BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA ,

In the Matter of the Appeal of)
)
THE YOUNGSTOWN STEEL PRODUCTS)
COMPANY OF CALIFORNIA)

Appearances:

For Appellant: O'Melveny & Myers, Attorneys at Law

For Respondent: Burl D. Lack; Chief Counsel;
Mark Scholtz, Associate Tax Counsel

O P I N I O N

This appeal was made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (now Section 25667 of the Revenue and Taxation Code) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of The Youngstown Steel Products Company of California to a proposed assessment of additional tax in the amount of $20,952.86 for the income year ended December 31, 1941.

Prior to and during 1941 The Youngstown Sheet and Tube Company, hereinafter referred to as the parent, engaged in the manufacture and sale of iron and steel products, but did not conduct any business activities in California; It owned all the stock of The Youngstown Steel Products Company, hereinafter referred to as the Ohio company, which acted as the wholesale marketing organization in California and other states with respect to certain of the parent's products.

Prior to 1941 the parent's oil country tubular products were sold at retail in California, Oregon and Washington by Republic Supply Company, hereinafter referred to as Republic, pursuant to its contract with the Ohio company for an exclusive distributorship of these products for a ten-year period beginning in 1938. Republic, an independent firm, also handled products other than those of the parent's manufacture.

In 1939 the parent reduced its established oil country distributors' discounts and in 1940, following the refusal of Republic to handle oil country products on the reduced discount basis entered into negotiations with the latter with a view towards revising the discount to be allowed Republic. Republic, however, refused to accept the parent's proposed revision of the contract and, as a result of the negotiations a contract was entered into by it on or about December 31, 1940, with the Ohio company for the cancellation of the 1938 distributorship

contract, the purchase from Republic of its yard facilities, the payment to Republic of $2.00 for each ton of oil country tubular goods of the parent's manufacture sold in California, Oregon and Washington during what would otherwise have been the remaining term of the distributorship contract, and the agreement of Republi not to handle or sell oil country tubular goods in those States during such remaining term.

Appellant was incorporated in January, 1941, to perform the sales and distribution functions theretofore conducted by Republic, and the Republic yard facilities were transferred to it. Appellant thereupon entered into the retail distribution of the parent's oil country tubular goods, those goods being billed to it on the basis of prices fixed by the established public price lists of the parent, Appellant was allowed a discount of 5% of those established prices instead of the 6% allowed other retail distributors, including independent distributors, in view of the payments made to Republic by the parent or the Ohio company of $2.00 per ton on the parent's oil country tubular goods sold on the Pacific Coast, it being considered by Appellant and its parent that these payments were in part for the benefit of Appellant.

During the income year 1941 Appellant handled only products of the parent company's manufacture and approximately 75% of the California sales of the parent's products were made through it. In addition to the oil country tubular goods, it handled other products of the parent, these other products being handled at prices and discounts identical to those offered by the parent and Ohio company to all other distributors, including independent distributors. Suggestions and decisions as to the addition of these other products, or the elimination of particular items, were made by Appellant, and while the parent, of course, possessed the power to reverse or reject those decisions it did not do so in any instance.

The parent owned and voted all the outstanding stock of Appellant, four of the five directors of Appellant being principal officers of the parent, Appellant's activities were for the most part carried on through its own officers and employee: located at Los Angeles, California. The parent and its officers and executives participated in the affairs of Appellant only to the degree and extent as is usual for a shareholder or directors and such participation did not extend beyond the field of genera policy. No expense for any managerial or executive services was charged or allocated to Appellant by the parent or any company affiliated with the parent.

Appellant maintained its own books and accounting records. The parent, however, with respect to Appellant and other subsidiaries, arranged and paid for independent audits, kept consolidated operations records, prepared and issued consolidated balance sheets and profit and loss statements, and prepared tax returns. The parent also advertised the products handled by its affiliates and independent distributors. There

was no charge or allocation to Appellant of any portion of these or any other central expenses incurred by the parent or any affiliated company.

For the income year 1941 the Appellant filed a return of its income and the Ohio company filed a return setting forth its income combined with that of its parent and allocating a portion of that combined income to California on the basis of the property-payroll-sales allocation formula. The Commissioner determined, however, that the three companies were conducting a unitary business and that their income should be combined. After obtaining that combined income he allocated a portion thereof to this State on the basis of the three-factor formula and then applied that formula again to allocate portions of the California income so ascertained between Appellant and the Ohio company. It is the deficiency assessment asserted against Appellant as a result of this action that is being questioned herein.

