

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ATLAS HOTELS, INC., AND)
 PICNIC 'N CHICKEN, INC.)

Appearances:

For Appellants: Philip Altfest
 Attorney at Law

For Respondent: Noel J. Robinson
 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 Atlas Hotels, Inc., and Picnic 'N Chicken, Inc., against proposed assessments of additional franchise tax in the amounts of \$11,708 and \$22,769 for Atlas Hotels, Inc., for the income years ended September 30, 1976, and September 30, 1977, respectively) and for Picnic 'N Chicken, Inc., in the amount of \$7,561 for the income year ended September 30, 1976.

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The sole **issue** in this appeal is at what time did Atlas Hotels, Inc., and Picnic 'N Chicken, Inc., become a unitary **business**.

Appellant Atlas Hotels, Inc. (Atlas), was formed in 1958. It is engaged in the hotel business in California and Arizona with headquarters located in San Diego. Atlas provided various centralized service functions through its wholly owned service subsidiaries Crest Advertising, Inc., Atlas Commissary, and Atlas Hotels Courtesy Card for the entire hotel group. In 1973, Atlas underwent a process of consolidation whereby the wholly owned service subsidiaries were merged into Atlas. Respondent agrees that from that date, the hotels and all other **ancillary** hotel service corporations were engaged in a single unitary business.

Most of Atlas' innkeeping capacity is located in San Diego. Other hotels are located in southern California and Arizona. The hotels typically include a lounge, restaurant, coffee shop, banquet rooms, or combinations of all of these. The largest facility is the Town and Country Hotel and Convention Center in San Diego **which also** houses the executive offices of Atlas.

Atlas gained, financial strength immediately prior to, and during, the **years** on appeal. As a result of its strong financial position, Atlas began looking for expansion opportunities and **became** interested in Picnic 'N Chicken, Inc. (PNC), as an acquisition. Atlas bought PNC in order to expand into a similar business. At the time of acquisition, the restaurant business comprised 44 percent of the gross revenue of Atlas. Atlas' management team had restaurant expertise because so much of its business depended on the restaurant business and because it had started as a restaurant business and then expanded into the hotel business. Atlas entered negotiations with PNC and reached an agreement to purchase the shares of PNC at a fixed price. The date of purchase was July 30, 1976.

PNC is a California corporation formed in June 1972. It is also the parent of its wholly owned subsidiary Picnic 'N Chicken of San Diego, Inc. PNC maintained its books on an accrual basis and its income year ended June 30.

Before its acquisition by Atlas, PNC owned and operated approximately 20 fast food outlets in the San Diego and Orange County area. All store sites were

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on leased premises. The outlets featured chicken which **was** marketed in a "drive-through" fashion. The outlets had no seating capacity and it was intended that the products be consumed off the premises. At the time PNC became an expansion prospect to Atlas, **PNC's** growth had slowed and it was in a weak financial position.

Shortly after its acquisition by Atlas, PNC requested and received permission from respondent to change its accounting period to a year ending September 30 in order to correspond with its parent's fiscal year. This created a three-month short period for PNC of July, August, and September 1976. This short period was included as a part of the Atlas combined return for its year ended September 30, 1976. Atlas included **PNC's** July 1976 operations although Atlas did not own PNC until July 30, 1976.

Immediately upon acquisition, two top Atlas executives (C. Terry **Brown**, Atlas' president and chief executive officer, and Mitchell **J. Cagalj**, Atlas' chief financial officer) assumed positions as the two top executives of PNC and began to run the day-to-day operations, as well as to set the major policies, of PNC. Mr. Brown moved his office to the PNC offices and spent substantially all of his time operating PNC. The time he spent on behalf of PNC was gradually reduced to approximately 25 percent in 1977. Throughout the appeal period, Mr. **Cagalj's** time stayed fairly constant at **about 25** percent of his workload. Brown and Cagalj, and one other Atlas executive, Jerome Sandstrom, also made up a majority of the PNC board of directors. The Atlas management team assumed full control over **PNC's** expansion activities.

Upon acquisition of PNC, Atlas signed ten-year employment agreements with several of the top PNC employees as part of the consideration they were asking for the sale of their PNC stock. Mr. Hutchinson, a previous major shareholder of PNC, remained as director, president, and chief operating officer of PNC. John **Reece**, a former shareholder, also remained as a director of PNC. The duties of the holdover PNC management were restricted to seeking new sites and their limited authority was governed by strict guidelines set down by Atlas. Mr. Brown retained final say on all lease transactions and rejected all site recommendations by the former PNC manager in the northwest territory and 50 percent of the Las Vegas recommendations. In effect, of the sites recommended by **PNC's** holdover management, less than 25 percent were ultimately approved by Atlas. Mr. Hutchinson

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was given the titular title of **president, but** in actuality he acted only as an intermediary between Mr. Brown and the PNC outlets and purveyors. In June 1977, Mr. Hutchinson and two other holdover employees who were running PNC were terminated by Atlas because of disagreements which had arisen between them and the Atlas management.

