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Op. 56-8

TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

January 18, 1956

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Havaii

Dear Sir:

This concerns the net income tax assessment of Sears, Roebuck and Co., a foreign corporation qualified to do business and doing business in Hawaii. The taxpayer has filed a protest against a proposed income tax assessment.

It is not contended by the corporation that the net income attributable to the Territory should be determined by an allocation and separate acounting, nor is it suggested by you that this would be proper. The business conducted in the Territory is, in the words of the statute (section 5511, R.L. 1945, as amended by Act 166, L. 1951) "an integral part of a unitary business conducted within and without the territory".

Section 5511, above cited, provides that, in such a case, the income taxable by the Territory shall be apportioned to the Territory on the basis of a ratio obtained by taking the arithmetical average of certain prescribed ratios. However it is further provided that if the taxpayer shall show that the statutory method results in net income being allocated to the Territory in a larger amount than is just and equitable then the Tax Commissioneer may prescribe a different formula for the apportionment of the income. (The Tax Commissioner independently may reject the statutory formula, but this is not involved.)

The statute provides that if the taxpayer's principal business in the Territory is selling tangible personal property, which is the case here, the ratio for the apportionment of income to the Territory shall be the arithmetical average of the property ratio, the payroll ratio, and the ratio of gross sales attributable to the Territory to the total of gross sales everywhere. The property ratio is determined by taking the ratio of the value of the tangible property of the taxpayer in the

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Territory, including both real and personal property, to the total of such property everywhere. The payroll ratio is determined by taking the ratio of the wages, salaries, commissions and other compensation of the taxpayer's employees for services performed in the Territory to the total of such compensation everywhere. The sales ratio is the one in dispute. That is, the taxpayer has filed in accordance with the statute except that it has not applied the statute in the matter of the sales ratio.

Taxpayer divides its sales into three categories. There are sales made by the retail stores in the Territory. These are the only sales which taxpayer has included in the numerator in determining the sales ratio. Taxpayer also has, according to its analysis of its sales, two other types of sales, that is, retail catalog sales and direct mail order sales. The retail catalog sales are filled by shipments from the taxpayer’s mainland mail order plant, but taxpayer maintains on its store premises a catalog order desk which takes orders from customers, sometimes receiving with the order the payment for it and at other times forwarding it without payment for filling on a C.O.D. basis. Sometimes the merchandise is picked up by the customer at the catalog desk and at other times is shipped to him direct from the mainland mail order plant.

The third category of sales, according to taxpayer’s analysis, consists in direct mail order sales. These also are filled by shipments from the mainland mail order plant. The customer himself sends the order to the mainland and the merchandise is sent directly to the customer. In some of these cases payment accompanies the order, but according to your investigation this is not necessarily the case. Taxpayer, while pointing out to its customers the added cost of parcel post C.O.D. due to the post office fee, does accept C.O.D. orders with stated exceptions.

Taxpayer also ships goods from the mainland mail order plant on a time payment basis to customers whose credit standing is acceptable to the mainland office. In such cases title to the goods is retained by taxpayer until the payments are completed. Direct mail order sales may be made on this basis.

It is stated in taxpayer's protest, referring to the direct mail order sales, that “no activities are performed by the taxpayer within the Territory in Securing the Sales”. However it is obvious that this is a proposition not susceptible of exact determination. Taxpayer's employee at the catalog order desk very well display the catalog to a customer and guide the customer in the selection of merchandise the customer may thereafter, after leaving the premises, make his decision on the purchase and himself send in the order. Even if the taxpayer's employees in the Territory perform no activities in securing the direct mail order sales it may be that they perform other activities in connection with some of these purchases, for example, those on a time basis. Moreover, as we will have occasion to note, the fact that the taxpayer is present in the Territory itself is a stimulant to the direct mail order sales.

The statute, as taxpayer concedes, calls for including in the numerator in determining the sales ratio the catalog order desk sales and the direct mail order sales as well as the retail store sales. Taxpayer, although following the statute in other respects, determined the sales ratio by including only the retail store sales as above noted. The proposed income tax assessment determines the sales ratio by including in the numerator the catalog order sales and direct mail order sales as well as the retail store sales, as provided by the statute. The statute reads as follows:

> "There shall be attributed to this territory all sales of such tangible personal property (I) delivered to a purchaser at a point within this territory, or (II) shipped to a purchaser at a point within this territory or (III) delivered to a purchaser at a point outside this territory or shipped to a purchaser at a point outside this territory if such point is located in a state, territory, or similar taxing jurisdiction in which the taxpayer is not doing business, and the sale was made on an order secured or received by an office or branch in this territory or a representative residing or stationed in this territory."

