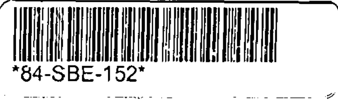

84-SBE-152

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
ALLSTATE ENTERPRISES, INC.,)
ALLSTATE ENTERPRISES MORTGAGE)
CORPORATION, AND ALLSTATE)
MOTOR CLUB, INC.)

Appearances:

For Appellants: Robert J. Wynne
Attorney at Law

For Respondent: Benjamin F. Miller
Counsel

O P I N I O N

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 Allstate Enterprises, Inc., et al., against proposed assessments of additional franchise tax in the total amount of $74,504.92 for the year 1973.

Appeals of Allstate Enterprises, Inc., et al.

The issue presented for decision is whether Allstate Enterprises Mortgage Corporation was engaged in a single unitary business with Allstate Enterprises, Inc., and its other subsidiaries.

Appellant Allstate Enterprises, Inc. (hereafter "AE"), is a wholly owned subsidiary of Sears, Roebuck and Company. It is engaged in the business of providing automobile and recreational vehicle financing and motor club services. To comply with the statutory requirements of various states, AE formed several wholly owned corporations to conduct portions of its business. The remainder-of its businesses are operated as unincorporated divisions. Thus, AE formed Allstate Credit Corporation (ACC), to provide automobile financing in California; Allstate Motor Club (AK), to operate a motor club in California; Allstate Enterprises Consumer Discount Company (AECD), to provide automobile and recreational vehicle financing in Pennsylvania; and Allstate Enterprises Financial Corporation (AEFC), to provide automobile and recreational vehicle financing in Texas, Oklahoma, and Indiana. Allstate Financial 'Corporation (AFC) was formed to purchase automobile loan contracts from AE, ACC, AECD, and AEFC.

In 1972, AE acquired all of the assets of National First Corporation, a-holding company for mortgage banking. AE formed Allstate Enterprises Mortgage Corporation (AEMC) to handle the mortgage banking operations. AEMC, through its branch offices, worked with real estate salesmen to develop real estate loan applications. AEMC processed the loan applications and advanced the funds necessary to make-the loans. The completed loans were accumulated in large blocks and sold to institutional investors. After selling the loans, AEMC serviced them for the investors by collecting the monthly payments, maintaining insurance coverage, paying property taxes, and handling foreclosures. AEMC's purpose for originating and selling mortgage loans was to retain the servicing contracts, the monthly fees from which it derived most of its income.

AEMC had substantial and fluctuating requirements for short-term money in connection with the originating and selling of loans. As explained by appellant,' in a typical sale of a block of loans, AEMC first obtained a commitment from an institutional lender to purchase a block of loans. AEMC then originated and funded the number of loans necessary to fulfill the commitment. This was the point in the transaction where

the working capital requirement of AEMC was at a maximum. AEMC held the loans usually for a period less than sixty days, until the necessary number of loans were accumulated. After the sale was completed, no further capital was required by AEMC in connection with the transaction.

Prior to its acquisition by AE in 1972, AEMC borrowed money from unrelated banks at a rate close to the prime interest rate. AEMC continued borrowing from unrelated banks until August, 1973. At that time, AEMC reduced its borrowing from outside banks and began to borrow money from AFC. As of December 31, 1973, AEMC had $18,135,136 in notes payable, of which $16,246,748, or 89.6 percent, was payable to AFC. The interest rate paid by AEMC to AFC was approximately equal to the rate AEMC would have had to pay third parties.