Appellant sets forth two grounds as the basis of its objection to the determination by the Commissioner of its income from its California activities in this manner. It contends that the Commissioner's action is erroneous because (1) the business conducted by the three companies did not constitute a unitary business and (2) even if that business wasunitary the application by the Commissioner of the formula to the combined income results in the taxation to it of extra-territorial values. Appellant has agreed, however, that the 1% differential between the 6% discount allowed by the parent to other distributors on oil country tubular goods and the 5% discount allowed Appellant on such goods may be disregarded and that Appellant shall be deemed for the purposes of this proceeding, to have done business on the same basis with respect to discounts and prices as in the case of all other distributors dealt with by the parent and Ohio company.

The question of when business within a state is to be considered separate and when it is a portion of a unitary business conducted within and without the state has been well summarized as follows:

> "The essential test is whether or not 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. If there is such a relationship, the business is unitary. If there is no such relationship, then the business in the state may be considered corporate and the income therefrom may be determined without reference to the success or failure of the taxpayer's activities in other states." Altman and Keesling, Allocation of Income in State Taxation, 2d ed., 1950, p. 101.

The business of manufacturing and selling, whether conducted through one or more corporations, is undoubtedly ordinarily to be regarded as unitary, Butler Brothers v.

McColgan, 315 U.S. 501; Edison California Stores, Inc., v. McColgan 30 Cal. 2d 472; John Deere Plow Co. v. Franchise Tax Board, 38 A.C. 216, appeal dismissed by United States Supreme Court May 5, 1952. The Appellant concedes this to be the case, but contends that the particular circumstances under which its activities were conducted require a different conclusion herein. The Appellant has not established, in our opinion, however, that the relationship between its operations and those of the parent and the Ohio company was such as to compel the conclusion, in the light of the foregoing test and these authorities, that its business was separate rather than a part of a unitary enterprise.

It has been pointed out in the Butler Brothers and Edison California Stores decisions that the unitary nature of a business is . . .definitely established by (1) unity of ownership; (2) unity of operation evidenced by central purchasing, advertising, accounting and management; and (3) unity of use in the centralized executive force and general system of operation." No question arises in this case as to the existence of unity of ownership. Unity of operation sufficiently appears, in our opinion, from the parent's central manufacturing, which of course includes central purchasing, and the handling by the Appellant of only the parent's products, about seventy-five per cent of the California sales of which were made by Appellant, It is also to be observed that some advertising, accounting and tax return services were performed or acquired by the parent for the members of the affiliated group.

The employment of the parent's management and centralized executive force in the retail distribution of Youngstown products in California is demonstrated, we believe, by the circumstances surrounding Appellant's formation in 1941. It was that management and executive force which sought unsuccessfully in 1940 to negotiate a new contract with Republic embodying the reduced discounts established by the parent in 1939. Similarly, it was the decision then of that management and executive force which resulted in the extension of Youngstown activities into the retail distribution field through the creation of Appellant, The interdependence or integration of the three members of the affiliated group is further evidenced by the fact that the contract entered into with Republic provided not only for the acquisition of certain of its facilities but also for the payment by the Ohio company to Republic of 42.00 for each ton of Youngstown oil country tubular goods sold in California, Oregon and Washington during what would otherwise have been the remaining eight year life of the original contract and for the agreement of Republic not to handle or sell such goods in those States during that remaining term.

It having been determined that the Appellant's activities in this State constituted a part of a unitary business conducted by it and the parent and Ohio company, it necessarily follows, in our opinion, that the Appellant has not established that the application of the allocation formula to the combined net income of the three corporations results in the taxation of

extra-territorial values. As in the Butler Brothers, Edison California Stores and John Deere Plow cases, the attack of the taxpayer has not been upon the particular allocation formula employed or the manner in which that formula was applied, but the argument has been advanced that the system of accounting employed correctly reflected Appellant's income from sources in this State. These authorities, however, preclude the establishing by the taxpayer of the unreasonableness of the result reached through the application of the property-payroll-sales allocation formula to the income of a unitary business solely by evidence of the taxpayer's separate accounting and the accuracy and reasonableness of the entries therein. The fact that the local member of the unitary group was not charged with a pro rata amount of central office expense or service charges was held to be of no significance in the John Deere Plow decision (38 A.C. 216, 230) as respects the determining of the propriety of the use of a formula method of allocation.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of the Youngstown Steel Products Company of California to a proposed assessment of additional tax in the amount of $20,952.86 for the income year ended December 31, 1941, be, and the same is hereby, sustained.

Done at Sacramento California, this 29th day of May, 1952, by the State Board of Equalization.

Chairman
Wm. G. Bonelli, Member
J. H. Quinn, Member
Geo. R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary