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California's Contributions to State and Local Taxation

Frank M. Keesling*

California is noted for many things, including various geographical, environmental, and sociological phenomena. For example, the San Andreas Fault commences in Mexico and continues northward throughout most of California. From it has emanated a great many earthquakes, one of which, with the resulting fire, nearly destroyed San Francisco in 1906. In terms of sheer beauty, it is difficult to match the Yosemite Valley—a gorgeous glacial-carved niche in the Sierra Nevada—or the majestic redwoods,1 some of which are among the largest and oldest living things. Many find a walk through a redwood grove to be an awe-inspiring and soul-satisfying experience. The gold rush of 1849,2 the weather,3 the smog,4 and weirdo cults too numerous to mention are all associated with California.

In addition to these things, California is also noted for its contributions to the law. This Article focuses on California's con-

* LL.B., 1931, Boalt Hall School of Law; various positions, 1931-1935, California State Board of Equalization; Counsel, California Franchise Tax Commissioner, 1935-1939; private practice in Los Angeles, 1939 to date.

1. There are two species of redwoods: Sequoia sempervirens and Sequoia gigantea. Numerous groves of the former dot the northwest California coast, while groves of the latter are scattered along the western slope of the Sierra Nevada. Three of the more famous groves are the Mariposa Grove located a short distance south of Yosemite Valley, the King's Canyon National Park Grove, and the Sequoia National Park Grove located southeast of Fresno. The name “Sequoia” is in honor of the Cherokee Indian Sequoya, who created the Cherokee alphabet in the early nineteenth century.

2. The discovery of gold in 1848 by James Marshall at Sutter's Mill on the American River, some 50 miles east of Sacramento, resulted a year later in an influx of thousands of people to California. Some came by prairie schooner, some by horseback, some by way of the Isthmus of Panama, others by Cape Horn, and still others from Honolulu. The sprawling villages of San Francisco and Sacramento were converted in a matter of months into fair-sized towns. The gold rush resulted also in the development of many villages in the Sierras, including Old Hang Town, now known as Placerville.

3. The contrary claims of California chambers of commerce notwithstanding, on any given day the weather in California can be just as bad as anywhere else! By and large, however, it is fairly good, as testified to by the annual migration of several hundred thousand people to California, which has made California the most populous state in the Union. This statistic is prized by many Californians, but some of the oldtimers, including the author, liked it better in the 20's, 30's, and early 40's before the days of traffic congestion, housing shortages, and the other concomitant ills of modern existence.

4. Recently the author came across the following delightful tidbit: In undeveloped countries, don't drink the water; in developed countries, don't breathe the air.
tribution to the law of state and local taxation.

Many of the more significant attempts to reform the law of taxation have originated in California. In former years the concept of a single tax created much interest. Henry George was a resident of California during the latter part of the last century when he conceived the idea of a single tax on the incremental increase in land values in lieu of all other taxes. The idea attracted substantial national and even international attention, but has never been accorded much, if any, practical application. In the 1930’s Dr. Francis Everett Townsend led a crusade for an initiative amendment to the California Constitution providing for a single tax on gross receipts in lieu of all other taxes, and also for “pie in the sky” pension payments to the elderly. It was defeated as the result of a massive campaign by business leaders and others. In 1948 another determined effort was made to adopt an initiative amendment to the California Constitution providing for a gross receipts tax, an elaborate pension payment system, a state lottery, and various other gambling activities. It was ruled off the ballot by the California Supreme Court on the grounds that it constituted a revision of the Constitution, which cannot be achieved by initiative. More recently, the impetus for reform has shifted to attempts to limit the level of taxation. The Jarvis-Gann initiative, Proposition 13, became law in 1978. In the opinion of many people, including the author, Proposition 13 is a poor

6. The provisions of Proposition 13 may be summarized very briefly. It establishes a maximum tax rate on real property of 1%. Other provisions of the California Constitution prohibit the tax rate on personal property from being higher than the rate on real property, and accordingly the maximum 1% rate also applies to personal property. The basic value for assessing property that has changed ownership or has been newly constructed since Mar. 1, 1975, is the fair market value at the time of the change of ownership or the completion of new construction. Personal property may be assessed each year at its current fair market value. According to an opinion of the State Board of Equalization, real property owned by public utilities may likewise be assessed annually on the basis of current market values. In all other cases the assessed value for property tax purposes is rolled back to its value as of Mar. 1, 1975. A 2% increase to cover inflation is permitted. No other type of tax except the 1% property tax may be imposed upon real property. The imposition of all other taxes is severely limited.

The validity of Proposition 13 was upheld by the California Supreme Court in Amador Valley Joint Union High School Dist. v. State Bd. of Equalization, 22 Cal. 3d 208, 583 P.2d 1281, 149 Cal. Rptr. 239 (1978). Chief Justice Bird concurred with respect to the rate provisions, but dissented with respect to the valuation provisions on the ground that the great disparity in valuation for tax purposes that the Proposition establishes offends the equal protection provisions of the United States Constitution. For a discussion of the Proposition published shortly after it was adopted, see Keesling and Ajalat, Taxing Jurisdictions: Before and After Prop. 13, L.A. Law., Sept. 1978, at 42.
solution to a serious problem.

Not all of California's contributions to state and local taxation are of the character of those just listed. On the contrary, many of them have been integral parts of the California tax system for many years, and serve to make the system fairer and more effective. They, together with capable administration, are largely responsible for the California tax system's reputation as one of the best in the country.

The identity of most of the contributors is unknown. A few contributors, however, can be identified and should be mentioned. Many of the characteristic California tax policies that will be reviewed herein were contributed directly, or indirectly, by Roger Traynor. Prior to his appointment to the California Supreme Court in 1940, where he served as Associate Justice for twenty-four years and as Chief Justice for six years, Traynor was well on his way to becoming an able and nationally known tax lawyer. Former Chief Justice Traynor retired from the bench in 1970. Several other ideas were contributed by Dixwell Pierce, who was Secretary of the California State Board of Equalization for some forty years. A few were contributed by the author. Finally, James Sabine, who served in the California Attorney General's office for some thirty years, first as Deputy Attorney General, and later as Assistant Attorney General,7 deserves special credit for the competent advice he has given to California tax administrators over the years, and for his successful court defense of many of California's novel and ingenious tax policies.

I. PROPERTY TAXES

In the past, in California as in most other states, the property tax has been relied upon as the principal source of revenue for state as well as local governments. In more recent years, however, various other sources of revenue have been developed that greatly reduce dependency on the property tax. In fact, since the adoption of the so-called "separation of sources system"8 in California

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7. Since his retirement from the Attorney General's office, James Sabine has been a Visiting Professor of Law at J. Reuben Clark Law School, Brigham Young University.

8. An amendment to the California Constitution, adopted in 1910, provided that the revenues from the following taxes should be used exclusively for state purposes: (1) a gross receipts tax on public utilities in lieu of all other taxes on such utilities, (2) a gross premiums tax on insurance companies in lieu of all other taxes on such companies except local real property taxes, and (3) an ad valorem tax on corporate franchises and bank shares in lieu of all other taxes on such franchises or shares. CAL. CONST. art. 13, § 14 (1910, amended 1926, 1930, 1933, 1949). In 1974 art. 13 was completely revised. The current
in 1910, a general *ad valorem* property tax has not been imposed by the state. Although its importance has been greatly reduced as a result of Proposition 13 and because of various exemptions,\(^9\) the property tax is still an important source of revenue for the support of local government.

In its major outlines, California's property tax is similar to the property tax structures of most other states. There are, however, a number of features sufficiently important and sufficiently novel to deserve comment.

A. Possessory Interests in Real Property

Property owned by the United States and its instrumentalities is exempt from state and local taxation. The constitutions of most states, including the Constitution of California, accord a similar exemption to property owned by the state and its political subdivisions. It has long been held, however, that privately owned interests in publicly owned property, such as leases, are subject to taxation.

The rule that leases and other possessory interests in publicly owned property, including interests in property owned by the federal government, are subject to taxation has been upheld by California courts since California was admitted to the Union in 1850.\(^10\) In addition to leases, interests in government lands that are taxable include but are not limited to mining claims, rights to extract oil and gas, rights to cut timber, and rights to graze sheep or cattle.

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9. California has the usual clutter of exemptions for publicly owned property, property used for charitable, religious, educational, and various nonprofit welfare purposes, and to a limited extent, property owned by veterans. In addition, California now exempts completely all of the following property: stocks, bonds, notes, mortgages, and other intangible property; household furniture, including art objects; money; and inventories. See generally CAL. REV. & TAX. CODE §§ 201-233 (West 1970 & Supp. 1979).

10. See People v. Shearer, 30 Cal. 645 (1866); People v. Morrison, 22 Cal. 74 (1863); Hall v. Dowling, 18 Cal. 619 (1861); State v. Moore, 12 Cal. 58 (1859).

In Moore the court upheld a tax on the possessory interest in a mining claim on land owned by the United States. Shearer involved the taxation of claims to publicly owned land that had not been perfected. Although the court clearly recognized that the property was still owned by the United States, it upheld the taxability of unperfected claims. The claimants had made improvements, had been in possession some 6 to 10 years or more, derived substantial revenues from such claims, and held possession against everyone except the true owner.
B. Valuation of Possessory Interests in Real Property

The value of privately owned leases of publicly owned real property is often determined by the "capitalization-of-net-income" method. Under this method an estimate is made of the net income to be produced by the property over the period of the lease. The present-day value of the right to receive such income is then determined. This amount is considered to be the value of the lease.

In determining the estimated net income to be produced over the period of the lease, it was the practice for many years to allow a deduction for the rent payable under the lease and also for amortization of improvements, if any, made by the lessee. Both such items, of course, are deductible for income tax purposes. A number of California cases held that such items were likewise deductible in determining the value of a lease for property tax purposes.\(^\text{11}\)

Eventually, however, the Assessor of San Diego County disallowed a deduction for both of the items. In *De Luz Homes, Inc. v. County of San Diego*,\(^\text{12}\) the California Supreme Court unanimously reversed its former view as to the proper treatment of rent and amortization of leasehold improvements. The court's views were expressed in a comprehensive opinion by Justice Traynor. These items were held not deductible because they constitute a part of the cost or purchase price of the interest being valued. In the words of Justice Traynor, "Rent paid for a leasehold interest, like the cost of improvements that revert to the lessor, is part of the cost or purchase price of the leasehold, and to include a deduction for it, is likewise to include an item of expense based on the answer, i.e., the value of the property."\(^\text{13}\)

The *De Luz* case is a landmark. It resulted in an enormous increase in the taxable values of privately owned leases in publicly owned real property. It received a great deal of attention and was bitterly criticized for some time after the decision. It seems eminently sound, however, and is still the law of California with respect to leases entered into after the case was decided.\(^\text{14}\)

\(^{11}\) See L.W. Blinn Lumber Co. v. County of Los Angeles, 216 Cal. 474, 14 P.2d 512 (1932); Hammond Lumber Co. v. County of Los Angeles, 104 Cal. App. 235, 285 P. 896 (1930).

