76-SBE-061

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
AUTOMATED BUILDING)
COMPONENTS, INC.)

Appearances:

For Appellant: William F. Jureit
Attorney at Law

For Respondent: Karl F. Munz
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Automated Building Components, Inc., against proposed assessments of additional franchise tax and penalties in the amounts and for the years as follows:

Income Years Ended	Proposed Assessments	Late Filing Penalties
January 31, 1966	$9,413.69	$ -0-
January 31, 1967	3,963.56	198.18
January 31, 1968	5,857.00	585.70
January 31, 1969	9,066.44	-0-
January 31, 1970	7,009.91	-0-

This appeal presents two issues for resolution. The primary issue is whether appellant, Automated Building Components, Inc., its California operation, and its foreign subsidiaries were engaged in a single unitary business during the years in issue. The secondary issue is whether royalties paid to appellant by the foreign subsidiaries were properly accounted for in determining unitary income.

Gang-Nail Components, Inc. , hereinafter referred to as GNC, was a wholly owned subsidiary of appellant. On January 31, 1966, GNC was merged into appellant. Thereafter, the business operation in California was continued as Gang-Nail Components, Division of Automated Building Components, Inc. , hereinafter referred to as the California Division. Appellant filed California franchise tax returns for the years in issue, utilizing separate accounting, and reported only the income from the operations of GNC for the income year ended January 31, 1966, and the income from the California Division for the subsequent years in issue.1/

After an audit, respondent determined that a combined report should have been filed for the single unitary business comprising appellant, GNC, and Automated Building Components, Inc. (Western Hemisphere), hereinafter ABC(WH), for the income year ended

1/ Apparently, GNC filed a return in its own behalf for the income year ended January 31, 1966, taxable year ended January 31, 1967. However, appellant's proposed liability for that year arises because of its status as successor in interest to GNC. (Rev. & Tax. Code, § 25701a.)

January 31, 1966. For the remaining years in issue, respondent determined that a combined report should have been filed for the single unitary business consisting of: appellant, including the California Division; ABC(WH); Automated Building Components (U. K.) Ltd. , hereinafter ABC(UK); and Automated Building Components (South Africa) Pty. Ltd., hereinafter ABC(SA). Respondent computed the combined income of the above entities and then applied the three-factor apportionment formula to determine the California portion of the unitary income. It is from this determination that appellant appeals. The delinquent filing penalties assessed pursuant to section 25931 of the Revenue and Taxation Code have not been contested by appellant.

Appellant is a Florida corporation with its headquarters in Miami. Its principal activity is the manufacture and sale of a proprietary item known as a Gang-Nail Connector Plate.' A Gang-Nail is a metal connector plate used for the manufacture of timber structural trusses. Equipment to manufacture the Gang-Nail Connector Plates is produced by appellant for its own use at its Florida factory. Appellant also produces equipment used to prefabricate the timber structural trusses at high speed. For the most part, the Gang-Nail Connectors and the equipment to prefabricate the timber trusses are sold to approximately 150 franchised fabricators located in various states who serve a local market selling completed assemblies to builders. Since these assemblies are generally required to be designed by a licensed engineer pursuant to local building codes, appellant provides a computerized engineering design service to its franchised fabricators. In addition to appellant's major activity, it manufactures a proprietary steel roofing tile which is sold directly to builders. Prior to 1970, appellant acted as a general contractor in the construction of fast food restaurant buildings.

In 1962, appellant acquired a Florida corporation and promptly changed its name to GNC. The following year GNC was moved to Buena Park, California, to replace appellant's previously franchised fabricator located in that area. GNC's formative years reflected an unfavorable profit performance. As a result of its sustained losses GNC's credit position was adversely affected and it became increasingly difficult to purchase its large lumber requirements at realistic prices. In order to stabilize GNC's faltering credit, appellant's management decided to merge GNC into appellant. As a result of this reorganization, whereby GNC became the California Division, the latter's credit position was substantially improved.

Prior to and during the first year on appeal, GNC and appellant had the following common officers and directors: Mr. J. Calvin Jureit was a director and president of both corporations; Mr. William F. Jureit was a director and secretary of both corporations; Mr. Alex Courtelis was a director of both corporations. Of course, when GNC became appellant's California Division the officers and directors were identical.

The first vice president and general manager of GNC was A. B. Catlin, a local California resident who served in this capacity for only 14 months. Mr. Catlin had not previously been associated with appellant. Similarly, the second vice president and general manager, who was employed for less than two years, had never been employed by appellant or any of its subsidiaries or affiliates. In June 1964, Thomas E. Rymer was transferred from the Florida headquarters to the California subsidiary as chief accountant. Mr. Rymer, who had previously been a staff accountant in Florida, was appointed general manager of the California Division in March, 1966. He continues to serve in that capacity.

