BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
PACIFIC COAST PROPERTIES, INC.;)
TECHNION CONSTRUCTION COMPANY;)
AND LAURELWOOD CO.)

Appearances:

For Appellants: Dudley M. Lang
Attorney at Law

For Respondent: A. Ben Jacobson
Counsel

Amicus Curiae: Theodore P. Lambros
Attorney at Law

O P I N I O N

These appeals are made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Pacific Coast Properties, Inc., Technion Construction Company, and Laurelwood Co. for refund of franchise tax in the amounts of $7,[illegible]66, $12 466.26 and $6,873.25, respectively, for the income years 1961, 1.560 and 1960, respectively.

Pacific Coast Properties, Inc., hereafter referred to as Pacific, is a Delaware corporation which qualified to do business in California on June 1, 1960. Pacific was organized so that it could acquire in 1960 certain properties and businesses in exchange for Pacific stock. In accordance with this plan Pacific acquired all the stock of three corporations: Technion Construction Company (formerly L. M. Halper & Co.) which owned all the stock of Laurelwood Co., Riskit Inc., and La Mirada Business Properties. A letter ruling was obtained from the Internal Revenue Service which stated that for federal income tax purposes no gain or loss would be recognized from these acquisition transactions as long as the subsidiaries were not liquidated into Pacific as part of the same acquisition plan. During 1961 Pacific acquired all the stock of two additional corporations, Signature Development Company and Midwood Building Supply Co.

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Pacific and its subsidiaries are engaged in the real estate development and investment business. The corporations have different functions, and as a group they can plan and carry out all phases of the development and marketing of residential or commercial real property, Financing, accounting, purchasing, and professional services are supplied to Pacific and its subsidiaries from a centralized source. Management is also centralized and therefore business decisions are based on the best interests of the group of corporations as a whole. Consequently, in any given income year the operations of several of the corporations may be favored over the operations of others, and significant intercorporate contribution occurs. Also the timing and success of one corporation's activities may depend upon another corporation's satisfactory completion of its phase of the development process.

During the years in controversy Pacific and its subsidiaries did business only in California. Each of the corporations filed a separate franchise tax return relating to the income year 1960. Technion Construction Company and Laurelwood Co. were the only corporations with a tax liability higher than the minimum statutory amount. They paid $12,566.26 and $6,973.25, respectively. Thereafter Pacific and its subsidiaries decided that they were authorized to submit a combined report which would consolidate their respective net incomes or losses. Since these corporations as a group in 1961 incurred a loss of approximately $388,500, Technion Construction Company and Laurelwood Co. filed claims for refund of the taxes which they had paid, less the minimum statutory amounts.

Pacific and its subsidiaries submitted a combined report relating to the income year 1961. It showed a franchise tax liability of $12,786.66. Respondent determined that each corporation was required to file separately, and that Pacific must compute its tax under the commencing corporation provisions of the Revenue and Taxation Code. This approach yielded a total tax liability of $88,587.17 for the corporations, $80,184.28 of this amount being assessed to Pacific. The tax was paid and Pacific, after recomputing the combined report with respect to the commencing corporation provisions, applied for a refund of $70,910.66.

The sole issue of the instant case is whether Pacific and its subsidiaries have a right to submit a combined report. Unless referred to separately, the amicus curiae's position coincides with the position taken by appellants.

Appellants state that Pacific and its subsidiaries are a highly integrated economic group. Therefore appellants argue that gain can only be realized by these corporations as a group, and sound accounting practice demands that their taxable income be computed on a consolidated basis.

Appellants point out that two or more corporations involved in an interstate unitary business are required to file a combined report which consolidates their respective net incomes and losses, and then are required to use formula allocation. (Edison California Stores, Inc, v. McColgan, 30 Cal. 2d 472 [183 P.2d 16].) They explain that when a business is unitary, i.e., when the business operations within this state are dependent upon or contribute to the operations outside California, the separate accounting of the operations within this state is inadequate and unsatisfactory in ascertaining the true income which had its source in California. (Edison California Stores, Inc. v. McColgan, supra; FTB LR 241, October 28 1959.) That is, according to appellants, separate accounting is congenitally incapable of producing an acceptable division of income for corporations operating an interstate unitary business, and therefore the state always requires a combined report and formula allocation. (See W. Beaman, Paying Taxes to Other States (1963) p. 7-3.)

