as a whole. Unfortunately, very few of the numbers in their respective computations correspond. However, using the latest figures submitted by the FTB, the largest difference between the apportionment formula percentage as computed using the FTB's method and as computed using the standard method was for 1973, when FTB's method produced a final California apportionment formula of 5.8637 percent, and the standard method produced a final formula of 3.4323 percent, a difference of only 2.4314. (Resp. Post. Brg. Memo., Schedule X.) The largest apportionment formula difference between the two methods as submitted by the appellant (taking into account its own concessions and various uncontested adjustments by the FTB), also occurred in 1973 and was 1.27718. (App. Second Post. Hrg. Letter, Exhibit titled "Summary.") We consider this difference much too slight to be justification for application of section 25137.

Appellant's figures, which appear to be more accurate than the FTB's, show a percentage difference between the two apportionment formulae during these years ranging from about 23 percent to about 36 percent. These figures are, as the Supreme Court said of the difference shown in Container Corp., supra, "a far cry from the more than 250 percent difference which led us to strike down the state tax in Hans Rees' Sons, Inc., and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business. [Citations.]" (Emphasis added.) (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 184.) "Rough approximation' of the income that is attributable to the taxing state has consistently been the standard applied in the formula apportionment of the income of a unitary business. (E.g., Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207, 223 [65 L.Ed.2d 66] (1980); International Harvester Co. v. Evatt, 329 U.S. 416, 422 [91 L.Ed 3901 (1947); El Dorado Oil Works v. McColgan, 34 Cal.2d 731, 741 [215 P.2d 4] (1950); Container Corp. of America v. Franchise Tax Board, 117 Cal.App.3d 988, 1003 [173 Cal.Rptr. 1211 (1981), affd., 463 U.S. 159 [77 L.Ed.2d 5451 (1983).) Even if we were to hold that the percentage difference shows that the FTB's method was more precise, that would not justify deviation from the standard method. as fong as the standard method fairly reflects appellant's business activity. (See Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982;'

Appeal of New York Football Giants, Opn. on Pet. Rhg., Cal. St. Bd. of Equal., June 28, 1979.) We believe that a rough approximation of income attributable to this state would, in most cases, and certainly in this one, constitute a fair reflection of the taxpayer's business activity in the state.

The FTB has also attempted to justify application of section 25137 by contending that its method is "better" than the standard formula. We have consistently rejected this type of argument as unavailing; what must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected. (See, e.g., Appeal of New York Football Giants, Inc., Opn. on Pet. Rhg., supra.)

We conclude that the FTB has not met its burden of proving that the statutory apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state. Therefore, it may not require appellant to use gross profits instead of gross receipts in the computation of appellant's sales factor.

Some of appellant's customers enter into margin account contracts with appellant's New York office. The customer agrees to leave his securities on deposit with appellant's New York main office and to pay interest on any amounts advanced by appellant in connection with the customer's trading activity. Appellant will advance funds to its margin account customers as long as the outstanding balance of the margin account does not exceed 50 percent of the value of the securities on deposit.

Appellant reported the interest income paid by California customers on margin accounts, but did not include the amounts in the California numerator of the sales factor. The FTB requested from appellant the amount of margin interest paid by California customers, but appellant failed to provide the information. The FTB, therefore, simply included 15 percent of all margin interest in the sales factor numerator, basing that figure on information obtained in an audit for a previous year. The appellant contends that the margin interest is not includible in the numerator of the sales factor, arguing that all of the activity giving rise to the income occurs in New York. In the alternative, appellant argues that the FTB should use the actual California margin interest figures which appellant provided in its initial brief in this appeal.

Receipts from transactions other than sales of tangible personal property are includible in the numerator of the sales factor according to the rules of section 25135. This section includes receipts in the numerator 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."

Appellant argues that all or most of the costs of performance occur in New York, and that the 'interest earned must be attributed to that state. However, we do not believe that it is the primarily ministerial functions in relation to the margin accounts, such as the recordkeeping and billing that are conducted in New York, which are the income-producing 'activities. Rather, it is the rendering of personal services by the brokers in California that is the income-producing activity. The local brokers deal directly with the California customers in taking and placing orders, which create the debts on which the interest is paid, and handling most other day-to-day transactions which affect the balance of the customers' margin 'accounts. Therefore, the margin account interest paid by California customers should be included in the California numerator.

We believe that the appellant must prevail, however, on the question of the figures to be used in the numerator. The FTB has been provided with the actual figures since appel-Lant's first brief'was filed in 1983, it has not seriously contested the accuracy of the figures, and when a specific offer was made by appellant to prove the accuracy of the figures if requested to do so, no request was made. Under these circumstances, we cannot see that there is any justifiable reason for the FTB not to use the actual figures provided by appellant.

For the reasons stated above, the action of the FTB must be modified to reflect our determinations as set forth In the foregoing opinion.

Appeal of Merrill, Lynch, Pierce, Fenner & Smith, 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Merrill, Lynch, Pierce, Fenner & Smith, Inc., for refund of franchise tax in the amounts of $145,672.19, $160,603.56, and $182,317.08 for the income years 1972, 1973, and 1974, respectively, be and the same is hereby modified in accordance with the foregoing opinion.

Done at Sacramento, California, this 2nd day of June 1989, by the State Board of Equalization, with Members Mr. Carpenter, Mr. Collis, Mr. Bennett, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

John Davies*, **, Member

*For Gray Davis, per Government Code section 7.9

**Abstained