87-SBE-013

BEFORE TBE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of) No. 82A-113-MW
CRAIG CORPORATION)

Appearances:

For Appellant: Richard E. Zimmerman
Attorney at Law

For Respondent: Karl Munz
Counsel

O P I N I O N

This appeal is nade pursuant to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Craig Corporation against proposed assessments of additional franchise tax in the amounts of $39,050, $50,498, and $53,922 for the income years ended June 30, 1976, June 30, 1977, and June 30, 1978.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Two questions are presented by this appeal: 1) Whether in-transit inventory was properly included by the Franchise Tax Board in the numerator of appellant's California property factor, and 2) whether the Franchise Tax Board properly required appellant to compute the inventory component of its property factor on a quarterly, rather than an annual, basis.

Appellant is a Delaware corporation whose principal business during the appeal years was the distribution and sale, throughout the United States and several other countries, of consumer electronic products, a substantial portion of which were purchased from manufacturets in the Far East. Monthly orders were placed which were designed to satisfy the needs of all the various sales regions for a period of three to six months in the future. Orders were placed based on historical usage of a product, existing product requests, and customer orders from the various sales regions. All inventory purchased from manufacturers in the Far East was ordered through appellant's California office, and that destined for the United States market was shipped to appellant's facility in Compton, California.

Upon receipt in Compton, the bulk shipments were subjected to any necessary quality control inspection, compliance with import and customs laws was completed, and the products were separated for shipment to the various regional centers. The goods for other regional centers generally remained at the Compton facility for 1 to 10 days, depending on how long it took to accumulate sufficient inventory for a particular regional center to dhip it economically.

Appellant was engaged in a unitary business and determined its income subject to California franchise tax by means of a combined report and formula apportionment. For the years in issue, appellant included in the numerator of its California property factor that proportion of in-transit inventory which corresponded to the ratio of California on-hand inventory at year end to total inventory. This method had been initiated by a Franchise. Tax Board auditor during an audit of appellant's return for the income year ended June 30, 1975. When an audit was conducted for the years now in issue, the Franchise Tax Board determined that the prior auditor's method was incorrect and required that appellant include all inventory in transit from the Far East in the California numerator of the property factor. In fact, this requirement was a return to the method used by appellant in its.1972 and 1973 income year returns. (App. Ex. B at 1.) For the years in issue, the Franchise Tax Board also adjusted appellant's inventory figures, using an average based on quarterly figures rather than the average based on annual figures used by appellant. These adjustments were reflected in notices of proposed assessment against which appellant protested. When the Franchise Tax Board affirmed its action, appellant filed this appeal.

Appellant, since it was engaged in a single unitary business, was subject to the apportionment and allocation provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), found in sections 25120 through 25139, in determining its income attributable to and taxable by California. (Rev. & Tax. Code, § 25101; Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).) Under UDITPA, a taxpayer's income attributable to this state is determined by multiplying its business income by a fraction (commonly called the apportionment formula), the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128,) The property, payroll, and sales factors are fractions, the denominators of which are composed of the taxpayer's worldwide property values, payroll, and sales, respectively, and the numerators of which are composed of the taxpayer's California property values, payroll, and sales, respectively. (Rev. & Tax. Code, §§ 25129, 25132, 25134.)

The regulations under section 25129 set forth the following rules regarding the numerator of the property factor:

> The numerator of the property factor shall include the average value of'the real and tangible personal property owned or rented by the taxpayer and used in this state during the income year in the regular course of the trade or business of the taxpayer. Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination. . ..

(Cal. Admin. Code, tit. 18, reg. 25129, subd. (d) (art. 2.5).)

The parties appear to be in agreement that the property in transit from the Far East is to be included in the numerator of the state of its destination. The disagreement is over which state is the 'destination" of the goods: the Franchise Tax Board contends that California is the destination of all the goods, while the appellant contends that some of the goods have destinations in other states where its regional centers are located. We agree with the Franchise Tax Board that, for purposes of the property factor, all goods in transit from the Far East must be included in the California numerator.

The crux of appellant's argument is that a large proportion of the goods in transit from the Far East are ultimately destined for the regional centers in other states and that they remain "in transit" until they reach that ultimate destination. Appellant relies on the following language found in the Appeal of Montgomery Ward & co., Incorporated,, decided by this board on March 20, 1963:

> As Respondent points out, once goods have been placed in transit, the economic benefit to be derived from them is most closely connected with the point of destination. For the purposes of allocating income, the point of origin or points along the journey which goods in transit must travel are of little significance, as compared to the place where such goods will actually be put in use in the unitary business.

Appellant's reliance on the phrase "the place where such goods will actually be put in use in the unitary business" is misplaced. We note first that Montgomery Ward, supra, dealt with the question of whether goods in transit to California should be assigned to their destination and was decided before the adoption of UDITPA. This question has now been answered in the affirmative by regulation 25129, supra, and both parties are in agreement on this point. Since a different question was being addressed, and the "destination" in Montgomery Ward was not in dispute, we do not regard the quoted language as an exclusive definition of destination. Even this langugage, however, does not necessarily support appellant's position. In appellant's situation, "the place where such goods will actually be put in use in the unitary business" is just as much Compton as it is any of the regional centers in other states. The efficiency and economy created by the stoppage of all the goods in Compton are advantageous to this unitary business as a whole and Compton is really the first place where the goods are "put in use in the unitary business." To read that language as meaning only the place where the goods ultimately are stored is far too restrictive in the context of a unitary business where the 'flow of value" and "economies of scale" arise from the operation of the business as a whole. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 [77 L.Ed.2d 545] (1983).)

