BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-1183
TRAILS END, INC.)

Appearances:

For Appellant: Larry Bowman
Attorney at Law

For Respondent: Gary M. Jerrit
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Trails End, Inc., against a proposed assessment of additional franchise tax in the amount of $116,617.56 for the income year ended August 31, 1977.

1/ Unless otherwise specified; all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The sole issue presented for our decision is whether appellant was engaged during the appeal year in a single unitary business with Amway Corporation and its subsidiary Nutrilite Products, Inc.

Incorporated in 1957 under the name 'Industrial Molding Corporation," appellant was a California corporation with its last principal place of business 'in Torrance. For 22 years until its dissolution in 1979, appellant was engaged in the business of molding and manufacturing custom-designed plastic parts and products.

When appellant was first organized as a corporate entity, shares were issued to and divided among three stockholders. Two individuals.,. Bernard Diggens and Robert Bloom, each acquired 25 percent of the stock. The remaining 50 percent of the shares was issued to Nutrilite Products, Inc. (Nutrilite), a California corporation which manufactures vitamin products and diet supplements. In 1971, Nutrilite increased its ownership interest to 80 percent 'by acquiring 15 percent of the-stock from each of the two individual shareholders.

In 1972, Nutrilite was the subject of a corporate acquisition or merger when Amway Corporation (Amway) purchased 51 percent of its stock. Organized and existing under the laws of the State of Michigan, Amway is a foreign corporation recognized as a leader in the direct sales industry. It manufactures and then sells household products directly to consumers through independent sellers. By 1977, Amway had increased its ownership interest in Nutrilite to 53 percent. Amway began purchasing products from appellant soon after it became the majority owner of Nutrilite.

During the income year in question, there were a number of common officers or directors between the executive staffs of appellant and Nutrilite. Five of appellant's six directors were concurrently officers of Nutrilite, including the executive vice president, secretary, and controller. The latter two Nutrilite officers served in similar positions on the managerial staff of appellant. Another director, Dr. Stefan Tenkoff, was formerly the executive vice president and treasurer for Nutrilite as well as the chairman and chief executive officer for appellant. In addition to being a shareholder of.appellant, Mr. Diggens performed as its long-standing president and.participated on its board of directors. He also served as a director of Pacific

Vitamin Corporation, a subsidiary of Nutrilite, during the 1977 income year.

In general, the board of directors of Trails End, Inc., was responsible for the establishment of company policy. At the same time, the board determined the annual budget for the corporation and made major decisions impacting upon the financial resources of the company. In order to keep its major stockholder apprised of its current financial condition, appellant was required to submit financial reports to Nutrilite on a monthly basis, Nutrilite was able to further monitor appellant's cash flow through the perspective of its controller who was appointed to appellant's board of directors.

In its day-to-day operations, appellant functioned as an autonomous business enterprise. Its staff of 60 to 90 employees conducted all of the plastic molding and manufacturing activities at the plant facility in Torrance. Appellant did not share facilities or exchange technical information with either Nutrilite or Amway. There were no transfers of personnel between appellant and the two parent companies. Nor did appellant participate or engage in the centralized purchasing of supplies or the mutual solicitation of orders. In the area of marketing, appellant directed its own advertising, promotion, and sales campaigns. Accounting, banking, insurance, legal counsel, personnel, administration, employee benefit plans, and research were likewise independently handled by appellant or its agents.

With regard to intercompany finances, appellant did not receive any loans from Nutrilite or Amway in the income year under review. In the early 1970's, however, Nutrilfte made three loans to appellant totalling $730,177. Appellant paid these loans in full with interest by the appeal year. In 1974, Nutrilite charged appellant for the costs of providing electronic payroll and financial services. This intercompany charge was discontinued after one year when appellant found a vendor at less cost. For the 1974-1977 income years, appellant's tax returns were prepared by the accountants for Nutrilite and Amway.

There were intercompany sales from appellant to both Nutrilite and Amway. During the income year under review, appellant sold $245,922 of products to Nutrilite and $925,863 of products to Amway. The combined intercompany sales figure of $1,171,085 represented 22 percent of appellant's total sales ($5,330,949) for the income

year 1977. In the immediately preceding income year 1976, appellant made total sales amounting to $5,113,833. Of this sum, intercompany sales equaled, $260,833, or 5.1 percent of total sales. For a known 8-month period of the 1975 income year, intercompany sales constituted 6.2 percent of the sales by appellant. For the 1974 income year, sales to Nutrilite and Amway accounted for 2.6 percent of appellant's total sales of $4,048,955.

