

Appeal of Dohrmann Commercial Company

it appears that accounting and advertising services are furnished to Supply Company by Appellant without charge. Financing is furnished to Supply Company by way of loans from Appellant at unspecified rates of interest. During the year in question Appellant received from Supply Company dividends in the amount of \$63,000.

For the income year ended January 31, 1941, Appellant and Supply Company filed separate franchise tax returns in which 95.752 percent of Appellant's net income and 76.86 percent of Supply Company's net income were allocated to sources within this State, Acting under Section 8(h) of the Bank and Corporation Franchise Tax Act, Appellant deducted from gross income 76.86 percent of dividends in the amount of \$63,000 received from Supply Company, on the basis that the income from which that proportionate share of the dividends had been declared had been included in the measure of the tax paid to this State by Supply Company, The remaining portion of the dividends was included as income of Appellant wholly allocable to California.

The Franchise Tax Commissioner redetermined the income of each corporation from sources within this State on the basis of a combined report. After eliminating intercompany charges and the intercompany dividends received by Appellant, the Commissioner computed the combined net income subject to allocation to be the sum of \$306,101.97. By the use of the usual three factor formula of property, payroll and sales, the Commissioner allocated 86.85% of such income, or the sum of \$265,849.56, to California. The Commissioner then apportioned 57.91% of the combined income from California sources to Appellant and the remainder to supply Company. The Commissioner next determined that 84.542% of the intercompany dividends received by Appellant were deductible under the provisions of Section 8(h), supra, as having been declared from income which had been included in the measure of the franchise tax, The remainder of the dividends, in the amount of \$9,738.54, was included as income of Appellant wholly attributable to California.

With other adjustments not material to this appeal, the reconstruction of income by the Commissioner resulted in a determination that Supply Company had overpaid its tax in the amount of \$5,273.83 and that Appellant had underassessed its tax in the amount of \$6,099.28. The Franchise Tax Board now concedes, however, that 86.85%, rather than 84.542%, of the dividends received by Appellant should have been deducted from income under Section 8(h).

Appellant does not dispute the mathematical correctness of the computation made by the Franchise Tax Commissioner but

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contends that there is no basis for combining the income of the two corporations. In the alternative, it contends that if the combining of income is proper, the entire amount of the dividends received by Appellant must necessarily be excluded from income,

Appellant's contention that the Commissioner erred in combining and reapportioning the entire income of the two corporations appears to be based upon three major points: (1) there was no attempt by Appellant and its subsidiary to shift income improperly from one corporation to another, (2) the two corporations are not engaged in a wholly unitary business enterprise and (3) the items of income reflecting unitary operations are small in number and definite in amount.

Neither the improper shifting of income nor the evasion of taxes is a factor which must be present to justify the apportionment of income by the formula method. Where a business is an integral part of a larger and unitary system, separate accounting is inadequate to ascertain the true result of the activities and values attributable to that business. Thus it has been held that the use by the Commissioner of the formula method of apportioning income between units of a single enterprise is authorized under the Act even though each unit of the system is organized as a corporation. When the unitary nature of the business has been established, the burden of producing evidence to show that the use of a formula reaches an arbitrary and unreasonable result is on the taxpayer, Edison California Stores, Inc. v. McColgan, 30 C. 2d 472.

Present in the multi-state operations of Appellant and its subsidiary are all of the elements of a unitary business -- unity of ownership, unity of operations by centralized purchasing, management, advertising and accounting, and unity of use in the centralized executive force and general system of operation. If any of the operations of Appellant or its subsidiary are not unitary in character, it is incumbent upon Appellant to establish both the nature and extent of the nonunitary operations and the amount of income derived therefrom. The only evidence presented by Appellant, however, is the statement, supported by its separate accounting, that during the year in question it had received from its subsidiary payments in the amount of \$94,118.57, representing the 3% differential between the price paid for merchandise and the price at which the property was transferred to the affiliate, rentals in the amount of \$89,886.10 and interest payments aggregating \$2,049.42. That these items of income, which under separate accounting were designed merely to reimburse Appellant for certain costs, do not adequately reflect the true benefits and values flowing

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to it from the integrated operations of the two corporations is obvious..

We have no doubt of the statutory authority of the Franchise Tax Board to allocate the unitary income of Appellant and its subsidiary so as clearly to reflect the income of each corporation from sources within this State. Butler Bros. v. McColgan, 17 C. 2d 664, 315 U.S. 501; Edison California Stores v. McColgan, supra, In the absence of evidence showing that specific nonunitary operations and income were included in the allocation formula, or that the formula used reached an arbitrary and unreasonable result, we conclude that the method used to allocate the combined income of the two corporations was proper.

Since we have concluded that the allocation of income by the Commissioner was proper, it is necessary to consider the status, for tax purposes, of the dividends received by Appellant from Supply Company. Appellant contends that if its business and the business of Supply Company constitute a unitary operation subject to allocation then (1) the inclusion in income of any portion of the dividends is, pro tanto, the taxation of the same income twice and (2) any portion of the dividends not deductible under Section 8(h) constitutes income attributable to sources without this State and not taxable in California.,

It is undoubtedly correct that intercompany dividends must be entirely eliminated to avoid distortion of income if two or more affiliated or related corporations are required to file a consolidated return and are taxed as one entity. That, however, is not the factual situation before us. The combined report of income requested by the Commissioner was merely a means of obtaining information required for the purpose of ascertaining the unitary income from sources within this State. It did not constitute a true consolidated return upon which a single tax would be based nor did the Commissioner's method of apportioning the combined income disregard, for purposes of taxation, the separate corporate entities of Appellant and its subsidiary. Edison California Stores, Inc. v. McColgan, supra. As reconstructed by the Commissioner, the net income of Supply Company remained in excess of the aggregate amount of all dividends which it had declared during the year, 13.15% of that income is attributable to sources without the State and has been excluded from the measure of the tax, It is clear, therefore, that the taxation in the hands of the recipient of only 13.15% of the dividends could not result in the taxation twice of the same income.

