BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THE AMWALT GROUP, INC.,)
FORMERLY ALLAN M. WALTER AND)
ASSOCIATES, INC.)

Appearances:

For Appellant: Jeffrey A. Walter
Attorney at Law

For Respondent: Karl F. .Munz
Counsel

OPINION

This appeal was made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of The Amwalt Group, Inc., formerly Allan M. Walter and Associates, Inc., against proposed assessments of additional franchise tax in the amounts of $21,969 and $25,710 for the income years ended November 30, 1975, and November 30, 1976, respectively. Subsequent to the filing of this appeal, appellant paid the proposed assessments in full. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of claims for refund.

The primary question presented by this appeal is whether appellant and its two subsidiary companies were engaged in a single unitary business during their income years ended November 30, 1975, and November 30, 1976.

During the years on appeal, appellant' was known as Allan M. Walter and Associates, Inc., and will be referred to in this appeal as "appellant" or "Amwalt." Appellant was a San Jose architectural firm with both California and out-of-state clients. 'Appellant., also owned a condominium in Hawaii that was rented or available for rental most of the time, providing appellant with net rental income. The condominium was occasionally used by vacationing employees of appellant's, In the early 1970's, appellant's ability to maintain cash reserves was seriously threatened by its increasing tax liabilities. Mr., Walter, the president and sole shareholder of Amwalt, directed Mr. Ealy, the accountant and financial advisor for both Amwalt and Mr. Walter, to locate and acquire companies which would reduce this tax impact.

To this end, Mr. Ealy located, and Amwalt purchased, in October 1974, all the shares of stock of Key Lease Corporation (KL), a Redwood City, California, automobile and equipment leasing firm. In November 1975, appellant concluded the purchase of 80 percent of the stock of Bakersfield Equipment Co., Inc. (BE), formerly Ellis Equipment Co., Inc., a heavy equipment dealership in Bakersfield, California.

After these acquisitions, Mr. Walter, Mrs. Walter, and Harold Everton, legal counsel for Amwalt, served as directors for all three corporations. KL and BE each had four directors, the fourth in each case being one of the former owners of the corporation. Mr. Walter was president of all three companies and Mrs. Walter and Mr.. Everton also served as officers of all three. During the appeal years, the accounting and legal services for all three companies were handled by Mr. Ealy and Mr. Everton, respectively.

Mr. Pollock, the fourth director and a former owner of KL, remained as manager of KL for some months while a replacement was found and trained. Mr. Pollock left KL in January 1975, but returned as manager in August of that year when the man who had replaced him proved unsatisfactory. KL had one other employee, a secretary, and used independent contractors to generate business. After acquiring KL, Mr. Walter changed its emphasis from automobile leasing to equipment leasing. KL leased to both California and out-of-state customers during these two years. Mr. Walter had Mr. Ealy change KL's accounting method to coordinate it with Amwalt's and to generate greater depreciation in the early years of the leases, resulting in increased "paper losses" for tax purposes. During the two appeal years, Amwalt and

Mr. Walter made loans to KL totaling $500,000, at interest rates between 6 percent and 10 percent. Amwalt also helped KL obtain more favorable terms and larger loans from the bank with which it dealt. Each month, KL's manager met with and prepared reports for Mr. Walter and Mr. Ealy. Appellant states that Mr. Walter reviewed and approved all leases over $10,000, which constituted the bulk of KL's leases during this period. However, it does not appear that Mr. Walter ever signed any of the leases, and minutes of KL's board of directors' meetings on the subject of lease application review do not indicate any review or approval by anyone other than KL's manager.

Negotiations for the purchase of BE were begun as early as July 1975. The stock purchase agreement, however, was not signed until November 4, 1975, and it appears that closing did not occur until November 10, 1975. Amwalt made loans to BE in August and September of that year, without which, appellant states, BE "would have been bankrupt by September 15, 1975." After the acquisition, Amwalt loaned an additional $76,000 to BE, guaranteed all of BE's indebtedness, and arranged extensions and other concessions with BE's equipment supplier.