On its California franchise tax return for the income year under appeal, appellant reported its income on the basis of a combined report which included the incomes of Nutrilite and its three other subsidiaries, Amcon Industries, Inc., Tera Pharmaceuticals, Inc., and Pacific Vitamin Corporation. Appellant's return was prepared by the public accounting firm retained by Nutrilite, but it was signed by Bernard Diggens in his capacity as president. Upon auditing the return, respondent determined that appellant was engaged in a single unitary business with Amway as well as with the Nutrilite group of companies. On April 3, 1980, respondent issued a notice of proposed assessment of additional franchise tax which reflected the inclusion of the California-source income of Amway as determined by formula apportionment.[2/] Appellant protested the proposed assessment, disputing the decision of the Franchise Tax Board that its business was unitary with Amway. On February 25, 1982, following a hearing on the matter, respondent affirmed the proposed assessment. Appellant, thereupon, filed this appeal.

2/ During the period between the filing of the 1977 return and the issuance of the proposed assessment, appellant redeemed the outstanding shares of stock held by Nutrilite and elected to wind up and dissolve. On May 23, 1979, Trails End, Inc., was dissolved after it had obtained and filed a certificate of tax clearance. Under section 23334, the Franchise Tax Board issued the tax clearance certificate on the basis that two individuals, Bernard Diggens and Larry Bowman, had executed and filed respondent's Assumption of Tax Liability form, agreeing to assume and pay all accrued or accruing franchise taxes of the dissolved corporation. Consequently, the proposed assessment at issue in this appeal was issued to these two individuals as assumers of appellant's tax liability. (See Appeal of B. & C. Motors, Inc. (George and Despina Peterson, Assumers), Cal. St. Bd. of Equal., Aug. 27, 1362.)

When a taxpayer derives income from sources both within and without California, its franchise tax liability will be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) 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. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has set forth two tests to determine 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 unitary nature of a business is definitely established by the presence of unity of ownership; unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions; and unity of *use* in a centralized executive force and general system of operation. The court subsequently added that a business *is unitary* if the operation of the business done within this state is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.)

Respondent's determination that appellant was engaged in a single unitary business with affiliated corporations is presumptively correct, and appellant bears the burden of proving that the determination is erroneous. (Appeal of John Deere Plow Co. of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.) Appellant must demonstrate by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by respondent were so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

In general, the existence of a unitary business may be established if either the three unities or the contribution and dependency test is satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) In the present matter, respondent employed the contribution and dependency test in its decision to include Amway in a unitary business with the Nutrilite group. An implicit requirement under the contribution *or*

dependency test is the presence of controlling ownership, which can only be established by common ownership, whether direst or indirect, of more than 50 percent of a corporation's voting stock. (Appeal of Revere Copper and Brass Incorporated, Cal. St. Bd. of Equal., July 26, 1977.) A showing of the requisite degree of common ownership is a necessary prerequisite to a determination that a business is unitary (Container Corp. v. Franchise Tax Board, 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), affd., 463 U.S. 159 [77 L.Ed.2d 545, 562] (1983), for the unitary theory contemplates control over all parts of a business by a majority interest. (See Appeal of Revere Copper and Brass Incorporated, supra.) "[This] concept of control over the entire business is. fundamental in the case of affiliated corporations because where unity is found between such corporations, all the income- and apportionment factors of each corporation are combined to determine the California taxable income." (Appeal of Albertson's, Inc., Cal. St. Bd. of Equal., Sept. 21, 1982.)

Here, Amway had a 53-percent interest in Nutrilite which in turn owned 80 percent of the stock in appellant. In other words, appellant was a subsidiary of Nutrilite and Nutrilite was a subsidiary of Amway. While it concedes that unity of ownership existed between itself, Nutrilite, 'and Amway, appellant asserts that it is nevertheless a second-tier subsidiary and its operatfons cannot properly be considered unitary with the operations of Amway. Appellant's objection is not well taken. Under the unitary business concept, all that need be established is that appellant formed an inseparable part of Amway's unitary business wherever it is conducted. (Appeal of Monsanto Company; Cal. St. Bd. of Equal., Nov. 6, 1970.) It is not necessary to find a direct-unitary relationship between appellant's California operations and the out-of-state operations of Amway; it is sufficient if the unitary relationship is indirect. (Appeal of Texaco, Inc., Cal. St. Bd. of-Equal., Jan. 11, 1978; Appeal of Arkla Industries, Inc., Cal. St. Bd. of Equal., Aug. 16, 1977; Edison California Stores, Inc. v. McColgan, supra.) The record in this case shows that Nutrilite and Amway acceded to the determination that their respective operations were unitary with one another. If appellant is shown to have been engaged in a single unitary business with either Nutrilite or Amway, then appellant's operations cannot justifiably be separated from the unitary operations of the two corporations. (Appeal of Arkla Industries, Inc., supra; Appeal of Monsanto Co., supra.)