Appellants argue that it is the unitary concept, i.e., the mutual dependence or contribution between the in-state and out-of-state portions of the business, which is the theoretical basis of the combined report requirement, not the fact of interstate operation. They state that Pacific and its subsidiaries are dependent upon or contribute to each other, and consequently they are in a unitary business. Therefore appellants argue that the separate accounting of Pacific and its subsidiaries is just as congenitally incapable of producing an accepted division of income among them as it would be of ascertaining California source income, if these corporations were engaged in an interstate unitary business with some of them operating solely outside this state.

Appellants contend that section 25102 of the Revenue and Taxation Code provides the necessary authority for the implementation of their position. This section provides:

> In the case of two or more persons, as defined in Section 19 of this code, owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may permit or require the filing of a combined report and such other information as it deems necessary and is authorized to impose the tax due under this part as though the combined entire net income was that of one person, or to distribute, apportion, or allocate the gross income, or deductions between or among such persons, if it determines that such consolidation, distribution, apportionment, or allocation is necessary in order to reflect the proper income of any such persons.

Appellants state that this statute allows a qualifying group of corporations to submit a combined report to the Franchise Tax Board which then must exercise its discretion in accepting or rejecting the report. The test to be applied by respondent, according to appellants, is whether the combined report is necessary in order to reflect the proper income of the corporations, Appellants state that respondent's exercise of discretion is reviewable under the standard that it must not be unreasonable, arbitrary or capricious.

We are not convinced that section 25102 controls the present case. Application of this section would seem to nullify the effect of the narrower section 25104 of the same code which applies specifically to parent and subsidiary corporations. 1/ (See Appeal of P. Lorillard Co., Cal. St. Bd. of Equal., Mar. 9, 1944; Appeal of Century Metalcraft Corp., Cal. St. Bd. of Equal., Mar. 30, 1944.) Section 25104 does not provide any authority

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1. Section 25104 provides:

> In the case of a corporation liable to report under this part owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation liable to report under this part and owned or controlled, either directly or indirectly, by another corporation, the Franchise Tax Board may require a consolidated report showing the combined net income or such other facts as it deems necessary. The Franchise Tax Board is authorized and empowered, in such manner *as it may* determine, to assess the tax against either of the corporations whose net income is involved in the report upon the basis of the combined entire net income and such other information as it may posses or it may adjust the tax in such other manner as it shall determine to be equitable if it determines it to be necessary in order to prevent evasion of taxes or to clearly reflect the net income earned by said corporation or corporations from business done in this State.

for the submission of a consolidated report by a group of qualifying corporations. Rather, authority is given solely to the Franchise Tax Board to require such a report when the board determines it to be necessary to prevent evasion of taxes or to clearly reflect net income. If the Franchise Tax Board does not require a consolidated report, then there is no reviewable exercise of discretion.

Assuming that section 25102, rather than section 25104, applies to the instant situation, we do not think it helps appellants' position. In Appeal of C. E. Toberman Co., Cal. St. Bd. of Equal., Feb. 15, 1951, this board construed section 25102 to be a grant of authority only to the Franchise Tax Board.

