BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HOLLYWOOD FILM ENTERPRISES, INC.)

Appearances:

For Appellant: William W. Sumner
Attorney at Law

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Hollywood Film Enterprises, Inc., for refund of franchise tax in the amounts of $80,597, $54,375, and $56,620 for the income years ended June 30, 1971, June 30, 1972, and June 30, 1973, respectively.

Appeal of Hollywood -Film Enterprises, Inc.

The sole issue presented by this appeal is whether appellant was engaged in a unitary business with its parent during its income years ended in 1971, 1972, and 1973.

Hollywood Film Enterprises, Inc. (hereinafter "Hollywood" or "appellant") was a wholly owned subsidiary of Inflight Services, Inc. (hereinafter "Inflight"), a Delaware corporation with headquarters in New York City. When Hollywood was acquired by Inflight in 1968, Hollywood's chief executive officer, Mr. Kaplan, continued as president (and as one of the four directors) under an employment contract with Inflight which was in-effect throughout the years on appeal. Two other Hollywood employees also remained as officers after the acquisition. Three officers and directors of Inflight served in similar capacities with Hollywood, and another of Inflight's officers was also an officer of Hollywood.

Hollywood's business, before and during the appeal years, was that of a film laboratory, developing motion picture film and converting film from one mode to another for use in different types of projectors. Its facilities were located in Hollywood, California; and its activities were all conducted within California. Although Hollywood apparently was capable of processing almost any type or size of film, it was involved primarily in developing and printing educational, informational, and training films for industry, government, and educational institutions.

Inflight's principal business was providing full length feature films to airlines for passenger viewing during flights. The airline would choose the film it wanted, and Inflight would ordinarily obtain the required number of prints from a film distributor,.. The distributor would arrange for developing, printing, and conversion of the film by a laboratory of its choice. Inflight's business was conducted both within and without California.

During the years on appeal, Hollywood was required to *conform* to Inflight's accounting and budget procedures so that it might be included in Inflight's consolidated financial statements and reports. Checks drawn for more than $10,000.00 required a countersignature by one of Inflight's officers in New York. The same accounting firm audited both companies', and Inflight apparently retained law firms which both companies used.

Appellant states that Inflight negotiated and purchased most of the liability and casualty insurance for the two companies. The employees of both were eligible for voluntary group life and disability, insurance coverage negotiated and partially paid for by Inflight. Certain key employees of Hollywood also participated in Inflight's executive stock option program. Inflight began providing Hollywood with marketing assistance during this time and several Inflight officers traveled to California to meet with Mr. Kaplan and review Hollywood's operations. On occasion, Hollywood provided Inflight with requested advice or information on technical matters.

For the income years ended in 1971, 1972, and 1973, appellant and Inflight each filed separate California returns. Appellant reported its entire net income from its operations and Inflight used formula apportionment to determine the income from its operations which was subject to taxation by California. Appellant subsequently filed claims for refund, asserting that it was engaged in a unitary business with Inflight during those income years and computing its revised California income on the basis of a combined report. Respondent determined that the two corporations were not unitary and denied the refund claims. This timely appeal followed.

A taxpayer which derives income from sources both within and without California is required to measure its California franchise tax liability by its net income derived from or attributable to California. (Rev. & Tax. Code, § 25101.) Even if a taxpayer does business solely in California, its income is derived from or attributable to sources both within and without California where that taxpayer is engaged in a multistate unitary business with affiliated corporations. In such a case, 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 corporations. (See Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

Respondent's determination is presumptively correct, and appellant bears the burden of proving that it is incorrect; i.e., that the two companies did constitute a unitary business. The existence of a unitary business is established if either of two tests is met. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) The California Supreme Court has

determined that the existence of a unitary business is definitely established by the presence of: (1) unity of ownership; (2) unity of operation as evidenced, by central 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, 17 Cal.2d 664, 678 [ill P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) The court has also stated that a business, is unitary when the operation of the portion of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc., supra, 30 Cal.2d at 481.)

