



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
R. J. REYNOLDS TOBACCO COMPANY)

Appearances:

For Appellant: M. C. Sloss and M. B. Clawson, San Francisco
For Respondent: A. A. Manship, Assistant Franchise Tax Commissioner

O P I N I O N

This is an appeal, pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats. 1929), from the action of the Franchise Tax Commissioner in denying the protest of R. J. Reynolds Tobacco Company against the levy of a proposed additional tax based upon its net income for the taxable year ended December 31, 1928. The issue between the Commissioner and the corporation is the application of the provisions of Section 10 of the Act relating to the allocation of **net income** of a bank or corporation which does not do its entire business within California. Section 10 reads as follows:

"If the entire business of the bank or corporation is done within this state, the tax shall be according to or measured by its entire net income; and if the entire **business** of such bank or corporation is not done within this state, the tax shall be according to or measured by that portion thereof which is derived from business done within this state. The portion of net income derived from business done within this state shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and **situs** of tangible property, or by **referenc** to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation.

"If the **commissioner reallocates** net income upon his examination of any return, he shall, upon the written request of the taxpayer, disclose to him the basis upon which his reallocation has been made."

There is no dispute as to the facts in this case. R. J. Reynolds Tobacco Company is a New Jersey corporation maintainir ing its principal offices at Winston-Salem, North Carolina. Its business is the manufacture of tobacco products which it

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sells in California and elsewhere. Domestic purchases of tobacco are made in the tobacco growing states., principally North Carolina, Virginia and Kentucky. All manufacturing and packing of products sold in California is done in North Carolina, but, because of the distance between the two states and market conditions here, the Appellant has found it necessary to make practically all local deliveries through warehouses in this state.

The selling price of the goods is the same in North Carolina and California. Thus, it is obvious that the additional expense arising out of the long distance shipping, warehousing, repacking and reshipping of products sold here requires consideration of other factors along with gross sales in order to arrive at a fair apportionment of the net income to California. When it made its return to the Commissioner, the Appellant used all of the five factors enumerated in Section 10 of the Act (supra), giving equal weight to each for the determination of the percentage of its net income to be allocated to this state. The result was an average of 1.24 per cent.

However, the Commissioner proceeding under Sections 10 and 25 of the Act, reallocated the net income, through elimination of the factors of (1) purchases, and, (2) expense of manufacture. Inasmuch as the Appellant made comparatively few purchases in California and had no expenses of manufacture here, this resulted in a substantial increase in the tax which had been self-assessed at \$10,578.68. According to the basis of apportionment employed by the Commissioner this would be increased to the extent of \$6,657.66.

Upon reconsideration of the matter following a protest made by the taxpayer under Section 25 of the Act, the Commissioner appears to have proposed some sort of a compromise through averaging the allocation of income made by the corporation in its return, using the five factors, and that computed by the Commissioner, when he employed only three factors. This resulted in a proposed additional assessment of \$3,284.66 from which the taxpayer has appealed. It is this "compromise" assessment which the Franchise Tax Commissioner would have upheld.

There is no authority given to the Commissioner anywhere in the Act to make compromises of this character. In our judgment such procedure is of doubtful merit and validity. The law contemplates the ascertainment of the tax liability of a corporation according to definite standards. Allocation is to be made upon the basis of five specific factors, "or by reference to these or other factors, or by such other method of allocation as is fairly calculated to assign to the state the portion of net income reasonably attributable to the business done within this state." (Stats. 1929, Chap 13, Section 10.)

We have emphasized the word "method" in our quotation

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from the statute because we think its use significant. It denotes that **allocation of** net income shall be accordance to some definite plan and not merely a haphazard affair resulting from a compromise. **"Method"** is defined in Webster's New International Dictionary as "an orderly procedure or process; a regular way or manner of doing anything." Similarl Funk & Wagnalls' New Standard Dictionary defines **"method"** as "a general or established way or order of doing or proceeding in anything."

