99-SBE-005

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	
Huffy Corporation	)	No. 96R-1263
	)	

Representing the Parties:

For Appellant: Norman H. Lane

For Respondent: Kathleen A. Andleman, Counsel

Counsel for Board of Equalization: Kathleen R. O'Connor, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19324,[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Huffy Corporation for refund of franchise tax in the amounts of $76,190, $110,743 , $95,106, $23,916, $108,663, and $42,423, for the income years ended December 31, 1989, 1990, 1991, 1992, 1993, and 1994, respectively.[2] The issue presented on appeal is whether the Board should overrule its opinions

[1] Unless otherwise specified, all section references in the body of this opinion are to the sections of the Revenue and Taxation Code in effect for the years in issue.

[2] Appellant originally filed only a claim for refund of tax and interest for income year ended December 31, 1989. Subsequently, appellant filed "supplemental petitions" for income years ended December 31, 1990, through December 31, 1994. Respondent does not object to appellant's request for consolidation of these "supplemental petitions" with the instant appeal, and we therefore consolidate them as requested.

in Appeal of Finnigan Corp. (88-SBE-022), decided on August 25, 1988 (Finnigan I), Appeal of Finnigan Corp. (88-SBE-022-A), Opinion on Petition for Rehearing, decided on January 24, 1990 (Finnigan II), and Appeal of The NutraSweet Company (92-SBE-024), decided on October 29, 1992, and return to the rule set forth in the Appeal of Joyce, Inc., decided by this Board on November 23, 1966 (Joyce).

I. Background:

During the income years in question, appellant, an Ohio corporation, was part of a unitary group of corporations.[3] It had two operating divisions, Huffy Bicycle Company and Huffy Sports Company. It was also the parent company of five active wholly owned subsidiaries, namely:

- Huffy Service First, Inc. (formerly YLCE, Inc.);
- Washington Inventory Service;
- Gerry Baby Products Company (formerly Gerico Enterprises);
- Gerry Wood Products Company (formerly Nuline Industries, Inc. and Memline); and
- True Temper Hardware (formerly HCA, Inc.).

Appellant filed a combined franchise tax report for each year at issue and appellant agrees that it was subject to worldwide combined reporting for those years. The combined report sets forth information from each member of the unitary group, including the value of each member's property, payroll and sales, located in the various states in which the group did business during the tax year. Information in the combined report allows for the

[3] Appellant's Huffy Bicycle Company division, headquartered in Ohio, manufactured and sold bicycles and related products. Appellant's Huffy Sports Company division, headquartered in Wisconsin, manufactured and sold recreational basketball equipment. Appellant's consumer products subsidiaries, Gerry Baby Products Company, headquartered in Colorado, and Gerry Wood Products Company, headquartered in Wisconsin, manufactured and sold a line of baby care products including cribs, car seats, tub seats and child carriers. True Temper Hardware Company, a leading domestic manufacturer and marketer of lawn and garden tools, and also a consumer products subsidiary, was purchased by appellant during 1990. Appellant indicates that True Temper Hardware Company conducted business within California through 1991; thus, it is only included in the refund claims for 1992 through 1994.

apportionment of the unitary group's income (or losses) to California, also known as interstate apportionment.[4]

Interstate apportionment relies on the combined values of the unitary group's property, payroll and sales within California (the numerators), as compared to the total values for each of those items in all states (the denominators); California utilizes a double-weighted sales factor, and, as such, the relative percentage of in-state to out-of-state sales is included in the formula twice. The resulting percentages are added together and divided by four (once for property and payroll, and twice for sales) to arrive at the percentage of the unitary group's taxable income to be apportioned to California.

Appellant agrees that its retail services subsidiaries, namely, Washington Inventory Service, and Huffy Service First, Inc., were subject to California tax during the subject income years on the basis that each company did business in this state, and had employees, property, and sales in this state during that time period.[5]

II. Factual Contentions:

Appellant states that neither it, its two operating divisions, nor its consumer products subsidiaries (collectively referred to as the consumer products divisions) did any business in California during the subject tax years. These entities did not own or rent any property in California and had no employees, facilities, or inventory in this state. According to appellant, these entities retained independent sales representatives to solicit sales of its products in California, and their employees did not make sales in the state which might otherwise subject them to California tax.[6] As a result of these

