



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
H & R BLOCK, INC.)

Appearances:

For Appellant: Lee Baldarelli
H & R Block Tax Service
Sacramento
For Respondent: A. Ben Jacobson
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of H & R Block, Inc., against proposed assessments of additional franchise tax in the amounts of \$617.58, \$3,637.44, and \$5,260.32 for the income years 1961, 1963, and 1964, respectively, and against a proposed assessment of additional franchise tax of \$2,197.67 and a penalty of \$109.88 for the income year 1962.

The primary question for decision is whether appellant was part of a unitary business operation during the years in question, requiring computation of its California income by means of formula allocation rather than separate accounting. If so, a second issue arises, i.e., whether respondent properly computed appellant's California income by use of a two-factor formula composed of sales and payroll, but omitting the property factor.

In support of its contention that appellant was operating as part of a unitary business during the period on appeal, respondent relies almost entirely upon information contained in a company prospectus dated August 11, 1966. Appellant admits that the facts as stated in that prospectus accurately describe the company's operations as

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of that date. Appellant urges, however, that during the years 1961 through 1964, the operations of the national organization and of appellant were quite different. Since respondent does not dispute appellant's statement of the facts as they were during those earlier years, we will accept those facts as true.

Appellant, a California corporation, is part of a nationwide system of offices operating under the name of "H & R Block" and engaging in the preparation of federal, state and local income tax returns, primarily for individual taxpayers. The original corporation of the system was formed under Missouri law in 1955 by two brothers, Henry and Richard Bloch, Its headquarters are in Kansas City, Missouri.

Subsequent to 1955 the Bloch brothers decided to expand their operations, and in this connection they formed corporations similar to the Missouri company in various other states. One of those corporations was appellant, which commenced doing business in California on January 14, 1960. During the years in question Henry and Richard Bloch and their wives owned 100 percent of appellant's stock., They were also its primary officers and directors, as they were of all the corporations in the system.

Since its inception the H & R Block organization has grown very rapidly. The number of offices throughout the United States has increased from nine in two states in 1956 to 2,200 offices in fifty states in 1968. During the income years under review the national growth pattern was as follows:

1961	-	140	offices in 27 states
1962	-	206	offices in 34 states
1963	-	353	offices in 34 states
1964	-	495	offices in 40 states

Some of the new offices opened in other states were owned and operated by the Bloch-controlled corporations. In order to obtain outside financing and thus to accelerate the expansion of their business, Henry and Richard Bloch, also launched a franchise program. Pursuant to that plan the local corporation in a state would grant franchises to independent businessmen who would then operate their own offices, using the name "H & R Block" and paying a percentage of their gross profits to the local corporation.

All of appellant's offices are located in California. The first offices established in this state were operated by

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franchisees and were located primarily in Northern California. Subsequently some company-owned offices commenced operations here, but during the years in question the majority of H & R Block offices in California were operated under franchise agreements.

The franchised offices accounted for the greatest volume of business and for the majority of appellant's net profits. Because the California franchisees had been exceedingly successful the managers of the offices owned by appellant relied on them for advice and guidance, and generally patterned their operations after those of the franchised offices. That being so, the following facts as to the manner in which the franchisees operated their offices will also apply to offices owned by appellant, unless otherwise stated.

During the years on appeal all of appellant's offices were operated substantially autonomously and free of control by the Blochs or the other Bloch-owned corporations in the system. The manager or franchisee of each office was given a great amount of discretion in handling all phases of its operation,

Each office maintained all of its own accounting records, including payroll and accounts payable. Each maintained its own bank account and paid its own obligations. The manager or franchisee of each of appellant's offices obtained liability, fire and theft insurance from local agents. Appellant prepared its own tax returns, covering the operations of all of the California offices. During the years in question the majority of appellant's advertising was done on a local basis, with television being its primary advertising medium. The Blochs imposed no restrictions on either the amount of advertising done in California or the form which it took.