AEMC had officers and directors in common with AE and its other subsidiaries.' Common officers and directors included: Mr. Archie Boe, chairman of the boards of directors of AE, AEMC, and other subsidiaries of AE; Mr. W. Boyd Christensen, vice chairman of the boards of directors of AE and AEMC; Mr. J. Allan McNichol, vice president of AE and AMC and a member of the boards of directors of AEMC and AMC; Mr. Robert Pelton, executive vice president, treasurer and member of the board of directors of AE, vice president, treasurer, and member of the board of directors of AMC, and member of the board of directors of AEMC; Mr. Mark Poss, senior vice president 'and member of the board of directors of AE, member of the board of directors of AEMC, and an officer and/or board member of ATC, AMC and AEFC; Mr. Donald Hansen, president and member of the board of directors of AEMC and a vice president of AE; Mr. Edward Noha, executive and member of the board of directors of AE, member of the board of directors of AEMC, and vice president and member of the board of directors of AX; Mr. Robert B. Sheppard, president and member of the board of directors of AE and a member of the boards of directors of AEMC, AMC, and AECD; Mr. Myron Resnick, secretary of AEMC, AFC, AMC, and AECD.

During the appeal year, AEMC paid AE $108,000 which was designated a management fee. In its reply to respondent's request for information during the audit, appellant stated that the fee was paid in accordance with a management agreement between AE and AEMC for the following services:

(1) advi-ce.and consultation concerning financial controls, budget analysis, management of accounting functions, profit planning, and recommendations on changes in-procedures;

(2) advice and consultation concerning methods of collecting, safeguarding and disbursing cash used in the conduct of operations and arranging sources of credit;

(3) advice and consultation concerning all phases of business related to obtaining, originating, selling, and servicing real estate loans and related products;

(4) assistance and guidance concerning personnel matters:

(5) performance of- management and administrative functioning as directed by AEMC's board of directors; and

(6) advice and consultation concerning other administrative and technical functions reasonably requested by AEMC.

AEMC shared facilities with Dayton Equities, a subsidiary of AE. AEMC's federal and state income tax returns were prepared at AE's corporate offices in Northbrook, Illinois.

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, 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. (See Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) 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 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., supra, 30 Cal.2d at 481.)

Respondent argues that the operations of AEMC were unitary with the AE group under both of these two tests. In support of its argument that the contribution and dependency test is satisfied, respondent points to a centralized management, the management agreement between AE and AEMC, shared know-how, centralized financing, and a common name.

With respect to centralized management, the record shows that seven of AEMC's board members were also members of the boards of directors of other Allstate companies. Two of its officers were officers of AE. Its president, Mr. Hansen, was a vice president of AE. Myron Resnick, secretary of AEMC, was also the secretary of AFC, AMC, and AECD. There is also the matter of the $108,000 management fee AEMC paid AE during the appeal year. In its brief, appellant claims that the $108,000 did not constitute a fee for management services, but rather was compensation to AE for the use of personnel functionally employed by AEMC, although nominally employed by AE. Appellant explains that after the acquisition of AEMC, Mr. Hansen, a vice president of AE, was chosen to be president of AEMC. Although Mr. Hansen retained the title of AE vice president, he did not function in that capacity after his move to AEMC. Mr. Thomas Davis, another employee of AE, also became an officer of AEMC at that time by assuming the duties of executive vice president and treasurer. In addition to Mr. Hansen and Mr., Davis, several other individuals left other Allstate companies to work at AEMC. According to appellant, although these individuals began working full time at AEMC, they continued on the payroll of AE and AE billed AEMC for their services, denominating the amounts billed as management fees. Thus, appellant contends that the $108,000 was compensation to AE for the use of personnel. functionally employed full time by AEMC rather

than a fee for management services from AE's own executive force.

Appellant's explanation does ndt explain why these AEMC employees were on AE's payroll when they had ceased all job responsibility for AE and worked full time for AEMC, or why, if they were full-time employees of AEMC, they were part of a management agreement between A3 and AEMC. Finally, appellant does not explain why it documented to respondent that the $108,000 was payment made for advice and consultation concerning such matters as all phases of business related to obtaining, originating, selling, and servicing real estate loans, financial controls, and methods of collecting and disbursing cash used in the conduct of operations. Rather, the record shows the existence of intercompany transfers of key personnel who had ties with both AE and AEMC, common officers, and common directors. We find these factors to be evidence of an integrated management.