[4] "The interstate apportionment of unitary business income for the purpose of taxation is a means of ascertaining the actual income attributable to the portion of the unitary business conducted within [California]." (Edison California Stores v. McColgan (1947) 30 Cal.2d 472, 481; Appeals of Safeway Stores, Cal. St. Bd. of Equal., Mar. 2, 1962; Appeal of Household Finance Corp., Cal. St. Bd. of Equal., Nov. 20, 1968.) The portion of the tax attributable to California is then further apportioned between members of the unitary group subject to tax in California, also known as intrastate apportionment. (Appeal of Household Finance Corp., supra; Appeal of Signal Companies, Inc., Cal. St. Bd. of Equal., Nov. 19, 1986 (Appeal No. 85A-203-MW).) This second apportionment is necessary because California taxes each member of the unitary group in its individual capacity; California does not tax the unitary group as a single entity. (Great Western Financial Corp. v. Franchise Tax Board (1971) 4 Cal.3d 1, 5; Edison California Stores, supra, at p. 481; Appeal of Young's Market company, Cal. St. Bd. of Equal., Nov. 19, 1986.))

[5] Washington Inventory Service provided inventory services to retail businesses, including counting, stock replacement, reporting, ordering and related services. Huffy Service First, Inc. provided assembly and maintenance services for consumer products including, but not limited to, bicycles.

[6] The independent sales representatives represented other sellers beside appellant and its subsidiaries, and were responsible for all sales solicitation and promotion activities of all of the consumer products in California. These

factors, appellant alleges that the consumer products divisions of its unitary group were not subject to California tax due to either the lack of jurisdictional nexus regarding those entities or to the protections afforded by Public Law 86-272 (15 U.S.C.A., § 381(a)), which provides a safe harbor from taxation for the mere solicitation of sales within a state taxing jurisdiction.[7] Respondent apparently does not contest these jurisdictional assertions, and, as such, the instant appeal presents a question of law for consideration by the Board.

III. Legal Discussion:

In the instant case, the parties dispute the proper determination of the numerator of the sales factor. In determining its combined sales factor for the subject tax years, appellant excluded sales to California customers from its consumer products divisions from the numerator. In so doing, appellant relied on this Board's prior opinion in Joyce. Respondent relies on more recent opinions of this Board (Finnigan I, Finnigan II, and NutraSweet), which expressly overrule the Joyce opinion, for its position that sales made to California customers by appellant's consumer products divisions must be included in the numerator of the sales factor.

In Joyce, the Board held that sales to California customers by an out-of-state seller which was not subject to California tax in its individual capacity, but which was part of a unitary business group of which some other member was subject to California tax, could not be included in the California sales factor of the combined franchise tax report. Since the out-of-state seller was immune from taxation in California pursuant to Public Law 86-272, the Board concluded that the net income which the seller derived from sources in California was not includable in the measure of California tax (the sales factor numerator), but the income which other members of the group, which were subject to California's taxing jurisdiction, were includable in the measure of tax.

Approximately 22 years later, the Board reached a contrary decision and overruled the Joyce opinion. In Finnigan I and Finnigan II, this Board considered whether sales to other states which

(..continued)
representatives received a sales commission, but the sales representative agreement specifically stated that they were not agents of appellant.

[7] Consistent with the requirements of Public Law 86-272, appellant states that the independent representatives could not accept orders from customers, that the representatives only demonstrated sample products, that all shipments of goods were made directly to the customers by appellant (or its subsidiaries), and that the representatives did not make any deliveries of products, accept any product returns, handle any warranty disputes, or deal with any collection or credit issues.

were protected from tax by Public Law 86-272 should be "thrown back" to California for inclusion in the California sales factor. The "throw-back" rule redefines the sales factor so that sales are assigned or "thrown back" to California if the property is shipped from this state and the "taxpayer is not taxable in the state of the purchaser." (See Rev. & Tax. Code, § 25122.) In the Finnigan I opinion we noted that in computing the sales factor of the apportionment formula, sales of tangible personal property are ordinarily assigned to the state of the destination of the goods (the destination rule). However, in order for the destination rule to apply, it must be shown that the "taxpayer" is actually subject to tax in the state to which the goods were shipped. While the subsidiary seller could not show that it was subject to tax in states outside California where it made sales, the taxpayer, another member of the unitary group, was taxable in those states. This Board determined that the term "taxpayer," as used in Revenue and Taxation Code section 25135, subdivision (b)(2), means all corporations within the combined unitary group. Because the Board construed the term taxpayer as used in the statute to include all members of the unitary group, and some member of the group was taxable in the destination state, the throwback rule did not apply and the sales were not included in the California sales factor.