We also disagree with appellant's contention that the goods remain in transit until they reach the regional centers. In the Appeal of Gibson Wine Co., decided by this board on June 22, 1956, the California appellant stored bulk wine, purchased by its out-of-state parent corporation from an unrelated winery, during a finishing process before sending it on to the parent corporation for bottling and sale. The appellant objected to the inclusion of this wine in the numerator of its property factor, contending that the wine was in transit to the parent and could not be considered as having a situs in California. We held that the wine was properly included in appellant's property factor, saying:

> The storage of this inventory in Appellant's warehouse was not a temporary interruption in its interstate journey for lack of facilities for immediate transportation, but instead was for the parent's own purposes. Accordingly, the inventory was not in transit in interstate commerce and had situs in this State for tax purposes. Yellow Cab Manufacturing Company v. The City of San Diego, 106 Cal.App. 587.

(Appeal of Gibson Wine Co., supra.)

The Gibson Wine appeal, although also decided before the adoption of UDITPA, is helpful in our determination of the present appeal because it addresses the precise issue raised by appellant, i.e., whether the goods remained in transit during their stop at Compton, and because that issue is not directly addressed by UDITPA. The present situation strongly resembles that in

Gibson Wine, supra. The stoppagt of the inventory at Compton was not due to lack of immediate transportation, but was for appellant's own purposes. The factual differences emphasized by appellant either do not exist or are not significant enough to distinguish Gibson Wine from appellant's situation. Therefore, we conclude that the inventory purchased from manufacturers in the far East was not in transit while it was in the Compton facility. Indeed, we have no indication that appellant failed to include in its California numerator the inventory in Compton on the requisite inventory days which was intended for its out-of-state regional centers. Appellant's "in-transit" argument appears to be inconsistent with its actions. Certainly, it would be illogical to have goods attributed to the regional centers before they arrive in Compton but attributed to Compton when they arrive there.

Appellant's argument that "destination," as used in the regulation, means "ultimate destination" is unsupported by any authority and is contradicted by the regulation itself. Subdivision (d) of regulation 25129, provides two rules for in-transit property. One deals with property in transit between locations of the taxpayer and the other deals with property in transit between a buyer and seller. Clearly, the regulation contemplates not one "ultimate" destination for goods in transit, but allows for several destinations for the same goods. Appellant's situation is a stereotypical example of the situation contemplated by the regulation. The goods in transit from the Far East are goods traveling from a seller to a buyer, and their destination, and place of attribution for property factor purposes, is Compton, California. When the goods leave Comptoc for the out-of-state regional centers, they are goods traveling between locations of the taxpayer, and their destinations, and places of attribution for property factor purposes, vary according to the regional center for which they are then destined.

After the oral hearing in this matter, appellant submitted summaries of records from July 1, 1983, through September 30, 1985, showing that, during that time, an average of 10.6342 percent of its sales were for products ordered specifically for two major out-of-state customers. None of the products ordered for these customers were ever ordered for or sold in the Caiifornia market. Appellant appears to argue that at least this percentage of in-transit goods should be excluded from the California numerator during the years in issue .

because these specific goods were unquestionably destined for states other than California.

We are not persuaded by appellant's argument. The goods that it ordered for these customers were apparently appellant's goods while being shipped from the Far East and, therefore, fall under the "between buyer and seller" rule of the regulation. When they were shipped from Compton to appellant's customers, they were again under the "between buyer and seller" rule, except the appellant was the seller rather than the buyer. Appellant must include all the goods in transit to Compton in its California numerator. When goods leave Compton for appellant's out-of-state customers, they are includible in the numerator of the property-factor at their new destination by either appellant or its customer, depending on which party would normally include the goods in its property factor denominator on the relevant inventory date.

The second question in this appeal is whether the Franchise Tax Board may require appellant to determine its average inventory value based on quarterly, rather than yearly, figures. Appellant argues that only its annual inventory figures are audited and include adjustments for items such as costing corrections, pilferage, and obsolete items. It contends that any quarterly figures are inherently inaccurate. The Franchise Tax Board argues that the quarterly figures were used because appellant's inventory fluctuated widely throughout the year and was at a low point when the annual year-end figures were compiled. It determined that averaging the quarterly figures was necessary to accurately reflect the California inventory, The Franchise Tax Board notes that appellant's concern fur the adjustments made only in the annual inventory figures is unfounded, since the same source was used for both numerator and denominator. It also notes that the year-end figures are a component of the quarterly computation method which it used.

Section 25131 provides:

> The average value of property shall be determined by averaging the values at the beginning and ending of the income year but the Franchise Tax Board may require the averaging of monthly values during the income year if reasonably required to reflect

> properly the average value of the taxpayer's property.

This section gives the Franchise Tax Board discretion to depart from the use of annual figures if 'reasonably required to reflect properly the average value of the taxpayer's property." The Franchise Tax Board has here exercised that discretion and the appellant must show that it has acted unreasonably in doing so. We do not believe that appellant has met that burden of proof. Its assertions of inaccuracy are not supported by any evidence. We do not believe that the use of quarterly figures, rather than monthly figures as directed by the statute, makes the Franchise Tax Board's action unreasonable, since it offered to compute the average using monthly figures, but appellant declined to supply the necessary figures. We conclude, therefore, that it was not improper for the Franchise Tax Board to use quarterly, rather than annual, inventory figures to compute the-average value of appellant's property during the income year.

For the reasons stated in this foregoing opinion, respondent's action must be sustained.

Appeal of Craig Corporation

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, oursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Craig Corporation against proposed assessments of additional franchise tax in the amounts of $39,050, $50,498, and $53,922 for the income years ended June 30, 1976, June 30, 1977, and June 30, 1978, be and the same 'is hereby sustained.

Done at Sacramento, California, this 3rd day of March , 1987 by the Sta-te Board of Equalization. with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9