84-SBE-131

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
LEE MAR OF CALIFORNIA AND)
VALLEY SPORTSWEAR MFG.)
CO., INC.)

Appearances:

For Appellants: David J. Neuman
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

OPINION

These appeals are made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Lee Mar of California and Valley Sportswear Mfg. Co., Inc., against proposed assessments of additional franchise tax in the amounts of $133,478 and $25,582, respectively, for the income year ended June 30, 1973.

Appeals of Lee Mar of California
and Valley Sportswear Mfg. Co., Inc.

The primary issue for determination is whether appellants were engaged in a single unitary business with their parent corporation and their parent's previously owned subsidiary.

Appellant Lee Mar, a manufacturer of women's clothing, was incorporated and began doing business in California in 1953. While its business activities have centered in California, it dia have a sales office in New York. Lee Mar, in turn, owned all of appellant Valley's voting stock. Since its incorporation in 1970, Valley has engaged exclusively in the business of providing Lee Mar with contract labor. All of Valley's business activities have been conducted within California. In 1972, CSI Corporation (hereinafter "CSI") became interested in purchasing the stock of Lee Mar. CSI, a Delaware corporation, began doing business in California in 1972 and is the successor to a California corporation of the same name (hereinafter sometimes denoted as "new CSI" and "old CSI", respectively). Old CSI had been formed for the purpose of acquiring a variety of businesses in selected industries and, in that pursuit, did provide management services for its sole active subsidiary, S and B Illumination Co., formerly known as Sunbeam Lighting Co., Inc.. (hereinafter "Sunbeam"). However, new CSI has been primarily a holding company, conducting no active business of its own and having no paid employees.

Sunbeam, incorporated in 1967 and doing business in California since then, had been engaged in the business of manufacturing lighting fixtures and systems, conducting that business entirely in California. Sunbeam had consistently operated at a loss, requiring its parent, old CSI, to continuously advance it large sums of money. In early 1972, due to serious financial difficulty, old CSI developed a plan of reorganization in which a new CSI would be incorporated in Delaware (i.e., "new CSI"). That plan envisioned that new CSI would buy the assets and assume the liabilities of old CSI, and thereafter dispose of the assets of Sunbeam as quickly as possible, terminating its operations. New CSI would acquire all of Lee Mar's voting stock held by Henry T. Kramer and Leon Frieden. Thereafter, in execution of the plan of reorganization and under a closing agreement dated October 2, 1972, new CSI purchased all of' the stock of Lee Mar. That agreement provided that this purchase would have *retroactive* effect to June 30, 1972. Sunbeam conducted.no active business for the remainder of 1972 or thereafter. In January 1973, Substantially all of the assets of Sunbeam were sold to an unrelated-third party.

For the entire income year enaed June 30, 1973, appellants. computed their California income by use of a combined report, and included in such report the income (or loss) of CSI and Sunbeam. Upon examination of these returns,. respondent made a preliminary determination that although appellants were engaged in a single unitary business with each other, they were not engaged in a single unitary

business with either CSI or Sunbeam or both. Thereafter, respondent recomputed appellants' California incomes by use of a combineo report, excluding the incomes and factors of CSI and Sunbeam. Respondent issued notices of proposed assessment to appellants for the subject income year reflecting these adjustments. Appellants protested, disputing respondent's determination that they were not conducting a single unitary business with CSI and Sunbeam. After a protest hearing, respondent reaffirmed its proposed assessments. Thereafter, appellants filed these appeals.

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 de'ermined 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 Ueere Plow Lo. 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 conclusively 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), affa., 315 U.S. 501 [86 L.Ed. 991] (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 at 481.) These principles have been reaffirmed in later cases. (Superior' Oil Co. v.' Franchise Tax Board, Lorp. Cal.2d 406 [34 Cal.Rptr. 545, 386 P.2d 33) (1963); Honolulu Oil 40] (Cor 40] . 1963).) v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552, 386 P.2d

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, 197'2; 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.) As indicated above, respondent concluded that appellants and the remainder of the group (new and old CSI and Sunbeam) were not engaged in a single unitary business under either of the above-described tests.

Appellants argue that during the year -at issue they were engaged in a single unitary business with new CSI and, derivatively, old CSI and its then wholly owned subsidiary Sunbeam. It is appellants' position that Sunbeam and old CSI had been engaged in a single unitary business; therefore, appellants continue, since old CSI was engaged in a single unitary business with Sunbeam during Sunbeam's active operations, and since new CSI was engaged in a single unitary business with appellants subsequent to their acquisition, "the conclusion is inescapable that the unitary business carried on by CSI encompasses both corporations [Sunbeam and Lee Mar]. ..." In that event, the argument concludes, appellants and Sunbeam were engaged *in* a single unitary business. Appellants, therefore, maintain that the group (i.e., appellants, new and old CSI, and Sunbeam) is entitled to file a combined report for the income year at issue.

Central to appellants' argument is its assertion that the <u>Appeal of Wm. Wrigley Jr. Company</u>, decided by this board on December 15, 1966, compels a conclusion that a holding company, such as CSI, is automatically includable in a unitary group made up of -operating subsidiaries. Appellants assert that Sunbeam and Lee Mar were not merely separate subsidiaries of CSI, old and new, respectively, but each was, during its period of active operation, the sole operating subsidiary, and, as such, constituted the operating vehicle through which CSI, old and new, conducted its business.

We believe that appellants' understanding of the <u>Appeal of Wm. Wrigley Jr. Company</u>, supra, is erroneous. Nothing in that opinion compels a conclusion that a holding company, by that classification or status alone, must be included as part of a single unitary business with its operating subisidiary or subsidiaries. In <u>Wrigley</u>, no exemption from the application of the usual tests used to determine the existence of a unitary business was extended to a holding company merely because it was designated a holding company. Accordingly, we must reject appellants' initial argument that the requisite unitary relationship is axiomatically present between a holding company and its sole operating subsidiary. Instead, we must now determine, pursuant to the standard tests, whether the requisite unitary relationship is present between new CSI and appellants, and then, if necessary, between old CSI and Sunbeam.

The presence of unity of ownership is a prerequisite to the existence of a unitary business under either the three unities or the contribution or dependency test. As indicated above, since the terms of the closing agreement dated October 2, 1972, by which appellants were acquired by new CSI provided that the purchase would have retroactive effect to June 30, 1972, appellants argue that unity of ownership would likewise be retroactive to June 30, 1972. Respondent, of course, disagrees. Appellants offer no statutory or case authority

for their argument. Instead, appellants contend the agreement's effective date is not a mere fiction, but defines the time from which the rights and obligations of the parties began to arise. We agree that taxpayers are free to adopt agreements as they choose which may affect their economic affairs; However, we do not agree that government is required to acquiesce in the taxpayers' election of that agreement. (See Higgins v. Smith, 308 U.S. 473 [84 L.Ed. 406-j (1936).) New CSI did not own or control any of the voting stock of the appellants until the closing agreement was executed on October 2, 1972, and title to that stock was thereby transferred. Accordingly, the conclusion is inescapable that unity of ownership did not commence until that date, October 2, 1972. Accordingly, we find that the unitary relationship between appellants and new CSI, if it existed at all, began October 2, 1972, and not June 30, 1972.

Next, we must determine whether new CSI's relationship with appellants beginning October 2, 1972, was unitary under either of the two tests. Appellants contend that unity of operation was present due to the existence of intercompany financing, centralized professional services (accounting, legal, insurance and management) and sharing of offices and facilities. Respondent, on the other hand, contends that these services were not substantial.

It is, of course, well established that intercompany financing is a factor indicating unity of operation. (See, e.g., Appeal of Automated Building Components, Inc., Cal. St. Bd. of Equal., June 22 1976; Appeal of White Motor Corporation, Cal. St. Bd. of Equal., 'Dec. 15, 1966). However, in the instant case, appellants ao not point to substantial loans from new CSI to them during the year at issue. Indeed, appellants have presented no evidence of such customary loans. Instead, appellants argue that losses incurred with respect to the operations of Sunbeam generated a federal tax loss which benefited old CSI and which, in turn, was carried over to new CSI. Appellants state that new CSI used this tax loss to shelter the income of appellants from federal tax and, in turn, used the tax savings in the acquisition and operation of appellants. This, appellants argue, was substantially similar to new CSI's making loans to them. Appellants argument is without merit. Appellants have not produced, and we have not found, any statutory or case authority which equates the purported transfer of tax benefits with, the making of loans. Moreover, appellants have not established to what extent such tax benefits were used in the operation of appellants as opposed to the acquisition of appellants. (See Appeal of Simco, Incorporated, Cal. St. Bd. of Equal., Oct. 27, 1964.)