In addition to the financial assistance which Amwalt -provided, KL provided the assistance of its bookkeeper and its manager to organize BE's records and train BE's personnel. For a short time, Mr. Ealy managed BE's operations. Amwalt paid for the services of these people and then billed BE for the cost.

In November 1975, KL purchased four pieces of used equipment from BE and simultaneously leased them back to BE. This ultimately resulted in a $10,000 profit for BE. BE also owned several trucks which were used for interstate hauling. The-. hauling arrangements were made by a company in Minnesota and the trucks were apparently driven by independent contractors with whom BE split the net proceeds from each trip. This operation proved unprofitable and the trucks were sold during 1976.

In spite of the financial assistance from Amwalt, BE's operations did not flourish, and all its assets were sold in July 1976. BE's ultimate failure created a substantial ($147,447) loss for KL on the sale and leaseback agreement.

For its income years ended in 1975 and 1976, appellant filed its California franchise tax returns on the basis of a combined report which treated Amwalt, KL, and BE as a single unitary business. Upon audit, respondent determined that the companies were not engaged in a

single unitary business and that the California taxable income of each should be determined by separate accounting.1/

Section 25101 of the Revenue and Taxation Code requires a taxpayer deriving income from sources both within and without this state to measure its franchise tax liability by its net income derived from or attributable to sources within this state. If the taxpayer is engaged in a single unitary business with affiliated corporations, the 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. Where truly separate businesses are involved, however, the separate accounting method is used to determine the income of each separate business. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

Respondent's determination is presumptively correct and the appellant bears the burden of proving that it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of. Equal., Dec. 13, 1961.) Appellant must show that the relationships of KL and BE with Amwalt were of sufficient substance to demonstrate the existence of a single unitary business.

The California Supreme Court has set forth two alternative tests for determining whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that the existence of a unitary business was definitely established by the presence of the three unities of ownership, operation, and use. Later, in Edison California Stores, Inc. v. McColgan, supra, the court said that a business is unitary if the operation of the business done within this state depends upon or contributes to the operation of the business outside the state.

Appellant contends that KL, BE, and Amwalt were clearly unitary under either of the two tests above. Respondent concedes that unity of ownership existed because Amwalt owned 100 percent of KL's stock and 80 percent of BE's stock. It argues, however,, that the unities of use and operation were not present and that contribution or dependency did not exist among the corporations. We agree with respondent.

1/ For purposes of the discussion which follows, we will assume, without deciding, that at least one of the three corporations involved had income from business activity which was taxable both within and without this state, as defined in the Uniform Division of Income for Tax Purposes Act. (Rev. & Tax. Code, §§ 25121, 25122.)

In a case of vertical or horizontal integration, the benefits to the group from certain basic connections are usually readily apparent. In a situation such as this one, however; where the companies in the affiliated group each engage in a distinct type of business, without vertical or horizontal integration, we must scrutinize the connections labeled "unitary factors" to see if, in substance, they really result in a single unitary business, the income of which is appropriately reflected in a combined report. "Where the businesses are distinct in nature, the mere recital of a number of centralized functions is not sufficient, in our opinion, to establish unity of operation, unity of use or contribution or dependency between the operations." (Appeal of Allied Properties, Cal. St. Bd. of Equal., March 17, 1964.)

Appellant contends that unity of operation was clearly demonstrated by the intercompany financing, the sale and leaseback between KL and BE, and the use by all three companies of the same accountant and lawyer. We agree with appellant that intercompany financing' has been considered "substantial evidence of unity of operation." (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal .App. 3d 496, 503 [87 Cal.Rptr.239] app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970); see also, Container Corp. of America v. Franchise Tax Board, 117 Cal.App.3d 988, 996 [173 Cal.Rptr. 121] (1981), affd., -- U.S. -- (June 27, 1983); Anaconda Co. v. Franchise Tax Board, 130 Cal.App.3d 15, 26 [-- Cal.Rptr. --](1982).)

In this case, however, we find nothing to indicate that these loans contributed to the operational integration of the three companies. The financing and guarantees provided by appellant and Mr. Walter were not used for any common business activity and served only to enhance the financial positions of KL and BE as independent assets of appellant. "If such financing results in a unitary business virtually every business would be unitary no matter how unrelated were the various activities." (Appeal of Simco, <Incorporated, Cal. St. Bd. of Equal., Oct. 27, 1964.) The other factors mentioned by appellant as indicators of unity of operation are similarly unconvincing. The single sale and leaseback between KL and BE was much more a "paper" financial arrangement, apparently entered into for the tax benefits it could provide, than a true intercompany sale and merely resulted in a redistribution of profit and loss between the two companies. The use in common of an accountant and a lawyer, while often listed in cases as a unitary indicator, has not been shown in this case to have resulted in any material advantage and, therefore, is not particularly significant. Unity of operation, therefore, cannot be said to have existed to any meaningful extent.

Appellant argues that Mr. Walter and Mr. Ealy constituted a centralized executive force which made the ultimate management decisions

for all three companies and, therefore, unity of use was present. It appears that the guidance, provided by these two men was almost entirely in the areas of financial control and tax planning. Central financial management is "to be expected in almost any case where a closely held corporation operates a number of enterprises." (Appeal of Jaresa Farms, Inc., now Harris Farms, Inc., Cal. St. Bd. of Equal., Dec. 15, 1966.) There is no indication that Mr. Walter was doing anything other than managing his assets in a manner beneficial to his own tax situation and that of his solely owned corporation, Amwalt. We find this general fiscal management insufficient to. support a finding of unity of use. (See Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., March 31, 1982 (no unity of use. where executive control merely made the subsidiary a more productive independent asset).

The lack of unity is also clear when judged by the contribution or dependency test. As appellant admits, the only contribution or dependency here was financial: Amwalt provided infusions of capital and loan guarantees, and KL and BE provided tax benefits. This is simply another example of a result which is to be expected in almost any case of commonly-owned enterprises, no. matter how unrelated operationally. (Appeal of Simco, Incorporated, supra.) It does not demonstrate that the operations of any of these companies contributed to or, depended upon the operation of any of the other companies.

We must conclude that appellant has failed to. show that Amwalt, KL, and BE were engaged in a single unitary business. Therefore, respondent properly used separate accounting to determine the income of each corporation which was attributable to California.

Appellant also objects to respondent's characterization of certain rental income as nonbusiness income. During the appeal years, appellant's condominium in Hawaii was available for rental to the public through the Hale Pau Hana Resort, a management and leasing business. Appellant's employees were allowed to use the condominium at little or no cost. In the two years on appeal, Mr. and Mrs. Walter used the condominium three times and other employees used it a total of four times. Mr. Walter recalls setting aside an area in the condominium for his drafting table.

"Business income" is defined in Revenue and Taxation Code section 25120, subdivision (a), as:

> . . . income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

"Nonbusiness income" is all income other than business income. (**Rev. & Tax. Code,** § 25120, subd. (d).)

Considering the minimal use of the condominium for purposes related to appellant's architectural business, we cannot say that it was acquired or managed as an integral part of the taxpayer's regular trade or business operations. It appears that it was rented to the public or held for rental during most of the two years involved. **The** rental of the condominium was clearly separate from the operation of appellant's trade or business' and the income did not arise from transactions or activities in the regular course of appellant's architectural business. The income, therefore, was properly classified as nonbusiness.

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

Appeal of The Amwalt Group, Inc., formerly Allan M. Walter and Associates, Inc.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of The Amwalt Group, Inc., formerly Allan M. Walter and Associates, Inc., for refund of franchise tax in the amounts of $21,969 and $25,710 for the income years ended November 30, 1975, and November 30, 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this **28th day of July**, **1983, by the State Board of Equalization,** with Board Members Mr. Bennett, Mr. Collis, Mr. **Dronenburg,** Mr. Nevins **and** Mr. Harvey* present.

William M. Bennett, **Chairman**

Conway H. Collis, **Member**

Richard Nevins, **Member**

Walter **Harvey***, **Member**

_____, **Member**

*For Kenneth Cory, **per** Government Code section **7.9**