\(^{12}\) 45 Cal. 2d 546, 290 P.2d 544 (1955). For a discussion of this case as well as the subject of taxation of possessory interests generally, see Keesling, *Property Taxation of Leases and Other Limited Interests*, 47 Calif. L. Rev. 470 (1959).

\(^{13}\) 45 Cal. 2d at 567, 290 P.2d at 558.

\(^{14}\) Shortly after *De Luz* was decided, the California Legislature enacted a statute
The capitalization-of-net-income method for the determination of the value of a leasehold interest in publicly owned property presents difficult problems, particularly when the property is used in the conduct of a business. In such cases it is necessary to estimate the amount of net income attributable to the property as distinguished from the amount of net income attributable to the services of personnel engaged in the business and the amount of net income attributable to capital invested in the business. This is a formidable task and often fraught with uncertainty. There is a simpler method for determining the value of a privately owned lease in publicly owned property: (1) determine the value of the publicly owned property in much the same manner as would be done if the property were privately owned and subject to taxation, (2) determine the present value of the remainder interest at the expiration of the lease by use of actuarial tables, and (3) subtract the value of the remainder interest so determined from the value of the entire property to obtain the value of the lease.\(^{15}\)

The simpler method can be illustrated by an example. A public agency leases land to X for a period of ten years. A survey of the selling price of comparable property in the area indicates that the land is worth $100,000. According to actuarial tables, using six percent as a reasonable rate of return, the remainder interest, which is exempt from tax, has a present value of $54,000. The $46,000 difference between this figure and the total value of the property represents the value of the lease subject to tax. If a higher rate of return than six percent is employed, the value of the remainder interest will be reduced and the value of the lease will be increased. Thus, if a nine percent rate of return is used, the value of the remainder in the above example would be $42,000, and the value of the lease would be $58,000. This method of determining the value of a privately owned lease of publicly

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\(^{15}\) This simplified method of determining the value of a privately owned lease of publicly owned property had previously been suggested by the author. See Keesling, note 12 supra.
owned property was upheld by the California Supreme Court in *Riverside County v. Palm-Ramon Development Co.*

**C. Possessory Interests in Personal Property**

In connection with the construction of ships and airplanes, the federal government often arranges to purchase and hold title to the machinery and equipment necessary to perform the construction work and makes such items available to the construction companies. The presumed purpose of such an arrangement is to avoid the personal property taxes which would be assessed if the construction companies purchased such items themselves. One might reasonably expect that insofar as the taxation of possessory interests is concerned there should be no difference between real property and personal property. Thus, one might expect that construction contractors could be taxed on the value of the right to use the machinery and equipment purchased by the government and made available to them.

In *General Dynamics Corp. v. County of Los Angeles* the California Supreme Court, again in an opinion by Justice Traynor, held that so far as the California Constitution is concerned there is indeed no difference with respect to the taxation of possessory interests in real and personal property. The opinion points out, however, that statutes enacted by the legislatures over the years have drawn a distinction. The statutes have consistently provided for taxing the right to the possession of real property, but with no similar provision for personal property. This omission, the court concluded, "reflects not merely a lack of detail, but a consistent pattern of taxing tangible personal property as an entity or not at all." It is clear from the court's opinion that the legislature could provide for the taxation of privately held possessory interests in publicly owned personal property. Moreover, the legislature could possibly go even further and subject the person in possession to a tax on the full value of such property, including the value of the publicly held remainder interest as well as the value of the privately held possessory interest.

In a sense the opinion of the court in *General Dynamics* constituted an invitation to the legislature to act. The legislature, however, has not acted and as a result possessory interests in

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18. Id. at 65, 330 P.2d at 797.
publicly owned personal property, unlike possessory interests in publicly owned real property, are not taxed.

D. Leases of Personal Property Title of Which Is Held by Insurance Companies

In California, as in most states, insurance companies are subject to a gross premiums tax for state purposes in lieu of all other taxes except taxes on real property. Thus, personal property owned by such companies is exempt.

Many insurance companies use their reserves to construct their own office buildings. Space not used by the company itself is leased to other parties. In an effort to obtain an exemption from taxation of furniture and equipment needed by tenants, some insurance companies arrange to purchase those items and make them available to the tenants under the terms of a lease with, of course, an appropriate adjustment in the rent. Suppose, for example, an insurance company leases an entire floor in an office building owned by it to a large oil company to be used as the tenant’s executive offices. The oil company plans to purchase furniture and equipment including electric typewriters, bookkeeping machines, computers, etc., at a total cost of approximately $500,000. At the tax rates prevailing in California until Proposition 13, the annual tax would amount to between $15,000 and $20,000 per year if the property were purchased and owned by the tenant. Arrangements are made, however, whereby the tenant gives the insurance company a list of the items it plans to acquire, and the insurance company makes the purchase. Since the personal property of insurance companies is exempt from tax, the property in this example, so it is commonly believed, is exempt from tax.

In view of General Dynamics this claim for exemption cannot be defeated on the theory that the tenant has a taxable possessory interest in the personal property. There are, however, other theories available to support a tax on the entire value of the property. In some instances it may be possible to establish that the lease arrangement is a sham, that the insurance company simply acted as an agent for the tenant in purchasing the furniture and equipment, and that in truth and in fact, as well as in law, the property is owned by the tenant.

In other cases, it may be possible to establish that the lease actually constitutes a sale from the insurance company to the tenant because the tenant acquires the right to use the property for a period substantially equal to its useful life. If, for example,
the term of the lease is for a period of eight years or more and the
furniture and equipment has an estimated useful life of ten years
or less, which is usually the case, the tenant should be considered
as the owner of the property and the property should be fully
subject to tax. The Internal Revenue Service has long held that
a person who has the right to the possession of personal property
for a period substantially equal to its useful life should be consid-
ered the owner for federal income tax purposes even though the
transaction whereby possession is acquired is called a lease.\textsuperscript{19}

This proposition is also supported by the opinion in \textit{General
Dynamics} where Justice Traynor indicated that under given cir-
cumstances the right to the possession of property may be treated
as the equivalent of ownership even though the transaction is
given a different label.\textsuperscript{20} Justice Traynor gave careful con-
sideration to whether the taxpayer in that case should be considered
the owner of the property, even though title was held by the United
States. He pointed out that the United States exercised close
supervision and control over the property and for that and other
reasons the taxpayer did not become the owner of the property.
In other cases, such as those involving so-called leases of personal
property from insurance companies, a different conclusion might
well be reached.

\textbf{E. Movable Instrumentalities of Interstate and Foreign Commerce}

The question as to jurisdiction to tax movable instrumental-
ities of interstate and foreign commerce, such as ships, rolling
stock of railroads, and airplanes, has long been a subject of con-
troversy and confusion. For many years the United States Su-
preme Court held that in the absence of a permanent situs in
some other state or country, such property could be taxed only
in the state or country of the owner’s domicile or the home port
of the property.

In \textit{Hays v. Pacific Mail Steam-ship Co.}\textsuperscript{21} the County of San
Francisco, shortly after California was admitted to the Union,
attempted to tax a vessel operating between New York, San Fran-
cisco, and ports in the Territory of Oregon. The vessel apparently
spent considerable time in San Francisco. The tax was assessed
in the belief that it had acquired a permanent situs in the County

\textsuperscript{20} 51 Cal. 2d at 67-68, 330 P.2d at 798-99.
\textsuperscript{21} 58 U.S. (17 How.) 596 (1854).
of San Francisco. The United States Supreme Court held that the vessel could be taxed only in the State of New York where the owner was domiciled and where the vessel had its home port.

The case of *Southern Pacific Co. v. Kentucky*\(^2\) was concerned with the jurisdiction to tax twenty vessels owned by the company, two of which operated between New Orleans and Havana, five between New York and New Orleans, and thirteen between New York, New Orleans, and Galveston. The company was incorporated in Kentucky in 1884, and at the time the case arose still had its principal place of business in that state. The vessels were enrolled in New York and bore on their sterns the name of that port. The Supreme Court first considered whether the vessels had acquired a permanent situs in New York, and answered that question negatively. The Court then proceeded to hold that Kentucky, as the domiciliary state, had jurisdiction to tax the vessels even though they had never been and probably never would be physically present there.

In *Northwest Airlines, Inc. v. Minnesota*\(^2\) the jurisdictional rules applicable to the taxation of oceangoing vessels were extended to aircraft. Thus Minnesota, as the home port of a fleet of aircraft operating in interstate commerce, was held to have jurisdiction to tax the entire fleet.

The Supreme Court has upheld the jurisdiction of states other than the state of domicile to tax the rolling stock of railroads on an apportionment basis since 1891. The apportionment basis gives recognition to the fact that although a particular item of property may not be in a state permanently, certain items of similar property may be present in the state more or less continuously. Under this method an effort is made, by the use of an appropriate formula, to determine the average number of items of property within the taxing state throughout the year. This amount is considered to have acquired a situs in the state for the purpose of taxation.

The apportionment rule was first upheld by the United States Supreme Court in *Pullman's Palace Car Co. v. Pennsylvania*.\(^4\) It was subsequently upheld in numerous other cases involving rolling stock. In *Ott v. Mississippi Valley Barge Line Co.*\(^5\) the home-port doctrine was repudiated and the apportionment rule was applied.

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2. 222 U.S. 63 (1911).
tionment method upheld as applied to tugs and barges operating on inland waterways. In the course of its opinion, the Court stated:

We see no practical difference so far as either the Due Process Clause or the Commerce Clause is concerned whether it is vessels or railroad cars that are moving in interstate commerce. The problem under the Commerce Clause is to determine "what portion of an interstate organism may appropriately be attributed to each of the various states in which it functions." . . . So far as due process is concerned the only question is whether the tax in practical operation has relation to opportunities, benefits, or protection conferred or afforded by the taxing State. . . . Those requirements are satisfied if the tax is fairly apportioned to the commerce carried on within the State.26

Predictably, in Braniff Airways, Inc. v. Nebraska State Board of Equalization27 the apportionment method was also held to apply to aircraft flying in interstate commerce.

