BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HUGO NEU-PROLER INTERNATIONAL)
SALES CORPORATION)

Appearances:

For Appellant: John S. Warren
Attorney at Law

For Respondent: John R. Akin
Counsel

O P I N I ON

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 Hugo Neu-Proler International Sales Corporation against proposed assessments of additional franchise tax in the amounts of $47,062.04, $124,377.11, $637,741.24, and $209,887.45 for the income years 1972, 1973, 1974, and 1975, respectively.

The issue for determination is whether appellant is subject to the franchise tax.

Appellant is a domestic international sales corporation (DISC). A DISC is solely a creature of federal income tax law. (Int. Rev. Code of 1954, §§ 991-997.) There are no DISC provisiotis in California law, For purposes of the federal income tax law, a DISC is a domestic corporation which is engaged almost exclusively in the sale of domestic products for export. A DISC is not subject to federal income tax on its qualified export income. Instead, a portion of that income is taxed to its shareholders currently, while the balance is taxed at the time it is either distributed or deemed distributed. Although a DISC must have a minimum capital stock of $2,500, its own bank account, and separate books and records, it need not have any employees. It may act either as an export sales company or as a commission agent.

Appellant (hereinafter sometimes referred to as HNP-DISC) was formed in 1972 and is owned by a partnership, Hugo Neu-Proler Company (HNP). The two equal partners in HNP are Hugo Neu & Sons, Inc. (Hugo Neu), an international trading company headquartered in New York, and Proler International Corporation (Proler), a steel company with headquarters in Houston, Texas. Proler owns a process for shredding, cleaning, and compressing scrap steel. The unrelated corporate partners, who are separately owned and independent of each other, are not parties to this appeal.

In 1962, prior to the formation of appellant HNP-DISC,, Hugo Neu and Proler formed the HNP joint venture to gather and process scrap metal in California and sell it to customers in Japan. In their respective California franchise tax returns for years'prior to 1.972, each corporation included in its net income 50 percent of the net income of HNP. The resulting total net income of each corporation was then apportioned to sources within and without California by the standard appdrtionment formula. This practice was in accordance with the principles now set forth in respondent's regulations. (Cal. Admin. Code, tit. 18, reg. 25137, subd. (e) (art. 2.5).)

In 1971 the United States Congress added the DISC provisions to the Internal Revenue Code to encourage the export of United States products. In January 1972 appellant was incorporated in Delaware and qualified to do business' in California. Appellant was organized under the new federal provisions as a DISC. It was capitalized for $3,000. All of its stock is owned by the partnership HNP. Although appellant keeps a separate set of books and has its own bank account, it has no employees.

Appellant and the partnership, HNP, are parties to a "DISC Sales and Commission Agreement" which provides that HNP will sell and appellant will purchase as much of HNP's output of export property as appellant can market.. During the appeal years, the export sales were made in the following manner: The export property was sold by HNP to appellant at a price which allocated to the DISC the maximum profit that a related DISC could receive under section 994 of the Internal Revenue Code. This price was considerably lower than could be obtained in an arm's length sale. Immediately upon purchasing the export property, appellant resold it to Hugo Neu & Sons International Sales Corporation (HN-DISC), a DISC wholly owned by Hugo Neu & Sons, Inc. These sales were made pursuant to an "Inter-DISC Sales Agreement" between appellant and HN-DISC. HN-DISC, in turn, resold the property to foreign customers. The price paid by HN-DISC to appellant was the price which HN-DISC received from the foreign customer less any costs of shipping, insurance, etc. incurred by HN-DISC and less a reasonable commission to HN-DISC.

With respect to the actual mechanics of the transactions, HN-DISC chartered a ship, and HNP arranged to have the ship loaded at a California port. When the ship was loaded, HNP sold the export property to HNP-DISC which simultaneously sold it to HN-DISC. HN-DISC, in turn, sold the property to the foreign customer.

After the formation of HNP-DISC, Hugo Neu and Proler continued to file their California franchise tax returns in the same manner as before. Hugo Neu and Proler each reported one-half of the net income of the partnership HNP. The partners included in the net income of the partnership HNP all of the income generated by appellant HNP-DISC. After an audit for the appeal years, respondent determined that, since appellant was a separate taxable entity and not part of the unitary businesses of either Hugo Neu or Proler, all of its income was taxable to it.

At the outset we note that appellant is a DISC for federal 'income tax purposes. However, since California has no similar provisions, appellant must be treated the same as any other corporation in applying the California Bank and Corporation Tax Law.

For purposes of this appeal, the Bank and Corporation Tax Law provides that every corporation doing business within this state must pay a franchise tax according to or measured by its net income for the privilege of exercising its corporate franchises. (Rev. & Tax. Code, § 23151.) '"Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." (Rev. & Tax. Code, § 23101.) It is well settled that doing business does not necessarily mean the conduct of a regular course of business; participation in any profit seeking activity is sufficient. (See Golden State Theatre and Realty Corporation v. Johnson, 21 Cal.2d 493 [133 P.2d 395] (1943); Appeal of Sugar Creek Pine Company, Cal. St. Bd. of Equal., March 30, 1955.) Therefore, the question becomes whether the transactions engaged in by appellant constituted doing business. In determining whether appellant was doing business, it is acknowledged that appellant had no employees and that the physical aspects of its activities were conducted on its behalf by the employees of the partnership HNP. However, it is apparent that the exercise of appellant's corporate powers and privileges was essential to the performance of the various'transactions it entered into. Initially, appellant qualified to do business in California as a corporation. Appellant entered into a written agreement, the Related DISC Agreement, with HNP, its producer. It also executed a second written agreement, the Inter-DISC Sales Agreement, with HN-DISC, its purchaser. Pursuant to the terms of these agreements, property was purchased, prices and terms were determined, and the property was resold by appellant in its corporate capacity. Furthermore, separate books and records were maintained for appellant and it maintained its own bank account. All of these transactions required the active use of appellant's corporate powers and privileges and were entered into for the purpose of pecuniary gain or profit. (See Cook Export Corp. v. King, -- Tenn. -- [617 S.W.2d 379] (1981).)