Appellant asserts that it was unitary with Inflight under bqth the tests for unity. Unity of ownership was clearly present since Inflight owned 100 percent of Hollywood's stock, Appellant contends that unity of operatipn was evidenced by Inflight's selection of legal, accounting, and public relations firms, Inflight's control of Hollywood's accouriting and budget procedures, Inflight's negotiation and purchase of liability, casualty, group term life, and group disability insurance for both companies, and Inflight's use of Hollywood's credit for obtaining loans. Unity of use is evident, appellant declares, in the interlocking officers and boards of directors, Inflight's executive assistance to Hollywood in the areas of financial guidance, marketing, and sales, Inflight's attempts to procure business for Hollywood, and the exchange between the two companies of technical knowledge and new developments in film processing. In support of its contention that contribution and dependency existed between the two companies, appellant cites execut-ive control and assistance by Inflight, the exchange of technical knowledge and research, some financial assistance to each other,, and services and employee benefits provided by Inflight.

Respondent argues that appellant and it!; parent are engaged in diverse enterprises which are neither horizontally nor vertically integrated, that in such cases a stronger evidentiary showing of unity is required, and that the connections alleged by appellant are insufficient to show unity under either test. It concludes, therefore, that the two companies were not engaged in a single unitary business during the years on-appeal.

Respondent contends that Inflight and Hollywood are engaged in diverse lines of business and, therefore,

a greater level of proof is required for appellant to show that they were unitary. It bases this contention on the following language from the Appeal of Wynn Oil Company, decided by this board on February 6, 1980:

> The thrust of the decisions cited by both parties is that the mere fact corporations are engaged in diverse lines of businesses, standing alone, does not preclude a finding that such businesses are unitary. However, the cited decisions also indicate that, in some instances involving diverse lines of businesses, the factual basis for a finding of unity may require a stronger evidentiary showing than would be required 'in situations involving vertical or horizontal integration, since, in diversification situations, the advantages to be gained by centralization may be less than they are in the more typical vertically or horizontally integrated unitary business.

(See also, Appeal of Daniel Industries, Inc., Cal, St, Bd. of Equal., June 30, 1980.)

The quoted language does not create a preliminary or separate test in which it must be determined whether or not two entities are engaged in diverse businesses. It does not shift the burden of proof as to issues of fact; 1/ neither does it impose a heavier burden. It merely points out that where there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow, will often not exist. Therefore, factors which might be considered relatively insignificantin a case of horizontal or vertical integration-take on added importance because they are the only factors present to consider. Each case must be decided on its own particular facts; here appellant must produce sufficient. evidence to show that in substance the factors present demonstrate the existence of a single integrated economic unit.

1/ Except when the Franchise Tax Board is asserting fraud with intent to evade tax, the burden of proof is on the appellant. (Cal. Admin. Code, tit. 18, § 5036.)

In this appeal, the traditional vertical or horizontal integration is lacking. Inflight and Hollywood did not deal with each other as steps in a vertical process, nor did they deal with the same level of technology or provision of the same end product or service. Usual significant factors such as intercompany product flow or central purchasing and distribution, which are often clear indications of unity, are entirely lacking. We must, therefore, scrutinize the other factors present, which are generally less forceful indications of unity, to see if they are really of such significance as to compel the conclusion that the two companies were engaged in a single unitary business.

Appellant urges that' "every factor pointing to unity of operation and unity of use is present." It then provides us with a list of 42 events and activities which it considers to be indicative of the unity between the two companies. We find many of the listed items unpersuasive for a number of reasons.

First, even with more than fifty exhibits in support of appellant's proffered facts, the record contains contradictions which make it difficult to know the true situation. For example, in its opening brief, appellantdescribed almost $5,000,000.00 transferred from Hollywood to Inflight over a period of seven years as a series of loans; in correspondence with respondent, however, appellant emphasized that the payments were not loans, but dividends.