If property is taxable by the state of domicile and also by other states on an apportionment basis, double taxation will result. In Standard Oil Co. v. Peck28 the Court solved this dilemma by holding that property taxable in two or more states on an apportionment basis may not be taxed in the state of domicile. Thus, the Court applied the same rule that has long been recognized in the case of property that has acquired a tax situs in some state other than the state of domicile by virtue of being permanently located in the other state.

In Scandinavian Airlines System, Inc. v. County of Los Angeles29 the California Supreme Court had occasion to consider whether the apportionment method could be applied in the case of airplanes that were owned, based, and registered in one or another of three Scandinavian home ports, were operated exclusively in foreign commerce, were taxed by the country in which the home port was located, and were physically present in the taxing county and city (Los Angeles) on only eight occasions during the year. The majority of the court, in an opinion by Justice Peters, held that the apportionment method could not be used and that the planes were taxable only by the foreign countries in

26. Id. at 174 (citations omitted) (quoting Nashville, C. & St. L. Ry. v. Browning, 310 U.S. 362, 365 (1940)).
which the owners were domiciled and in which the planes had their home ports. In fact, Justice Peters' opinion indicated that instrumentalities operating on or over the high seas, whether in interstate or foreign commerce, cannot be taxed by the apportionment method:

The language and rationale of the decisions create the inference that, should the United States Supreme Court be presented with a situation involving airplanes engaged in foreign commerce, or planes engaged in interstate commerce via international routes, it would apply the same doctrines it has consistently applied to ocean-going vessels similarly engaged.36

In his opinion Justice Peters referred to the possibility of double taxation as a reason for prohibiting the application of the apportionment method to instrumentalities of foreign commerce. He pointed out that in the case of foreign commerce, unlike interstate commerce, the courts of this country cannot prevent double taxation by prohibiting taxation at the domicile of the owner or the home port of the instrumentalities in question. For this and other reasons he concluded that foreign commerce is peculiarly a concern of the federal government and that in the absence of treaties or congressional legislation specifically permitting taxation, state taxation of instrumentalities engaged in foreign commerce is not permissible.

Justice Traynor wrote a vigorous dissenting opinion, concurred in by Chief Justice Gibson. Justice Traynor discussed at considerable length the reason why foreign commerce and interstate commerce should be treated alike for state taxation purposes. He pointed out that when the home-port doctrine with respect to vessels operating in interstate or in foreign commerce originated years ago, the apportionment method had not yet been formulated. Since then the use of apportionment in interstate commerce has been firmly established. If not applied to instrumentalities employed in foreign commerce, the result would clearly discriminate against interstate commerce.

With respect to the argument that application of the apportionment method for foreign commerce may result in double taxation, he stated emphatically:

This argument erroneously attributes to such taxation the risk of discrimination. Actually it is attributable to the freedom of foreign countries, not permitted to our own states, to adopt rules

30. Id. at 28, 363 P.2d at 35, 14 Cal. Rptr. at 35 (footnote omitted).
of their own that can result in multiple burdens. The court cannot prevent foreign countries from taxing instrumentalities of foreign commerce owned by their domiciliaries even if those instrumentalities are permanently located here, just as it cannot prevent foreign countries from taxing American aircraft temporarily abroad even though they have been taxed at full value at the domicile of their owners here. It is without power to compel independent nations to adopt a uniform nondiscriminatory system of taxation. It does not follow that the states must forego the power to impose taxes that are not in themselves discriminatory. It bears noting that Congress remains free to prohibit altogether state taxation of instrumentalities of foreign commerce. Alternatively, treaties could govern such taxation to preclude the risk of discrimination.31

Justice Traynor's analysis is much preferable to that of Justice Peters. The apportionment method permits taxation by the jurisdiction where the property is physically present and which gives it protection. If all jurisdictions employed it, there would be neither double taxation nor discrimination against one form of commerce in favor of another. The federal government should endeavor to negotiate treaties with various other countries requiring that this method be used.

In Sea-Land Service, Inc. v. County of Alameda32 the California Supreme Court was presented with the question whether the apportionment method can be applied in the case of sea vans employed in both interstate and foreign commerce and owned by a corporation organized in Delaware and having its principal place of business in New Jersey. The court unanimously upheld the apportionment method and distinguished Scandinavian Airlines on several grounds. First, in Scandinavian Airlines the planes were operated exclusively in foreign commerce, whereas the sea vans in Sea-Land were used in interstate commerce as well as foreign commerce. In addition, the aircraft in Scandinavian Airlines had only minimum contacts with Los Angeles, the jurisdiction that sought to tax them, whereas the containers involved in Sea-Land had a daily contact with Alameda County and the City of Oakland.

In Japan Line, Ltd. v. County of Los Angeles33 the California Supreme Court again considered the application of the apportionment method to sea vans continuously in the taxing jurisdic-

31. Id. at 44-45, 363 P.2d at 45, 14 Cal. Rptr. at 45 (Traynor, J., dissenting).
tion. In this case, unlike Sea-Land, the owner of the vans was domiciled in a foreign country, Japan, the vans had their home port there, they were used exclusively in foreign commerce, and they were taxed in Japan. Thus, the issue presented was identical to that presented in Scandinavian Airlines. A unanimous court upheld the tax. It is apparent from both the decision and the opinion that the court was more favorably impressed with Justice Traynor’s dissenting opinion in Scandinavian Airlines than with the majority opinion of Justice Peters.

So far, so good. If the United States Supreme Court had upheld the California Supreme Court, all instrumentalities of commerce, insofar as United States taxes are concerned, would have been taxed alike regardless of whether used in interstate commerce, foreign commerce, or partly in both, and likewise regardless of where the owner is domiciled and where the instrumentalities’ home port is located. Such a decision upholding the use by a state of the apportionment method would have provided a substantial incentive to foreign countries using the home-port doctrine to eliminate double taxation by either abandoning the doctrine or entering into treaties with the United States prohibiting its use and substituting the apportionment method.

Unfortunately, the United States Supreme Court, somewhat surprisingly, reversed the California Supreme Court,34 thus removing any incentive on the part of foreign countries to abandon their antiquated conceptions of jurisdiction. In an uninspired opinion, the Court emphasized that commerce with foreign countries is a matter of peculiar concern to the federal government. It completely disregarded Justice Traynor’s view as to responsibility for the risk of double taxation as between the home-port doctrine and the apportionment method. It simply repeated Justice Peters’ point regarding the California court’s inability in the case of foreign commerce to prevent double taxation by prohibiting the use of the home-port doctrine.

As a result of the Supreme Court decision there are only two areas where there can be any certainty as to the jurisdiction of the states to tax instrumentalities of foreign or interstate commerce. One of these is in cases that present the same basic factual situation as was presented in Scandinavian Airlines and Japan Line, i.e., the owner of the instrumentalities is domiciled in a foreign country, the instrumentalities have their home port in the

foreign country, they are used exclusively in foreign commerce, and they are taxed by the foreign country. In these cases the states are without jurisdiction to tax. The other situation occurs where the instrumentalities are owned by a corporation domiciled in one of the states and are used exclusively in interstate commerce on or over land or inland waters. In such cases the states may tax on an apportioned basis only. In all other cases the question of the jurisdiction of the states to tax is left by Japan Line in a state of considerable uncertainty. A few of the possible fact patterns will be briefly discussed.

1. The facts are the same as those in Scandinavian Airlines and Japan Line, except that the instrumentalities are not taxed by the foreign country. Although one cannot be certain as to the answer, from a careful reading of the Supreme Court's decision it is possible to glean some support for the proposition that the possibility alone of foreign taxation—even without actual taxation—is sufficient to prohibit the states from using the apportionment method in the case of foreign-owned instrumentalities used exclusively in foreign commerce.35

2. The factual situation is the same as in Scandinavian Airlines and Japan Line, except that the instrumentalities are used not only in foreign commerce between the country of the owner's domicile and the United States, but are also used in interstate commerce between various states and may or may not be taxed by a foreign country. This example presents a closer question than the previous one. Surely one might think that the states should have jurisdiction to tax instrumentalities used in interstate commerce. However, there is the same risk of foreign taxation and hence double taxation as in the case of foreign-owned instrumentalities employed exclusively in foreign commerce. This circumstance may well lead the Court to extend its decision in Japan Line to all foreign-owned instrumentalities operating in foreign commerce notwithstanding that they may be used in interstate commerce as well.

3. The foreign-owned instrumentalities operate exclusively in interstate commerce on or over international waters, such as ships or aircraft operating between various mainland states and Hawaii, or between Alaska and other states on the West Coast. It may be recalled that Justice Peters, whose views obviously found favor with the United States Supreme Court in Japan Line,

35. Id. at 447-48.
predicted that if such a case ever came before the United States Supreme Court, it would uphold the home-port doctrine to the exclusion of the apportionment method.36

4. The owner of instrumentalities of commerce is domiciled in one of the states and the instrumentalities have their home port in the same state. The instrumentalities are used exclusively in foreign commerce. Insofar as ownership and home port are concerned, this is the converse of Scandinavian Airlines and Japan Line. One might expect a converse answer, i.e., that such instrumentalities could be taxed by the state in which the owner is domiciled and the instrumentalities have their home port to the exclusion of taxation elsewhere. However, as Justice Traynor pointed out in his dissenting opinion in Scandinavian Airlines, in such a case as well as others, the courts of the United States are unable to control the taxation of instrumentalities of commerce by foreign countries. It is certainly possible that sooner or later some foreign country may develop the practice of applying the apportionment method to instrumentalities of commerce more or less continuously within their borders even though they are owned and domiciled elsewhere. Accordingly, taxation by the state of domicile or home port would involve the risk of double taxation. There is nothing in the opinion of the Court in Japan Line to suggest that the decision turned on foreign domicile and that a different answer would result in a case where the instrumentalities of foreign commerce are owned by a domiciliary of the United States. Thus, the Court may forbid taxation by the state of domicile or home port of instrumentalities of foreign commerce.

Whether or not the states can tax on an apportioned basis is questionable. Just as San Francisco in the Hays case endeavored to tax the entire value of a vessel within the county even though the owner was domiciled elsewhere, so some foreign country may endeavor to tax vessels present within that country even though the owner is domiciled in the United States or some other country. In Hays the United States Supreme Court denied San Francisco the right to tax, but the courts of some foreign country may well reach a different conclusion. Hence it is at least arguable that state taxation on an apportioned basis is forbidden because of the possibilities of double taxation involved.