Applicable here is that portion of the above quoted excerpt which provides that there shall be attributed to the Territory all sales of tangible personal property either delivered to a purchaser at a point within the Territory (such as the retail store sales and the catalog order desk sales where the customer picks up the merchandise at the catalog order desk), or shipped to a purchaser at a point within the Territory (such as the prepaid mail order sales filled by direct shipment).

After determination of the sales attributable to the Territory the statute provides as to the sales ratio that it consists of the ratio of gross sales attributable to this Territory to the total of gross sales everywhere. As above noted this is only one of three ratios and the ratio actually to be used is the arithmetical average of the three.

For the year here involved the property ratio is .430501%, the payroll is .310899% and the sales ratio as determined by the taxpayer's return is .422850% but as redetermined by the proposed assessment is .441616%. The arithmetical average of the three ratios according to the taxpayer's return is .388083% and according to the proposed assessment is .394338%.

The taxpayer contends that the Tax Commissioner must determine "where does the activity creating the income take place?" The substance of the argument is that in the case of the catalog order desk sales and direct mail order sales the activity creating the income occurs outside the Territory and for that reason these sales must be excluded from the numerator of the sales ratio.

Preliminary attention will be given to a contention made by the taxpayer on the basis of paragraph (3) of section 5511, which states that every person shall be deemed to be carrying on a trade or business in the Territory if his net income therefrom is subject to the taxing jurisdiction of the Territory "by reason of his engaging in activities in this territory". This provision does not signify that, in the case of a unitary business governed by the statutory formula, the business nevertheless may be broken into segments for the purpose of determining the income from each. Moreover, the quotation is incomplete. The full paragraph adds: "or causing transactions to be conducted in this territory, with the object of gain, profit, or economic benefit, whether or not such activities or transactions are in or connected with interstate or foreign commerce." The real significance of this paragraph is that it asserts the intention to adopt the widest possible concept of what constitutes doing business in the Territory. Once a taxpayer is found to be doing business in the Territory then the only question is whether application of the statutory formula causes more income to be attributed to the Territory than is just and equitable.

The adjudicated cases show that taxpayer's line of reasoning has been repeatedly rejected by the courts. That is, although this is a unitary business taxpayer is seeking to separately take up the various segments of the business. A leading case is Butler Brothers v. McColgan, 315 U.S. 501, affirming 111 P.2d 334, Calif. Taxpayer was an Illinois corporaion qualified to do business in California. It was a wholesaler having outlets in seven different states. It maintained a central buying division and allocated to its outlets the cost of operating the central division. After allocation of such expenses the California outlets showed a loss. The california

Tax Commissioner rejected the separate accounting basis and assessed taxpayer as a unitary business employing the property, payroll and sales ratios. By this method there was net income taxable in California. This action was sustained. The Court said:

> "One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed. * * *.
>
> "It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed.* * *
>
> "* * * California may properly treat appellant's business as a unitary one. Cf. <u>Great Atlantic & Pacific Tea Co.</u> v. <u>Grosjean,</u> 301 U.S. 412. There is unity of ownership and management. And the operation of the central buying division alone demonstrates that functionally the various branches are closely integrated. Admittedly, centralized purchasing results in more favorable prices being obtained than if the purchases were separately made for the account of any one branch. What the savings were and what portion is fairly attributable to the volume contributed by the San Francisco branch do not appear. But the concession that a reduction or addition of purchases 'in an amount equal to the purchases made for the San Francisco house' would not result in higher or lower purchase prices respectively does not aid appellant's case. There is no justification on this record for singling out the San Francisco branch rather than another and concluding that it made no contribution to those savings. As aptly stated by the Supreme Court of California, 'If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities.' Nor are there any facts shown which permit the conclusion that the other advantages of centralized management <u>(Great Atlantic & Pacific Tea Co.</u> v.

Grosjean, supra) are attributable to other branches but not to the one in California. The fact of the matter is that appellant has not shown the precise sources of its net income of $l,149,677. If the factors which are responsible for that net income are present in other states but not present in California, they have not been revealed. At least in absence of that proof, California was justified in assuming that the San Francisco branch contributed its aliquot share to the advantages of centralized management of this unitary enterprise and to the net income earned."