Respondent filed a petition for rehearing in the initial Finnigan case, and the Board issued its Opinion on Petition for Rehearing in Finnigan II. In that opinion, we attempted to resolve any doubts as to whether there was a jurisdictional aspect to Finnigan I by stating that "it is only an apportionment rule which has been changed" (emphasis original). The Board also stated that "nothing we have said in this case alters or affects in any way the existing rules concerning a state's jurisdiction to tax a particular corporation." (Finnigan II.)

The Board in NutraSweet, relying on Finnigan II, noted that NutraSweet's factual situation was similar to that in Joyce. Since Joyce had been overruled by the Finnigan cases, California destination sales made by the taxpayer's wholly-owned unitary subsidiary operating in the Commonwealth of Puerto Rico were correctly included in the California sales factor numerator and no refund claim was allowed.

Although there was the hope that with the adoption of the Finnigan/NutraSweet line of cases, the new apportionment rule would lead to a more theoretically sound application of the unitary method, there has been academic criticism of the actual result. A key factor stems from this Board's unfulfilled expectation that most other taxing authorities would also implement the reasoning in Finnigan/NutraSweet. The majority of the tax authorities in other states have not done so. The Multistate Tax Commission Review for January 1997 indicates that 15 state tax authorities had

endorsed the Joyce rule which was approved by the Multistate Tax Commission, and that California has adopted a minority view by adopting Finnigan I and II. (App. Br., Attachment F.)[8]

The application of the rule gives rise to the following scenarios:

- California-based sellers who sell into other states where they are immune from tax as individual corporations will not be subject to tax in any jurisdiction even though their sister entities are taxable.

- Non-California based sellers who sell into California where they are immune but their sister entities are taxable will run the risk of being subject to double taxation. (Their home states will treat the sale as allocable there because of the throwback rule; California will treat the same sales as California-based.)[9]

Our Finnigan/NutraSweet interpretation of Revenue and Taxation Code section 25135 remains inconsistent with that of nearly all other states that have comparable legislation and should not be adhered to. In that regard, we are mindful of Revenue and Taxation Code section 25138, which states that the Uniform Division of Income for Tax Purposes Act (UDITPA) shall be "so construed as to effectuate its general purpose to make uniform the laws of the states which enact it."

While there were theoretically good reasons for the initial implementation of the Finnigan/NutraSweet rule,[10] the actual practice has resulted in the taxation of income which would not otherwise be taxed by the State of California. In order to promote uniformity of the UDITPA law, and to more fairly reflect the fundamental principles of combined reporting, this Board believes that its pre-Finnigan decision in Joyce is the better law.

We note, however, that respondent and appellant, as well as other taxpayers, have relied on the Finnigan decisions for roughly the past eight years. Thus, there are a number of considerations for prospective application of a decision re-adopting the Joyce rule. A prospective ruling

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[8] There is an indication that additional states have endorsed the Joyce rule subsequent to the 1997 Review.

[9] We note that if the Joyce rule is followed, we do not have to deal with either of these scenarios.

[10] The Finnigan II opinion argued that by forbidding the assignment of sales to the state of destination in situations where at least one member of the unitary group is taxable in that state, but the actual seller is not, the basic purpose of the sales factor, which is to reflect the markets for the unitary business's goods and services, was defeated. Our response is that the application of that principle as applied by the Franchise Tax Board in Legal Notice 90-3 has resulted in income properly apportionable to a corporation protected by Public Law 86-272 being improperly taxed by California.

allows taxpayers to make an informed decision concerning their tax matters.[11] Prospective application does not penalize or provide a windfall to taxpayers with standards which took effect subsequent to their tax planning. When a "new" principal of law is created by the overruling of past precedent, stability should remain a consideration.