5. Instrumentalities of commerce operating in both foreign

36. 56 Cal. 2d at 36, 363 P.2d at 40, 14 Cal. Rptr. at 40.
commerce and interstate commerce are owned by a domiciliary of one of the states and the instrumentalities have their home port in the same state. This factual situation includes an enormous volume of property worth untold billions of dollars. It includes instrumentalities of many major airlines and many major shipping lines as well. It is no exaggeration to state that the question as to the jurisdiction of the states to tax the instrumentalities of these lines operating in both interstate and foreign commerce presents the most serious property tax problem that has ever existed at any time in the United States. In view of the United States Supreme Court’s decision in *Japan Line*, one can only conjecture as to how the problem will be solved.

**F. Public Utility Property**

Under the “separation of sources system” adopted in California in 1910, public utilities became subject to a tax on gross receipts, to be used exclusively for state purposes, in lieu of all other taxes including local property taxes. This arrangement was not a success. There was a widespread belief that by playing politics, public utilities were able to keep the rate of gross receipts tax so low that the utilities did not bear their fair share of the tax burden. Furthermore, even back in the 20's and early 30's when tax rates were relatively low compared to modern standards, there were widespread complaints concerning high local property taxes. In addition, the public schools needed additional funds.

In 1933 Dixwell Pierce, Secretary of the State Board of Equalization, which administered the gross receipts tax, conceived a program that came to be known as the Riley-Stewart Plan. It provided for the repeal of the gross receipts tax and the return of public utility property to local tax rolls, thereby broadening the tax base and, hopefully, resulting in lower tax rates. It also provided for the enactment of a general sales tax to replace the revenue that would otherwise have been produced by the gross receipts tax and to provide additional funds to distribute to local school districts. A constitutional amendment incorporating many of these proposals was adopted in June 1933.

One important feature of the program was a provision requiring public utility property to be assessed centrally by the State

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37. See note 8 and accompanying text *supra*.
38. Riley at the time was State Controller and ex-officio member of the State Board of Equalization. Stewart was a member of the board. Both men are now deceased.
39. See *Cal. Const.* art. 4, § 34a, art. 11, §§ 12, 20, art. 13, §§ 14-16.
Board of Equalization. This provision, which also originated with Dixwell Pierce, was a stroke of genius. Utility property often extends into numerous taxing jurisdictions such as counties, cities, school districts, flood control districts, and many other special taxing agencies. Often, such as with railroads, telephone and telegraph lines, and express companies, public utility property extends into other states as well. The task of determining the value of the entire system and then determining how much of that value is attributable to the portion of the system within each of the numerous local taxing districts is hopelessly beyond the ability of most local assessors. Furthermore, the requirements of furnishing the necessary information to numerous local assessors imposes substantial burdens upon the utilities. These problems are solved by central assessment of utility property, which permits the development of an adequate staff of experienced personnel. Over the years the provision for central assessment has worked exceedingly well and there has been little, if any, criticism of it.

G. Motor Vehicles

For many years in California, motor vehicles, including trucks, were assessed and taxed locally the same as other personal property. In cases where the taxes were secured by real property, and also where the taxes were unsecured but were substantial in amount, it was usually possible for local tax collectors to effect collection without much difficulty or expense. But in cases where the tax on motor vehicles was both unsecured and relatively small in amount, collections were poor. In these cases the owners of motor vehicles often ignored their tax bills with impunity.

To correct this situation, Dixwell Pierce conceived the idea of arranging to have local property taxes on motor vehicles paid at the same time and as a part of the annual registration fee. A bill so providing was enacted by the legislature in 1935.40 Since then, when Californians pay their annual state motor vehicle license fee they, in effect, pay two fees.41 One is a registration fee, which incidentally is not deductible for federal or state income tax purposes, and the other is a license fee in lieu of local property taxes, which is deductible.

II. BANK AND CORPORATION FRANCHISE TAXES

During the years 1911 through 1928 corporation franchises and bank shares were subject to an ad valorem tax, which was to be used exclusively for state purposes. The rates were determined by the state legislature and the tax was administered by the State Board of Equalization. Pursuant to a recommendation made by a tax commission appointed in 1927 by Governor C.C. Young, the California Legislature in 1929 replaced the ad valorem tax with a franchise tax measured by income, one of the alternate methods of taxing national banks permitted by federal law.

The office of Franchise Tax Commissioner was created to administer the tax. Charles McColgan was Franchise Tax Commissioner for many years. During his administration, particularly during the years 1933 to 1939, a great many new policies were instituted. Because of illness, McColgan was compelled to resign in 1951, at which time the position of Franchise Tax Commissioner was abolished and replaced by the Franchise Tax Board. For the most part, the Board has delegated its function to its executive officer, who for many years was Martin Huff, an able tax administrator. He did an outstandingly competent job of administering the franchise tax, the California personal income tax, and the California corporate income tax.42

Under the measured-by-net-income method, the franchise tax for a given year is measured by the income for the preceding year. Thus, the first tax under the new method was for the year 1929—measured by net income for the year 1928.

A. Income from Tax-Exempt Bonds

From the inception of the measured-by-net-income method, the Franchise Tax Commissioner took the position that the measure of the tax included interest on federal and state bonds, which could not be taxed directly. This policy was upheld in Pacific Co. v. Johnson.43

42. Martin Huff was largely responsible for California adopting the Uniform Division of Income for Tax Purposes Act and for California becoming a member of the Multistate Tax Compact. He also actively opposed the inclusion in a treaty with the United Kingdom of a provision that would have prevented the application of California's so-called unitary method to United Kingdom corporations deriving income from sources in the United States. See text accompanying notes 62-63 infra. He has also repeatedly and aggressively opposed the enactment by the California Legislature of provisions that would prevent the application of the unitary method to either domestic or foreign corporations to the extent their income is derived from foreign countries. He retired as Executive Officer of the Franchise Tax Board effective Dec. 31, 1979.

B. Rate of Tax on Banks and Financial Corporations

In 1931 the California Legislature appropriated funds for a Tax Research Bureau. The bureau was organized and commenced functioning in 1932 under the direction of the members of the State Board of Equalization and its secretary, Dixwell Pierce. During 1932 and early 1933 the counsel and assistant counsel for the bureau prepared a 200-page report recommending numerous changes in the Bank and Corporation Franchise Tax Act. One of the changes recommended related to the rate of tax on banks and financial corporations.

Under applicable federal law, banks were subject to only two types of taxes—the tax measured by net income and local real property tax. The rate of tax measured by income could not be higher than the highest rate on general business corporations, nor higher than the rate on financial corporations. Banks could not be taxed on their personal property, such as money, accounts receivable, and other personal property such as furniture, equipment, motor vehicles, etc. Other corporations, including financial corporations, were required to pay the same taxes as banks, i.e., a tax measured by income and local real property taxes, and in addition were subject to tax on their personal property. As a result, the burden of taxation on these other financial corporations was considerably higher than it was on banks.

To correct the inequality, the report recommended that banks be required to pay an additional rate of tax, measured by net income, equal to the proportion of net income that general business corporations pay in personal property taxes. To make certain that the rate of tax on banks would not be higher than that imposed upon financial corporations, it was recommended that the additional rate be imposed upon financial corporations as well, but they should be allowed an offset for the amount of local personal property taxes paid by them.

Representatives of banks strongly objected to the proposal on the ground that it violated federal law restricting the rate of tax. However, Roger Traynor, who had made an extensive study of

44. Roger Traynor was counsel to the Tax Research Bureau and the author was assistant counsel. For a detailed discussion of the recommendations in the report, see Traynor and Keesling, Recent Changes in the Bank and Corporation Franchise Tax Act (pts. 1-3), 21 CALIF. L. REV. 543 (1933), 22 CALIF. L. REV. 499 (1934), 23 CALIF. L. REV. 51 (1934).

national bank taxation and had written an article on the subject that was published in 1929, was of the opinion that the term "rate" in the federal law did not mean "arithmetical" rate, but instead meant "burden." In other words, he believed that the arithmetical rate of tax measured by the net income of banks could be higher than the arithmetical rate imposed upon other corporations provided the total burden of state and local taxes on banks was not greater than that imposed upon other corporations.

When it became apparent that the report's proposal might be approved by the legislature, the banks offered to withdraw their opposition before the legislature if the differential in arithmetical tax rates were limited to four percent. This was agreed to and legislation embracing the report's recommendation was duly enacted. The banks then began preparations for extensive and aggressive litigation of the validity of the higher arithmetical bank tax rate. After several years a case involving the issue came to trial in the superior court in Sacramento, California. James Sabine of the Attorney General's office was in charge of the case for the state. After a lengthy trial, the superior court upheld the tax. Its judgment was unanimously affirmed by the California Supreme Court in an opinion by Chief Justice Gibson.

The provisions for an additional rate of tax on banks and financial corporations have continued in effect to the present time. For the most part throughout the years the differential has amounted to the maximum of 4%, or to approximately that amount. As a result of the adoption of Proposition 13 the rate of tax on personal property may not exceed 1% of the fair market value. Because of a 50% exemption applicable to inventories, the rate of tax on inventories is only 1/2%. Thus, for years after Proposition 13 the differential will be substantially less than 1%. It is questionable whether such a small differential is worth the time and effort involved in making the necessary computations to determine the amount of the differential. One solution is to eliminate the differential entirely. Another is to establish a statutory specific differential of 1/2% or 3/4%, thereby eliminating the

47. Id. at 107-08.
49. See note 6 supra.
complex and administratively expensive task of annually determining the percentage of net income paid by general business corporations in personal property taxes.

C. Deductions for Federal Income Taxes

The original Bank and Corporation Franchise Tax Act provided for a deduction for federal income taxes. The report prepared for the Tax Research Bureau in 1933 recommended that this deduction be eliminated. The rationale was that it was appropriate for the state to apply its tax to a corporation's total income without diminution for the amount of income taxes paid to another jurisdiction such as the United States, another state, or a foreign country. This principle was recognized in the original act insofar as taxes paid to other states and foreign countries were concerned, but, inconsistently, was not followed with respect to the federal tax. The report's recommendation was approved by the legislature. Later, when the state adopted a personal income tax, consistently with the treatment for franchise tax purposes, no deduction was allowed for taxes paid to other jurisdictions, including the United States.