Next, appellants argue that the centralized professional services (i.e., accounting, legal, insurance and management) and sharing of offices ana facilities which existed with new CSI indicated unity of operation. (See, e.g., Appeal of The Seng Company of

California, Cal. St. Bd. of Equal., March 7, 1967.) Indeed, on the surface, it would appear some centralizea services and sharing of offices dia exist. For example, after' its acquisition in October of 1972, appellant Lee Mar's corporate counsel was appointed corporate. counsel to new CSI. In November of 1972, the principal accounting officers of appellant Lee Mar began maintaining tne records of both Lee Mar and new CSI. Also, since April of 1973, new CSI and Lee Mar have maintained common insurance policies for public liability, property damage and workmen's compensation. In addition, Henry Kramer, who had been the principal shareholder and president of appellant Lee. Mar before its acquisition by CSI, was appointed executive officer for new CSI for much of fiscal 1973. 'In such position, appellants note that Mr. Kramer had final approval of the compensation'of all employees and independent contractors hired by new CSI or its subsidiaries. Appellants state that as "chief executive officer of both Lee Mar and CSI during the greater part of the 1973 fiscal year, Mr. Kramer exercised daily operation control over all phases of the business of the CSI group." Lastly, appellants point out that in November of 1972, new CSI's activities were shifted to the premises of Lee Mar, In April of 1973, appellants state. that new CSI began paying rent to Lee Mar and' began reimbursing- it for expenses. The record does not disclose what that rent was or what expenses were' incurred.

Appellants' position, while superficially appealing, lacks substance upon analysis. For example, it is not significant that Lee Mar's corporate counsel was appointed the corporate counsel of new CSI if he did nothing more for new CSI than he had done at Lee Mar. Further, it does not satisfy appellants' burden merely to establish that the principal accounting officer of Lee Mar began maintaining the records of both Lee Mar and new CSI if the only additional records involved were the handling of the anticipated tax benefits. Moreover, it does not further appellants' cause to allege that new CSI and Lee Mar maintained common insurance- for public liability, property and workman's compensation, when new CSI had no-property or employees and such insurance coverage was no greater than that which Lee Mar had previously carried alone: And it does no good'to establish that new CSI shifted its activities to" the premises of Lee Mar if there were no activities of substance. Simply put, appellants have not established that the alleged centralization of business functions was substantial,. Accordingly, we must find that significant unity of operation'did not exist between new CSI and appellants subsequent to their acquisition.

Unity of use relates to executive forces and operational systems. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App.3d 496 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970); Superior Oil Co.. v. Franchise Tax Board, supra.). Indeed, the integration of executive forces is an element of

exceeding importance. "The ability of the companies to profit from a pooling of the technical knowledge, experience and expertise possessed bv . . . seasoned executives would seem to be of immeasurable value." (Appeal of Scholl, Inc., et. al., Cal. St. Bd. of Equal., Sept. 27, 1978). Appellants note that there were two common officers and one common director between new CSI and Lee Mar during part of the year at issue. Of particular note was the fact that Mr. Kramer, the president and a director of Lee Mar, occupied the same position for new CSI from October of 1972 to June of 1973, at which time he resigned. Appellants argue that this integration, particularly that involving Mr. Kramer, indicates unity of use. We cannot agree. Appellants' argument here suffers from the same malady as does their argument concerning unity Of operation in that the purported integration lacked substance. First, new CSI carried on no active business and had no paid employees. Thus, Kramer's position appears to be ceremonial and without practical significance. Moreover, the record indicates that since 1953, Mr. Kramer's technical knowledge had centered around the manufacturer of women's clothing. There has been no indication of what technical knowledge, experience or expertise possessed by Mr. Kramer was of value to new CSI. Accordingly, we must find that unity of use did not exist between new CSI and appellants subsequent to their acquisition.

Thus, we conclude that under the three unities test no unitary business existed between new CSI and appellants. Furthermore, no evidence has been offered which would prove that the operations of appellants contributed to, or were dependent upon, the operations of new CSI. (See Superior Oil Co. v. Franchise Tax Board, supra; Appeal of F. W. Woolworth Co., supra). Indeed, except for the accounting technicalities involved with the tax benefits, there was no contribution or dependency between new CSI and appellants. Accordingly, under either the three unities or the contribution or dependency test, no unitary relationship existed between new CSI and appellants. Thus, appellants are not entitled to use combined reporting with new CSI but each group must report their income by separate accounting. In view of this determination, it is not necessary to consider appellants' relationship with old CSI and Sunbeam.

Appeals of Lee Mar of California and Valley, Sportswear Mfg. Co.,, Inc.

O R D E R

Pursuant to the views expressed in the op,ini-on of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 2566.7 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Lee Mar of California and Valley Sportswear Mfg. Co,., Inc., against proposed assessments of additional franchise tax in the amounts of $133,478 and $25,582, respectively, for the income year ended June 30, 1973, be and the same is hereby sustained.

Done at Sacramento, California this 12th day of September, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

________________, Member