We note that certain California decisions have employed the reasoning of the landmark case of Chevron Oil Company v. Huson (1971) 404 U.S. 97, 106-107 (Huson), regarding prospective application of a court decision. (See, for example, Schettler, etc. v. County of Santa Clara (1977) 74 Cal App. 3d 990; Kreisher v. Mobil Oil Corporation (1988) 198 Cal. App. 3d 398, 398-402.) Huson outlined a three-part test in determining whether a judicial determination should be employed prospectively only: 1) the decision must establish a new principle of law by overruling past precedent; 2) the merits of the case must be weighed by looking to the prior history of the rule in question, its purpose and effect and whether retrospective operation would further or retard its operation, and 3) the inequity which would result from retroactive application must be weighed.

The three factors set forth in Huson clearly apply to the instant case. First, our decision will establish a "new" principle of law by overruling the past precedent of Finnigan I, Finnigan II, and NutraSweet. Clearly taxpayers have relied upon this precedent in conducting tax planning. Taxpayers could not be expected to have anticipated the Board's rejection of the Finnigan rule since Finnigan had survived for more than eight years. While it was subject to academic criticism, even respondent's recently drafted proposed regulations (Cal. Code Regs., tit. 18, § 25106.5, et seq.) included a regulation adhering to Finnigan. We note that respondent's proposed regulations also included an alternative draft which follows a prospective application of the Joyce rule so that "[t]axpayers who have filed in reliance on the Finnigan holding ...[do] not have those positions disturbed by regulation."

Second, we must weigh the merits of the case by considering the prior history of the rule in question, its purpose and effect. As stated previously, while there was the hope that the apportionment rule would lead to a truer application of the unitary concept, the actual practice has resulted in the taxation of corporations which would not otherwise be taxed as they have no tax nexus with the State of California. It has also resulted in the failure to tax California-based sellers who sell into other states where they are immune from tax as individual corporations. Another unexpected result is the hostility of other states to the Finnigan rule. While we had anticipated that adoption of Finnigan would lead to greater uniformity between jurisdictions following UDITPA, California's implementation of Finnigan has had the opposite effect. Overriding all of these concerns, however, is our concern that

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[11] See Revenue and Taxation Code section 21002, which states that, "It is the further intent of the Legislature to promote improved taxpayer self-assessment by improving the clarity of tax laws and efforts to inform the public of the proper application of those laws."

various tax planners have relied upon the Finnigan (and NutraSweet) opinions since they were issued. This overriding concern suggests that a prospective application of the "new" rule has merit.

Third, the hardship to taxpayers and the injustice/inequity must be considered. If the decision is not applied prospectively, taxpayers run the risk of being penalized for following the law in effect at the time their transactions were conducted. While a prospective application of a decision should be used "[o]nly occasionally," under well-reasoned guidelines," (Newman v. Emerson Radio Corp. (1989) 48 Cal.3d 973, 981) this case warrants prospective application.

We are mindful of the majority opinion in the 1993 case of Harper v. Virginia Department of Taxation (1993) 509 U.S. 86, 95 (Harper) which limited Huson. However, as we read Harper, the limitation occurred because the United States Supreme Court had already rendered an opinion on the pertinent issue in Harper and applied it retroactively. Thus, the states could not rely on Huson to escape retroactive application of the ruling for any pending cases. (See also Waller v. Truck Insurance Exchange, Inc. (1995) 11 Cal.4th 1, 24, which adopted the Harper reasoning.) In light of our interpretation of Harper, it is clearly appropriate to apply the Huson rule of law to this decision. We recognize that the Board has not previously issued a prospective opinion; however, our analysis weighs heavily in favor of issuing such a prospective opinion in this case.

Accordingly, our holding regarding renewed implementation of the Joyce rule shall only apply to those income years beginning on or after the date of this opinion. Thus, the actions of respondent must be sustained as to this appeal.[12]

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[12] We express no opinion as to whether the principles discussed in this apportionment case apply in other contexts such as the treatment of tax credits generated by the unitary business.

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 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Huffy Corporation for refund of franchise tax in the amount of $76,190, $110,743 , $95,106, $23,916, $108,663, and $42,423, for the income years ended December 31, 1989, 1990, 1991, 1992, 1993, and 1994, respectively, be and the same is hereby sustained. The Joyce rule shall be applied prospectively to those income years beginning on or after the date of this opinion. (Cal. Code Regs., tit. 18, § 5082.1.)

Done at Sacramento, California, this 22nd day of April, 1999, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, and Mr. Parrish, present.

Johan Klehs, Chairman

Dean F. Andal, Member

Claude Parrish, Member

________________, Member

________________, Member