D. Basic Date

The original act provided that for the purpose of determining gain or loss and depreciation, the basis of property should be its fair market value as of January 1, 1928. The report recommended that the basic date be changed to March 1, 1913. There were two reasons for this. One was to make the state law conform to the federal, which used March 1, 1913, as the basic date, and the other was to permit increases in the value of property occurring before January 1, 1928, but realized thereafter, to be included in the measure of the franchise tax. This recommendation was likewise approved by the legislature. The validity of the change to March 1, 1913, basic date has never been litigated with respect to the franchise tax. A comparable provision in the state personal income tax was challenged on constitutional grounds, but was upheld by the California Supreme Court in *Holmes v. McCollan*.

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51. A less elegant way of expressing the same principle is to say that a state should be able to take a slice of "the entire pie without diminution by the slices taken by other jurisdictions."

52. 17 Cal. 2d 426, 110 P.2d 428 (1941).
E. California's Unitary Policy

With the exception of Proposition 13, California's best known contribution to state and local taxation is the one which in recent years is usually referred to as California's unitary policy.33 This policy has two parts. One part consists of a rule, adopted in 1935, requiring that the formula method34 be used to apportion the income of a unitary business operated within and without California. The second part consists of a rule, adopted in 1936, extending the unit method to a unitary business operated by two or more affiliated corporations. In these cases the income attributable to the state is computed in much the same manner as it would be if the business had in fact been operated by one corporation. A combined return is required that reports the combined income of all the different entities nominally operating the business; the combined property, payroll, and sales of the business; and other information needed to determine the amount of income from the business that is attributable to the state.

Both of these rules constitute extensions or developments of an evolutionary process that commenced during the latter part of the nineteenth century in connection with the application of state and local property tax laws to railroads, telephone and telegraph lines, and the property of express companies. The owners of such property insisted that the value of the portion of their property located in any given state should be determined on the basis of local fair market values in the same manner as similar property used in purely local businesses. Most of the states insisted, however, that property obtains an additional or greater value when used as an integral part of a vast and profitable interstate system.

53. The author was counsel to the California Franchise Tax Commissioner from Sept. 15, 1935, to July 15, 1939. During this time he initiated California's so-called unitary policy and the other policies relating to the California franchise tax that are discussed below. He also conceived the idea for a separate corporation income tax, see text accompanying note 87 infra, the use of residence rather than domicile as a test of jurisdiction for the California personal income tax, see text accompanying note 92 infra, the credit provisions of the California personal income tax, see Section IV-C infra, and the rule that income of estates and trusts for the year of distribution is taxable to the beneficiaries rather than to the estate or trust, see Section IV-D infra.

54. Under the formula method of apportioning the income of a unitary business, the net income from the unitary business is calculated, and a formula which gives weight to the various factors responsible for the earning of income such as property, payroll, and sales is applied to determine the amount of income attributable to the portion of the business within the state. Each factor in the formula is computed as a ratio, the numerator of which represents the portion of that factor attributable to the state, and the denominator of which represents the amount of that factor for the entire business. See G. Altman & F. Keesling, Allocation of Income in State Taxation 97 (2d ed. 1950).
Accordingly, these states valued the portion of the property within their borders by first computing the entire value of the system of which the property was a part and then apportioning the total or unit value by a formula. The formula most commonly used for this purpose was the single factor of mileage. In numerous cases the United States Supreme Court upheld the unit rule.55

In the early part of this century the states began to impose on corporations income taxes or franchise taxes measured by income. In the case of corporations operating a business within and without a taxing state it was a common practice to compute the income attributable to the state by computing the income from the business as a unit and apportioning the income by the application of a formula. In the early days the formula commonly used consisted of the single factor of property. This method was upheld by the United States Supreme Court in two leading and well-known cases, one of which involved a domestic corporation engaged principally in interstate commerce,56 and the other a foreign corporation that manufactured its product in a foreign country and sold it through branches in numerous countries including the United States.57

In a third well-known case58 the United States Supreme Court, without repudiating the formula method, repudiated the results that it produced in the case before it, i.e., the attribution of some eighty-nine percent of a corporation's income to the state where its manufacturing operations were located, a result, the Court held, that did not give sufficient weight to the corporation's extensive selling activities in other states.

Following the decision in this case, the single factor formula of property was abandoned by the states. In time, the states adopted other formulas, some a two-factor formula consisting of the factors of property and sales, and others the three-factor formula of property, payroll, and sales, commonly known as the Massachusetts Formula. Many of the states, particularly the southern states, continued to permit, and even favored, the use of separate accounting to apportion the income of interstate businesses without regard to whether the businesses were unitary or not. It is questionable whether even among the states that made

extensive use of the formula method there was any state which prior to 1935 had specific clear-cut rules as to when the method should be employed.

From the inception of the measured-by-net-income method in California, extensive use was made of the formula method; but for several years there were no definite rules as to when it should be used. Instead, the choice of methods was left to the judgment of individual auditors with little or no guidance as to when one method rather than the other should be employed. The rule that was adopted in 1935⁵⁹ clarified the matter substantially. At least the auditors knew that the choice of methods should be made according to a rule and not haphazardly or capriciously, and certainly not on the basis of which method would produce the greatest amount of revenue for the state.

The rule that was adopted in 1936⁶⁰ definitely plowed new ground. Prior to its adoption no other state had ever required that the income of a unitary business conducted by two or more corporations be computed on a combined basis.⁶¹ Since 1936 nine other states have adopted the combined-return approach. However, most of the states that tax corporations on or measured by income apply the formula method on a corporation-by-corporation basis. In these states, if a corporation is dissatisfied with the results obtained by the formula method, it can easily obtain a computation by separate accounting through the simple expedient of organizing a separate corporation to conduct a portion of the business within a given state. The possibilities of tax avoidance by this method, coupled with the manipulation of transactions between commonly owned companies, are tremendous and well exploited.⁶²

Even in 1936, when California adopted its combined report approach, instances of multcorporate and multijurisdictional businesses were fairly common. Subsequently, in an effort to obtain a federal surtax exemption worth approximately $6000 per

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⁵⁹. See notes 54-55 and accompanying text supra.
⁶⁰. See notes 54-55 and accompanying text supra.
⁶¹. Years ago the New York State Tax Commission endeavored to compel a foreign manufacturing corporation with a New York selling subsidiary to compute the New York income from the business operated by the corporation by using a consolidated return. In People ex rel. Studebaker Corp. v. Gilchrist, 244 N.Y. 114, 155 N.E. 68 (1926), the New York Court of Appeals in an opinion by Justice Cardozo held that the tax commission was without authority to make such a requirement.
⁶². For a comprehensive discussion of the combined-return policy, see Keesling, California's Combined Report, 42 J. Tax. 106 (1975). This article is based on an address delivered to a meeting of the Multistate Tax Commission in 1974.
corporation, the use of numerous corporations to operate a single unitary business increased greatly. Corporations sprang up like mushrooms on a sunny day after a rain. In numerous cases as many as several hundred and in some cases 2000 or more corporations were organized for this purpose.

California’s unitary method has been given extensive publicity in recent years—largely because of its application to businesses conducted between one or more of the states and one or more foreign countries. The objection to the use of the unitary policy has been particularly vigorous in cases of businesses owned by foreign corporations unfamiliar with the policy, and which dislike paying the additional taxes that frequently result from its use. A few years ago the State Department negotiated a treaty with the United Kingdom, one of the provisions of which would have prohibited the application of the unitary policy in such cases. The State Department intended to negotiate similar treaties with various other countries. The adoption of treaties containing these provisions would have afforded domestic corporations operating businesses in foreign countries a virtually irresistible argument to urge that Congress, in order to prevent discrimination against them, should prohibit the states from employing the formula method in the case of businesses conducted partly in the United States and partly in one or more foreign countries. The provision was defeated, and rightly so.

If a method of apportionment is appropriate for use in the case of businesses operated between two or more states, it is equally appropriate in cases where the business is, in addition, operated partly in a foreign country. The location of the business, whether wholly within the United States or partly within the United States and partly within some foreign country such as Canada, Mexico, or England, is immaterial insofar as the question of the proper apportionment method to be used is concerned. There is ample precedent for this, and there is little doubt that the United States Supreme Court would so hold if the question should ever again be presented to it.

1. Cases upholding the unitary policy

In Butler Bros. v. McCollan the use of the formula method

63. See Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm’n, 266 U.S. 271 (1924). 64. 17 Cal. 2d 664, 111 P.2d 334 (1941), aff’d, 315 U.S. 501 (1942). The case was argued for the state by Valentine Brookes, then a deputy in the California Attorney General’s office. Justice Jackson of the United States Supreme Court called him into
was aggressively challenged. The company had its headquarters
office in Chicago, and operated seven wholesale department
stores located in as many states—one of which was California. All
merchandise for all stores was purchased by the Chicago office
and charged out to the stores at cost. The operations of the com-
pany as a whole produced a substantial profit. By the use of a
separate accounting computation the company reported a net loss
for the California store. However, the use of the formula method
attributed a substantial profit to the California store.

By buying in large quantities the company was able to realize
a purchasing profit in the acquisition of merchandise for all of its
stores. In support of the proposition that the business was unitary
and that the formula method should be used, it was urged that
the company was able to purchase in large quantities, and
thereby obtain a purchasing profit, only by selling in large quanti-
ties. The store in California contributed sales and thereby con-
tributed to the ability of the company to acquire its merchandise
for all of its stores at a lower cost than would have been possible
if the store had been operated separately. Thus, the California
store contributed to the company's earnings as a whole.

The use of the formula method was upheld by the California
Supreme Court. In its opinion the court relied heavily on the
relationship described above between sales and purchases. The
United States Supreme Court also upheld the use of the for-
mula.\textsuperscript{65} It stated that the relationship between sales and pur-
chases alone was sufficient to justify its use. It also stated that
anyone challenging the formula method has the burden of estab-
lishing that it produces an unreasonable result, and that the re-
sults obtained by a separate accounting computation cannot be
used to impeach the results obtained by the formula method.

The \textit{Butler Bros.} case is commonly considered as a leading
authority with respect to the apportionment of income for state
tax purposes. As such it ranks with \textit{Underwood Typewriter Co. v. Chamberlin}\textsuperscript{66} and \textit{Bass, Ratcliffe \\& Gretton, Ltd. v. State Tax Commission},\textsuperscript{67} the first two decisions of the United States Su-
preme Court to uphold the formula method in the apportionment

\begin{footnotesize}
66. 254 U.S. 113 (1920).
67. 266 U.S. 271 (1924).
\end{footnotesize}
of corporate income.

