Corporate Franchise Tax: Apportioning the Value of Goods in Interstate Commerce, Montgomery Ward & Co. v. Franchise Tax Board, 85 Cal. Rptr. 890 (1970)

CORPORATE FRANCHISE TAX: APPORTIONING THE VALUE OF GOODS IN INTERSTATE COMMERCE

Montgomery Ward & Co. v. Franchise Tax Board, 6 Cal. App. 3d 149, 85 Cal. Rptr. 890, appeal dismissed, 400 U.S. 913 (1970)

Plaintiff—taxpayer Montgomery Ward, an Illinois corporation doing business in California and other states, was assessed an annual corporate franchise tax by the State of California. The tax was measured by net income "attributable" to California and determined by means of a three factor apportionment formula comprising the average ratio of tangible property, payroll, and sales within the state to tangible property, payroll, and sales in all states.[1] In computing the property factor, the value of all the taxpayer's tangible property located in all states constituted the denominator. The numerator included, over the taxpayer's objections, the value of goods in transit to California in interstate commerce. The taxpayer contended that the inclusion of the value of the goods in interstate commerce in the numerator resulted in measuring the tax by extra-territorial values in violation of the due process and commerce clauses of the U.S. Constitution. The trial court denied relief. On appeal, *held:* Affirmed. Inclusion of the value of goods in interstate commerce in transit to the state in the numerator of a three factor formula for apportioning net income for a corporate franchise tax does not contravene the due process and commerce clauses of the U.S. Constitution.[2]

Montgomery Ward is another example of the conflict in the field of interstate commerce between two objectives: the proper division of taxes among the states[3] and the maintenance of a free flow of interstate commerce.[4] The long recognized inadequacy of the judicial process to resolve the multifarious interstate taxation problems[5] prompted a study[6]

1. For an excellent treatment of the principle of allocation of business income and the theory and application of apportionment formulas *see generally* G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION (2d ed. 1950). The apportionment formula utilized by California may be illustrated thus:

$$\frac{\frac{\text{In-state property}}{\text{total property}} + \frac{\text{In-state sales}}{\text{total sales}} + \frac{\text{In-state payroll}}{\text{total payroll}}}{3} \text{ X total net income X Rate} = \text{Tax}$$

2. Montgomery Ward & Co. v. Franchise Tax Bd., 6 Cal. App. 3d 149, 85 Cal. Rptr. 890, *appeal dismissed,* 400 U.S. 913 (1970).

3. W. BEAMAN, PAYING TAXES TO OTHER STATES 1 (1963).

4. H.R. REP. NO. 1480, 88th Cong., 2d Sess. 9 (1964).

5. The following Justices, writing or concurring in the opinions indicated, have recognized this

leading to the proposal of the Interstate Taxation Act[7] by the House Judiciary Committee and prompted the approval of the Uniform Division of Income for Tax Purposes Act by the National Conference of Commissioners on Uniform State Laws.[8]

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inadequacy: Black, McCarrall v. Dixie Greyhound Lines, 309 U.S. 176, 188-89 (1940) (dissenting opinion), Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434, 448-55 (1939) (dissenting opinion), J.D. Adams Mfg. Co. v. Stoven, 304 U.S. 307, 327 (1938) (dissenting opinion); Clark, Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 457-58 (1959); Douglas, McCarrall v. Dixie Greyhound Lines, *supra* at 188-89 (dissenting opinion); Frankfurter, McCarrall v. Dixie Greyhound Lines, *supra* at 188-89 n. 24 (dissenting opinion), Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 475-77 (1959) (dissenting opinion); Northwest Airlines, Inc. v. Minnesota, 322 U.S. 292, 300 (1944) (dissenting opinion); Jackson, Northwest Airlines, Inc. v. Minnesota, 322 U.S. 292, 306-07 (1944) (concurring opinion); Rutledge in an opinion covering three cases, International Harvester Co. v. Department of Treasury, 322 U.S. 340, 360 (1944) (concurring opinion), General Trading Co. v. State Tax Comm'n, 322 U.S. 335, 360 (1944) (concurring opinion), McLeod v. J.E. Dilworth Co., 322 U.S. 327, 360 (1944) (dissenting opinion).

