BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DANIEL INDUSTRIES, INC.)

For Appellant: Robert A. Petersen
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief, Counsel

John A. Stilwell, Jr.
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Daniel Industries, Inc. against proposed assessments of additional franchise tax in the amounts of **$1,847.32, $2,113.16, and $4,435.84** for the income years ended September 30, 1969, 1970, and 1971, respectively.

Appeal of Daniel Industries, Inc.

The primary issue for determination is whether appellant's wholly owned subsidiary, Daniel Bolt Company, was engaged in a unitary business with appellant and appellant's other subsidiaries during the appeal years.

Appellant is a Texas corporation with its principal office in Houston. In addition to Daniel Bolt Company (Bolt), appellant owned 80 percent or more of the capital stock of four additional subsidiaries: Poole Advertising, Inc.: Daniel Industries (UK) Ltd.; Daniel de Mexico, S.A.; and Ruth-Berry Co. Appellant agrees that it is engaged in a unitary business with these four subsidiaries.

The principal bus'iness activity of appellant and its four unitary subsidiaries is the manufacture and sale of devices to meter and control the flow of liquid and gas. Appellant's product line includes sophisticated electronic metering equipment, orifice measurement equipment, check valves and water pumps. The major markets for appellant's products are. the petroleum and chemical industries. Appellant has plants in Texas, California, Mexico and England. Its sales offices are located in major American and foreign cities.

As part of a diversification and expansion program, Bolt was formed as a separate subsidiary in 1961. Bolt is engaged in the manufacture and sale of alloy steel stud bolts and nuts and other industrial fasteners. The major markets for Bolt's products are the petrochemical industries located chiefly in the Gulf Coast region of the United States. Bolt's only plant is located in Houston. The plant, which was constructed and is owned by appellant, is rented to Bolt at a fair market rental.

Appellant operates in a high technology environment where advanced technical knowledge is essential to maintaining its market position. Bolt, on the other hand, is engaged in the manufacture and distribution of stud bolts and nuts, a relatively low technology field involving repetitive manufacturing operations. Its operations do not require the highly skilled personnel as do the operations of appellant. As a result of the difference in technology levels, the engineering and sales forces of appellant and Bolt were totally separate. For the same reason, research and development programs were not integrated. Neither company shared plants, sites, machinery or equipment. Purchasing, sales invoicing, inventory control, and most other functions were separate and distinct within each company. A limited amount of

Bolt's accounting and data processing, such as,. payroll, accounts' receivable, and accounts' payable was performed by appellant. Bolt was charged a fee for this service.

Appellant had five directors and six officers. Bolt had three directors and five officers. Two of appellant's five directors were also directors of Bolt. Four of appellant's six officers were also officers of Bolt. Although there were some common officers and directors, there is no indication that a strong centralized management or integrated executive force existed between appellant and Bolt. The record indicates that, with the exception of Francis A. Wise, Bolt's vice president and general manager, the overlapping officers served merely to satisfy legal requirements. Not only did they not become involved in Bolt's day-to-day operations, but they also provided only the required legal ratification of major policy decisions. The executive forces were separate and distinct due to the separate and distinct nature of the business operations. With the exception of the common officers and directors, whose positions were titular only, the companies did not have any common employees, and there has never been an exchange of personnel.

Although Mr. Wise, the general manager of Bolt, was also a vice president of Bolt, he was neither an officer nor a director of appellant. When Bolt was formed, Mr. Wise agreed to leave his former employer and manage the new enterprise. Due to 'the diverse operating environments, Mr. Wise had little contact with appellant's management. In his capacity as general manager of Bolt he was permitted a great deal of autonomy with respect to major policy decisions and was totally responsible for Bolt's day-to-day operations.

In the respective appeal years appellant purchased stud bolts and nuts from Bolt in the amounts of: $166,269; $163,195; and $191,027. During the same period, appellant'-s total annual purchases of materials averaged $10,000,000. These sales represented approximately five percent of Bolt's total sales and were made at an arm's length price. Although appellant's purchases from Bolt represented approximately 50 percent of its stud bolt and nut requirements, these items did not comprise a significant part of appellant's finished products. Appellant also purchased locally the same items from Western Screw Company, Texas Screw Products Company and Coast Industrial Supply Company in the Houston and Los Angeles areas, and from several foreign sources to supply its foreign subsidiaries.