The case of *John Deere Plow Co. v. Franchise Tax Board* is also an important case upholding the unitary policy. In that case the taxpayer introduced voluminous evidence to the effect that wages and the value of property were higher in California than in various other areas where it did business. On the basis of this evidence it vigorously contended that the use of the three-factor formula of property, payroll, and sales would attribute an unduly large share of income to California. It therefore insisted that the formula method should not be used, but instead that its California income should be computed by separate accounting. The Court upheld the use of the formula, and stated that its reasonableness is beyond question.

In *Edison California Stores, Inc. v. McColgan* a corporation doing business in California was a member of a group of corporations consisting of a parent and fifteen subsidiaries, all engaged in the conduct of a multistate unitary business. The California income of the California subsidiary was computed by combining the total income of the parent and all the subsidiaries and apportioning such income by means of the three-factor formula of property, payroll, and sales in much the same manner as would have been employed if the business had been conducted by one corporation. In the course of its opinion upholding this method, the court stated:

The business of the parent and all of its subsidiaries is owned and managed under one centralized system, to the same extent as in the Butler Brothers case and other cases considered therein. Thus the business is unitary regardless of the fact that in the Butler Brothers case there was but one corporation involved, owning as parts of the unitary system seven different branches in as many states, and that in the present case there is a parent corporation owning and controlling as units of one system fifteen different branches organized as corporations in as many states. No difference in principle is discernible. If the crux of the matter is to ascertain that portion of the business which is done within this state, then the same considerations justify the use of the formula allocation method in the one case as in the other.

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68. 38 Cal. 2d 214, 238 P.2d 569 (1951), *appeal dismissed*, 343 U.S. 939 (1952). James Sabine was in charge of this case for the state. The firm of Kent & Brookes, see note 64 *supra*, represented the taxpayer.

69. 176 P.2d 697, *aff'd on rehearing*, 30 Cal. 2d 472, 183 P.2d 16 (1947). This is another important tax case in which James Sabine successfully represented the state.

70. *Id.* at 701-02, *aff'd on rehearing*, 30 Cal. 2d at 480, 183 P.2d at 21.
2. Extension of the unitary policy

In Superior Oil Co. v. Franchise Tax Board the California Supreme Court held that the formula method employed by the taxpayer rather than separate accounting employed by the tax board could be used by a nonintegrated oil company doing business within and without California. (A nonintegrated oil company is a company that neither operates refineries nor sells refined products at wholesale or retail in various states, but instead sells at the well all oil it produces.) Pursuant to this decision, the Franchise Tax Board extended the use of the formula method to companies operating mines, farms, bakeries, and other businesses in which all the products produced in a given state are sold within that state. All of these companies had previously been considered engaged in the conduct of separate businesses. The tax board has subsequently gone even further, and now holds that the unitary policy is applicable in any case where there is strong central management and there is centralized performance of various functions such as accounting, financing, advertising, purchasing of equipment and supplies, etc.

There has also been a great increase in the use of the formula method in other states. In the middle of the 1960's, many states, including California, adopted the Uniform Division of Income for Tax Purposes Act. This Act contains a provision requiring all business income to be apportioned by the formula method. California, like many other states, has interpreted this provision to apply only to unitary businesses.

Many tax administrators are of the opinion that all corporate income, nonbusiness as well as business income, should be apportioned. Such a policy would result in a sharp change in prevailing allocation and apportionment practices. It would also present serious constitutional questions in the case of corporations domiciled in other states or countries that have income derived from nonbusiness sources outside the taxing state, such as income from the rental or sale of real property not used in business, and interest or dividends or other income from intangibles that are commonly considered to be located at the domicile of the owner. California has not as yet adopted this policy, but continues to

71. 60 Cal. 2d 406, 386 P.2d 33, 34 Cal. Rptr. 545 (1963).
73. CAL. REV. & TAX. CODE § 25128 (West 1979).
3. Definitions of a unitary business

California has contributed two classic definitions of a unitary business—the "three unities" definition and the dependency-or-contribution definition. According to the first definition, a business is unitary if there is unity of ownership, unity of use, and unity of operation. According to the second definition, a business is unitary if the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state.

The three-unities definition first appeared in the state's trial brief in *Butler Bros.*, and was later incorporated verbatim in the concluding paragraph of the California Supreme Court's opinion in that case.75 The dependency-or-contribution definition first appeared in a treatise on allocation of income published in 1946,76 and shortly thereafter was used with approval by the California Supreme Court in its opinion in *Edison Stores*.77

Both definitions have been used extensively throughout the country. It is questionable, however, whether either of them is of much help in determining in any particular case whether the business activities in a given state constitute a separate business or whether they are part of a unitary business carried on within and without the state. In any given case there are two essential tests: (1) is it possible to identify receipts that are wholly attributable to property or services located or performed within the taxing state, and (2) is it possible to identify the direct expenses incurred in earning these receipts? Those who advocate the use of separate accounting in the allocation of business income commonly attribute to a given state receipts that are attributable in substantial part to property located or services performed outside the state. A classic example is the case of a company that manufactures a product in one state and sells it in other states. In these cases, contrary to the practice of advocates of separate account-

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75. 17 Cal. 2d at 678, 111 P.2d at 341-42. The trial brief was written by the author, but the three-unities definition was contributed by James Arditto, then a deputy in the office of the California Attorney General.


77. 176 P.2d at 702, aff'd on rehearing, 30 Cal. 2d at 480-81, 183 P.2d at 21.
ing, the receipts are not wholly attributable to the state of sale, but are attributable in large, but specifically unidentifiable part, to the manufacturing operations. Again, in many cases these receipts may be attributable to a substantial, but specifically unidentifiable, extent to management and the centralized performance of numerous services on behalf of the business as a whole. This was the situation in *Butler Bros.* Contrary to the contention of the company, the receipts from sales made by the California store were not wholly attributable to property or services performed in California, but were attributable to a substantial, but specifically unascertainable, extent to management, including purchasing functions, performed in Chicago. Furthermore, since the operation of the California store benefited the company's business in other states it was not proper to consider that the expenses incurred in operating the California store were wholly incurred in the earning of income in California.

Business methods have become so complex and interdependent that it is questionable whether there is any such thing as a nonunitary interstate business. Certainly instances where the business activities in any state can properly be considered for tax purposes as being separate and distinct from business activities carried on by the same taxpayer in other states are extremely rare.

**F. Commercial Domicile**

In 1936 the United States Supreme Court in *Wheeling Steel Corp. v. Fox*\(^7\) held that a corporation incorporated in one state could be taxed on accounts receivable by another state in which the corporation's principal place of business was located and where the accounts receivable were managed and controlled. In the course of its opinion the Court coined the phrase "commercial domicile."\(^7\)

Counsel for tax departments in many states thought the case was just another business situs case and of no particular significance. The counsel to the California Franchise Tax Commissioner was of a different opinion. He believed that the state of commercial domicile of a corporation could be substituted for the state of incorporation as the situs for tax purposes of all intangibles. If so, then in cases where the commercial domicile of a corporation

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\(^7\)8. 298 U.S. 193 (1936).
\(^7\)9. Id. at 211.
is located in a state other than the state of incorporation, income from intangibles such as interest on bonds and dividends from stock could be taxed or included in the measure of a tax by the state of commercial domicile rather than by the state of incorporation. Instructions to this effect were given to the audit department.

In *Southern Pacific Co. v. McCollan*\(^{80}\) the California District Court of Appeal in an opinion by Justice Peters\(^{81}\) held that the Southern Pacific Co., which was incorporated in Kentucky, had established a commercial domicile in California where it maintained large executive offices from which the company's vast business activities were managed and controlled. The case further held that the company's substantial income from stocks and bonds was properly includible in its entirety in the measure of the California franchise tax. Since then the commercial domicile doctrine has spread across the country and is used by virtually all states that impose taxes on or measured by income. It is also extensively used for determining the situs of intangibles for property tax purposes.

**G. Interest Equivalent Provisions**

In California, as in most other states, corporations with a domicile outside the state have for many years been permitted to exclude income such as dividends and interest from intangibles from the measure of the tax and to charge all interest expense to the unitary business income.

To illustrate, using rounded figures of an actual case, a corporation, prior to the deduction of interest but after deducting all other expenses, has a $10,000,000 income from a unitary business carried on in a number of states including California. It derives further income of $10,000,000 from dividends and interest. It has interest expense in the amount of $10,000,000. Since the corporation is domiciled in some state other than California it could exclude the dividend and interest income in computing the measure of the California franchise tax. The entire interest expense could be charged against the allocable business income with the result that it realizes no net income to be included in the measure of the tax.

81. This is the same Justice Peters who later wrote the majority opinion in the *Scandinavian Airlines* case. See text accompanying notes 29-30 supra.
In 1939 the California Bank and Corporation Franchise Act was amended to provide that in cases of this character the interest must first be charged against the income from intangibles not included in the measure of the tax, and only the excess, if any, would be allowed as a deduction from the unitary business income. Thus, in this example, under the amendment the interest is charged against the income from dividends and interest. Since there is no excess interest none is deductible in computing the corporation's unitary business income. Thus the company is considered to have realized a net income of $10,000,000 from its unitary business, which is apportionable by the usual formula. If in this example the interest expense had amounted to a figure in excess of the income from interest and dividends, such as $12,000,000, only the amount equal to the interest and dividend income is disallowed as a deduction, and the excess of $2,000,000 would be deductible from the unitary business income, thus reducing it to $8,000,000.

In 1957 the Act was further amended to apply a similar principle to corporations with a domicile in California. Thus, if in the above example the corporation were domiciled in California, under the amendment the entire interest expense would be charged against the income from interest and dividends that would otherwise have been included in the measure of the tax in its entirety. In this example there would be no interest remaining to charge against the unitary business income, but the result is still favorable to the corporation. The reason for this is that the interest is used to reduce income which would have been fully includible in the measure of the tax, whereas under the law prevailing previously the interest expense would have reduced the unitary business income, only a portion of which would have been included in the measure of the tax.