6. H.R. REP. No. 1450, 88th Cong., 2d Sess. 11 (1964).

7. H.R. REP. No. 7906, 91st Cong., 1st Sess. (1969). Title II of § 201 of the Act provides that a state may not impose on a corporation doing business in more than one state a tax in excess of that calculated by a two factor formula of property and payroll. With respect to the property factor, § 202(a) of the proposed statute provides:

> A corporation's property factor for any State is a fraction, the numerator of which is the average value of the corporation's property *located* in that state . . . . (emphasis added)

This provision appears to require that property not *physically located* in the state be excluded from the numerator of the property factor. If this interpretation is adopted, the *Montgomery Ward* holding would be made obsolete. However, the California statute in *Montgomery Ward* required the property to have a "situs" in the state and situs was there interpreted to include goods in interstate commerce which were "appropriated for the production of income in the state. *See* notes 9 and 25 *infra.* A similar interpretation of the proposed Interstate Taxation Act seems unlikely, but the word "physically" could be inserted between the words "not located" to avoid a decision like *Montgomery Ward.* On the other hand, if the term is to be interpreted as was "situs" in *Montgomery Ward,* changes should be made to avoid potential litigation on this issue.

8. The Uniform Division of Income for Tax Purposes § 10, 9A UNIFORM LAWS ANNOTATED (1957) contains a property factor defined as follows:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented *and used* in this state during the tax period . . . (emphasis added).

There are apparently no decisions under this act on the issue in *Montgomery Ward.* However the Act may be reasonably interpreted in two ways, each yielding a conclusion contrary to that in *Montgomery Ward.* The word "owned" can be read with "and used in this state". This interpretation would appear to exclude goods in interstate commerce because they are not owned in the state and because they are not used in the state. If the word "owned" is read only with "in this state", potential problems may arise because title may be in the name of a taxpayer's in-state operation. It is also possible, but unlikely, that "used in this state" could be interpreted as was "situs" in *Montgomery Ward* to mean "appropriated for the production of income" in the state. *See* note 25 *infra.* These potential interpretations suggest that a modification of the act for clarity is in order. In January, 1971 advisory regulations were proposed for adoption by the Multistate Tax Commission which could eliminate the statutory construction problems but not the constitutional problems. The regulations specifically provide that the numerator of the property factor includes "property in transit between locations of the taxpayer . . . shall be considered to

A fundamental limitation on state taxing power is that property physically located outside the state may not be taxed.[9] The tax involved in *Montgomery Ward* was not a property tax but a corporate franchise tax measured by net income and apportioned in part on the basis of a property factor.[10] The taxpayer did not contend that this in-transit property was taxed; nor would such an argument be persuasive in light of the principles espoused by the Supreme Court in *International Harvester Co. v. Evatt.*[11] There the taxpayer claimed that the state was taxing sales made outside its borders. The Court replied:

> A complete answer . . . is that Ohio did not tax these sales. Its statute imposed the franchise tax for the privilege of doing business in Ohio for profit. The fact that it chose to measure . . . the tax by the value of the goods . . . does not transform it to something else.[12]

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be at the destination for purposes of the property factor. P-H STATE & LOCAL TAXES, ALL STATES UNIT ¶ 6185 (1971). California adopted these regulations on May 11, 1971. CAL. REV. & TAX. CODE §§ 25120-39 (West 1970). 1 CCH STATE TAX REP., CALIF. ¶ 12-419 (1971). For an analysis of the development of formulary apportionment in California *see* Boren, *Separate Accounting in California and Uniformity in Apportioning Corporate Income,* 18 U.C.L.A. L. REV. 478, 481 (1971).

The Uniform Division of Income for Tax Purposes Act has been substantially adopted in the following jurisdictions: Alabama, Arkansas, California, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Maine, Michigan, Montana, Nebraska, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, South Carolina, Utah, and Virginia. West Virginia adopted the provisions of the Act applicable to corporate nonbusiness income only. Michigan adopted the provisions the Act applicable to franchise and intangibles taxes only. CCH ALL STATES TAX GUIDE ¶ 1029.