During the second and third years under appeal, appellant made several loans to Bolt totalling approximately $400,000. These loans were made at market interest rates. At the time the loans were made, Bolt's current assets were valued at approximately $12,000,000, while its net worth approximated $1,500,000. By the end of the final appeal year the entire amount of the loans had been paid off by Bolt.

Appellant and Bolt also shared the same insurance carrier. However, there is no indication that the insurance was centrally purchased, or that common experience ratings were used. Apparently, both companies offered their employees the same retirement plans. The use of the name "Daniel" was common to both companies.

When a taxpayer derives income from sources both within and without California, it is required to measure its California franchise tax liability by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with an affiliated corporation, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16] (1947); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dism., 343 U.S. 939 [96 L. Ed. 13451 (1952).) If, however, the business within this state is truly separate and distinct from the business without the state so that the segregation of income may be made clearly and accurately; the separate accounting method may properly be used. (Butler Bros. v. McColgan, 17 Cal. 2d 664, 667 [111 P.2d 334] (1941) affd., 315 U.S. 501 [86 L. Ed. 9911 (1942).)

The California Supreme Court has determined that a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation as evidenced by centralized purchasing, advertising, accounting and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, supra, 17 Cal. 2d at 678.) The court has also held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal. 2d at 481.) These principles have been reaffirmed in more recent

cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963).)

The existence of a unitary business may be established if either the three unities or the contribution or dependency test is satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Implicit in either test, of course, is the requirement of quantitative substantiality. (Appeal of Beatrice Foods Co., Cal. St. Bd. of Equal., Nov. 19, 1958; Appeal of Public Finance Corp., Cal. St. Bd. of Equal., Dec. 29, 1958; see also Superior Oil co. v. Franchise Tax Board, supra.) In other words, corporations are engaged in a unitary business within the scope of either test if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporations.

Initially, appellant argues that it is not engaged in a single trade or business with Bolt and, therefore, is not unitary with Bolt. While a determination whether an enterprise is engaged in a single trade or business must turn on the facts of each case, some guidance is provided by respondent's regulations which state:

> In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the divisions under consideration are integrated with, dependent upon or contribute to each other and the operations of -the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business; and the presence 'of any of these factors creates a strong presumption'that the activities of the taxpayer constitute a single trade or business:
>
> (1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. ...
>
> (2) Steps-in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions are engaged in different steps in a large, vertically structured enterprise. ...

> (3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management,. coupled with the existence of centralized departments for such functions as financing, advertising, research, and purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are involved in the day-to-day operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself. ... (Cal. Admin. Code, tit. 18, reg. 25120, subd. (b) (art. 2).)

Based on this record, we cannot conclude that any of the three factors set forth in the regulation are present, or that any other reason exists which would require a conclusion that appellant and Bolt were engaged in a single trade or business.

Appellant and Bolt are not in the same type of business. Appellant manufactures and sells devices to measure and control the flow of oil and gas, a high technology operation. Bolt manufactures and sells bolts and nuts which require a relatively low technology level. It is true that the general market for the products of both companies is the petrochemical industry. However, appellant's market is international in scope while Bolt's is relatively limited geographically. Although it could be argued that both appellant and Bolt are in the business of supplying the petrochemical industry, in view of the disparate nature of the technology levels and the end products themselves, such conclusion would be far too broad. Appellant manufactures and sells measurement and control devices while Bolt is in the separate business of manufacturing and selling bolts and nuts.

It is also apparent that the two companies are not involved in different steps in a large, vertically integrated enterprise. While appellant does purchase 50 percent of its bolt and nutrequirements from Bolt, these items are a relatively insignificant part of appellant's finished products. Furthermore, the purchases represent only five percent of Bolt's total sales, and less than two percent of appellant's total purchases.