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With the exception contained in Section 8(h), the Bank and Corporation Franchise Tax Act included in the measure of the tax all dividend income from shares of stock having a situs in this State. Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48. Unless the situs of the stock in question was without the State, accordingly, the Commissioner was required to include in income the dividends received by Appellant, subject to the deduction afforded by Section 8(h). As we have demonstrated above, the inclusion in net income of the nondeductible portion of the dividends did not result in double taxation,

In support of its position that any portion of the dividends not deductible under Section 8(h) constitutes income attributable to sources outside this State, Appellant contends that the rule of mobilia sequuntur personam is not applicable to shares of stock held by a parent corporation in a subsidiary engaged in the same unitary business as that of the parent. It argues, accordingly, that income and loss realized on the shares of stock are attributable to the place or places where the subsidiary is doing business. It is stated in behalf of Appellant in this connection that "The portion of the dividends paid by the subsidiary to the parent attributable to sources within this State is deductible under Section 8(h). The remaining portion, constituting, as it does, income attributable solely to sources outside the state, under Section 10 of the Act is not taxable."

As we understand its position, Appellant conceives the situs of shares of stock, in the case of related or affiliated corporations engaged in the conduct of a multi-state unitary business, to be spread among the various states in which the issuing corporation does business, in precisely the same proportion as the unitary income derived by the corporation is spread among those states. Since the percentage of the unitary income attributable to sources in each state is subject to fluctuation from year to year, the situs of the shares of stock would apparently shift from one state to another annually on the basis of income derived from each state, without regard to the legal or commercial domicile of either the owning or issuing corporation. This concept of situs is not supported by the authorities and is contrary to well settled principles of law.

By incorporation under the laws of this State Appellant established its legal domicile here and all shares of stock and other intangibles owned by it have a taxable situs here (Miller v. McColgan, 17 Cal. 2d 432; Rainier Brewing Co. v. McColgan, 94 Cal. App. 2d 112), at least in the absence of the acquisition of a business situs elsewhere. It is in this State, however, that Appellant and Supply Company maintain

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their principal places of business. It is from the common executive office in this State that the multi-state unitary business conducted by the two corporations is managed and controlled. It is here that the shares of stock in question are used by Appellant to control the policies and operations of the subsidiary as a unit in the single unitary enterprise.

Appellant relies on three decisions as support for its view that the situs of the shares of stock is spread among the several states in which the subsidiary does business. In Holly Sugar Company v. Johnson, 18 Cal. 2d 218, the facts were that a New York corporation doing business in California, but with its principal office in Colorado, acquired 70% of the shares of a California corporation engaged in the same type of business wholly within this State, for the purpose of controlling the policies and operations of the domestic corporation as a mere "adjunct, agency or instrumentality" of the foreign corporation in the conduct of its unitary business. The court held that by economic integration with the owning corporation's operations within California the shares of stock had become sufficiently localized to acquire a business situs here, thus permitting a loss sustained on liquidation of the domestic corporation to be included in the tax base for the purpose of ascertaining that portion of the foreign corporation's net income derived from business done within this State.

While it is true that the court relied on the unity of operations of the two companies as the basis for its conclusion that the shares of stock there in question had become localized as an integral part of the foreign corporation's activities within the State, Appellant's interpretation of the decision overlooks the fact that the stock owned by Holly Sugar Company was used to control a corporation having its legal and commercial domicile within this State and whose activities were localized here. Since the question was not in issue, the decision is certainly not authority for the arbitrary assignment of a business situs of a fragmentary portion of stock to each state in which a multi-state subsidiary conducts a portion of the unitary business. First Bank Stock Corp. v. Minnesota, 301 U.S. 234, on the other hand, supports the view that the shares of Supply Company had a situs in this State by reason of their ownership by Appellant and their identification with the activities here of Appellant,

In National Leather Co. v. Commonwealth of Massachusetts, 152 N.E. 916, affirmed 277 U.S. 413 and Stanley Works v. Hackett, 190 Atlantic 743, the court in each instance merely construed a local statute. Neither case involved the apportionment of the situs of shares of stock between several

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states on the basis of the unitary business conducted therein by the issuing corporation.

For the reasons stated herein, we conclude that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) should be modified by increasing the deduction from income allowable under Section 8(h) of the Act from 84.542% to 86.85% of the dividends received by Appellant from Supply Company, As so modified the action of the Commissioner must be sustained.

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 Commissioner (now succeeded by the Franchise Tax Board) on the protest of Dohrmann Commercial Company to a proposed assessment of additional tax in the amount of \$6,099.28 for the income year ended January 31, 1941, be and the same is modified as follows: that the portion of the dividends allowed as a deduction from income under Section 8(h) of the Bank and Corporation Franchise Tax Act (now Section 24402 of the Bank and Corporation Tax Law) be increased from 84.542% to 86.85% and that the amount of the deficiency assessment be adjusted accordingly; as so modified said action is hereby sustained,

Done at Sacramento, California, this 29th day of February, 1956, by the State Board of Equalization,

Paul R. Leake, Chairman

Robert E. McDavid, Member

J. H. Quinn, Member

Geo. R. Reilly, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary