BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MYLES CIRCUITS, INC.)

Appearances:

For Appellant: Hartley E. Jackson III
Certified Public Accountant

For Respondent: Jean Harrison Ogrod
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 Myles Circuits, Inc. against proposed assessments of additional franchise tax in the amounts of $119,693 and $23,721 for the income years ended September 30, 1974 and 1975, respectively.

Appeal of Myles Circuits, Inc.

Appellant's parent, D.F. Myles Co., Inc. (hereinafter referred to as "Myles"), a California corporation incorporated in 1970, was originally engaged in the manufacturing of circuit boards for the electronics industry. Recognizing the unpredictable nature of the circuit board business,, the sole shareholder and president of Myles, Douglas F. Myles, decided to diversify the business activities of his corporation in order to insulate it from complete dependence upon one business activity. During its 1973 income year, Myles acquired a plum orchard, an interest in a vineyard previously doing business under the name Rio Blanco Vineyards, and 237 head of cattle located in Texas. Confronted with an unwillingness on the part of commercial banks to lend the money necessary to pay for these assets, Myles accepted the suggestion of its bank that it establish the circuit board business as a corporate entity distinct from its other activities. In this manner, the bank explained, the separately incorporated circuit board business could obtain a loan; that corporation could then lend the borrowed funds to the entity holding Myles' other interests.

On October 1, 1973, two wholly owned subsidiaries of Myles were created: Myles Properties, Inc. (hereinafter referred to as "Properties") and appellant. Myles' assets from the circuit board manufacturing business were placed in appellant, which operated solely within California under the active management of Mr. Myles. Myles' other interests, together with a limited partnership interest in Selma Fruit Company and the commercial building in which the circuit board business operated, were placed in Properties. Myles became a holding company. With the exception of the cattle business, the affiliated group's various business activities were.conducted entirely in California.

During the. appeal years, Properties' vineyard, cattle, and plum orchard were managed by independent management firms. Farm Financial, Inc. was responsible for the vineyard, Stratford of Texas, Inc. (hereinafter referred to as "Stratford") managed Properties' cattle, and the operation of the plum orchard was overseen by Associated Farm Management, Inc. The management contracts between Properties and each of the three aforementioned firms set forth that the latter would supervise and be directly responsible for Properties' various interests. Specifically, the management firms agreed to perform all services and furnish all supervision, materials, and labor necessary for the customary and proper care cf Properties' investments.

As previously indicated, Mr. Elyles was actively involved in the management of appellant's circuit board business. His involvement with Properties' activities is, however, a matter in dispute. Appellant alleges that Mr. Myles was engaged in such aspects of Properties' operations as: (1) initiating and reviewing cattle purchases, sales, and bulk feed purchases; (2) management level decisions pertaining to the vineyard; and (3) decision making with regard to the care, harvesting, and production of the plum orchard. Respondent, on the other hand, argues that the record on appeal indicates that Mr. Myles' involvement in Properties' various business endeavors was minimal. Specifically, respondent notes that the contracts concluded between Properties and the aforementioned management firms reveal that those companies, not Mr. Myles, were responsible for all decisions pertaining to the interests they were hired to manage.

Appellant concluded that it was engaged in a single unitary business with Myles and Properties during the years on appeal. Consequently, it computed the affiliated group's income for those years in accordance with California's combined reporting.and apportionment of income procedures. The significant losses resulting from Properties' activities were offset against appellant's substantial profits. In 1974, Properties' loss was $429,039; appellant's profits totaled $554,363. The subsequent year, appellant's $338,511 profit was offset by Properties' $250,569 loss.

Upon audit, respondent determined that Properties' diverse business activities were neither unitary with each other nor with those of any of the other members of the affiliated group. In accordance with that determination, and in view of the fact that all of the affiliated group's other business activities were pursued entirely within California, respondent concluded that the loss resulting from the Texas cattle operation was to be determined by separate accounting and that use of California's combined reporting procedures was inappropriate for determining the franchise tax liability of the affiliated group's other business activities.

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 or corporations, the amount of business

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. 1345] (1952).)

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 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 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 9911 (1942).) The Supreme 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 472, 481.) These principles have been reaffirmed in later 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; Appeal of Browning Manufacturing Co., et. al., Cal. St. Bd. of Equal., Sept. 14 1972; Appeals of the Anaconda Company, et. al., Cal. St. Bd. of Equal., May 11, 1972.) In concluding that it was engaged in a single unitary business with Myles and Properties, appellant relied upon the following factors: common ownership; certain intercompany transactions; intercompany financing; an integrated executive force which controlled the major policy decisions of the affiliated corporations; and common professional advisors.

Respondent, as previously noted, argues that the only non-California activity pursued by the affiliated group, i.e., the Texas cattle operation, was not unitary with any of the affiliated group's other business endeavors under either the three unities or the contribution or dependency test. Since, during the years in

issue, a taxpayer qualified to report its income under California's combined reporting procedures only when it was engaged in a unitary business both within and without this state, respondent maintains that it properly determined-that the affiliated group did not qualify to file a combined report.

Prior decisions of this board have upheld the position taken by respondent that corporations engaged solely in intrastate businesses have no inherent right to file a combined report merely because they are carrying on what would be regarded as a unitary business if it were a multistate operation. (Appeal of E. Hirschberg Freeze Drying, Inc., Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Kim Lighting and Manufacturing Co., Inc., Cal.-St. Bd. of Equal., June 2, 1969; Appeals of Pacific Coast Properties, Inc., et. al., Cal. St. Bd. of Equal., Nov. 20, 1968.) The above cited decisions are buttressed by Handlery v. Franchise Tax Board, 26 Cal. App.3d 970 [103 Cal.Rptr. 465] (1972), which held that the unitary business concept is applicable only with respect to interstate operations. Consequently, corporations engaged solely in intrastate business activities have no right, at least for income years beginning prior to 1980, 1/ to file a combined report and be treated as a unitary business, even though they would have been considered as such had the business activities been interstate.

1/ Section 25101.15 of the Revenue and Taxation Code, enacted by chapter 390 of the 1980 Statutes, permits intrastate "unitary" businesses to file combined reports for income years beginning on or after January 1, 1980. Consequently, it is of no assistance to appellant here. Section 25101.15 provides:

> If the income of two or more taxpayers is derived solely from sources within this state and their business activities are such that if conducted within and without this state a combined report would be required to determine their business income derived from sources within this state, then such taxpayers shall be allowed to determine their business income in accordance with Section 25101.

In view of the above discussion, the sole issue presented by this appeal is whether the operation of appellant, Myles, and Properties (herein collectively referred to as "the affiliated group") constituted a single unitary business.

The fact that the affiliated group was engaged in a number of different types of businesses does not, per- se, require a determination that 'the affiliatetl group was not engaged in a single unitary business. (See Appeal of Wynn Oil Company, Cal. St. Bd. of Equal., Feb. 6, 1980; Appeal of Hunt Foods and Industries, Inc., Cal. St. Bd. of Equal., April 5, 1965.) However, in order to prevail in its contention that the affiliated group constituted a single unitary business, appellant must produce sufficient evidence to show that in substance the unitary factors present demonstrate the existence of a single integrated economic unit. (Appeal of Hollywood Film Enterprises, Inc., Cal.. St. Bd. of Equal., March 31, 1982; cf. Appeal of Saga Corporation, decided this date.)

As previously noted, for the affiliated group to have qualified to file combined reports for the 'income years in issue, it is imperative for the Texas cattle operation to have been unitary with the affiliated group' s California business activities under either the three unities or the contribution or dependency test. Upon careful. review of the record on appeal, and for the specific-reasons set forth below, we conclude that respondent correctly determined that the Texas cattle operation was not unitary with any other aspect of the affiliated group's various business activities and that, accordingly, the affiliated group did not constitute a unitary business and was not qualified to file combined reports pursuant to California's combined reporting and apportionment of income procedures,,

The record on appeal reveals that', initially, appellant was unaware that the affiliated group was not eligible to file combined reports for the years in issue unless the group was conducting a unitary business within and'without California. In a letter to respondent dated January 27, 1978, appellant emphasized that it was "not relying on the Texas [cattle] 'operation as the basis for a unitary filing." In view of the. fact that the affiliated group was eligible to file combined reports only if the cattle operation was unitary with any of its other business activities, appellant's statement effectively undermines its position here. Furthermore,

appellant's representative acknowledged at the oral hearing on this appeal that he was previously unaware of the requirement that the affiliated group be conducting a unitary business within and without this state in order for it to be eligible to file combined reports for the years in issue.

Originally, appellant relied upon the purported existence of various "unitary" factors to demonstrate that the affiliated group's California activities were unitary. While appellant presented a considerable amount of evidence for the purpose of demonstrating that those activities were dependent upon, or contributed to, each other, such evidence is, as discussed above, irrelevant under the circumstances of this appeal.

Subsequent to the oral hearing on this appeal, appellant altered its original position and attempted to demonstrate that the Texas cattle operation was unitary with the affiliated group's other business activities. Towards that end, appellant supplied extensive documentation pertaining to the affiliated group's operations, especially those engaged in by Properties. The documentation provided by appellant, however, actually refutes, rather than supports, its claim that the Texas cattle operation, the affiliated group's only non-California business activity, was unitary with any of the affiliated group's other operations.

The management contract which Properties concluded with Stratford, and which appellant has acknowledged was adhered to by both parties, indicates that Properties' cattle were managed by Stratford which had broad discretion to purchase, brand, feed, care for, and sell the cattle to which Properties retained title. Stratford maintained and supplied the pasture, feed lots, feed, and employees needed to conduct the cattle operations. Furthermore, the management company insured the cattle against loss, contracted with outsiders as needed, and maintained the records of the business. Finally, Stratford warranted that it was equipped and skilled to conduct the cattle business and guaranteed Properties a ninety percent return on its equity investment of $300,000. It is inconceivable that Stratford would have made such a guarantee had it not exercised the virtually complete control granted it under the cattle service contract. Despite appellant's assertions, the record is virtually devoid of any evidence establishing a unitary relationship between the Texas cattle operation and any of the affiliated group's other business activities.

Appellant has argued that the financing it extended to Properties, thereby enabling the latter to invest in the Texas cattle herd, is convincing evidence that the affiliated group constituted a single unitary business. This board has previously held, however, that inter-business financing is not enough to mandate a finding that otherwise unrelated businesses are unitary. (Appeal of Simco, Incorporated, Cal. St. Bd. of Equal., Oct. 27, 1964.) There is no reason to reach a different conclusion here.

Appeal of Myles Circuits, Inc.

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 Myles Circuits, Inc. against proposed assessments of additional franchise tax in the amounts of $49,693 and $23,721 for the income years ended September 30, 1974 and 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 29thday of June , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member

_____, Member