The Butler Brothers case is a direct holding that in the case of apportionment of income of a unitary business by a formula the state may attribute to itself net income arising from central purchasing activities, though not conducted in the state, since they nevertheless stem from the volume of sales which the state contributes. This principle again was applied in California in John Deere Plow Co. v. Franchise Tax Board, 238 P.2d 569, affirmed 343 U.S. 939. Taxpayer was on Illinois corporation authorized to do business in California and maintaining in San Francisco a jobbing house serving several states. Goods were charged to the jobbing office on the basis of the uniform price charged to all jobbing houses, determined by applying certain discounts to the minimum resale price of the goods. Taxpayer sought to use the separate accounting system; the California Tax Commissioner used the three factor formula. Taxpayer contended that its San Francisco house was not conducted as profitably as other jobbing houses, basing his contention on accounting records which were found to be accurately kept. The court nevertheless upheld the Tax Commissioner saying:

"* * * plaintiff fails to take into account the underlying concept of formula apportionment in the allocation of income from a unitary business: that the unitary income is derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of the formula method in assigning to the taxing state its fair share of taxable values. Butler Brothers v. Mccolgan, supra, 17 Cal.2d 664, 667-668, 111 P.2d 334; Edison California Stores v. McColgan, surpra, 30 Cal. 2d 472, 477-479, 183 P.2d 16; El Dorado Oil Works v. McColgan, supra, 34 Cal.2d 731, 735, 215 P.2d 4. As above

> stated, here the overall organization of Deere & Company was a manufacturing and selling business having its operations extending into a number of different states and providing an example of a typical unitary business subject to formula allocation as a reasonable method of apportionment for franchise tax purposes. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed.165; Bass, Ratcliff & Greton, Ltd. v. State Tax Com. 266 U.S. 271, 45 S.Ct. 82, 69 L.Ed. 282; North American Cement Corp. v. Graves, 299 U.S. 517, 57 S.Ct. 311, 81 L.Ed. 381; International Harvester Co. v. Evatt, 329 U.S. 416, 67 S.Ct. 444, 91 L.Ed. 390. The fact that the taxpayer may show that according to a separate accounting system, the activities in the taxing state were less profitable than those without the state, or even resulted in a loss, does not preclude use of a formula as a method of apportionment of the unitary income. (Ibid.) The only requirement is that the formula used be not intrinsically arbitrary or produce an unreasonable result."

This leaves only the question whether it is unreasonable to introduce into thee formula used in apportioning the income of the unitary business any figure having to do with the place where the buyer is located, in the absence of specific facts definitely showing intrastate activities in relation to the particular purchase. Just as the profit from centralized buying is, as has been held, derived from the volume of purchases in all of the states, so is the profit from the mail order business based on the volume of purchases in all of the states. Hawaii is the place where the orders are signed by the purchasers. It also is the place where title passes in some cases. These are transactions occurring within the Territory and they play their part in the making of the sales. In some cases there is dependence upon employee activity, as in the case of the catalog order desk sales; also in the case of the time sales there necessarily is dependence upon representation in the Territory. But even in the case most favorable to the taxpayer--the case of a prepaid direct mail order sale--this business still is a proper ingredient in the apportionment formula. Under the <u>Butler Brothers</u> case, the income upon which the tax is imposed may be commensurate with the benefits stemming from taxpayer's presence in the Territory. Those benefits include the mail order business. As stated by the court in <u>Nelson</u> v. <u>Sears, Roebuck & Co,</u> 312 U.S. 359, 364, in which it was held that Sears, since it had entered Iowa, could be forced to act as a collection agency of the Iowa use tax in respect of mail orders which were not shown to have been actually solicited or placed by any agent of Sears in Iowa:

"So the nub of the present controversy centers on the use of respondent as the collection agent for Iowa. The imposition of such a duty, however, was held not to be an unconstitutional burden on a foreign corporation in Monamotor Oil Co. v. Johnson, 292 U.S. 86, and Felt & Tarrant Mfg. Co. v. Gallagher, 306 U.S. 62. But respondent insists that those cases involved local activity by the foreign corporation as a result of which property was sold to its local customers, while in the instant case there is no local activity by respondent which generates or which relates to the mail orders here involved. Yet these orders are still a part of respondent's Iowa business. The fact that respondent could not be reached for the tax if it were not qualified to do business in Iowa would merely be a result of the 'impotence of state power' Wisconsin v. J. C. Penney Co., supra. Since Iowa has extended to it that privilege, Iowa can exact this burden as a price of enjoying the full benefits flowing from its Iowa business. Cf. Wisconsin v. J. C. Penney Co., supra. Respondent cannot avoid that burden though its business is departmentalized. Whatever may be the inspiration for these mail orders, however they may be filled, Iowa may rightly assume that they are not unrelated to respondent's course of business in Iowa. They are nonetheless a part of that business though none of respondent's agents in Iowa actually solicited or placed them. Hence to include them in the global amounts of benefits which respondent is receiving from Iowa business is to conform to business facts."

The Court also said in footnote 3:

"In 1937 respondent mailed to residents of Iowa about 600,000 small catalogues and 427,000 large ones. Respondent maintains 12 retail stores in Iowa, its investment therein exceeding $500,000. The aggregate sales of the retail stores in Iowa for 1936 amounted to $5,080,000; for 1937, $560,000. Its mail order sales in Iowa for 1936 aggregated about $5,900,000; for 1937, about $35,400,00. It estimates that it has some 300,000 Iowa customers of its mail order houses and that in 1937 there were about 1,200,000 orders received from Iowa customers.

"One of respondent's witnesses testified that the catalogues and bulletins mailed out were 'our sole means of securing' the mail order business. But he also testified, 'If a customer inquired from a clerk in the store as to whether or not he would have to pay a use tax upon an order, I believe the clerk would inform him that if he himself mailed the order that there would be no sales tax or use tax charged."

If taxpayer were right in its contention that no part of the income from mail order business can be apportioned to Hawaii, the remedy would be to segregate the total mail order income of the company from the total retail store income, the total tangible property and payroll associated with the mail order business from that associated with the retail store business, and the total mail order sales from the total retail store sales, then apply to the total retail store income the arithmetical average of the ratios computed by considering retail store business only. If this were done the Hawaii taxable income might be more or less than the proposed assessment. It is impossible to say because the segregation cannot be made; the business is a unitary one. Taxpayer's contention simply is that, though Hawaii's percentage is deflated by the absence from the numerator of the property and payroll ratios of any figures derived from mail order business while at the same time those figures appear In the denominator, it is unjust to the taxpayer not to deflate the figure further by omitting from the numerator of the sales ratio any figures derived from mail order business while at the same time including them in the denominator. There is no support for this contention. The Colorado case cited by the taxpayer is not good authority, as below explained.

To compute the sales ratio in accordance with the Hawaii statute is not to assert that the mail order sales themselves are taxable. In Commonwealth v. Quaker Oats Co., 38 A.2d 325, Pa., the inclusion in the property factor of tax exempt federal, state and municipal securities was questioned by the taxpayer. The court held that to include the tax exempt securities in the formula was not to impose a tax upon them. These merely were used as an index. The court said:

> "Nor is it necessary to devote additional discussion to appellant's contention that the tax falls upon exempt Federal, State and municipal securities. The court below has found, and appellant concedes, that these securities 'were employed or held as a reserve by [appellant] in its purchasing business'. As the purchasing function was related by integration to the selling function, and as it affected the value of appellant's franchise in Pennsylvania, the inclusion of these securities in the formula producing the tax base was proper. They, themselves, were not taxed."

Taxpayer relies upon State ex rel. Cruse v. American Can Co., 186 P.2d 779, Colo. There are several points which distinguish that case and make it inapplicable, but most significant is the court's misapprehension as to the interpretation that was necessary to save the constitutionality of the Colorado statute. The court was of the view that if Colorado included in the numerator of the sales ratio the sales made on orders filled by shipment by common carrier F.O.B. a point outside the state, "we would be imposing a tax and projecting our tax powers beyond the borders of the state of Colorado, and this power of taxation has never been upheld in any decision called to our attention * * *". However on June 10, 1946 the Supreme Court of the United States had affirmed, on motion, West Publishing Co. v. McColgan and on October 14, 1946 had denied rehearing, 328 U.S. 823, rehearing denied 329 U.S. 822, affirming 166 P.2d 861, Cal.