Appellants argue strenuously that the Toberman decision, supra, is erroneous or obsolete. They argue that the case was based upon the misconception that the first paragraph of section 14 of the 1937 Bank and Corporation Franchise Tax Act (a predecessor of section 25102) was the counterpart of section 45 of the Federal Internal Revenue Code (a predecessor of the present section 482). 2/ The Toberman decision, supra, relied upon the federal regulation applicable to the latter statute. That regulation states that the statute gives authority only to the government and not to the taxpayer. Amicus curiae argues that the 1937 amendment to the first paragraph of section 14, which added the combined report language, ended any reliable comparison between this statute and federal section 45 by substituting the remedy of a combined report for the remedy of reallocation of gross

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2. Section 45 of the 1939 Internal Revenue Code provided:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

income or deductions. However, the amicus curiae misconstrues the effect of the 1937 amendment. It did not substitute a new remedy, but rather added an alternative one. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal. 2d 472 [183 P.2d 16]; Appeal of Planned Music, Inc., Cal. St. Bd. of Equal., April 25, 1962.) The reallocation remedy remained the counterpart of federal section 45, and the Toberman decision did not err in referring to the applicable federal regulation as an aid for the interpretation of the first paragraph of section 14.

The amicus curiae contends that regulation 24303-24304, title 18, California Administrative Code, is controlling authority for the position that section 25102 allows corporations to submit a combined return. This regulation applies to section 25102 and its immediate predecessor. Regulation 24303-24304 states in part:

> Where a unitary business is owned and controlled by the same interests, regardless of whether it is conducted in the *name* of two or more corporations, or in the name of one or more corporations and one or more partnerships or individuals, the income from the entire unitary business will first be determined as if the business had been conducted in the name of one corporation. The portion of the unitary income derived from or attributable to California will be determined by means of a formula. If the business in California is conducted by two or more corporations, the portion of the income attributed to California may be further apportioned between the corporations. If the business in California is conducted by two or more entities, one of which is a corporation, the portion of the income attributed to California in the manner outlined above may be further apportioned between such entities.

We do not think that this regulation is relevant to the instant issue. The regulation, read as a whole, refers to an interstate unitary business involving two or more taxable entities. It covers subject matter relevant to section 25101, but omitted from the regulation applicable to that section. Consequently regulation 24303-24304.1s not germane to appellant's intrastate fact situation.

Appellants argue that the phrase "may permit" in section 25102 indicates a legislative intention to authorize taxpayers to submit a combined report. We do not agree. If the Legislature had intended to give such authority, it is probable that it would have been explicit. We think that the proper construction of this language of the statute is that the Franchise Tax Board is given discretionary authority to permit the submission of a combined report if one is offered, or to require such a submission, if the board determines that a combined report is necessary in order to reflect the proper income of the corporations. A taxpayer cannot compel the Franchise Tax Board to act, that is, to permit or require submission of a combined report. If the board does not act, then under section 25102 there is no reviewable exercise of discretion.

Appellants challenge the constitutionality of an interpretation of the Bank and Corporation Tax Law that allows corporations which are part of an interstate unitary business to file a return which consolidates their respective net incomes and losses, but denies this right to their intrastate counterparts. This contention is based primarily on the equal protection clause of the Fourteenth Amendment to the United States Constitution. However, after reviewing the authorities cited by appellants and the amicus curiae we are not convinced that the separate classification of these two types of businesses is an arbitrary or invidious discrimination. In dealing with taxation, the utmost latitude under the equal protection clause must be afforded a state in defining categories of classification. (Allied Stores of Ohio v. Bowers, 358 U.S. 552 [3 L. Ed. 2d 480].)

We conclude that appellantsand amicus curiae have not presented us with adequate authority upon which to base a right of a group of corporations, engaged in an intrastate "unitary" business, to submit a combined report which consolidates their respective net incomes and losses. We also conclude that denial of such a right to appellants is not unconstitutional. Therefore respondent's determination that Pacific and its subsidiaries are required to file separate returns must be upheld.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Pacific Coast Properties, Inc., Technion Construction Company and Laurelwood Co. for refund of franchise tax in the amounts of $70,910.66, $12,466.26 and $6,873.25, respectively, for the income years 1961, 1960 and 1960, respectively, be and the same is hereby sustained..

Done at Sacramento, California, this 20th day of November, 1968, by the State Board of Equalization.

_____, Chairman

John W. Lynch, Member

_____, Member

Paul R. Leake, Member

_____, Member

ATTEST: _____, Secretary