9. Frick v. Pennsylvania, 268 U.S. 473 (1925). Limitations on the power of a state to tax beyond its jurisdiction were recognized prior to the adoption of the fourteenth amendment. Case of the State Tax on Foreign—Held Bonds, 82 U.S. (15 Wall.) 300 (1872); Railroad Co. v. Jackson, 74 U.S. (7 Wall.) 262 (1869); Hays v. Pacific Mail S.S. Co., 58 U.S. (17 How.) 596 (1855). Following the adoption of the amendment, limitations similar in nature came to be expressed in due process terms. *See, e.g.,* Frick v. Pennsylvania, *supra;* Wisconsin v. J.C. Penny Co., 311 U.S. 435 (1940); for an early treatment of this development. *See* Bird, *The Evolution of Due Process of Law in the Decisions of the United States Supreme Court,* 13 COLUM. L. REV. 37, 41 (1913). Commerce clause limitations on state taxing power have existed since Brown v. Maryland, 25 U.S. (12 Wheat.) 419 (1827). Chief Justice Marshall set the stage for *Brown* in McCulloch v. Maryland 17 U.S. (4 Wheat.) 316 (1819) and Gibbons v. Odgen, 22 U.S. (9 Wheat.) 1 (1824). Some cases and authorities suggest that the two clauses are intertwined in application. *See, e.g.,* Ott v. Mississippi Valley Barge Line Co., 336 U.S. 403 (1936); American Mfg. Co. v. St. Louis, 250 U.S. 459 (1919); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194 (1905). Others suggest that they should be separately applied because they present different limitations on state taxing power. *See, e.g.,* Norfolk & W. Ry. Co., Missouri State Tax Comm'n, 390 U.S. 317 n. 5 (1968); International Harvester Co. v. Dept. of Treasury, 322 U.S. 340, 353 (1944) (Rutledge, J., dissenting). For a general discussion of the relationship between the two clauses *see* P. HARTMAN, STATE TAXATION OF INTERSTATE COMMERCE 13 (1953).

10. CAL. REV. & TAX. CODE § 23151 (West 1949).

11. 329 U.S. 416 (1947).

12. *Id.* at 420.

Two clearly identifiable constitutional tests have evolved as limitations on state taxing power. The threshold test, called the "nexus" test,[13] requires that the "taxing power exerted by the state bear fiscal relation to the protection, opportunities and benefits given by the state."[14] This test answers the question of whether the state may impose any tax and requires some "definite link" between the taxpayer's activities and the taxing state.[15] It is clear Montgomery Ward has substantial activities within the state of California due to its ownership of property and operation of its retail stores within the state[16] and thereby benefits from activity in the state.

A second clearly identifiable constitutional test involves the use of apportionment formulas. Succinctly stated, this test requires that the apportionment formula be "reasonable."[17] Montgomery Ward stipulated that the three factor apportionment formula employed by the Franchise Tax Board was reasonable.[18]

However, if the test is phrased in terms of what is "justly attributable" to the state,[19] the inclusion of extra-territorial values in the numerator of apportionment formulas may take on a constitutional dimension. This position finds support in *Wallace v. Hines*,[20] the case principally relied upon by the taxpayer. That case involved a special excise tax on doing business in the state, measured on capital invested in the transaction of business in the state. The tax was apportioned by means of the ratio of miles of track of the taxpayer-railroad within the state to the total miles of track in all states. In holding the formula unconstitutional as applied, the Court relied on three facts: first, the cost of track was considerably less in North Dakota due to its topography; second, the expensive terminals owned by the taxpayer were located in other states; and third, the bonds held within the state were secured by mortgage of lands in other states. Justice Holmes reasoned for the Court that property located outside the state could not be "taken

13. Wisconsin v. J.C. Penny Co., 311 U.S. 435, 445 (1940); W. BEAMAN, PAYING TAXES TO OTHER STATES 9 (1963).

14. Wisconsin v. J.C. Penny Co., 311 U.S. 435, 445 (1940).

15. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 465 (1959).

16. 6 Cal. App. 3d 149, 153, 85 Cal. Rptr. 890, 893 (1970).

17. Butler Bros. v. McColgan, 315 U.S. 501, 506 (1942).

18. 6 Cal. App. 3d 149, 153, 85 Cal. Rptr. 890, 894 (1970).

19. Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 134 (1931). J. HELLERSTEIN, STATE AND LOCAL TAXATION CASES AND MATERIALS (3d ed. 1969).