Second, a number of the factors listed by appellant as evidences of unity reveal only that Hollywood was considered'an asset owned by Inflight. Among these are the restrictions on some of Hollywood's financial activities imposed by Inflight's credit agreements with banks and some of the reporting procedures required by Inflight to enable it to file consolidated returns.

Quite a few of the items refer to events which took place in years after the income years on appeal, Appellant argues that they are relevant since they show the later effect of attempts by Inflight during the appeal years to channel processing business to Hollywood. It cites the Appeal of Williams Furnace Co., decided August 7, 1969, Appeals of Monsanto Company, decided November 6, 1970, Appeals of Anaconda Company, et al., decided May 11, 1972, and Appeal of I-T-E Circuit Breaker Company, decided September 23, 1974, as cases in which this board has considered activities or events in

years other than those under consideration as significant or relevant evidence of unity. In only the Appeal of I-T-E Circuit Breaker Comhowever, is any direct reference made to the significance of events in other years, and those were years before the ones on appeal. Activities from prior years which continue during years being appealed may, 'in some cases, be appropriately considered as evidence of a long-standing interrelationship between two companies rather than mere isolated events which would do little to show unity. However, only in rare instances would activities after the appeal years be relevant since we must look at the integration which actually existe'd, not that which may have existed later. We do not believe that this appeal presents one of those rare instances. Therefore, we find that the ac-tivities which occurred after the income year ended June 30, 1973, are not germane to the determination of whether Inflight and Hollywood were unitary during the years on appeal.

Viewing the situation of Inflight and Hollywood with the preceding'considerations in mind, we conclude that the relationship between the two companies during the appeal years was not such that they'constituted a single integrated economicunit. Although there clearly was unity of ownership, the factors alleged by appellant as indicating unity'of operation and use or contribution or dependency were more form than substance.

Unity of operation encompasses what may be called staff functions; e.g., common purchasing, advertising: accounting, and intercompany financing. Although some of these factors were present to a certain degree, they were in the least significant categories, such as use of the same advertising agency and auditors, and there is no indication that the relatively minor centralized functions resulted in any substantial mutual advantage. Operational unity, therefore, cannot be said to have existed to any meaningful extent.

Under unity of use, appellant stresses the interlocking boards of directors and officers which provided Hollywood with executive assistance in the areas of financial guidance, marketing, and sales. While high level executive assistance is considered an important element of unity of use (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 504 [87 Cal. Rptr. 239] (1970)), in the instant case it lacks significance because it did not contribute to inteqration of the two companies. The executive assistance-described

by appellant, which was provided primarily in the areas of marketing and financial control, reveals nothing more than Inflight's interest in expanding Hollywood's own market and making it into a more productive asset. Other than providing general fiscal guidance, there is little indication that Inflight's executives had the expertise, at least during the appeal years, to provide Hollywood with the type of assistance which is associated with the integrated executive forces of a unitary business. The instances of technical or informational interchange which occurred during these years, rather than showing any integration of operational systems;, point up the learning process which Inflight's executives were undergoing at that time. We find that appellant has not shown that there was unity of use during the appeal years.

The lack of unity is even more clear under the contribution or dependency-test. The preceding discussion shows that, upon examination, the unitary factors propounded by appellant do not show that the operation of Hollywood contributed to or depended upon the business of Inflight in such a way as to compel the conclusion that the two companies were engaged in a single integrated economic enterprise. This is not to say that the companies could never be found to be unitary, given a somewhat different factual situation in other years, but only that appellant has not shown that they were sufficiently integrated during these years to be considered a single unitary business. Under these circumstances, respondent's action is sustained.

O R D E R

Pursuant to the viewsexpressed 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 Hollywood Film Enterprises, Inc., for refund of franchise tax in the amounts of $80,597, $54,375, and $56,620 for the income years ended June 30, 1971, June 30, 1972, and June 30, 1973, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 31st day of March , 1982, by the State Board of Equalization, with Board Members Mr. Reilly, Mr. Dronenburg and Mr. Nevins present.

_____, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member