First, respondent relied in part upon the factor of centralized management to conclude that a mutually dependent relationship existed between appellant and Nutrilite. The existence of integrated executive forces at the, top management level .has been emphasized as a unitary element of great importance under the contribution or dependency test. (Chase Brass & Copper Co., Inc. v. Franchise Tax Board, 10 Cal.App.3d 496 [87 Cal.Rptr. 239], app. dism. and cert. den., 4trO'U.S. 961 [27 L.Ed.2d 381) (1970); Appeal of F. W. Woolworth Co., supra.) Appellant contends that its manufacturing activities were a separate and autonomous operation whose day-to-day functions and overall control lay in the hands of its own employees. It is appellant's position that the executive assistance provided by Nutrilite lacked unitary significance since Nutrilite in appointing its personnel to appellant's board of directors simply sought to monitor its investment.

We are not convinced that' the closely integrated management of the two companies reflected nothing more than an owner's interest in overseeing its investment. (See Appeal of Mole-Richardson Company, Cal. St. Bd. of Equal., Oct. 26, 1983.) Nutrilite may not have been involved-in the day-to-day operations of appellant's plastic molding business, but it is clear that the parent company did more than just offer financial guidance. With its executives serving in the top management positions of appellant, Nutrilite exercised executive control of appellant at the highest. level. During the year in question, all six directors on appellant's board were currently or had previously been officers or directors of Nutrilite or its other subsidiaries. The secretary and controller were identical for the two corporations. Bernard Diggens, who was president and chairman of the board for appellant, served on the board of directors for another subsidiary of the Nutrilite group. The presence of Nutrilite officers on appellant's executive staff and board is relevant to show that appellant was subject to at least the implicit control of Nutrilite so as to render the two corporations an integrated enterprise. (Container Corp. of America v. Franchise Tax Board, supra, 463 U.S. at ___.) Appellant has stated that its board, regardless of its composition, exercised only the ordinary powers of a board in setting the policy outlines for the corporation. Yet, it is exactly the establishment of "major policy matters" which demonstrates that executive control at the highest level was vested in this top management team. (Chase Brass. & Copper Co., Inc. v. Franchise Tax Board, supra, 10 Cal.App.3d at 504.)

Furthermore, the record indicates that Nutrilite had more than implicit control over appellant's operations. In 1972, an integrated executive committee was formed to develop, coordinate, and direct all of appellant's administrative, manufacturing, and sales functions in the wake of appellant's first substantial operating loss in its then 15-year history. The creation of the executive committee was the idea of Dr. Stefan Tenkoff who at that time was appellant's chairman and chief executive officer and concurrently a high-ranking official of Nutribite. While this event took place prior to the appeal year, we observe that two members of the executive committee, Tenkoff and Diggens, remained on appellant's board of directors through 1977. Additional evidence that demonstrates Nutrilite exercised control over appellant's activities was in the area of finances. Not only did Nutrilite's controller monitor xts financial condition but also appellant was required to submit monthly reports to Nutrikite and assented to the preparation of its annual tax returns on a combined, report basis by accountants for the parent corporation. Appellant's annual report for 1976-1977 further indicates that it consulted Nutrilite before deciding to purchase a new plastic injection machine to replace an obsolete model. Thus, the'evidence shows that Nutrilite exercised direct control over appellant's activities. Based on our review of the record, we find the integration of executive members and the centralization of management between appellant and Nutrilite to have unitary significance.

Second, respondent contends that the substantial product flow from appellant to both Nutrilite and Amway demonstrates that the companies contributed to or depended upon each other for their mutual economic well-being. This board has held intercompany product flow to be an important indicator of unity under the contribution or dependency test. (Appeal of Nippondenso of Los Angeles, fnc., Cal. St. Bd. of Equal., Sept. 12, 1984: Appeal of Beecham, Inc., Cal. St. Bd. of Equal., *Mar.* 2, 1977.) The United States Supreme Court has affirmed that one of the ways by which substantial mutual interdependency can arise is through a substantial flow of goods. (Container Corp. of America v. Franchise Tax Board, supra, 463 U.S. at ____.) In prior appeals, we have found intercompany sales to be substantial in instances where a corporation sold 10 to 15 percent of its products to affiliated companies (Appeal of I-T-E Circuit Breaker co., Cal. St. Bd. of Equal., Sept. 2?, 1974) and where 22 percent of a subsidiary's production was purchased by the parent company. (Appeal of Arkla Industries; Inc.,

supra; Appeals of Harbison-Walker Refractories Company, (on rehearing), Cal. St. Bd. of Equal., Feb. 15, 1972.)

In the present matter, appellant's sales to Nutrilite and Amway in the income year in question exceeded $1.1 million. In the context of appellant's total sales figure, this amount was substantial in that it r&presented 22 percent of its total sales volume for the income year. Appellant has argued that these intercompany sales were insignificant and "only incidentally related" to its association with the two parent corporations, (App. Reply Br. at 3.) In particular, appellant asserts that 90 percent of its sales to Amway consisted of two products, a tote-tray used as a promotional gift by Amway dealers and a housing for fire detectors, and the Nutrilite sales were containers for two lines of vitamins. It is appellant's position that those sales constituted a very small portion of all purchases made by Nutrilite and Amway.

Even if the product flow was one-way and the sales were made at market or arms-length prices, however, it was nevertheless advantageous to appellant to have had ready and willing buyers for such a substantial portion of its production. (Chase Brass and Copper Co. v. Franchise Tax Board, supra, 10 Cal.App.3d at 505; Appeal Nippondenso of Los Anueles. Inc., supra; Appeals of Harbison-Walker Refractories Company, supra.) The unitary importance of these intercompany sales was that they allowed appellant to benefit from the economics of a larger scale operation while guaranteeing the parent corporations an available source of customized plastic products. (See Appeal of Arkla Industries, Inc., supra; Appeal of I-T-E Circuit Breaker Company, supra.) Here, the evidence suggests that the sales may not have been at arms-length prices. An analysis of appellant's sales figures for the income year indicates that its average gross profit on all sales for the year was 17.1 percent. On the other hand, its profit margin was 36.6 percent on sales to Nutrilite and 21.6 percent on sales to Amway. Since appellant's sales volume to its other customers were in much smaller amounts, the sales to Nutrilite and Amway would be expected to have been less profitable due to the likelihood of volume discounts. The fact that appellant derived higher than average profits on its high-volume sales to Nutrilite and Amway strongly suggests that the parties engaged in preferential pricing practices for appellant's benefit. This conclusion is supported by an inter-office memorandum dated August 30, 1976, which was written by one of appellant's sales representatives

and addressed to Bernard Diggens, President. According to this correspondence, an Amway purchasing, employee informed the sales representative that Amway could purchase the smoke detector housings and measuring cups from other manufacturers at less cost but that he understood that he was required to continue to do business with the sales agent since Amway was giving "top priority" to appellant. (Resp. Br., Ex. C. at 3.) In this regard, Bernard Diggens testified that appellant dropped customers in favor of Amway, which it judged to be a more reliable and desirable customer.

The unitary significance of the higher profit margins on these intercompany sales becomes more apparent when we consider appellant's financial condition during this period. In the three income years prior to the year in question, appellant sustained losses or negative taxable income. (App. Br. at 4.) Six months through the appeal year, appellant's annual report states that cash flow problems persisted due to litigation expenses and slow payments by debtors. However, the report indicates that six-month sales to Amway had increased to $370,132 from $39,085 for the same six-month period in 1976 and attributes this "substantial increase" to the Amway orders for the tote-trays and smoke detector housings. The quantity of business generated by Amway's orders for the tote-trays is substantiated by the- aforementioned memorandum which mentions purchases of 40,000 to 60,000 units per month. (Resp. Br., Ex. C. at 2.) Sales to Amway continued at an incresed rate for the remainder of the income year. For the income year in question, appellant reported a taxable income of $280,516, its first profitable year in at least four years. The evidence thus has a tendency in reason to show that Amway decided to purchase the products from appellant in order to assist its subsidiary and that the orders were in large part responsible for appellant's profitable income year.

Based upon the foregoing, we must conclude that the factors of centralized management and intercompany sales at preferential prices demonstrate that appellant's business depended on both Nutrilite and Amway to a significant degree. We, therefore, find that appellant formed a functionally integrated enterprise with its two parent companies. Accordingly, respondent's determination of unity must be sustained.

Appeal of Trails End, 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Trails End, Inc., against a proposed assessment of additional franchise tax in the amount of $116,617.56 for the income year ended August 31, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of September, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9