BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
C. H. STUART, INC.)

For Appellant: J. Douglas Donenfeld
Attorney at Law

For Respondent: Jon Jensen
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of C. H. Stuart, Inc., for refund of franchise tax in the amounts of $13,183 and $11,110 for the income years ended March 31, 1974, and March 31, 1975, respectively.

The question presented by this appeal is whether certain of appellant's subsidiaries were part of appellant's unitary business.

Appellant is a closely held New York corporation with its headquarters in Newark, New York. Appellant and a number of its subsidiaries admittedly constitute a single unitary business engaged in manufacturing and selling jewelry and china, using the "party-plan" method of sales.

During the appeal years, appellant also owned fou'r other subsidiaries which are the subject of this appeal. Maestro International Industries, Inc. (International), was an importer and wholesaler of furniture. Industrias Maestro, S.A. (Industrias), a subsidiary of International, operated in Ecuador and manufactured and sold furniture; International was one of its customers. Aquasport, Inc., was located in Florida and manufactured boats. Artcraft Concepts, Inc., was acquired by appellant in September 1974 and sold arts and crafts supplies through the party-plan method.

There was considerable overlap between the officers and directors of appellant and those of each of the four subsidiaries. In every subsidiary, overlapping directors outnumbered independent directors. Appellant provided all financing for the four subsidiaries in the forms of both capital and loans. The corporate headquarters of all four subsidiaries were located in Newark, New York, apparently at appellant's headquarters. Appellant's employees performed a number of functions for the four subsidiaries, such as accounting, bookkeeping, budgets, legal services, tax return preparation, corporate record keeping, bill paying, pension fund administration and management, and record keeping for local bank accounts. The costs of these services were shared ratably by appellant and the four subsidiaries.

Although, as noted previously, Industrias sold some of its products to International, there was no other in-tercompany product flow among the four subsidiaries themselves, among the four subsidiaries and appellant's other subsidiaries, or between appellant and any of the four subsidiaries;

Appellant originally filed separate California franchise tax returns for itself and one of its other subsidiaries which did business in California. Later, however, appellant filed amended returns for the appeal

years, using the combined report and apportionment method to compute its California tax, including all of its subsidiaries in the combined report. Respondent allowed the combined report method with respect to appellant and its jewelry and china subsidiaries, but excluded the four subsidiaries discussed above, concluding that they were not part of appellant's unitary business. Therefore, appellant's claims for refund were partially denied and appellant filed this appeal.

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 business 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 the four subsidiaries with appellant 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 the four subsidiaries and appellant were clearly unitary under the three unities test above. Respondent concedes that unity of ownership existed. 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.

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 engaged 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.)

Unity of operation encompasses what may be called staff functions, e.g., common purchasing, advertising, accounting, and intercompany financing. Appellant contends that unity of operation is clearly demonstrated by the financing it provided for its subsidiaries and the centralized service functions which it performed.

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 Bd., 117 Cal.App.3d 988, 996 (173 Cal.Rptr. 121] (1981), affd., -- U.S. -- [77 L.Ed.2d 545] (1983).) In this case, however, we find nothing to indicate that these loans or infusions of capital contributed to the operational integration of these companies. The financing was not used for any common business activity and, as far as we can tell from the record, served only to enhance the financial positions of the four subsidiaries 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 types of centralized services listed by appellant, while often mentioned in cases as unitary indicators, have not been shown in this case to have resulted in any material advantage and, therefore, are not particularly significant. Operational unity, therefore, has not been shown to have existed to any meaningful extent.

Appellant contends that unity of use was present in the interlocking officers and directors because appellant's board of directors considered "important matters affecting the subsidiaries such as the sale of (International] and the establishment of a new product line for Aquasport ...." (App. Br. at 8-9.) While it appears that appellant's board did in fact consider those two matters, we note that they were considered after the end of the second appeal year. In addition, the approval for the sale of a subsidiary would, of necessity, come from the board of directors of the corporation which owned the subsidiary. It appears from the record that the policy-making functions which appellant alleges it performed for its subsidiaries were basically those which any investor would perform in managing its investments. An owner's interest in overseeing its assets is insufficient to demonstrate unity of use.

Appellant has not argued that unity existed under the contribution or dependency test of Edison California Stores, supra. In reviewing the record, we find that there was no contribution or dependency beyond the financial contributions that any investor would make to its investments. There has been no demonstration that the operations of appellant (or any of its unitary subsidiaries) contributed to or depended upon the operation of any of the four subsidiaries at issue here.

Appellant has not shown that the relationships between or among the corporations here were of sufficient substance to demonstrate the existence of a single unitary business. Therefore, we must sustain respondent's action.

Appeal of C. H. Stuart, Inc.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Hoard in denying the claims of C. H. Stuart, Inc., for refund of franchise tax in the amounts of $13,183 and $11,110 for the income years ended March 31, 1974, and March 31, 1975, respectively, 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