



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
COMBUSTION ENGINEERING, INC.)

Appearances:

For Appellant: Philip A. Stohr
Attorney at Law

For Respondent: Lawrence C. counts
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Combustion Engineering, Inc., against proposed assessments of additional franchise taxes in the amounts of \$1,943.35, \$4,986.47, and \$8,873.24 for the income years 1956, 1957, and 1958, respectively,

The *question* presented for each year on appeal is whether appellant and **the** Air Preheater Corporation (hereinafter referred to as APC) were engaged in a single unitary business.

Appellant is a Delaware corporation qualified to do business in California. it owns all of the stock of APC. The chairman of appellant's board of *directors* and one other member of its board are on the nine-member board of directors of APC. APC did not qualify to do business in California until after the years in question.

Appellant designs and installs steam generating units for utilities and industrial customers. A major item in these units is a *boiler* which appellant manufactures using components obtained in part from other suppliers.

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APC's principal business activity consists of the manufacture and sale of the Ljungstrom Air Preheater, a regenerative type preheater which is widely used as a component part of boilers of the type manufactured by appellant. This regenerative preheater is a unique patented product sold only by APC. During the years under appeal sales of the preheater averaged between 91 percent and 98 percent of APC's total sales,

Since the year 1948 appellant has made extensive use of the Ljungstrom preheater in fulfilling its boiler contracts. For the combined income years 1956, 1957, and 1958, appellant's purchases from APC amounted to 40.4 percent of APC's total sales. Substantially all of these purchases consisted of the Ljungstrom preheater. The balance of the APC preheater sales were made to appellant's competitors at the same unit prices paid by appellant.

It appears from the record that appellant's customers usually specified the Ljungstrom preheater in soliciting bids for boiler units. When given discretion appellant, as well as its competitors, voluntarily selected the Ljungstrom preheater,

On its franchise tax returns for the years in question, appellant computed its income separately from that of APC. Respondent Franchise Tax Board, however, determined that APC and appellant were engaged in a single unitary business. It combined the income of the two corporations and by means of a three-factor formula allocated the income within and without the state. This action increased the amount of income attributable to California sources.

Appellant cites the large volume of sales made by APC to appellant's competitors and the absence of centralized functions such as common management, purchasing, financing, accounting and research as demonstrating that APC was engaged in a completely separate business.

Respondent points to the substantial volume of sales made by APC to appellant and appellant's ownership and control of APC as compelling a finding that the two corporations were engaged in a unitary business.

If the operations of the two corporations were unitary the share of the combined income attributable to California sources must be determined by means of formula apportionment; separate accounting may not be used. (Rev. & Tax. Code, § 25101 EKO Teleradio Pictures Inc., Franchise Tax Board, *246 Cal. App. 2d [___ Cal. Rptr. ___].)

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Commonly owned business operations carried on at locations within and Without the state have been held to be parts of a single unitary system where "... the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state" (Superior Oil Co. v. Franchise Tax Board, 60 Cal, 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33].) In Edison California Stores, Inc. v. McColgan, 30 Cal, 2d 472 [183 P.2d 16], the court applied this test in finding that operations conducted by commonly owned corporations were unitary.

A classic example of a unitary business is one in which, through commonly owned operations, goods are manufactured in one state and sold in another. (Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 [65 L. Ed, 165]; Altman & Keesling, Allocation of Income & State Taxation (2d ed. 1950) p. 101; Cal, Admin. Code, tit. 18, reg. 25101, subd. (a),) Under those circumstances the mutual contribution and dependency between the manufacturing operation and the selling operation are clear. The same type of contribution and dependency exists if only a portion of the output of one operation is marketed or utilized by the other; the difference is merely in degree. If two operations are commonly owned and only a portion of the output of one is marketed or utilized by the other, a unitary business may be found to exist. (Phillips v. Sinclair Refining Co., 76 Ga. 34 [44 S.E. 2d 671]; RKO Teleradio Pictures, Inc. v. Franchise Tax Board, supra, *246 Cal. App. 2d ____ [____ Cal. Rptr. ____]; Appeal of Youngstown Steel Products Co., Cal. St. Bd. of Equal., May 29, 1952; Wilkie, Uniform Allocation of Income from Unitary Business (1959) 37 Taxes 437.) The question must turn on whether the degree of mutual contribution and dependency reflected by the transfer of products is substantial, not on whether it is total, As stated in Butler Bros. v. McColgan, 17 Cal, 2d 664, 667, 668 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed, 991]:

if there is any evidence to sustain a finding that the operations of appellant in California during the year 1935 contributed to the net income derived from its entire operations in the United States, then the entire business is so clearly unitary as to require a fair system of apportionment by the formula method in order to prevent overtaxation to the corporation or undertaxation by the state.

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We find a significant connection in the business operations of the two corporations in the substantial transfer of goods by APC to appellant. In our opinion this activity, together with appellant's absolute right to control and direct the activities of APC through its complete stock ownership and membership on the board of directors of APC, warrants a finding that a unitary business operation was conducted,

Appellant purchased approximately 40 percent of APC's preheaters for use in the performance of its contracts. Since sales of this product represented in excess of 90 percent of APC's sales volume, it is clear that appellant's purchases represented a substantial contribution to the operations of APC. Appellant, in turn, was highly dependent upon APC to supply the preheater required for the performance of its contracts.

Under the circumstances *present* in this case, the sales of preheaters by APC to *customers* other than appellant must be regarded as merely an aspect of the unitary business. The additional sales resulted in optimum use of APC's facilities and presumably resulted in lower per unit costs, thus benefiting the entire business.

While the service or overhead functions of the two corporations were not centrally performed, we have previously ruled that such is not required if the operations are otherwise unified to the extent that they are mutually dependent and contribute to each other. (Appeal of McCall Corp., Cal. St. Bd. of Equal., June 18, 1963. Also see Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417, 424 [34 Cal. Rptr. 552, 386 P.2d 40].)

For the reasons stated, we conclude that the business operations of appellant and APC were not truly separate and that formula allocation of their combined income was proper,

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,

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IT IS HEREBY ORDERED, AD JUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Combustion Engineering, Inc., against proposed assessments of additional franchise taxes in the amounts of \$1,943.35, \$4,986.47, and \$8,873.24 for the income years 1956, 1957, and 1958, respectively be and the same is hereby sustained.

Done at Sacramento California, this 7th day
of July, 1967, by the State Board of Equalization,

Paul R. Lesto, Chairman
John W. Lynch, Member
J. Andrew Stein, Member
_____, Member
_____, Member

ATTEST: J. J. [Signature], Secretary