



Appeal of Kikkoman International, Inc.

Two questions are presented by this appeal: (1) whether appellant and its Japanese parent were engaged in a single unitary business, and (2) if so, whether appellant was entitled to use a special allocation and apportionment method pursuant to Revenue and Taxation Code section 25137.

Appellant, Kikkoman International, Inc., is a California corporation, 70 percent of which is owned by a Japanese corporation, Kikkoman Shoyu Co., Ltd. (hereinafter "KSC"). Appellant imports and sells soy sauce, all of which it buys from KSC. The soy sauce is sold to appellant at an arms-length price, apparently because of United States customs requirements. During appellant's 1969, 1970, and 1971 income years it had the exclusive right to market KSC's soy sauce in the United States.

KSC is the leading seller of soy sauce in Japan and, through subsidiaries, is engaged in a number of other activities worldwide, most of which are related to various food products. Sales to appellant during the appeal years were 1.46 percent of KSC's total sales.

Three of appellant's ten directors were also directors of KSC, and appellant's president was an officer of KSC throughout this time. Twenty-eight percent of appellant's employees were former mid-management employees of KSC, and employees of both companies met two or three times a year in California for management conferences.

Although appellant had its own advertising department and used marketing techniques different from KSC's, part of its advertising cost was reimbursed by KSC (14.5% in 1969, 23.7% in 1970, and 16.2% in 1971). Appellant maintained its own legal, accounting, and research and sales departments, as well as its own insurance and employee benefit programs. The two companies also kept separate accounting records and used different fiscal years.

For the years on appeal, appellant reported its California income on a separate accounting basis. After an audit, the subject assessments were issued because respondent had determined that the two companies were engaged in a single unitary business and that appellant's income taxable by California should have been determined by formula apportionment. After appellant's protest, respondent affirmed the assessments, and this timely appeal followed.

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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 sources. (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 when that taxpayer is engaged in a unitary business with affiliated corporations doing business 'outside California. 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 161 (1947)].)

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.) In Butler Bros. v. McColgan, 17 Cal.2d 664, 678 [111 P.2d 334] (1941), affd. 315 U.S. 501 [86 L.Ed. 991] (1942), the California Supreme Court determined that the existence of a unitary business had been definitely established by the presence of unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions, and unity of use in a centralized executive force and general system of operation. The court later 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. v. McColgan, supra, 30 Cal.2d at 481.)

Respondent's determination that appellant is engaged in a unitary business with its parent is presumptively correct, and the burden is on the appellant to show that such determination is erroneous. (Appeal of John Deere Plow Co. of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Appellant must, therefore, prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by respondent are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., decided this day.) We find that appellant has not met this burden.

The interrelationships between the two companies demonstrate a marked contribution and dependency,

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making it unnecessary to discuss the three unities test. Appellant and KSC are a classic example of the type of vertically integrated enterprise to which the unitary concept has been applied. KSC owned 70 percent of appellant. Appellant was in the business of importing and selling soy sauce, all of which it bought from KSC. Appellant had the exclusive right to market KSC's soy sauce in the United States. Soy sauce was KSC's original product., and even after the product lines and markets were expanded, it was still a major product of KSC.

Although appellant denigrates the importance of the overlapping directors and officers, we cannot imagine that appellant did not benefit from the expertise and experience of these executives. The Japanese executives may not have been experts in United States marketing, but they' certainly knew about the product appellant sold. The transfer of the parent's employees to appellant and the joint management conferences also indicate an interchange of expertise beneficial to both corporations. KSC's contributions to appellant's advertising budget undoubtedly helped appellant in its marketing, and appellant's marketing improvement and expansion helped KSC sell more soy sauce to appellant.

We are not persuaded that, in the aggregate, these connections between appellant and KSC lacked substance. In light of the substantial interrelationships of the two companies, the elements of independence and separateness emphasized by appellant are inconsequential. We find that KSC and appellant operated as a single integrated economic enterprise, and respondent's determination of unity is, therefore, correct.

Because appellant was engaged in a single unitary business with KSC, its net income for the years in question must be allocated and apportioned in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120-25139 of the Revenue and Taxation Code. Generally speaking, UDITPA requires that a taxpayer's business income be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.) The numerators of the respective factors are composed of the taxpayer's property, payroll, and sales in California; the denominators consist of the taxpayer's property, payroll, and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25131, & 25134.)

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Occasionally, however; UDITPA's allocation and apportionment provisions may lead to inequitable results when applied to unusual fact situations. Discretionary adjustments to UDITPA's allocation and apportionment provisions may be made under the circumstances described and limited in Revenue and Taxation Code section 25137, which states:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting:

(b) The exclusion of any one or more of the factors;

(c) The inclusion of any one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Section 25137 allows the use of reasonable allocation and apportionment methods different from those of UDITPA only in exceptional circumstances, that is, only where UDITPA's provisions "do not fairly represent the extent of the taxpayer's business activity in this state." Furthermore, the party seeking to deviate from the statutory formula bears the burden of proving that such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

Appellant contends that respondent's use of the UDITPA apportionment and allocation methods results in an unreasonable, arbitrary, and inequitable determination. It asserts that the income or loss reflected by separate accounting represents a more accurate and substantially fairer basis for taxing its activities in California, and contends that under section 25137 it must be allowed to use separate accounting to determine its income taxable by California.