Atlas' operating philosophy caused two substantial changes in PNC's operations. First, Atlas abandoned PNC's philosophy of gearing growth to a franchising concept and all existing franchises were terminated. Secondly, Atlas set about to change **PNC's** business from a strictly "take-home" concept. It immediately began to take steps to attract eat-in and luncheon customers by adding luncheon items such as sandwiches and designing all new outlets with seating capacity.

Immediately upon acquisition, the Atlas management team took charge and several service functions between Atlas and PNC were combined. Atlas brought in its own outside legal and accounting firm and consolidated pension plans. Common insurance was obtained for both PNC and Atlas. At the same time, Atlas' purchasing and personnel manager did a complete audit and investigation of PNC's operations and implemented a number of operational changes. As a result of combined purchasing operations, Atlas and PNC were able to obtain more favorable discounts on purchases made for each organization. PNC converted two rooms at the Mission Valley Inn to its own use as headquarters and operated there rent free from August 1976 through June 1977 when it began to pay rent to Atlas. Warehouse space at the Town and Country Hotel was also used for PNC.

The acquisition agreement required **Atlas to** guarantee a bank indebtedness of approximately \$500,000 previously guaranteed by PNC's principals. On the day of acquisition, Atlas immediately infused \$233,000 into **PNC's** operations. This amount increased to \$600,000 by December 1976 and to \$943,000 by September 30, 1977.

Although during **PNC's** short period ending September 30, 1976, no intercompany transactions occurred, other activities were commenced both prior to and immediately following the acquisition date. Many of the managerial and operational changes were in the planning stage well before the actual acquisition date and implementation of these changes was commenced immediately upon acquisition.

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Immediately after acquisition, Atlas added seating capacity, wherever possible, to PNC locations in order to change the basic thrust of the PNC operation from drive-in to full-service restaurants. Wherever this was accomplished, an average gross revenue increase of 10.25 percent per facility was realized.

During the year ended September 30, 1977, Crest Advertising, Atlas' advertising division, developed and provided all of PNC's advertising. Total billings paid by PNC to Crest were \$12,346. In February 1977, PNC introduced bakery products, which were baked by the Town and Country Bake Shop, as part of its menu. Total purchases by PNC of such products from Atlas during the year ended September 30, 1977, were \$5,597. Total intercompany transactions between Atlas and PNC for the year ended September 30, 1977, equaled \$19,715.

As the result of an audit, respondent determined that Atlas and PNC were not unitary for Atlas' year ended September 30, 1976, or the year ended September 30, 1977. Respondent left undisturbed the combined status of Atlas and PNC for the year ended September 30, 1978. PNC's liability for the short period ended September 30, 1976, was redetermined on a separate accounting basis. PNC's year ended September 30, 1977, was a loss year.

Atlas and PNC protested the proposed deficiencies. Respondent denied the protest. Atlas and PNC thereafter appealed.

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, 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. dismissed, 343 U.S. 939 [96 L.Ed. 1345] (1952).)

The California Supreme Court has determined that a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of

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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 [11 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 9911 (1942).]) The 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 more recent cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552, 386 P.2d 40] (1963).)

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, 1972.) Respondent contends that appellant cannot be considered unitary under either the contribution or dependency test or the three unities test. As to the first test, respondent suggests that after taking the following factors into consideration--ownership, nature of the business, common management, support services and intercompany financing--Atlas and PNC are lacking in the requisite involvement to support a finding of unity. Respondent contends that although food service plays a role in the operations of each, the two operations have little in common, and during the appeal period the hotel operation, as run by Atlas, and the fast food operation were two separate, distinct, and diverse businesses.

Respondent also contends that Atlas fails all three of the aspects of the three unities test. Unity of ownership is absent, respondent contends, because PNC was not wholly owned by Atlas for the entire period on appeal. Respondent also argues that unity of use does not exist, because of absence of common product, facilities, and market. Finally, respondent maintains that unity of operation is missing because the basic diversity of the two **businesses** does not lend itself to uniform or standardized business practices.

Respondent concedes that Atlas and PNC were unitary for the year ended September 30, 1978. It submits that the absence of significant ties for the first 15 months of operation inhibited a unitary operation and that it was only after this time or possibly as

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earily as June 1977, when the holdover management was discharged that Atlas and PNC became unitary. However, it **concludes that** looking at the events overall, and particularly with the more active **intercompany** exchanges commencing with the year ended September 30, 1978, Atlas and PNC should not be considered unitary until that time.