The general manager of the California Division reported directly to Mr. W. F. Jureit, executive vice president of appellant.. Although Mr. Jureit retained full authority over the general manager according to the corporate organizational structure, appellant maintained that no practical control was exercised. However, the general manager was required to prepare and submit a capital budget and an operational budget to appellant for approval. The general manager also submitted monthly operating statements and balance sheets of the California Division as well as periodic correspondence dealing with legal matters.

GNC and, thereafter, the California Division purchased all of the Gang-Nails required to connect the roof trusses from appellant. During the years in issue the intracompany transfers from appellant to CNC or the California Division expressed as a percentage of the latters' total material purchased for manufacture or sale varied from 20 to 42 percent. Intracompany transfers from the parent expressed as a percentage of the subsidiary's or the California Division's gross sales varied from 9 percent to 15 percent over the same period.

Outstanding loans from the parent to the subsidiary and the California Division at the close of each successive year in issue were: $576,357; $523,511; $452,636; $617,258; and $658,604. These loans were interest free with the exception of one year when the California Division's books reflected a $45,954 intracompany interest payment made to appellant. By comparison, only a few loans in relatively small amounts were obtained by the California operation from commercial lending institutions.

GNC and the California Division maintained their own accounting records, and paid their own accounting fees for the services of independent certified public accountants. They also paid, directly, their own legal fees as well as the fees for other professional services obtained in California. The general manager negotiated, without parental approval, all labor union contracts, sales and purchase contracts, all credit approvals and acceptances, and the employment of all managerial personnel of the California operation.

The recognition of the economic worth of the Gang-Nail system by foreign construction industries caused appellant to consider expanding its operation into foreign markets. High import duties coupled with difficulty in obtaining import permits and excessive transportation costs suggested local foreign manufacture, rather than importation from Florida. In 1962, ABC(WH), a wholly owned subsidiary, was incorporated. Its principal office is in Toronto, Canada. In 1966, ABC(UK), another wholly owned subsidiary, was incorporated. Its home office is located in Surrey, England. Also in 1966, ABC(SA), a subsidiary in which appellant owns 90 percent of the stock, was incorporated in Johannesburg, South Africa. Common directors are present on the boards of both appellant and the foreign subsidiaries. The foreign subsidiaries manufacture and sell Gang-Nail Connectors and provide structural engineering design services to their foreign customers.

The foreign subsidiaries are licensed to manufacture and sell the Gang-Nail Connectors by appellant. In exchange for this right the subsidiaries pay royalties to appellant based on their annual net sales of Gang-Nails. Appellant is obligated to collect these -royalties to satisfy its contractural obligations to the inventor of the Gang-Nail system. During the years in issue appellant did not license any nonsubsidiary firms to manufacture and sell its products.

Appellant provided the initial financing for the foreign subsidiaries. Additionally, the record reflects substantial intercompany financial transactions between appellant and ABC(UK) and ABC(SA) during the remaining years in issue. Some of these transactions were labeled as loans and others merely *as* intercompany transactions. The balance of these accounts with respect to ABC(UK) approached $150,000 in 1.968 and 1969. For the same years the books of ABC(SA) reflected balances of approximately $30,000. In at least some of the years in issue interest payments were made to appellant by both ABC(UK) and ABC(SA). Dividends were also paid by the same companies during these years.

Appellant selected the local managing directors who, in all cases, were local nationals with no prior employment experience with appellant. No personnel were transferred to the foreign subsidiaries from the Florida headquarters. The local. managing director of each foreign subsidiary employed his own staff. The local managing directors received a one-month training period in Florida. Thereafter, they were granted a high degree of autonomy' in managing their foreign companies. However, they did consult with appellant's staff when necessary.

When the income of a taxpayer is derived from or attributable to sources both within and without California the taxpayer is required to measure its franchise tax liability by the net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer's business is unitary, the income attributable to California sources must be determined by formula apportionment rather than by the separate accounting method. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P. 2d 334], aff'd, 315 U. S. 501 [86 L. Ed. 991].)

The California Supreme Court has developed two general tests for determining whether a business is unitary. In Butler Bros. v. McColgan, supra, the court held that the existence of a unitary business is definitely established by the presence of: (1) unity of ownership; (2) unity of operation, as evidenced by central purchasing, advertising, accounting and management division; and (3) unity of use in its centralized executive force and general system of operation. Subsequently, in Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P. 2d 16] the court stated that a business is unitary when the operation of the 'business within California contributes to or is dependent upn the operations of the business outside the state. Later cases have reaffirmed these tests and have given them wide application. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33]; Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40].)

Initially appellant argues that the Butler Bros. three unities test is the only test for determining the existence of a unitary business. It is appellant's position that the three unities test is merely a more precise statement of the contribution or dependency test set forth in Edison. However, we have held that a unitary business exists if either the three unities or the contribution or dependency tests are satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972; *see* also Appeal of Browning Manufacturing Co., Cal. St. Bd. of Equal., Sept. 14, 1972.)

GNC and the California Division

In originally establishing GNC, appellant named its corporate offspring after its primary proprietary product, Gang-Nail. After the merger, the California Division was known as Gang-Nail Components, a Division of Automated Building Components, Inc. Thus, appellant was able to project the name of its primary product as well as its own name and image into the California market. This is an indicator of unity. (See Appeal of F. W. Woolworth Co., supra; Appeal of Simonds Saw and Steel Co,, Cal. St. Bd. of Equal., Dec. 12, 1967.)

GNC and appellant shared common officers and directors, The mutual benefits provided by interlocking officers and directors have been recognized by the courts. (See Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. hpp. 3d 496 [87 Cal. Rptr. 239] appeal dismissed and cert. denied, 400 U. S. 961 [27 L. Ed. 2d 381].) We have also recognized that the presence of integrated executive forces is important evidence of contribution and dependency. (See generally Appeal of Harbison-Walker Refractories Co., Cal. St. Rd. of Equal., Feb. 15, 1972.)

The poor credit position of GNC in its formative stage was the motivating factor for the merger whereby appellant was able to shore *up* GNC's weak credit position by its own strong credit rating.

Without this merger and the resulting stabilization of the California operation's credit, it is questionable whether the latter would have survived. This is a strong indication of a unitary business.

Appellant argues that our prior decision in Appeal of Simco, Inc., decided October 27, 1964, foreclosed considering the use of credit as a unitary factor. However, in Simco, which involved an entirely different factual setting, we me-stated that business expansion accomplished by a corporation's own funds or by the use of its credit, standing alone, is an insufficient basis for concluding that the resulting operation is a unitary business.

The record indicates a consistent pattern of substantial intercompany financing during the years in issue. With the exception of one year, the loans were interest free. Appellant argues that, in reality, the loans were equity investments which were converted into loans on the California Division's books as a result of the merger. However, appellant does not explain how the merger converted equity into debt. In any event, the amount of the loans carried on the California Division's books indicates an increasing trend which reflects continued financing throughout the years in issue. In view of the mutual advantages accruing to appellant and the California operation from this financing, we find it substantial evidence of the existence of a unitary business. (See Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of Browning Manufacturing Co., supra; Appeal of Perk Foods Co. of California, Cal. St. Bd. of Equal., Nov. 23, 1966.)

Appellant maintained that they exercised no control over the California operation, only requiring that the business be profitable. However, appellant terminated the employment of GNC's first two general managers after brief and apparently unsuccessful tenures. Neither had ever been associated with appellant before. They were replaced by a seasoned and respected member of appellant's home office staff. It may be true, as appellant argues, that the general manager was granted wide latitude in conducting the day-to-day affairs of the California operation. Nevertheless,. he was required to submit operational and capital budgets to appellant for approval and control. The general manager also consulted with appellant's top management when the necessity arose. Regardless of the latitude granted the general manager in the conduct of the

California operation's day-to-day affairs, ultimately, he was answerable to appellant. These examples of managerial control exercised by appellant are further evidence of mutual dependence and contribution. (See Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of Browning Manufacturing Co., supra.)

The existence of substantial intercompany product flow has consistently been held to be an important evidentiary element of contribution and dependency. (See, e.g., Appeal of Harbison-Walker Refractories Co., supra; Appeal of Swift & Co., Cal. St. Bd. of Equal., April 7 1970; Appeal of Cutter Laboratories, Cal. St. Bd. of Equal., Nov. 17, 1964; Appeal of Campbell Chain Co. of California, Cal. St. Bd. of Equal., Oct. 27, 1964.) Here, as related above, we have a substantial flow of the proprietary item, Gang-Nails, from appellant to the California operation. Appellant's Florida manufacturing operation was the sole available source for this product. The California operation provided an outlet to the valuable Southern California building market for appellant's production. The marked degree of contribution and dependency evidenced by these transfers is evident.