The above amendments are good as far as they go. They do not, however, go far enough. There is no reason why income from interest and dividends should be singled out for the purpose of determining the extent to which interest is deductible. The same principle should be applied in the case of any income not derived from the operation of a unitary business. Thus, suppose in the

82. See CAL. REV. & TAX. CODE § 24344 (West 1979).
83. See id. The idea for this amendment was contributed in 1957 by John Warren, who was then assistant counsel to the Franchise Tax Board. Shortly thereafter he left the tax board to enter private practice with the firm of Loeb & Loeb in Los Angeles, where he has been a partner for many years.
above example the corporation, instead of realizing $10,000,000 income from dividends and interest, had realized $10,000,000 from the rental of real estate not connected with its unitary business, or from the operation of a separate nonunitary business. The result should be the same as in the example. If the real estate or separate business is located outside the taxing state, the corporation’s income expense should be disallowed as a deduction in computing the unitary business income in an amount equal to the amount of the nonapportionable income. If, on the other hand, the real estate or separate nonunitary business is located in the taxing state, the interest expense should first be charged against the income from the real property or separate business and only the excess, if any, charged against the unitary business income.

Even such an extension of the interest equivalent principle does not go far enough. Not uncommonly corporations own non-unitary business assets, such as unimproved land held as an investment, or stocks in corporations that seldom declare dividends but instead accumulate most of their earnings and use them for expansion purposes. Why in such cases should all or most of the interest expense be charged against the unitary business income? Perhaps a more comprehensive solution should be adopted that would provide that interest expense should be apportioned between the two classes of assets—those used in the unitary business and those not so used—in the ratio which the value of each class bears to the total value of both assets. Thus, if the assets employed in a corporation’s unitary business have a value of $1,000,000, and the corporation owns separate assets of equal value, the total interest incurred or paid would be apportioned between the two classes of property with the result that only one-half would be deductible in computing the unitary business income and one-half would be considered as an expense of acquiring or carrying the nonunitary business assets and would be deductible, if at all, only to the extent such assets are located in the taxing state.

H. The Port-Day Formula

In the case of corporations operating instrumentalities such as ships and aircraft on or over the high seas, the normal application of the three-factor formula of property, payroll, and sales results in attributing a substantial amount of the corporation’s income to the operations on or over the seas. It is commonly considered that aircraft operated over states or countries in which
they do not land do not have a situs in those states and countries for tax purposes. Nevertheless, the normal application of the formula attributes a substantial amount of income to those states or countries.

The formula should be adjusted in such a manner as to apportion the entire unitary business income of a corporate taxpayer among the states or countries of the world in which it does business, with no income being apportioned to the area on, under, or over the oceans, and none to states or countries in which the taxpayer is not engaged in business. Years ago the California Franchise Tax Commissioner made such an adjustment, commonly known as the port-day formula.

Under the port-day formula, if the vessels operated by a steamship company were in California ports 50 days out of the year and were in other ports of the world 100 days of the year, one-third of the total value of the vessels (i.e., the proportion that the days in port in California bear to the total number of days in port in any state or country) would be included in the numerator of the property factor. Under the normal application of the three-factor formula less than one-seventh (the ratio which 50, the days in port in California, bears to 365, the total number of days in a year) of the value of the vessels would have been considered located in California.

In the case of the payroll factor, payroll attributable to the operation of vessels on the high seas is omitted from both the denominator and the numerator of the payroll factor with a result similar to that obtained in the case of the property factor. Similar adjustments were made in the formula applicable to companies operating aircraft.

The port-day formula was first used to allocate income pursuant to an administrative ruling, and language supporting such action was added to the Act itself in 1937. In 1957, however, representatives of corporations operating steamships and aircraft were successful in influencing the legislature to amend the Act to prohibit its use as applied to them. In Luckenbach Steamship Co. v. Franchise Tax Board the port-day formula was upheld for years prior to 1957 as a reasonable administrative apportionment.
policy. In addition, the port-day rule is still being used with respect to other property operated on, over, or under the high seas, such as cables and satellites. The port-day formula may well be used for the apportionment of the value of instrumentalities of interstate and foreign commerce for property tax purposes.

III. CORPORATION INCOME TAX

In Complete Auto Transit, Inc. v. Brady the United States Supreme Court held that a state franchise tax measured by income could be imposed upon a foreign corporation engaged in business exclusively in interstate commerce. The case represented a sharp change in the Court's position.

For many, many years the following rules were more or less axiomatic regarding the inclusion in the measure of a franchise tax of income from interstate or foreign commerce: (1) in the case of a corporation domiciled in the taxing state, all income from sources in the state, including income from interstate or foreign commerce, could be included in the measure of a franchise tax; (2) in the case of a foreign corporation, a franchise tax could likewise be measured by all income from sources in the state including income from interstate or foreign commerce provided the corporation was engaged in some local business; and (3) a foreign corporation doing business exclusively in interstate or foreign commerce could not be required to pay a state franchise tax measured by income.

In an effort to impose upon foreign corporations doing business exclusively in interstate or foreign commerce the same burden of taxation as borne by other corporations doing business in the state, California in 1937 adopted a separate corporation income tax applicable principally to such foreign corporations. The Corporation Income Tax Act does not provide for a minimum tax nor does it provide for the suspension of a corporation's right to do business in the state in the event of failure to pay the tax. Otherwise the provisions of the Act are much the same as those in the Franchise Tax Act, except that the tax is designated as a tax on income from California sources rather than a franchise tax measured by income.

The corporation income tax supplements the franchise tax in

88. For an excellent discussion of this subject, see Sabine, Constitutional and Statutory Limits on the Power to Tax, 12 Hastings L.J. 23 (1960).
much the same manner as a use tax supplements the sales tax. In *West Publishing Co. v. McColgan*,90 in an opinion by Justice Traynor, the California Supreme Court unanimously upheld the constitutionality of the Act. Although in view of *Complete Auto Transit* a separate corporation income tax is no longer needed, it well served its purpose of equalizing tax burdens for some forty years.

IV. PERSONAL INCOME TAX

In 1933 the California Legislature enacted legislation providing for a personal income tax, but it was vetoed by Governor Rolph. In 1935 the legislature again enacted legislation for a personal income tax which was approved by Governor Merriam and became effective January 1, 1935.91 The provisions of the law are much the same as personal income tax laws in various other states, but there are several distinctive features.

A. Definition of Resident

At all times since its inception, the California law has taxed individuals classified as residents on their total worldwide income including income from sources in other states, and has taxed nonresidents on income from sources in the state. In this respect the California law is much the same as the personal income tax laws of other states.

From its inception the law has defined "resident" as including anyone in the state for other than temporary or transitory purposes.92 Thus anyone falling within this definition is taxable on his total worldwide income even though domiciled in some other state or country. Conversely, any individual who is absent from the state for other than temporary or transitory purposes is taxable only on income, if any, from California sources even though domiciled in California. The regulations to the Personal Income Tax Act that were adopted in the fall of 1935, and which, like the definition of resident, have remained substantially unchanged over the years, explain in some detail the meaning of the

90. 27 Cal. 2d 705, 166 P.2d 861 (1946).
phrase "temporary or transitory."\textsuperscript{93}

Although the California definition is quite similar to the one employed for federal income tax purposes for many years,\textsuperscript{94} California was the first state to use this definition for state tax purposes. Since 1935 a number of other states have adopted the same definition and in a number of instances have also adopted the California regulations interpreting the definition.

\textbf{B. Trusts That Accumulate Income}

From its beginning the California law has contained unique and specific provisions as to the taxability of trust income that is not currently distributable in instances where some of the parties to the trust, such as trustees, fiduciaries, or beneficiaries, are residents and some are nonresidents of the state.\textsuperscript{95} These provisions constitute a major contribution to tax law in this area. They afford specific and reasonable answers to numerous questions that might otherwise require extensive litigation.\textsuperscript{96}

\textbf{C. Credit for Taxes Paid Other States}

The practice that the states follow in taxing residents on their entire income and nonresidents on income from sources within the taxing state inevitably results in double state taxation of the same income in many instances. In 1937 the California Franchise Tax Commissioner made a survey of the personal income tax laws of the other states to determine the extent to which the states endeavored to eliminate the burden of double taxation through the allowance of credits for taxes paid other states. It was discovered that many states did not make any provision for allowance of credit at all. It was further discovered that some states allowed credit to residents, whereas other states allowed credit to nonresidents. Although these provisions eliminated double taxation in some cases, residents of the latter group of states who derived income from sources in the former group were not able to

\textsuperscript{93} 18 Cal. Admin. Code, reg. 17014-17016(b) (1979).
\textsuperscript{94} See Bowring v. Bowers, 24 F.2d 918, 923 (1928), in which the term resident was defined in much the same terms as defined later in the California Personal Income Tax Act. Over the years since this case was decided, the federal definition of "resident" has changed greatly. For a discussion of the subject, see G. Altman and F. Keesling, Allocation of Income in State Taxation 42 (2d ed. 1950).
\textsuperscript{96} These provisions were devised by Roger Traynor and upheld by the California Supreme Court in McCulloch v. Franchise Tax Bd., 61 Cal. 2d 186, 390 P.2d 412, 37 Cal. Rptr. 636, appeal dismissed, 379 U.S. 133 (1964).
obtain credit by either state for taxes paid the other, and thus were subject to double taxation.

In 1937 California's Personal Income Tax Act was amended to provide carefully worked out and fairly comprehensive credit provisions. The provisions were so designed as to protect residents from double taxation in all cases and to protect nonresidents from double taxation on a reciprocal basis. If a resident of California derives income from sources in another state that taxes the income, but allows a credit for the California tax, double taxation is eliminated by the taxpayer claiming a credit in the other state. If, however, the state in which the income has its source does not allow credit, then the taxpayer may claim credit against the California tax for the taxes paid the other state. If the state of residence of individuals who derive income from sources within California allows credit to California residents who derive income from sources in that state, then California reciprocates by allowing residents of that state a credit against taxes imposed by California on income from sources therein.

As initially enacted the California credit provisions allowed credit for taxes paid foreign countries. However, the provisions for this credit were subsequently repealed for two reasons. First, it proved extremely difficult in many cases to determine whether the taxes imposed by some of the numerous foreign countries constituted an income tax eligible for credit, or whether such taxes were in the nature of a gross receipts tax not eligible for credit. Second, the federal law has long been quite liberal in allowing credit against federal taxes for income taxes paid foreign countries. For the state also to allow credit would permit one dollar of foreign tax to offset two dollars of tax in this country—one dollar of federal and one dollar of state tax.