The existence of a strong centralized management is not apparent from the record. The executive forces of appellant and Bolt were separate and distinct due to the diversity of the companies' operations. Mr. Wise, Bolt's general manager, was given a great deal of latitude not only with respect to day-to-day operations but also with major policy decisions. Other than the common officers and directors, the companies have no common employees and there has never been an exchange of executives. Furthermore, centralization of both line and staff functions are minimal.

Although we have determined that appellant and Bolt were engaged in more than one trade or business our inquiry does not end here; As we have recently restated in the Appeal of Wynn Oil Company, decided February 6, 1980, the mere fact corporations are engaged in diverse lines of business, standing alone, does not preclude a finding that such businesses are unitary. However, in some instances involving diverse businesses, the factual basis for a finding of unity may require a stronger evidentiary showing than would be required in situations involving an integrated business, since, in diversification situations, the advantages to be gained by traditional unitary characteristics are less obvious and more attenuated than they are in the more typical integrated unitary business. (See, e.g., Appeal of Wynn Oil Company, supra.) Or, stated in another way, the burden to rebut the presumption of correctness attached to respondent's determination borne by an appellant challenging the existence of a unitary business in this setting may be less onerous.

We believe, however, that an application of either of the two traditional tests leads to the conclusion that Bolt is not unitary with appellant and appellant's other unitary subsidiaries.

It is not disputed that unity of ownership is present since appellant owns all of Bolt's stock. Appellant argues, however, that any contribution or dependency that does exist is quantitatively insubstantial and that the unities of use and operation are not present in a degree sufficient to justify a finding of unity. We agree.

In arguing that contribution or dependency is present in a degree sufficient to establish the existence of a unitary business, respondent relies, primarily, on integrated executive, forces. Respondent first asserts that Bolt and appellant had identical officers and directors during the appeal years. As we have previously

indicated, this is incorrect as a matter of fact. While some of the officers and directors were the same they were not identical. Furthermore, with the exception of Bolt's vice president and general manager, the positions of Bolt's other officers were titular only. Respondent also fails to recognize that Mr. Wise, Bolt's vice president and general manager, was also an officer of Bolt although not an officer or director of appellant. Mr. Wise, a seasoned executive, had little contact with appellant's management. He was given wide latitude with respect to both major policy decisions and day-to-day operations. As we have indicated, due to the vastly different technological requirements of the two organizations, the executive forces were not significantly integrated. Furthermore, the benefits of an exchange of operational know-how which is characteristic of integrated executive forces may not be presumed where, as here, we are dealing with two diverse enterprises. (Compare Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3d 496 [87 Cal. Rptr. 239] app. dism. and cert. den., 400 U.S. 961 [27 L. Ed. 2d 381] (1970).) While appellant has effectively negated the existence of either an integrated executive force or strong centralized management, respondent has failed to offer a single example which tends to indicate their existence.

Next, respondent argues that the intercompany loans are evidence of contribution or dependency. It is well established thqt the existence of intercompany financing can be an indication of unity. However, we can attach little significance to isolated short-term loans totalling less than four percent of the value of Bolt's current assets, which were liquidated within approximately one year. This is neither the amount nor the extent of intercompany financing relied on as a unitary characteristic in the authorities cited by respondent. (See Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeals of Browning Manufacturing CO., Cal. St. Bd. of Equal., Sept. 14, 1972.)

Although admitting that they were not substantial, respondent points to the intercompany sales as evidence of contribution or dependency. Traditionally, significant intercompany sales have been considered a unitary factor. However, in the instant appeal the admittedly insubstantial sales constituted only five percent of Bolt's total sales and constituted less than two percent of appellant's total purchases. Furthermore, the fungible items sold, nuts and bolts, are not a significant part of appellant's finished products and are also purchased from local suppliers as required. Contrary

to respondent's assertion, no plausible "guaranteed source of supply" argument can be maintained here as was made in Chase Brass, supra, where copper, an ore in short supply worldwide, made up the bulk of the intercompany sales.

Respondent seeks further support for its position from the following factors: centralized accounting; common insurance carrier: use of the name "Daniel"; availability of a common retirement plan: and appellant's ownership of Bolt's plant.

