BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MOHASCO CORPORATION)

Appearances:

For Appellant: David J. Neuman
Attorney at Law

For Respondent: John R. Akin
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 Mohasco Corporation against proposed assessments of additional franchise tax in the amounts of $1,180.56, $3,698.21, and $14,667.63 for the income years 1970, 1971 and 1972, respectively.

Appeal of Mohasco Corporation

The sole issue for determination is whether appellant was engaged in a unitary business with its Mexican subsidiaries during the appeal years.

Appellant was incorporated in New York in 1873. It is engaged in the manufacture and sale of wool and synthetic rugs and carpets, carpet cushions, upholstered furniture, reclining chair and folding bed mechanisms, and wood and metal furniture.

In 1946, appellant formed Alfombras Mohawk de Mexico, S.A. de C.V. (Alfombras) in Mexico. Although Alfombras was initially established to conduct appellant's own operations in Mexico, it proved to be only marginally successful. Therefore, appellant sought to acquire a more profitable company in order to turn the entire operation over to a management capable of operating successfully in the Mexican market. Accordingly, in 1965, Alfombras acquired all the capital stock of Tapetes Luxor, S.A. de C.V. (Tapetes) and three other Mexican corporations (hereinafter referred to collectively as the Mexican subsidiaries). One of appellant's principal objectives in acquiring Tapetes was to obtain the services of Roger Beauroyre, who remained as Tapetes' president after the acquisition, to manage the entire Mexican operation. After the acquisition, the Mexican companies were reorganized with Tapetes becoming a 100 percent owned subsidiary of appellant. Tapetes, in turn, owned all the stock of the remaining Mexican corporations.

Although the primary business of the Mexican subsidiaries was the manufacture and sale of carpets, the Mexican subsidiaries' carpet operation differed in several respects from appellant's. For example, the Mexican subsidiaries used jute as a backing for their carpets while appellant used synthetic fibers. The Mexican subsidiaries used different fibers for their carpets since the Mexican government required them to purchase fibers in Mexico while appellant's fibers were purchased in the United States. Auto carpets and oriental-style rugs were produced by the Mexican subsidiaries while these products were not included in the United States line. The Mexican subsidiaries' sole product was carpet while appellant also produced several other product lines. Over 80 percent of the Mexican subsidiaries' manufacturing equipment was acquired from suppliers different from appellant's.

In addition to Mr. Beauroyre, its president, Tapetes' seven-man board of directors included four members who were also officers and directors or employees of appellant. Despite this nominal majority, however, the four directors employed by appellant granted unqualified proxies to Mr. Beauroyre, and never attended a directors' meeting. Tapetes had three officers, president, secretary and assistant secretary. The assistant secretary was also an employee of appellant who was so designated in order to have an individual at appellant's headquarters authorized to sign pertinent documents. However, during the appeal years, the assistant secretary did not even perform this ministerial task. None of the officers or directors of the remaining four Mexican subsidiaries were in any way associated with appellant.

Mr. Beauroyre, Tapetes' president and general manager, made annual trips to appellant's United States headquarters where he would generally spend an hour discussing the Mexican operation with the chairman of the board. During the remainder of the year, Mr. Beauroyre would communicate with appellant's officers about twice a month when he would forward the Mexican operation's profit figures. Several of appellant's officers and executives made occasional trips to Mexico during the appeal years. The purpose of their trips was to conduct "operational" and "style" review. Operational review consisted of Mr. Beauroyre answering questions sent from appellant's New York office concerning the Mexican subsidiaries' inventories, receivables, finances and future prospects. Style review involved a consideration of the Mexican subsidiaries' various carpet lines and their marketing success, as well as a review of appellant's available designs.

Appellant provided some technical style and design assistance to the Mexican subsidiaries. For these services, appellant received a nominal fee. Appellant had similar technical assistance agreements with other unaffiliated companies throughout the world. Although appellant's style and design sources were available to the Mexican subsidiaries, only 25 percent of the latter's carpet line was attributable to these sources. The remainder was independently developed through the Mexican subsidiaries' own research and development facilities or obtained from other sources which Mr. Beauroyre had developed throughout his career. Mr. Beauroyre testified that appellant's assistance was

generally unsatisfactory since the Mexican markets differed substantially from the United States markets. The ultimate decision with respect to what lines of carpet would be manufactured rested with the local management of the Mexican subsidiaries.