In the West Publishing Co. case there was involved a foreign corporation which maintained in California employees who had space in attorneys' offices and were soliciting and taking orders which were filled by direct shipment from out-of-state points. All of these sales were included in the numerator of the sales ratio. Not only the West Publishing Co. case affirmed by the Supreme Court of the United States but it also on January 6, 1947, decided International Harvester Co. v. Evatt, 329 U.S. 416. In the International Harvester Co. case the Court assumed that the state had included as business done in Ohio the sales made by Ohio branches to Ohio customers, filled by delivery from out-of-state factories, citing International Harvester Co. v. Department of Treasury, 322 U.S. 340 for the proposition that these sales were intrastate activities and saying: "What effect inclusion of this element in the 'business done' numerator would have were these transactions not intrastate is a question we need not now decide."

As to the question left undecided in International Harvester Co. v. Evatt, it is sufficient to note that this was a case of a corporation franchise tax, not a net income tax. As shown by Texas Gas Transmission Corp. v. Atkins, 270 S.W.2d 384, a franchise tax presents interstate commerce problems which in the case of a net income tax are not involved. Net income from interstate commerce may be taxed, as held in Southwestern Gas & Electric Co. v. Oklahoma Tax Commission, 253 P.2d 549.

In the Cruse case the court erred in failing to hold that the sales in question were intrastate business

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as specificallY stated International Harvester Co. v. Evatt, on the basis of International Harvester Co. v. Department of Treasury), and further erred in failing to note that in the case of a net income tax the income from interstate commerce in any event may be included.

While the Colorado court was influenced in its interpretation of the Colorado statute by constitutional questions it specifically stated that it was not determining the constitutional questions and rested its decision on its interpretation of the Colorado statute. That statute called only for the taxation of income "derived from property located and business transacted within this state". The Colorado court distinguished the West Publishing Co. case on the ground that it provided for a tax upon net income "derived from sources within this state". In the West Publishing Co. case California Supreme Court called attention to the express provisions of the California statute including as income from sources within the state income from any activities carried on in the state regardless of whether carried on in intrastate, interstate or foreign commerce. The Hawaiian statute taxes the income from all sources in the Territory (section 5505) and specifically provides that it is immaterial whether or not income is from interstate or foreign commerce, if the net income is subject to the taxing jurisdiction of the Territory either by reason of activities in the Territory or transaction caused to be conducted in the Territory (section 5511, paragraph (3), as amended by Act 168, L. 1951). Hence the Cruse case, in our opinion wrongly decided in the light of other cases including United States Supreme Court cases, in any event is inapplicable.

In the book "Allocation of income in State Taxation" by Altman and Keesling, Commerce Clearing House, 1946 pp. l26-127, the assignment of sales to the state from which the order is received is recommended in the case of mail order sales. The authors state:

> "Where an order is received at an office within the state by telephone, telegram, or mail from a customer in another state and the seller is engaged in business in such other state, the sale would be assigned to the state from which the order is received. If, however, the seller is not engaged in business in the state from which the order is received, the sale would, for lack of a better place, be attributed to the state where the order is received."

Oklahoma uses the same method as Hawaii in determining what sales are to be included in the numerator. Tennessee uses this method and in addition uses a ratio depending upon the location of the branch through which the sale is made. Tennessee applied its law in R. J. Reynolds Tobacco Co. v. Carson, 213 S.W. 2d 45, in which the only business done by the taxpayer in the state consisted in the operation of a fleet of motor vehicles from which sales were made direct to customers, which operation had nothing to do with the main business in the state, and the storage in public warehouses of products in order that orders placed at the office outside the state directly by the customers might be filled from the warehouses, this being the main business. The net income was apportioned by using the property ratio, the ratio of sales made through branches in the state to sales everywhere, and the ratio of sales to customers in the state to sales everywhere. The last two ratios were exactly the same under the circumstances of this case. The tax was sustained.

In Tennessee Gas and Transmission Co. v. Commonwealth, 216 S.W.2d 102, Ky. the statute contained language providing for sales to be assigned to the office through which the transactions were chiefly handled with respect to negotiations and execution, but the court nevertheless sustained an assessment based upon a formula attributing to the state of Kentucky the sales to customers in the state.

We understand that in your opinion the taxpayer has not shown that the application of the statutory formula as written results in allocating to the Territory a larger amount than is just and equitable. We have concluded that you lawfully may so determine.

Respectfully,

RHODA V. LEWIS
Deputy Attorney General

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