While all these factors have been considered. indicators of unity in appropriate circumstances, under the facts of this particular appeal it is not apparent that they resulted in any significant contribution or dependence. Initially, we note that the so-called/centralized accounting is merely a small amount of data processing -in a limited area. Similarly, there is no suggestion of any cost savings obtained by the use of a common insurance carrier through common purchasing, common coverage or otherwise. With respect to the use of the name "Daniel", there is no evidence of any common advertising or other promotion of the trade name. Although both companies tend to serve a somewhat similar market, there is no indication that appellant's reputation has any impact on Bolt's competitive position in a totally unrelated field, or vice versa. There is some unitary significance to the fact that appellant owns Bolt's plant and that a common retirement plan is available to the employees of both companies. However, we do not find -these factors sufficient, either singularly or in combination with the other factors advanced by respondent, to justify a determination that a unitary business exists.

Many other factors relied on to establish the existence of a unitary business in prior cases are not present here. For example: Due to the two enterprises' differing technology levels, engineering, research and development, purchasing, sales forces and most other line and staff functions were separate and distinct within each organization. There is no evidence of the exercise of any operational control by appellant over Bolt through standardized policies and procedures, budgeting, executive exchanges, or otherwise. There was no exchange of personnel and no sharing of plants, sites, machinery or equipment.

For the above reasons we conclude that the quantum of contribution and dependence existing between appellant and Bolt is insubstantial.

With respect to the three unities test, for similar reasons, we cannot conclude that either unity of use or unity of operation is present in a degree sufficient to justify a finding of unity.

In attempting to establish the existence of unity of use, which involves line functions, respondent apparently relies on; integrated executive forces, intercompany sales and loans, and appellant's ownership of Bolt's plant. As we have previously indicated, although there is some overlap of officers and directors, there is no integrated executive force in fact. Additionally, the facts presented in this appeal indicate that the intercompany sales and loans are insubstantial. Finally, we are able to attach little unitary significance to the fact that Bolt rents a building owned by appellant.

It is asserted by respondent that unity of operation, involving staff functions, is established by; centralized accounting, the availability of a common retirement plan, use of a common insurer, and a common trade name. Centralized accounting, as alleged, does not exist. What does exist is merely a small amount of data processing performed for Bolt by appellant. The mere availability of a common retirement 'plan is of little significance. The use of the same insurer is also of little significance in the absence of common purchasing, common coverage, or some other indication of cost savings. In the absence of common advertising or other promotion, the value attributable to the joint usage of the name "Daniel" is conjectural. This is especially true in this appeal where appellant and Bolt have totally different sales forces which serve entirely different segments of the petrochemical industry.

In this appeal, we cannot conclude that the factors relied on by respondent, either singularly or in combination, establish a sufficient degree of unity of use and unity of operation to justify a finding that a unitary business exists.

The determination in this appeal that 'neither the contribution or dependency test nor the three unities test is satisfied is not intended to denigrate the importance of any traditional unitary factors of substance. However, in situations involving separate trades or businesses it is not sufficient merely to recite traditional unitary characteristics which, in the environment of diverse enterprises, are lacking in substance. We must always be mindful that at the heart of the determination of the existence of a unitary business by the application

of either of the two established tests is the question whether, as a result of the unitary characteristics, the income (or loss) of the combined operations are materially different from what they would have been in the absence of those unitary characteristics. In this appeal that question must be answered in the negative.

Appellant also contends that the rental income received from the rental of the building to Bolt is nonbusiness income specifically allocable to the situs of the property in Texas. Respondent has offered no argument in opposition to this contention. Under the circumstances, it is readily apparent that the rental income in question constitutes nonbusiness income. (Rev. & Tax. Code, § 25120, subd. (a) and (c).) Accordingly, it is specifically allocable to its situs in Texas., (Rev. & Tax. Code, §§ 25123 and 25124.)

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 Board on the protest of Daniel Industries, Inc. against proposed assessments of additional franchise tax in the amounts of $1,847.32, $2,113.16, and $4,435.84 for the income years ended September 30, 1969, 1970, and 1971, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 30th day of June , 1980, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member