Intercompany sales from appellant to the Mexican subsidiaries consisted of thread waste, tufting needles, pattern slats and serrated slats. These items are necessary for the manufacture of carpet in the sense that carpet cannot be made without them. They are items of general application readily available from third parties, however, and it was not necessary that the Mexican subsidiaries acquire these items from appellant. During the appeal years, these sales averaged less than $45,000 per year. This amounted to an average of approximately one-tenth of one percent of appellant's annual sales and one percent of the Mexican subsidiaries' annual purchases. There were no sales from the Mexican subsidiaries to appellant.

The Mexican subsidiaries' annual operating and capital budgets were reviewed by appellant. The subsidiaries also submitted monthly financial reports for appellant's review. There was no requirement that the budgets or reports be approved by appellant. However, appellant did retain the right to approve budgeted capital expenditures in excess of $25,000 and nonbudgeted expenditures in excess of $5,000. As a practical matter, no expenditures were ever disapproved by appellant. The accounting policies and procedures of the Mexican subsidiaries were similar to appellant's in order to facilitate the rendition of consolidated financial statements.

None of the Mexican subsidiaries' internal or external policies and procedures with respect to manufacturing, operations, sales, personnel or administration were either: patterned after comparable policies or procedures of appellant; dictated by appellant; or subject to approval or review by appellant. Mr. Beauroyre, Tapetes' president, testified that he had complete freedom "in every way" to manage the Mexican subsidiaries.

After an audit, respondent determined that appellant and its Mexican subsidiaries were engaged in a unitary business and issued notices of proposed assessment reflecting this determination. Appellant protested the proposed assessments. After a hearing,

appellant's protest was denied. Thereafter, appellant filed this appeal.

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 affiliated corporations, 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. 1345] (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. 991] (1942).)

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 its centralized executive force and general system of operation. (Butler Bros. v. McColgan, supra, 17 Cal.2d at 678.) 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. v. McColgan, supra, 30 Cal.2d at 481.)

Respondent's determination that appellant and the Mexican subsidiaries are engaged in a unitary business is presumed to be correct. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) The burden to produce sufficient credible evidence to negate the existence or significance of the unitary connections relied upon by

respondent and thereby overcome the presumptive correctness of respondent's determination is upon appellant. (See Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

In applying either the contribution or dependency test or the three unities test, respondent based its unitary determination on the following factors: unity of ownership, similarity of products, centralized management, exchange of know-how, intercompany sales, financial reporting, and budgetary control. Appellant argues that, to the extent these factors exist, they are not substantial enough to support a finding of unity.

It is undisputed that the unity of ownership required under either test is present. Appellant owned 100 percent of Tapetes, and Tapetes owned all of the stock of the remaining Mexican companies.

Respondent maintains that the products manufactured by appellant and by the Mexican subsidiaries were substantially identical except for color schemes. Initially, we note that appellant manufactured many products other than carpet. Even with respect to carpet, there were numerous differences with respect to fiber, backing, style and design. Additionally, the Mexican subsidiaries' production equipment differed substantially from appellant's. In summary, the products produced by appellant and the Mexican subsidiaries were similar only in that both products were carpets.

Although respondent maintains that the management of appellant and the Mexican subsidiaries was centralized as evidenced by an integrated executive force, the record does not support that contention. Respondent first argues that Tapetes' board of directors was controlled by appellant. It is true that employees of appellant occupied four of the seven positions on the board of directors of Tapetes, the controlling Mexican company. Despite this nominal majority, however, appellant did not control the actions of Tapetes' board in fact. This is evidenced by the fact that appellant's directors gave their unqualified proxies to Mr. Beauroyre, president of Tapetes, and never attended a director's meeting. Although respondent maintains that appellant was capable of controlling the major policy decisions of Tapetes, the fact remains that appellant did not do so. In reaching our determination,

of course, we must be guided by what did happen, not what might have happened. In effect, appellant relinquished its nominal control over the Mexican subsidiaries by granting the unqualified proxies to Mr. Beauroyre. The lack of centralized management or an integrated executive force is further evidenced by the uncontradicted testimony of Mr. Beauroyre that he was free to manage the Mexican subsidiaries in whatever way he determined. Mr. Beauroyre's testimony is buttressed by the uncontroverted evidence that none of the Mexican subsidiaries' policies or procedures were: patterned after appellant's policies or procedures; dictated by appellant; or subject to appellant's approval or review.

