67-SBE-016

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MAX FACTOR & CO,)

Appearances:

For Appellant: Bert A. Lewis
Attorney at Law

For Respondent: Crawford H. Thomas
Associate Tax Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests of Max Factor & Co, against proposed assessments of additional franchise tax in the amounts of $2,979.31, $8,576.77, $12,678.55, $11,785.09, $8,590.95, $14,229.77, $9,491.90, $20,009.63, and $23,697.14 for the income years 1952 through 1960, respectively.

Appellant is engaged in the manufacture and sale of cosmetics within and without this state. Its principal place of business and commercial domicile are in California. It owns the stock of several subsidiaries which are engaged in the sale or manufacture and sale of cosmetics in various foreign countries. During the years here in question it received dividends from certain of its foreign subsidiaries,

In its franchise tax returns, appellant computed its income attributable to California by treating its own operation, exclusive of the operations of its subsidiaries, as a unitary business. It allocated a portion of its net income to this state by employing the usual three-factor formula of property, payroll and sales. The dividends it received from its subsidiaries were reported as income attributable entirely to California.

Respondent Franchise Tax Board, however, treated appellant and its subsidiaries as together engaged in a unitary business. On this basis, respondent combined the net income of all of the corporations and apportioned it according to the combined property, payroll and sales within and without this state. The dividends were treated as additional income of appellant attributable entirely to California but a deduction was allowed for each year in an aggregate amount representing the dividends derived from income which had already been included in the measure of the California tax under the apportionment formula.

Appellant argues that: (1) having treated the subsidiaries as engaged in a unitary business with appellant for purposes of allocating the combined income, respondent should completely eliminate intercompany dividends from appellant's income; (2) the subsidiaries were improperly treated as engaged in the unitary business for the years 1952 through 1954: (3) distributions made by the subsidiaries from income included in the measure of California tax were "repayments" to appellant rather than dividends; and (4) in computing dividend deductions, foreign income taxes imposed on the subsidiaries should be charged only against income not included in the measure of California tax.

We will discuss these arguments in the order set forth above.

I

SHOULD DIVIDENDS BE ELIMINATED COMPLETELY FROM APPELLANT'S INCOME?

The contention that the dividends received by appellant from its subsidiaries should be ignored entirely presents an issue which we decided adversely to appellant's position in the Appeal of Safeway Stores, Inc., Cal. St. Bd. of Equal., March 2, 1962. In accordance with that holding, no elimination of dividends from income separately attributable to appellant is required by the fact that appellant's income was combined with that of its subsidiaries for purposes of allocating a portion of the unitary income to California. The formula method of allocation does not ignore the separate entities of the corporations involved; (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16].) The dividends had their taxable source at appellant's commercial domicile in this state (Southern Pacific Co. v. McColgan, 68 Cal. App. 2d 48 [156 P.2d 81]) and were includible in the measure of its franchise tax subject to adjustments which will be discussed later in this opinion.

II

SHOULD THE SUBSIDIARIES BE TREATED AS ENGAGED IN THE UNITARY BUSINESS FOR THE YEARS 1952-1954?

As authority for its second argument, appellant relies upon section 25102 of the Revenue and Taxation Code. Before 1955, that section provided that in the case of "taxpayers" owned or controlled by the same interests, the Franchise Tax Board could impose a tax as if the combined income were that of one of them or could allocate the gross income or deductions among them. In 1955, the word "taxpayers" was changed to "persons." Appellant points out that its subsidiaries did not do business in California and were not taxable here. It is argued, therefore, that section 25102 was not applicable during the period when it referred to "taxpayers."

We do not believe, however, that section 25102 is the controlling section. The authority of the Franchise Tax Board to allocate the income of a unitary business is derived from section 25101 of the Revenue and Taxation Code, which provides in general terms for the determination of income attributable to California sources. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal. 2d 472 [183 P.2d 16].) Since appellant's argument that the subsidiaries should not be included in the unitary business for the years 1952 through 1954 rests entirely upon section 25102, the argument cannot be accepted.

III

SHOULD PART OF THE DIVIDENDS BE TREATED AS REPAYMENTS?

Formula allocation of the combined income of a unitary business does not ordinarily coincide with the distribution of earnings and profits by separate accounting. If under the formula allocation a larger portion of the combined income of a group of affiliated corporations engaged in a unitary business is attributed to California than the aggregate of the income attributable to this state by the separate accounts of each member of the group, an adjustment to intercompany dividend income may be required to avoid double taxation of the same income.

As computed by respondent, all of the unitary income allocated to this state was initially included in the measure of appellant's tax. A portion of that income represented income reflected on the separate accounts of the subsidiaries from which dividends were paid. If all of the dividends paid by appellant's subsidiaries were included in the measure. of appellant's tax, some income would be included in the measure twice, once as unitary income and a second time as a dividend.

Exercising its statutory discretion to achieve a proper apportionment of income (Rev. & Tax. Code, § 25101; El Dorado Oil Works v. McColgan, 34 Cal. 2d 731 [215 P.2d 4], appeal dismissed, 340 U.S. 801 [95 L. Ed. 589]), respondent undertook to reduce the measure of tax by the a-mount of any of the dividends derived from that portion of the unitary income which was allocated to California under the formula method.