Supplies and equipment could be purchased by appellant's office managers from the headquarters in Kansas City, or locally, whichever the manager deemed most economical and expedient. During the years on appeal appellant's offices purchased, or leased, the bulk of their office equipment from local suppliers. Although in subsequent years the appearance and furnishings of H & R Block offices throughout the country have become standardized, that was not the case during these formative years.

Appellant financed the offices which it owned, and its franchisees did all their own financing with no aid from appellant or the national organization. Appellant provided life, health and accident insurance for its California

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employees under an independently negotiated policy,

During the four years on appeal approximately three employees of H & R Block from other states transferred into California. Otherwise each of appellant's office managers hired his own personnel and conducted his own training programs, at his discretion. The national organization did conduct a brief annual training program for new managers; a very small number of appellant's managers attended, however? because of limited finances. In addition, noncompulsory national meetings were held periodically, but again the attendance of appellant's managers at those meetings were limited for financial reasons.

For each of the years in question appellant filed franchise tax returns covering only its own operations. Respondent's proposed additional assessments are based upon its determination that appellant and other members of the group of affiliated corporations were engaged in a unitary business.

section 25101 of the Revenue and Taxation Code requires a taxpayer deriving income from sources within and without the state to measure its California tax by the net income derived from or attributable to sources within this state. If a business is thus unitary in nature, the income attributable to California must be determined by formula allocation rather than by the separate accounting method. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P. 2d 3343, aff'd, 315 U.S. 501 [86 L. Ed. 991]]; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P. 2d 16].)

In recent decisions the California courts have reaffirmed the tests to be used in ascertaining the existence of a unitary business. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P. 2d 33]; Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P. 2d 40]; RKO Teleradio Pictures, Inc. v. Franchise Tax Board: 246 Cal. App. 2d 812 [55 Cal. Rptr. 299].) Under one test a business is unitary in nature if there is unity of ownership, unity of operation, and unity of use. (Butler Bros. v. McColgan, supra.) Under another approach, a unitary business exists when operation of the business done within the state is dependent upon or contributes to the operation of the business without the state. (Edison California Stores, Inc. v. McColgan, supra.)

Upon application of **these tests to the facts** of the instant case we conclude that appellant was not participating in a unitary business operation in the years 1961

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through 1964.

In this appeal we are concerned with: appellant's operations during its formative years. The national organization was also evolving rapidly during those years. Following the formation of appellant in 1960 the primary concern of the Bloch brothers was that appellant's offices in California be profitably and conscientiously operated. Beyond that rather vague overall policy it appears that appellant's various offices functioned substantially independently. Each franchisee or manager had to rely on his own business resourcefulness to a great extent. It appears that appellant's franchisees proved to be so successful in their operations in California that many of the procedures and techniques which they developed were later assimilated into the nationwide operations,

The integrating links which could be said to exist between appellant and the national organization during the years 1961 through 1964 were appellant's ownership by the Blochs, appellant's use of the name "H & R Block," its engagement in the same business as the national organization, and the small amount of supplies and equipment which it purchased through the Missouri headquarters. In this case it is our opinion that those connecting factors do not demonstrate that degree of mutual dependency and contribution which is required to establish participation in a unitary business. We conclude that during the years 1961 through 1964 appellant's operations were sufficiently separate from those of the national organization to justify computation of appellant's California tax by the separate accounting method.

Because of its rapid growth appellant's operations have changed drastically in each year of its existence. Therefore our decision that appellant was not part of a unitary business during the years in question does not preclude an opposite conclusion with regard to later years.

In view of our determination on the unitary business question we do not reach the issue of the proper allocation formula to be used in computing appellant's California income.

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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 the protests of H & R Block, Inc., against proposed assessments of additional franchise tax in the amounts of \$617.58, \$3,637.44, and \$5,260.32 for the income years 1961, 1963, and 1964, respectively, and against a proposed assessment of additional franchise tax of \$2,197.67 and a penalty of \$109.88 for the income year 1962, be and the same is hereby reversed.

Done at Sacramento, California, this 6th day of June, 1968, by the State Board of Equalization.

Chairman

Member

Member

Member

Member

ATTEST:

Secretary