Throughout this proceeding, appellant has emphasized the limited degree of centralized service functions (unity of operations). However, we have held that central performance of service functions is not essential to a finding that a unitary business exists if the onerations of the entire organization are mutually dependent and contribute to each other. (Appeal of F. W. Woolworth Co., supra; Appeal of Swift & Co., supra; Appeal of Combustion Engineering, Inc., Cal. St. Rd. of Equal., July 7, 1967; Appeal of Cutter Laboratories, supra.)

In view of all the factors considered above, we believe that there is a substantial basis for determining that GNC and, thereafter, the California Division were engaged in a single unitary business with appellant.

The Foreign Subsidiaries

Here, as in the case of the California operation, unity of ownership is not disputed. Similarly, the fact that appellant and the foreign subsidiaries shared common directors is not contested.

In creating its foreign offsprings, appellant continued the family name, Automated Building Components, thus, projecting itself and its name into the foreign markets. As we have noted above, the use of a common name is one factor which indicates the existence of a unitary business. (See Appeal of F. W. Woolworth Co., supra; Appeal of Simonds Saw and Steel Co., supra.)

The record indicates a pattern of intercompany financing through loans and other transfers during the years in issue. These transactions were in addition to appellant's initial infusion of equity reflecting its ownership interest. The existence of intercompany loans is another factor indicating unity. (See Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of Browning Manufacturing Co., supra.)

The overall manner in which the foreign subsidiaries operate their businesses is similar to that of their domestic parent. Both manufacture and sell the Gang-Nail Connector and provide structural design services to their customers. This conclusion is inevitable, notwithstanding the unique requirements of the individual foreign marketing areas. This is further evidence of the existence of a unitary business. (See Appeal of AMP, Inc., Cal. St. Bd. of Equal., Jan. 6, 1969.)

In the instant case, the foreign subsidiaries owed their entire existence and success to the patents, trademarks and continuing know-how supplied by appellant. For example, the foreign subsidiaries were licensed to manufacture and sell the Gang-Nail Connectors by appellant. Appellant received substantial royalty payments from the foreign subsidiaries for this privilege. During the appeal years no one else was licensed to manufacture and sell this proprietary product. Without these licenses the foreign subsidiaries could not exist, and appellant would be deprived of 3 significant source of income. The continuing flow of the proprietary right to the subsidiaries and a reciprocal flow of income to the parent is a substantial indicator of the mutual dependency and contribution existing between appellant and its foreign subsidiaries. (See Appeal of AMP, Inc., supra; Appeal of Anchor Hocking Glass Corp., Cal. St. Bd. of Equal., Aug. 7, 1967.)

In support of its position that the foreign subsidiaries are not part of a unitary business, appellant relies on the absence of any intercorporate relationship between the foreign subsidiaries and the California operation. However, a determination that a business is unitary does not require an interdependence between one segment of that business and every other segment of it. This argument was considered and rejected by this board in Appeal of Monsanto Company, decided November 6, 1970, where we stated:

> The argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separated from either Chemstrand or the California operations ....

In the instant appeal we believe the evidence amply supports the determination that the foreign subsidiaries formed an integral part of appellant's business.

Appellant also contends that the holding in Chase Brass & Copper Co. v. Franchise Tax Board, supra, precludes the inclusion of the foreign subsidiaries with appellant in a unitary business. However, this same argument was previously raised in Appeal of The Anaconda Co., decided by this board May 11, 1972, where it was resolved adversely to the taxpayer.

When all the factors are considered, there is substantial evidence that the foreign subsidiaries were engaged in a single unitary business with appellant and the California operations.

Royalty Income

Next, appellant argues that certain intercompany royalty payments were not eliminated in the combined report, thereby overstating the combined group's unitary income. Appellant has submitted no evidence which would tend to establish the validity of its assertion. Accordingly, respondent is entitled to the presumption of correctness which attaches to its determinations. (Appeal of AMP, Inc., supra.)

For the reasons set out above, respondent's action in this matter must be sustained.

ORDER

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 Automated Building Components, Inc. , against proposed assessments of additional franchise tax and penalties in the amour&s and for the years as follows:

Income Years Ended	Prop sed Assessments	Late Filing Penalties
January 31, 1966	$9,413.69	$ -0-
January 31, 1967	3,963.56	198.18
January 31, 1968	5,857.00	585.70
January 31, 1969	9,066.44	-0-
January 31, 1970	7,009.91	-0-

be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of June, 1976, by the State Board of Equalization.

William M. Bennett, Chairman

George R. Reilly, Member

Ruth K. Nan, Member

Iris Sankey, Member

________________, Member

ATTEST: W. W. Dunlop, Executive Secretary