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Appellant argues that separate accounting must be used because the property and payroll factors do not account for the disparity between California and Japan in property costs and wages.\* However, there is not a sufficient basis in the record to demonstrate that the usual apportionment factors do not fairly represent the extent of appellant's business activity in this state.

In simply comparing Japanese property costs and wages with those in California, appellant totally overlooks the effect of the property and payroll of the rest of the worldwide unitary business. Isolated comparisons which take into account less than the whole of the unitary business do nothing to show that formula apportionment does not fairly reflect the California portion of the activities of the entire unitary business. In any event, variations in profitability among different jurisdictions have been held not to preclude apportionment of the income of a unitary business by an appropriate formula. (John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214, 224 [238 P.2d 569] (1951), app. dism., 343 U.S. 939 [96 L.Ed. 13451 (1952)]; Container Corp. of America v. Franchise Tax Board, 117 Cal.App.2d 988, 1003 [--- Cal.Rptr. ---] (1981); Chase Brass & Copper Co. v. Franchise Tax Board, 70 Cal.App.3d 457, 472 [138 Cal. Rptr. 901] (1977).)

Appellant contends that separate accounting would be more accurate and a better approach to the determination of its California income. Revenue and Taxation Code section 25137, however, does not authorize deviation from UDITPA's normal provisions simply because

\* Appellant notes that some of the land in Japan has been owned for centuries and contends that to include this in the property factor at its original cost would grossly distort that factor. However, "original cost" is deemed to be the basis of the property for federal income tax purposes, with certain adjustments. (Cal. Admin. Code, tit. 18, rcy. 25130, subd. (a)(1)(art. 2).) Under Internal Revenue Code § 1053, the basis for property acquired before March 1, 1913 is the greater of its cost (with applicable adjustments) or its fair market value as of March 1, 1913. (See Treas. Reg. § 1.1053-1.) Consequently, appellant is not burdened with a centuries-old cost which presumably would be much lower than the cost of more recently acquired property.

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one purports to have found a better approach. (Appeal of New York Football Giants, Inc., Opinion on Rehearing, Cal. St. Bd. of Equal., June 28, 1979.) Allegations that the standard-formula is not precise also do not justify the deviations proposed by appellant. Rough approximation has been held sufficient in the formula apportionment of income from a unitary business. (International Harvester Co. v. Evatt, 329 U.S. 416, 422 [91 L.Ed. 390] (1946).) As long as the normal apportionment methods fairly represent the extent of the taxpayer's business activity in this state, their use will be upheld. Appellant's mere allegations of distortion, based on separate accounting principles, are insufficient to persuade us that the normal factors should not be used.

Appellant states that the Franchise Tax Board has made no attempt to exclude from the sales of KSC or its worldwide operations income from products other than soy sauce or from activities wholly unrelated to those being performed in California. However, where a unitary business is found, all of its business income is subject to formula apportionment. (Rev. & Tax. Code, § 25128.) We have previously held that the relationship between the parts of a unitary business need not be direct. (See, e.g., Appeal of Texaco, Inc., Cal. St. Bd. of Equal., Jan. 11, 1978; Appeal of Arkla Industries, Inc., Cal. St. Bd. of Equal., Aug. 16 1977; Appeals of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970.) In Appeals of Monsanto co., supra, the taxpayer argued that one of its subsidiaries could not be part of its unitary business because it had no dealings with the California facilities and none of the products which the parent sold to the subsidiary had any-direct or indirect-connection with any of the parent's California locations. In rejecting this argument we stated:

The argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand [the subsidiary] formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separated from either Chemstrand or the California operations.

If appellant is arguing that it is not unitary with part of the unitary business, its contention is

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rejected by the cases cited above. If it is arguing that certain product, sales should be excluded from the sales factor, it has cited no authority. If it is arguing that some of the income involved is nonbusiness income, it has presented no evidence of this. Under any interpretation of this argument, therefore, we find no reason to reject formula apportionment as applied by respondent.

In further support of its contention that separate accounting is required, appellant alleges that it would encounter numerous hardships in filing a combined report. It recites the lack of information available regarding the operations and financial data of the rest of the unitary business, the language difficulties, different accounting standards and fiscal years, and the fluctuating currency exchange rate. The short answer to all of these perceived problems is that appellant has not shown how they would affect the fair reflection of its business activity in this state,, A number of these issues are addressed in respondent's "Guideline for the Preparation of Combined Reports Which Include. Foreign Country Operations" and resolved in a manner which appellant has not challenged as unreasonable. Although we recognize that some difficulties may arise whenever foreign country operations are included in a combined report, we are not persuaded that they cannot be overcome by the **good-faith** efforts of the respondent and the involved taxpayers. We are also not persuaded that the alleged difficulties preclude formula apportionment.

The constitutional objections originally raised by appellant have apparently been abandoned. In any case, this board% established policy of abstention from deciding constitutional questions in appeals involving proposed assessments of additional tax would prevent us from considering them. (Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.)

For the reasons stated above, we sustain respondent's action.