20. 253 U.S. 66 (1920). For an analysis of the role that *Wallace v. Hines* plays in the historical development of the problem of tax valuation under the unit rule, *see* 2 J. BONBRIGHT, THE VALUATION OF PROPERTY 672-75 (1965 reprint Michie Co.).

into account unless it [could] be seen in some plain and fairly intelligible way that it adds to the value of the road and the rights exercised in the state."[21]

The court in *Montgomery Ward,* while suggesting that constitutional questions were at an end when the "nexus" and "reasonable formula" tests were satisfied,[22] alluded to the problem of establishing that the in-transit goods added to the value of business done in the state.[23] In light of this allusion, the dismissal of appeal by the Supreme Court[24] gives no clear indication of the constitutional test to be employed in these factual situations.

The taxpayer argued that the in-transit goods in no way contributed to net income earned in California. The court replied that since the value of the goods was included in the denominator of the property factor, it should also be included in the numerator in the state to which the goods were "appropriated for the production of income . . . ."[25] The court failed to explain *how* the value of these goods added to the business done in the state during the taxing year. Notwithstanding this omission, the court held that the taxpayer failed to meet his burden of proof by clear and convincing evidence. This device for resolving the problem, while not atypical in the interstate taxation cases,[26] does not appear to satisfy the test set out in *Wallace v. Hines, i.e.* that it must be shown "in some plain and fairly intelligible way"[27] that the goods add to the value of the business done in the state. Goods in inventory within the state are ordinarily available for immediate sale and reflect the volume of business done in the state in the taxing year. The goods traveling in interstate commerce to the state, but which have not yet arrived, are

21. *Id.* at 69.

22. 6 Cal. App. 3d 149, 158, 85 Cal. Rptr. 890, 897 (1970).

23. *Id.* at 159, 85 Cal. Rptr. at 898.

24. 400 U.S. 913 (1970).

25. 6 Cal. App. 3d 149, 160, 85 Cal. Rptr. 890, 898 (1970).

26. *See, e.g.,* Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920). Beaman attacked the Supreme Court for using this approach:

> The ultimate holding is that the taxpayer has failed to discharge his burden of proof. This is arrived at in two steps. First, the court disposes of the contention that the formula is invalid on its face by observing that a formula may not be judged in the abstract. Next, the Court examines the contention that the formula in operation reaches an unreasonable result. Without satisfactory standards for determining what would be a *reasonable* result, the court finds itself powerless to say whether or not the result is *unreasonable.* Therefore the Court arrives, essentially by a confession of *ignoramus,* at a finding that the taxpayer has failed to prove the unreasonableness of the formula.

W. BEAMAN, PAYING TAXES TO OTHER STATES (1963).

27. Wallace v. Hines, 253 U.S. 66, 69 (1920).

not immediately available for sale, nor can they be used in the business during the taxable year. Moreover, the inclusion of the value of these in-transit goods would seem to distort the property ratio. Such a distortion would result because these goods are included in inventory in the year in which they travel in interstate commerce and included again in the year in which they arrive in the state. Depending on the ratio of the value of goods in interstate commerce to the goods in inventory in the state, the distortion could be substantial. To this argument the court replied: "today's inventory does not include today's goods in transit."[28] In the next paragraph, however, the court held that the inventory for the tax year included the goods in transit in interstate commerce on the final day of the tax year.[29]

As a result of the *Montgomery Ward* decision, the taxpayer is placed in the unenviable position of either paying the tax or avoiding it by terminating orders or shipments due to arrive in the taxing year. Courts then may be placed in the position of deciding whether goods ordered, but not shipped for tax avoidance reasons, are "appropriated to the production of income" in the state.

If the "nexus" and "reasonable formula" tests, both somewhat threshold in nature, are all that is constitutionally required, only the gross abuses of state taxing power could be constitutionally challenged,[30] and potential problems of the nature involved in *Montgomery Ward* would remain to be corrected by state courts on state constitutional and statutory grounds. A state could employ a reasonable formula, place extra-territorial values in the numerator and increase its tax revenues with impunity. A constitutional test requiring the income to be "justly attributable" to the state provides a basis for a reasoned analysis of the issues raised by the inclusion of certain values in the apportionment ratio factors. *Montgomery Ward* leaves unanswered these serious questions of an arguably constitutional nature.

28. 6 Cal. App. 3d 149, 162, 85 Cal. Rptr. 890, 900 (1970).

29. *Id.*

30. *See, e.g.*, Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931), where the statutory formula allocated approximately 80% of the net income of the corporation to the state but operations within the state produced only 17% of the net income. The formula was invalidated on the grounds that it was unconstitutional as applied.