Appellant would have us ignore its corporate status and pass its income through to the partnership HNP and, ultimately, to the corporate partners, Hugo Neu and Proler. Appellant seeks suppor't for its position from the federal income tax regulations which provide that, although a DISC is treated as a corporation for federal tax purposes, as a general rule it would not be treated as a separate corporate entity for federal income tax purposes if it were not a DISC. (Treas. Reg. 1.992-1(a).) A corporation may be recognized as such at the federal level only because it is a properly organized and qualified DISC. However, simply because California has no DISC provisions, it does not follow that appellant cannot be recognized as a viable corporation for state tax purposes. Since California has no DISC provisions we must determine whether appellant shall be recognized as a corporation solely by analyzing its activities with respect to those standards developed by case law dealing with corporate recognition. When considering appellant's activities discussed above, we believe appellant must be considered a viable corporation for tax purposes under the rule of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (87 L.Ed. 1499] (1943) and its progeny. (See, e.g., Paymer v. Commissioner, 150 F.2d 334 (2nd Cir. 1945); David F. Bolger, 59 T.C. 760 (1973); cf. National Carbide Corp. v. Commissioner, 336 U.S. 422 [93 L.Ed. 779] (1949); Harrison Property Management Co. v. United States, 475 F.2d 623 (Ct. Cl. 1973), cert. den., 414 U.S. 1130 [38 L.Ed.2d 754] (1974).)

Appellant also argues that it is part of two unitary businesses. According to appellant, one unitary business is composed of Hugo Neu and its 50 percent interest in the partnership HNP which includes one-half of appellant, while the second unitary business apparently includes Proler and its one-half interest in the partnership which includes one-half of appellant. It is appellant's position that there were two unitary businesses before appellant was formed; therefore, the interposition of the new DISC into the operations should effect no change in the resulting tax treatment. We disagree.

A determination of unity under either the three unities test or the contribution or dependency test requires a finding of controlling ownership. As we have stated in the Appeal of Revere Copper and Brass, Incorporated, decided July 26, 1977:

> The ownership requirement contemplates an element of controlling ownership over all parts of the business; the lack of controlling ownership standing alone requires separate treatment regardless of how closely the business activities are otherwise integrated. [Citation omitted.] A mutual dependence and contribution may exist between two enterprises,

> for example, where one enterprise supplies the raw materials for fabrication by a second enterprise. However, it would be improper to treat the two enterprises as unitary unless one owns and controls the other.

In the instant appeal both the corporate principals,, Hugo Neu and Proler, own only a 50 percent interest in HNP. Since the partnership HNP owns all of appellant's stock, neither corporation can establish controlling ownership of appellant.

Next, appellant argues that all of appellant's income has been properly reported by the corporate partners, Hugo Neu and Proler, in accordance with respondent's regulation 25137, subdivision (e). (Cal. Admin. Code, tit. 18, reg. 25137, subd. (e) (art. 2.5).) The cited regulation concerns the apportionment and allocation of income where there is a partnership composed of partners who are corporate taxpayers. Here; in contrast, we have a corporate taxpayer whose sole shareholder is a partnership comprised of corporate partners who are not parties to this appeal. Under these circumstances we are unable to ascertain the applicability of the regulation.

Finally; appellant argues that, if the unitary business concept is not applied in this situation, the income of appellant and the partnership should be" redetermined under the "arm's-length method" authorized by sections 24725 and 25103 of the Revenue and Taxation Code. It may be, as appellant argues, that this is a situation where sections 24725 and 25.103 might be invoked by respondent since respondent stands to lose as much as it gains. For example, if appellant were operated as a commission DISC rather than a purchase and sale DISC, it could earn its commission without any presence or nexus in California; therefore, California would have no jurisdiction to tax it. However, the aforementioned sections are to be applied solely at respondent's discretion. (Cf. Handlery v. Franchise Tax Board, 26 Cal.App.3d 970 [103 Cal.Rptr. 465] (1972) app. dism., 410 U.S. 921 [35 L.Ed.2d 5821 (1973).) Since, in this appeal, respondent has chosen not to exercise that discretion, this board is powerless to grant appellant relief under either section.

For the reasons discussed above, we conclude that respondent's action must be sustained.

Appeal of Hugo Neu-Proler
International Sales Corporation

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 Hugo Neu-Proler International Sales Corporation against proposed assessments of additional franchise tax in the amounts of $47,062.04, $124,377.11, $637,741.24, and $209,887.45 for the income years 1972, 1973, 1974, and 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June, 1982, by the State Hoard 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

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