Respondent also contends that the travel to Mexico by some of appellant's executives evidenced appellant's supervisory control over the Mexican subsidiaries. The record does not support respondent's conclusion that these visits involved the exercise of "supervisory" control by appellant over the Mexican subsidiaries. Mr. Beauroyre described these visits more in the nature of information-gathering junkets in which he would answer questions from the New York office which the visitors brought with them. There is no evidence to indicate that the exercise of any supervisory control occurred during these meetings.

Respondent also argues that the technical assistance provided to the Mexican subsidiaries by appellant constitutes evidence that these entities were engaged in a unitary business. Initially, respondent maintained that appellant provided 100 percent of the Mexican subsidiaries' style and design requirements. However, as we have related above, this is not the case. Under Mr. Beauroyre's direction, the Mexican subsidiaries selected appropriate styles and designs developed by appellant or developed or acquired their styles and designs as they saw fit. When appellant's designs were selected, they were selected because they were perceived by the management of the Mexican subsidiaries to be best suited for their product lines and for the types of designs acceptable to the Mexican market. Based upon these facts, we cannot conclude that the limited technical assistance provided by appellant constituted a significant unitary factor.

Although acknowledging that the intercompany sales were miniscule, respondent contends that they were a significant factor because they were sales of key

items absolutely necessary to the manufacture of rugs and carpets. While the items sold - thread waste, needles and slats - were required to produce carpet in that carpet could not be manufactured in their absence, to characterize them as "key" items is inappropriate. These items were of a general nature which amounted to only one-tenth of one percent of appellant's annual sales and one percent of the Mexican subsidiaries' annual purchases. Under these circumstances, we cannot conclude that the intercompany sales were a significant unitary factor.

Finally, respondent relies on the existence of financial reporting and budgetary control to support its position. While recognizing that these factors alone do not necessarily establish the existence of a unitary business, appellant argues that they further amplify the control and integration that existed in this matter.

With respect to appellant's review of the Mexican subsidiaries' financial reports, the apparent purpose was merely to keep appellant cognizant of the course of the subsidiaries' operations. There was no requirement that the financial reports be approved by appellant. The only effort to exercise any control over the Mexican subsidiaries was the requirement of appellant's approval for budgeted capital expenditures exceeding $25,000, and nonbudgeted capital expenditures in excess of $5,000. There is no indication that this control was ever exercised. Based on this very limited degree of control, we are unable to conclude, as respondent would have us, that such control "goes to the very heart of the Mexican subsidiaries' operations".

The heart of respondent's unitary determination is based upon its conclusions that the Mexican subsidiaries relied on appellant for the design and styling of their entire line of carpets, and that centralized management as evidenced by an integrated executive force was present. As we have seen, appellant has established that neither of these conclusions was correct as a matter of fact. Furthermore, we have concluded that, to the extent they existed, the peripheral factors relied on by respondent such as product similarity, miniscule intercompany sales, financial reporting and limited budgetary control were of little significance in this setting. Therefore, we cannot conclude that the unities of use or operation were present or that the operations of appellant and the Mexican subsidiaries contributed to or depended upon one

another in such a way as to require the conclusion that they were engaged in a single integrated enterprise. Accordingly, respondent's action is this matter must be reversed.

Appeal of Mohasco Corporation

ORDER

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 Mohasco Corporation against proposed assessments of additional franchise tax in the amounts of $1,180.56, $3,698.21, and $14,667.63 for the years 1970, 1971 and 1972, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 14th day of October , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

* _____, Chairman

Conway H. Collis _____, Member

Ernest J. Dronenburg, Jr. _____, Member

Richard Nevins _____, Member

_____, Member

*I do not agree with the conclusion that appellant was not engaged in a unitary business with its Mexican subsidiaries during the appeal years.

William M. Bennett _____, Chairman