The approach taken was to allow dividend deductions to appellant in accord with the underlying purpose of section 24402 of the Revenue and Taxation Code, that of avoiding double taxation, Section 24402 allows a deduction for dividends derived from income included in the measure of tax "upon the taxpayer declaring the dividends." Literally, the section has no application here since no California tax was imposed on appellant's subsidiaries. Nevertheless, some portion of the dividends were declared from income which, by reason of. formula allocation, was included in the measure of California tax. We held in the Safeway appeal that it was proper for respondent to apply the principle of section 24402 to prevent double taxation of portions of intercompany dividends received from foreign subsidiaries which. did no business in this state and had no California allocation factors. The deduction. there allowed was in the proportion that the earnings and profits of the payor subsidiary attributable to California bore to the payor's total earnings and profits as determined from its separate accounting records.

In the Safeway appeal the earnings and profits of each, payor attributable to California were calculated through a mathematical formula which we approved. Applying the same formula in the instant case, a share of the income reflected on the books of each payor was determined by respondent to have been "included in the measure of California tax." A proportionate part of the earnings and profits on the books of each payor was also considered to have been "included in the measure of California tax," and appellant. was allowed a deduction. for part of each dividend in the proportion which the payor's earnings and profits "included in the measure of California tax" bore to the total earnings and profits on the payor's books. Respondent's method of computing the earnings and profits as distinguished from the income, "included in the measure of California tax" is the subject of a separate issue which was not specifically raised in the Safeway appeal and which we trill consider later in this opinion, For convenience at this point we will, as the parties have also done, discuss the present issue in terms of income rather than earnings and profits.

Appellant argues that to the extent of the book income of a subsidiary which was "included in the measure of California tax" under respondent's calculations, the dividend paid by it should not be considered a dividend at all but an adjustment of accounts to coincide with the results obtained by the allocation formula, Appellant's position is that part of the dividend was a constructive "repayment" of income to which appellant was entitled.

In support of its position, appellant has cited a ruling by the United States Internal Revenue Service. (Rev. Proc. 65-17, 1965-1 Cum. Bull. 833.) That ruling involves a federal statute which permits the Internal Revenue Service to allocate income and deductions among corporations in order to properly reflect their income, The ruling allows a domestic corporation to exclude from its income dividends uaid by a foreign subsidiary to the extent that income on the book-s of the subsidiary is allocated by the Service to the parent.

The approach taken in that ruling represents an exercise of discretion by the Internal Revenue Service and not a conclusion that a dividend paid by a subsidiary must, as a matter of law, be treated as a "repayment." That such treatment is discretionary and not compelled by legal principles is demonstrated by the fact that the benefit of the ruling is, by its own terms, not available when the allocation of income is necessitated by an attempt to avoid taxes.

Resolving the problem of double taxation in a case like that before us is particularly difficult because separate accounting concepts must be superimposed upon the conflicting concept of a unitary business. We are not aware of any "perfect" solution, The solutions offered by both appellant and respondent necessarily involve certain arguable assumptions,

The fundamental reason why the opposing methods reach different tax results is that respondent's method is based on an assumption that a dividend is paid proportionately from all of the- income on the payor's books while appellant's method is" based -on an assumption "chat the dividend is paid first from the income "included in the measure of California tax." The assumption underlying respondent's method is, in our opinion, at least as reasonable as that upon which appellant* s approach is founded.

Although the method proposed by appellant is not wholly illogical, it is but one means of resolving a question to which there is no perfect answer, Exercising its discretion, respondent has dealt with the problem by applying the substance of a California statute allowing dividend deductions. In the Safeway appeal we approved that approach as "an acceptable solution to a difficult and complex problem." Upon reconsideration, we see no reason to withdraw that approval and accept appellant's theory of constructive "repayment."

IV

HOW SHOULD FOREIGN INCOME TAXES BE TREATED IN COMPUTING DIVIDEND DEDUCTIONS?

Appellant also contends that the dividend deductions should Se recomputed and increased. Appellant argues that no part of the foreign income taxes paid by its subsidiaries should be deducted from that portion of their income which respondent has regarded as "included in the measure of California tax."

The issue may be illustrated by taking as an example a subsidiary which did business in England. That subsidiary paid England a tax imposed on all the income reflected on its books. After calculating the portion of the subsidiary's book income which was "included in the measure of California tax," respondent deducted the English tax from the book income to arrive at the earnings and profits from which a dividend was paid. Under respondent's approach the numerator and denominator of_ the dividend deduction fraction were reduced proportionately by the amount of the tax. If the English tax were deducted only from that part of the subsidiary's book income which was not "included in the measure of California tax," as appellant urges, the denominator would be reduced by the -entire amount of the English tax but the numerator would not be reduced at all. The result would be a larger dividend deduction than was allowed by respondent.

Appellant relies on the fact that in another type of case respondent follows a procedure similar to that advanced by appellant here. That type of. case is one in which the dividend. payor does business partly in California.; is taxable here; and is not engaged in a unitary business with the payee. In a case of that kind respondent deems the foreign tax to have been imposed. only on the income not included in the measure of California tax.

We cannot properly evaluate the approach taken in cases that are not before *us*. Suffice it to say that appellant's case is distinguishable from that class of cases just described. The dividend payors in this case did not do business in California they were not taxable here; and the foreign taxes paid by them were unquestionably imposed on all of the income reflected on their books. On the facts of appellant's case, we see no reason why the foreign taxes should be deemed to reduce only a particular part of the book income of a subsidiary in arriving at the earnings and profits from which a dividend was paid.

ORDER

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 protests of Max Factor & co. against proposed assessments of additional franchise tax in the amounts of $2,979.31, $8,576.77, $12,678.55, $11,785.09, $8,590.95, $14,229.77, $9,491.90, $20,009.63, and $23,697.14 for the income years 1952 through 1960, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 24th day of April, 1967, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

Richard Nevins, Member

__________, Member

George R. Reilly, Member

ATTEST: W. W. Dunn, Secretary