D. *Income of Estates or Trusts for the Year of Distribution*

For many years the federal government, in effect, allowed the executors of estates and trustees of trusts an option as to whether income of the estate for the year of distribution should be taxable to the estate or trust, or taxable to the beneficiaries. If a survey of the tax rates applicable to beneficiaries as compared with those applicable to the estate or trust indicated that the taxes would be lower if the income were taxable to the estate or trust, this

result could be accomplished by the maintenance of separate bank accounts for trust income, such as dividends, interest, and rent, and then by paying charges against the estate or trust, such as estate and inheritance taxes, out of the funds in the separate accounts. By this means it was considered that the income of the estate or trust for the year of distribution was absorbed in the payment of various nondeductible charges with the result that there was none left for distribution to the beneficiaries. By this strategy the income became taxable to the estate or trust and not to the beneficiaries.

If, on the other hand, it was desirable to have the income taxed to the beneficiary rather than the estate or trust, this result could be accomplished by paying estate and inheritance taxes and other capital charges from assets other than the funds in the special bank accounts in which income had been deposited, and then distributing the funds in the special accounts to the beneficiaries. By this means it was thought that the income of the estate or trust was distributed to the beneficiaries, and hence was taxable to them rather than to the estate or trust.

Early in the administration of the California income tax the validity of the described procedures was challenged. The position was taken that income cannot be identified with particular dollars or bank accounts and that, since amounts paid for estate and inheritance taxes and other capital items are not deductible for income tax purposes, the entire income of the estate or trust for the year of distribution is taxable to the beneficiaries regardless of the source of the funds used to pay the items. This position was upheld by the California Supreme Court in *Malmgren v. McColgan.* 98 Subsequently the Commissioner of Internal Revenue abandoned the former rule and adopted the California rule.

### V. Sales and Use Taxes

As indicated previously, 99 California adopted a general sales tax applicable to the sale of tangible personal property, which became effective August 1, 1933. 100 California was the third state

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98. 20 Cal. 2d 424, 126 P.2d 616 (1942).
99. See notes 38-39 and accompanying text supra.
100. The act was drafted by Roger Traynor who served as Director of the Sales Tax from its inception until the end of 1933, when he resumed teaching at the University of California School of Law (Boalt Hall). He continued as consultant to the State Board of Equalization until his appointment to the California Supreme Court in 1940. The sales tax rules discussed herein were initiated while the former Chief Justice was Director of the Sales Tax.
to adopt such a tax, being preceded by New York and Washington. A use tax was enacted to supplement the sales tax in 1935.101 Today, forty-five of the states impose these taxes. California’s sales and use taxes are similar to those in most other states, but again, as in the case of other California taxes, there are several distinctive features.

A. Classification of Tax as Retailers Tax or Consumers Tax

In drafting the bill that provided for the imposition of the sales tax, care was taken to omit any provision that might be construed as imposing a tax on consumers. Many organizations were exempt from this type of tax, such as the federal government and various agencies thereof; national and state banks; insurance companies; and public utilities, which were subject to the gross receipts tax until 1935.102 If the tax had been held to be a consumers tax it could not have applied to sales to these agencies; hence it was important to make certain, if possible, that the tax was a tax on retailers.

Unfortunately, representatives of retailers took a different position. They insisted that the tax had to be a consumers tax and even wanted to insert provisions setting forth a tax schedule and requiring that the amount of tax be added as a separately stated item. A stalemate developed. This was eventually compromised by the adoption of a provision prohibiting retailers from advertising that the tax would be absorbed, and a provision that the tax would be collected by the retailer from the consumer insofar as possible.

Notwithstanding these provisions, the California courts, as well as some lower federal courts, have consistently held that the tax is a retailers tax and is applicable to sales made by retailers even though the purchasers are exempt from the tax. The leading case is De Aryan v. Akers.103 However, the United States Supreme Court in Diamond National Corp. v. State Board of Equalization104 recently held that the provision regarding the collection

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101. This act was also drafted by Roger Traynor. For a discussion of it, see Traynor, The California Use Tax, 24 CALIF. L. REV. 175 (1936).
102. See text accompanying note 37 supra.
of the tax from consumers indicated an intent on the part of the legislature that the tax should be considered a tax on consumers. It therefore held that the tax did not apply to sales to national banks. Presumably, the same rule would apply to sales to instrumentalities of the federal government.

Notwithstanding the decision in Diamond National, the California State Board of Equalization, which administers the California sales and use taxes, has taken the position that as applied to sales to purchasers other than national banks and instrumentalities of the federal government, the tax is a retailers tax that must be paid by the retailer on all taxable sales, including sales to purchasers that are exempt from such a tax. This position was upheld in United States v. State Board of Equalization with respect to sales to state banks.

In 1933 the California Legislature specifically exempted sales to the federal government from the tax. Congress has recently amended federal law to permit the application of state sales taxes to sales to national banks. Hence, the only continuing effect of Diamond National is to prohibit the state from collecting the tax on sales to other federal instrumentalities, such as Federal Reserve banks, federal land banks, and federal credit unions. The case also presents some problems regarding the application of the tax on sales to Indians on reservations.

B. The Fabrication Rule

Shortly after the sales tax became effective in 1933, it was learned that a company, which even in those days annually ordered large amounts of printing at a cost amounting to several million dollars per year, was planning to avoid the sales tax by purchasing the paper and ink and furnishing it to the printer. It was hoped that by this means there would be no tax on the printer’s charges since the printer would be performing only services and would not be selling anything tangible. Tailors throughout the state were confronted with a similar problem. They were fearful that customers would purchase cloth from a department store and furnish it to a tailor who would be performing services only, which the customers hoped would be exempt from the sales tax.

In order to prevent disruption of business and loss of revenue, a rule was adopted to the effect that charges for services that resulted in the creation of a finished article of tangible personal property were taxable even though the tangible materials were furnished by the customer.\footnote{108} This is the famous fabrication rule, without which the sales tax could be avoided on a wholesale scale and normal business practices would have been greatly disrupted. A survey made a few years ago indicated that all of the other forty-four states imposing a sales tax have adopted a comparable rule—in many cases using language virtually identical to the California rule.

C. Application of Sales Tax to Contractors

Another rule that deserves comment is the rule applicable to contractors who make improvements to real estate under a lump sum contract. California’s rule is unique among the states. Under it a distinction is made between so-called finished articles of tangible personal property, such as bathtubs, chandeliers, elevators, etc., and materials, such as cement, brick, lumber, etc. In the case of finished articles of tangible personal property, contractors are considered the retailers and must pay sales tax on their selling price rather than on the cost of such items to them. On the other hand, contractors are considered the consumers of materials with the result that the sale to them constitutes the taxable retail sale. This two-headed rule has proved extremely difficult to apply in practice, but has been upheld by the courts and is still in effect.\footnote{109}

D. Application of Tax to Motion Pictures

Another rule that deserves comment is the motion picture rule. Under this rule, motion picture producers are considered the consumers of all the materials used in the production of motion pictures, and are not subject to tax either on the receipts from the

\footnote{108. See Cal. Rev. & Tax. Code §§ 6006(b), 6010(b) (West Supp. 1979).}

\footnote{109. See, e.g., General Electric Co. v. State Bd. of Equalization, 111 Cal. App. 2d 180, 244 P.2d 427 (1952).}

The author was Assistant Director of the California Sales Tax in 1933 when this and other rules relating to the sales tax were adopted. He believed and still believes that contractors should be regarded as retailers rather than consumers in all cases. Many contractors have also recently adopted this point of view. As consumers they must absorb the sales tax, but if classed as retailers, even in the case of materials they could pass the tax on to the owner of the real property being improved.
licensing of motion pictures for exhibition, or on the receipts from the outright sale thereof. This rule is still in effect to the present day. Although this rule has been severely criticized, it is believed, for reasons too intricate to discuss here, that it represents the correct construction of the law.

E. Application of Tax to Leases

Still another rule that deserves comment deals with the application of the sales tax to leases. A few years ago the State Board of Equalization proposed an amendment that, if passed, would have extended the sales tax to all leases of tangible personal property. However, at the last minute an amendment was adopted providing that leases would not be taxable if (1) the sales or use tax is paid at the time of the purchase of the property leased, and (2) the property is leased in substantially the same condition as when acquired. As a result of this amendment the only leases that are definitely taxable are leases of property that has been changed substantially by the lessor between the time of acquisition and the time of the lease.

In all other cases, lessors have an option as to whether or not the tax shall apply. If they wish the tax to apply at the time of purchase and not to the receipts from leasing, this can be achieved by paying the tax at the time of purchase. If, however, they want the lease receipts to be taxable, this can be achieved by giving a resale certificate at the time of purchase. It is of some interest to note that many large leasing companies, such as Hertz and Avis, have adopted the second alternative notwithstanding that it results in the payment of much greater taxes. By electing the option that makes their receipts taxable, they pay more taxes but are able to add the tax to the rental charge and collect it from their customers.

VI. SUITS IN OTHER STATES TO COLLECT TAXES

From time immemorial there has been an inflexible rule to the effect that a sovereign nation may not use the courts of another sovereign nation to enforce its criminal laws or its tax laws. The powers of the individual states of the United States as well as the powers of the federal government are limited by the United States Constitution. Thus, although the states are members of a

nation that is sovereign, the individual states are not sovereign. Nevertheless, in the past the courts in many states followed the rule applicable to sovereign nations and refused to entertain suits or actions by other states to enforce the tax laws of the other states.\textsuperscript{112} As a result, in many cases taxpayers who had incurred a tax liability to a given state could "thumb their noses" with impunity at that state's efforts to enforce the liability. A dramatic example of this occurred years ago when a resident of California won the Irish Sweepstakes and shortly thereafter moved to Nevada without paying the California personal income tax on his winnings. California endeavored to sue him in federal court in Nevada, but the court refused to permit the suit.

In 1937 the California Legislature enacted a statute specifically authorizing other states to use California courts to enforce their tax liabilities, provided that the other states extend a like comity to California.\textsuperscript{113} Since then virtually every state in the Union has enacted similar statutes. Thus a taxpayer who incurs a tax liability to a given state can no longer use another state as a tax haven.

VII. Conclusion

The perspective of this Article has been somewhat historical, but hopefully not without continuing relevance. Certainly many other California tax policies could be mentioned in the context of this Article, although the foregoing illustrations should be sufficient to indicate that over the years California tax administrators have been resourceful in developing policies to prevent tax avoidance and to increase the effectiveness of California's tax laws within a fair and equitable framework.

Legal milestones such as those discussed here have intrinsic value as they encourage and perpetuate correct policies and proper administration of the law. Hopefully, too, there is an added value in reviewing our progress, as there are yet ample opportunities to improve the law.


\textsuperscript{113} See CAL. REV. & TAX. CODE §§ 30-31 (West 1970). This statute was conceived and drafted by Roger Traynor.