In the light of these definitions and from the facts before us we conclude that the Commissioner has proceeded with a lack of method in the instant case. The taxpayer used all five of the factors enumerated in the statute. This was clearly a **method** authorized by law, but not necessarily enjoined upon the Commissioner who proposed using only three of those factors. That this also constituted a method within the statutory sanction seems self-evident. The question then arose as to which method was better calculated to assign the proper share of net income to California. As a result of his further consideration of the matter, the Commissioner might have determined that both methods should be abandoned in favor of a third deemed better than either of them.

However, the Commissioner did not do this but proceeded to **"split the difference"** between the results obtained by the taxpayer's method and his. Such a process is, in reality, no method at all. If the use of the five factors was not the best method and the Commissioner had become convinced that the use of only three of them, as he had proposed, was not to be preferred, then he should have determined upon some other method as the statute directs. He should not have arbitrarily averaged the results of two methods, one of which was unsatisfactory to him, and the other to the taxpayer. Consequently, we are of the opinion that the proposed assessment of additional taxes based upon "splitting the difference" between the results of using five factors and three is invalid and not authorized by law,

Once an appeal from the ruling of the Franchise Tax Commissioner has been perfected under the provisions of Section 25 of the Act, it becomes the duty of our Board to determine the amount of the tax. Therefore, we must consider the proper method to be employed for the allocation of net income of the Appellant to California. In support of his position in the matter, the Commissioner has devoted much time to the proposition that his **"method"** of allocating net income is final and **conclusive**, and cannot be disturbed by our Board on appeal, unless the Ppellant shows fraud on the part of the Commissioner, or such a gross abuse of discretion or palpable misapplication of the law as to be equivalent to fraud. To such a view we cannot assent. For the reasons discussed in detail in our opinion in the matter of the appeal of Miss Saylor's Choaiates, Inc., (filed

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August 4, 1930), we believe that our Board possesses full power to determine the correct amount of the tax of any Appellant complying with the jurisdictional requirements of the law.

Certainly, no taxpayer has an absolute right to have its net income allocated upon the basis of the five factors specifically enumerated in Section 10 of the Act. We have already observed this in our opinion in the matter of Pacific-Burt Company, Limited, (filed August 4, 1930). Nothing in the statute indicates a legislative intent that the five factors named therein must be considered mutually exclusive. We do not apprehend that such is their normal relationship. Ordinarily, omission to use any one of the factors in an allocation formula would not necessarily imply failure to consider the elements of the business of the taxpayer involved in that particular factor. This can be illustrated by reference to the affairs of the Appellant.

Earlier in our opinion we noted that the Appellant confines its activities in California almost entirely to the sale of tobacco products grown and manufactured elsewhere. To facilitate these sales so far from its headquarters in North Carolina, the corporation has made deliveries in most instances from stocks maintained in California warehouses. This business involves the employment of a sales force in this state and the situs here of some personal property belonging to the Appellant. However, the amount of the California payroll and the value of the property having its situs here are insignificant in comparison with the total payroll and the total property owned. Thus, although the California sales are 3.459 per cent of the total sales, the corresponding percentages for payroll and tangible property are only 1.288 and .465, respectively. The average of the three percentages is 1.737, and this would be the basis of allocation to California if the formula outlined in the form for report is used.

'In its report the Appellant made a different allocation of income through use of the factors of purchases and expenses of manufacture. The California percentage of the former was shown as .987 and of the latter as nil. Basing the allocation on an average of the five percentages would reduce the California proportion to 1.240 per cent. But it is obvious that the factors are not mutually exclusive. What element of the expense of manufacture can be more inevitable than payroll? Do not purchases of raw materials constitute an important part of manufacturing costs? And wherever manufacturing is done, is there not apt to be the situs of tangible property belonging to the taxpayer?