We have previously held that where members of an affiliated group share common officers and directors while engaging in the same type of-business, a reasonable inference can be drawn that the affiliated group benefited from the exchange of significant information. (Appeal of Maryland Cup Corporation, Cal. St. Bd. of Equal., March 23, 1970; Appeal of Anchor Hocking Glass Corporation, Cal. St. Bd. of Equal., Aug. 7, 1967.) The businesses need not be exactly the same. (See Appeal of Credit Bureau Central, Inc., Cal. St. Bd. of Equal., Feb. 2, 1981.) In the present case, both AE and AEMC were concerned with making loans and the accompanying functions of credit analysis, money management, collection, and foreclosure or repossession. In response to respondent's question pertaining to shared know-how, appellant stated:

> The individuals employed by AE who provided advice and consultation to AEMC did not have previous experience with real estate loans. However, they did have substantial experience with a financing business (AE) and with money management. Because of this experience, these individuals were able to assist AEMC with financial problems which were similar to problems they encountered at AE.

(Resp. Br., Ex.3.)

These similarities, coupled with the high degree of integration in the executive forces of the affiliated group, create an inference of shared know-how. (Appeal of Credit Bureau Central, Inc., supra.)

A third area of contribution and dependency can be seen in the loans made to AEMC by AFC. Although AEMC could have used at least five different banks to secure loans at approximately the same rate it paid AFC, appellant has acknowledged that it was far more convenient for AEMC to centralize the loans with AFC. As described by appellant, when AEMC sold a block of loans, it had to obtain the actual notes from the lenders in order to transfer them to the purchasers. It was much easier to secure notes from one lender than from five lenders located in different parts of the country. In addition, there were fewer communication problems and there was less paperwork with only one lender. (Resp. Br., Ex. 3.) AFC also made loans to AE, ACC, and AECD. It did not make any loans to customers outside the Allstate group in 1972 or 1973. Thus, belonging to the Allstate. group gave AEMC a convenient guaranteed lender which is a significant contribution in a business where loaning mortgage funds was an essential part of AEMC's primary business of servicing the loan contracts.

Lastly, the name Allstate was used by all the corporations in the combined group. The use of a common name is a unitary factor, (Appeal of Data General Corporation, Cal. St. Bd. of Equal., July 26, 1982), particularly here, where tne name used is widely recognized. We believe that the combination of centralized management, shared know-how, centralized financing, and use of a common, nationally-known name show contribution and dependency between AEMC and AE and its other subsidiaries.

The three unities test for a unitary business is also met in this case. AEMC is a wholly owned subsidiary of AE, so there is unity of ownership. Unity of operation is present in the centralized financing, management services, transfer of personnel, common name, and preparation of tax returns. The unity of use prerequisite is satisfied by a centralized executive force as we discussed under the contribution and dependency test.

Appellant argues that these unitary factors did not materially affect the earnings of AEMC or AE and its other subsidiaries and therefore there was no "quantitative

substantiality." In the Appeal of Scholl, Inc., after describing the two tests for unity, we stated:

> Implicit in either test, of course, is the requirement of quantitative substantiality. [Citations.] In other words, corporations are engaged in a unitary business within the scope of either test -if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporations.

(Appeal of Scholl, Inc., Cal. St. Bd. of Equal., Sept. 27, 1978.)

Appellant interprets this language to mean that a measurable earnings increase must be shown for quantitative substantiality to be present. We answered this same argument in the Appeai of Saga Corporation, decided by this board on June 29, 1982, where we stated:

> [A] discrete and measurable ear-nings increase from each corporation in the group is not necessary. ...
>
> The concept of "quantitative substantiality" merely distinguishes between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise. Each case must be decided on its own particular facts; where, as here, the taxpayer is contesting respondent's determination of unity, it must prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by respondent are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

We do not believe that the unitary connections between AEMC and AE and its other subsidiaries were lacking in substance. As discussed above, we find that the companies operated with such contribution and

dependency that respondent's determination of unity **must** be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in these proceedings, 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 protests of Allstate Enterprises, Inc., et al., against proposed assessments of additional franchise tax in the total amount of $74,504.92 for the year 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 14th day of November, 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