Appellants contend that their operations were unitary under either test from July 30, 1976, the date PNC was acquired. Their contention is based on the existence of the following factors: (i) substantial intercompany financing; (ii) modifications **made to PNC's** method of operations; (iii) some intercompany transactions; (iv) integrated management; and (v) common officers and directors.

For the reasons which will be discussed below, we believe that from the date **of its** acquisition PNC was unitary with Atlas under either of the two tests described above and could properly file a combined report.

With the exception of the first month of the **15-month** appeal period (July 1976), the Ownership requirement is satisfied since after July 30, 1976, Atlas owned 100 percent of the stock of **PNC**.

Respondent argues that **PNC's operations** do not contribute to or depend upon the operation of Atlas to a degree which is substantial enough **to** warrant their classification as a unitary business. Respondent also contends that, since PNC was engaged in a different type of business from that of Atlas, the contribution or dependency test is not satisfied and **PNC** cannot be unitary with Atlas. However, the mere fact that corporations are engaged in diverse lines of businesses, standing alone, does not preclude a finding that such businesses are unitary (see Appeal of Wynn Oil Company, Cal. St. Bd. of Equal., Feb. 6, 1980; cf. Appeal of Gear Siegler, Inc., Cal. St. Bd. of Equal., April 24, 1967). Additionally, providing food service in its hotels was a major part of Atlas' activities and its major source of income; therefore, the diversity is not as great as respondent would have us believe.

Several important unitary features; are present which indicate that interdependence and Contribution existed between Atlas and PNC. Chief among these are an integrated executive force, intercompany financing, and intercompany product flow. The existence of these three

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factors has previously been found by this board to carry great weight in supporting a finding of unity. (See Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

The existence of an integrated executive force is an element of exceeding importance in determining unity, (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).) An integrated executive force existed between Atlas and PNC because of the direct involvement in PNC's affairs by Mr. Brown and Mr. Cagaij, who also served on the board of directors of each company. Additionally, Atlas personnel made up a majority of the board of directors of PNC.

PNC and Atlas had common officers, indicating that the companies shared a strong central management. Many high level Atlas employees were involved not only in major policy decisions with respect to PNC; but also participated directly in PNC's day-to-day operations. Mr. Brown, president and chief executive officer of Atlas testified that immediately after Atlas acquired PNC, he became its chief executive officer, moved to PNC's offices, and became involved in all aspects of their operations. (R.T. p. 8.) Mr. Mitchell Cagaij, chief financial officer of Atlas, also took on the same duties at PNC.

Another important indicator of unity present in this appeal is the immediate infusion of capital by Atlas into PNC. (Appeal of Saga Corporation, supra; Appeal of I-T-E Circuit Breaker Company, Cal. St. Bd. of Equal., Sept. 23, 1974.) At the time of acquisition, PNC was on the verge of bankruptcy and many of the PNC officers had to make personal guarantees on PNC's outstanding debts; Atlas cleared all of these guarantees. On the day of acquisition, Atlas provided \$233,000 to PNC, an amount which was increased to \$600,000 by December 1976 and to \$943,000 by September 1977. Although we recognize that financing alone, absent other significant ties, does not convert a diverse enterprise into a single economic unit, this factor does weigh heavily given the other involvements listed above.

Substantial intercompany product flow is also significant evidence of unity. (See, e.g., Appeal of Saga Corporation, supra) Appeal of I-T-E Circuit Breaker Company, supra.) Although there was minimal transfer of goods between the two companies, there was a substantial

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transfer of intercompany services including both management and staff personnel, support services such as legal and accounting, and use by PNC of Atlas' advertising division, Crown Advertising.

With respect to the three unities test, respondent contends that unity of operation and unity of use were not present because there was no centralized executive force and because PNC's fast food operations were not incorporated into Atlas' general system of operations. We disagree. As we demonstrated above, there is ample evidence of a centralized executive force because of the involvement of the top Atlas officers in PNC's day-to-day affairs as well as in its major policy decisions. Additionally, while not all of the operations of PNC and Atlas were centralized, there was evidence of significant combination of service functions.

For the reasons set out above, we conclude that PNC and Atlas were engaged in a unitary business during the appeal years with the exception of the month of July 1976, before the purchase of PNC by Atlas. Accordingly, respondent's action in this matter must be modified.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Atlas Hotels, Inc., and Picnic 'N Chicken, Inc., against proposed assessments of additional franchise tax in the amounts of \$11,708 and \$22,769 for Atlas Hotels, Inc., for the income years ended September 30, 1976, and September 30, 1977, respectively, and for Picnic 'N Chicken, Inc., in the amount of \$7,561. for the income year ended September 30, 1976, be and the same is hereby modified in accordance with this opinion.

Done at Sacramento, California, this 8th day of January, 1985, by the State Board of Equalization, with Board **Members** Mr. Dronenburg, Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

<u>Ernest J. Dronenburg, Jr.</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Richard Nevins</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9