That there is difficulty in drawing nice distinctions between the component elements of these factors is evidenced from the reclassification of expenditures indicated in the Appellant's opening brief. Originally, the taxpayer reported purchases other than materials used in manufacturing and expenses of manufacture exclusive of wages and salaries. In a reclassification urged on appeal, the purchases were greatly

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increased, due, undoubtedly, to the inclusion of amounts expended for materials used in manufacturing., while a marked reduction was shown in manufacturing costs. The total of wages and salaries was somewhat larger. There was no change in the California amounts for purchases or wages and salaries so that the percentages for this state were reduced. Inasmuch as there were no expenses of manufacture in California, the decrease in the total of these had no significance in the application of the formula.

The further suggestion was made that the number of employees should be averaged with the payroll to arrive at a proper percentage for this factor, Naturally, a large number of factory-hands and other employees paid low wages will be included on an equal basis along with highly paid executives, branch-managers and salesmen, There is no logic in this and the payroll itself should be sufficient. If the President is paid more than a factory-hand, it is because he contributes more to the earning capacity of the corporation.

In view of the difficulties which arise from the attempt to consider each of the five factors specifically mentioned in the statute, we conclude that the Appellant has shown no sufficient reason for departure from the established practice of the Commissioner. If the use of the three factors of tangible property, payroll and sales is standardized upon the form for report and proves satisfactory in most cases, we think that any corporation claiming that the formula operates unfairly must adduce convincing proof in support of its position. This, in our opinion, the Appellant has failed to do,

The design of the allocation formula, as expressed in the statute is "to assign to the state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation." (Stats. 1929, Chap. 13, Section 10.) Three factors enter primarily into the earning capacity of the ordinary business. They are ownership of property, employment of persons and sale of some product or service. At best, any allocation is but rough justice, because it is impossible to estimate exactly the weight of these or other factors in that common Commercial pursuit - the acquisition of net income. Therefore if consideration of the three primary factors on an equal basis appears best calculated to accomplish the design of the statute in most cases, we think it should be preferred in all cases in the absence of compelling reasons to the contrary. There is still much force to the observation which Adam Smith made in 1776 that "The tax which each individual is bound to pay ought to be certain, and not arbitrary, ----- The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

Consequently, we are of the opinion that the income of the Appellant should be apportioned by means of a percentage

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produced in accordance with the formula outlined in the form for report prescribed by the Commissioner. We believe that the Commissioner has determined to his satisfaction that Appellant's net income for the purposes of the Act is \$33,044,453.59. Without further evidence in support of the reclassification attempted by the taxpayer in its brief, we are constrained to believe that it should be required to adhere to the figures shown in Schedule C of its return to the Commissioner. Consideration of the three factors of tangible property, payroll and sales, as these are detailed, will produce an average for California of 1.737 percent. Application of this percentage to the net income above mentioned results in the determination that the net income of the Appellant from its California business was \$573,982.16. On this basis we determine the tax as follows:

Item 40:	Net Income	\$573,982.16
41:	4%	22,959.29
42:	Offset for Taxes	6,053.51
43:	Tax after Offset	<u>\$ 15,905.78</u>
44:	Add 4% of Offset	<u>242.14</u>
45:	Total Tax	\$ 17,147.92
	Self-assessed and paid	<u>\$0,578.88</u>
	Additional Tax	\$ 6,569.04

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, that the action of Reynold E. Blight, as Franchise Tax Commissioner, in overruling the protest of R. J. Reynolds Tobacco Company, a corporation, against a proposed additional assessment based upon a return of said corporation for the year ended December 31, 1928, under Chapter 13, Statutes of 1929, be and the same is hereby modified. It is further ordered that the amount of the tax of said corporation based upon said return be and the same is hereby determined at \$17,147.92. Albert A. Manship, Franchise Tax Commissioner, is hereby directed to note the deficiency in the payment of said tax as heretofore made, and to proceed in conformity with this order.

Done at Sacramento, California, this 19th day of January, 1931, by the State Board of Equalization.

Jno. C. Corbett, Chairman
R. E. Collins, Member
H. G. Cattell, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary