77-SBE-051

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THE O.K. EARL CORPORATION)

Appearances:

For Appellant: A. J. Krappman, Jr.
Vice President and
Corporate Counsel

For Respondent: Kendall Kinyon
Counsel

O P I N I O N

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 The O.K. Earl Corporation against proposed assessments of additional franchise tax in the amounts of $8,061.38 and $1,100.71 for the 'income years 1968 and 1969, respectively.

Appeal of The O.K. Earl Corporation

Appellant is a California corporation engaged in the business of designing and constructing commercial, industrial, and institutional projects and properties. Under a single coordinated management system, appellant offers its clients all of the services of a real estate company, an architectural and engineering firm, a construction company, and a property management organization. During the years in question, appellant's business operations were conducted solely within California. However, one of appellant's wholly owned subsidiaries, the Earl Corporation of Delaware, conducted a general construction contracting business wholly outside California. In the appeal years, this corporation's only contract involved the construction, in Ohio, of a microfilm processing plant designed by appellant. Three other subsidiaries of appellant--Earl Properties Corporation of California, Earl Long Beach Corporation, and Earlton Corporation--were the owners and/or lessors of commercial buildings that had been constructed in California by appellant. The rental income from these buildings was the only income these subsidiaries had during the years in question.

Respondent has determined that appellant and its four subsidiaries were engaged in a single unitary business, requiring that their combined net income be apportioned by a single formula. At the oral hearing on this matter, appellant conceded that it was engaged in a unitary construction contracting business with Earl Corporation of Delaware, but it contends that the three real estate subsidiaries were not a part of that business. Appellant also objects to respondent's determination that the property factor of appellant's apportionment formula should include the costs of "construction in progress" only to the extent not compensated for by progress payments.

The California Supreme Court has laid down two general tests for determining whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334] (1941) aff'd, 315 U.S. 501 [86 L. Ed. 991] (1942), the court held that the existence of a unitary business is established by the presence of: (1) unity of ownership; (2) unity of operation; and (3) unity of use. Subsequently, the court held 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 without the state. (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16] (1947).)

We believe that under either test the three real estate subsidiaries were a part of the unitary business. Unity of ownership existed by virtue of appellant's ownership of at least two-thirds of the stock of each corporation. Unity of operation was present because of centralized service and overhead functions such as accounting, legal, management, and advertising under appellant's corporate name. These functions were so centralized, in fact, that the three subsidiaries had no employees of their own at all. Appellant's employees performed all of the services essential to the operations of these corporations, and appellant paid their salaries. (Two of the subsidiaries did, however, pay appellant certain fees for services performed on their behalf.) Finally, unity of use existed in the form of interlocking officers and directors, who made all of the policy decisions affecting the affairs of each corporation. Orrin K. Earl, Jr., and Joseph B. Earl, who were, respectively, appellant's chairman of the board and president, were officers and directors of each subsidiary during the two years in question. Such integration of executive forces is an element of exceeding importance. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3d 496 [87 Cal. Rptr. 239] appeal dismissed and cert. denied, 400 U.S. 961 [27 L. Ed. 2d 381] (1970); see also Appeals of The Anaconda Co., et al., Cal. St. Bd. of Equal., May 11, 1972, and Appeal of Browning Manufacturing Co., et al., Cal. St. Bd. of Equal., Sept. 14, 1972.)

The type of mutual dependency and contribution referred to in the Edison California Stores case is also present in this case because the acquisition of their rental properties by the three subsidiaries was an outgrowth of the parent corporation's design and construction business. It appears that in each case appellant had a client who wanted a building designed and built for its use on a lease basis. Although appellant desired to accommodate its clients in this respect, it did not want to expose its assets or activities as a general contractor to the risks inherent in becoming a landlord. For those reasons, appellant created three subsidiaries to acquire title to the properties and to act as lessors to its clients. In our opinion this clearly establishes mutual contribution and dependency between the contracting and rental activities.

Having found that the real estate subsidiaries were part of appellant's unitary business, we are required to answer appellant's alternative argument that the rental income of these corporations constituted "non-business income" that must be excluded from the apportionment formula. Under the Uniform Division of Income for Tax Purposes Act (UDITPA), contained in sections 25120-25139 of the Revenue and Taxation Code, "business income" is defined as:

> income arising from transactions and activity in the regular course of the taxpayer's trade or Ibusiness and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (Rev. & Tax. Code, § 25120, subd. (a).)

"Nonbusiness income" is defined as "all income other than bus-iness income." (Rev.& Tax. Code, § 25120, subd. (d).)

Appellant contends that the rental income would constitute "business income" only if appellant were in the real property development business. We disagree. The rental income is "business income" because it was income from tangible property whose acquisition, management, and disposition constituted integral parts of appellant's regular trade or business (design and construction). This result is clearly contemplated by the relevant regulation, which provides:

> Rental income from real and tangible property constitutes business income when the rental of such property is a principal business activity of the taxpayer or the rental of the property is related to or incidental to the taxpayer's principal business activity. (Emphasis added.) (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (1) (art. 2).)

For the reasons we have already explained in deciding the unitary business question, there is no doubt that the rental income was related or incidental to appellant's design and construction activities. Examples (D) and (E) of the above quoted regulation do not require a contrary result, since the rental income from the office buildings in those examples was obviously unrelated to the taxpayers' respective clothing and grocery businesses.

As we indicated earlier, appellant disputes respondent's composition of the property factor of its apportionment formula. Since the effective date of UDITPA in 1967, respondent has consistently required construction contractors to include in their property factor the costs of any "construction in progress," but only to the extent such costs exceed progress billings. In the present case, appellant and Earl Corporation of Delaware each had construction in progress during the appeal years, but respondent ruled that none of it would be reflected in the property factor since the progress payments received had exceeded the costs of construction in each year. Appellant contends that this exclusion is inequitable and creates an unreasonable apportionment of the total unitary income.

Revenue and Taxation Code section 25129 defines the normal property factor as follows:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property <u>owned or rented</u> and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property <u>owned or rented</u> and used during the income year. (Emphasis added.)

Upon analyzing the application of this section to the construction contracting industry, respondent discovered that in many cases the title to improvements and materials included in the contractor's construction in progress account passed immediately to the other contracting party by the terms of the contract or by accession.[1] Thus, since only property owned or rented by a contractor would be includible in the property factor under section 25129, many contractors would be prohibited from recognizing the contribution to income reflected by their investment in construction in progress owned by someone else. To correct this problem and to place all contractors on an equal footing, respondent decided that costs of construction in progress should be included in the factor regardless of ownership. But respondent also determined that

1/ Under the common law rules of accession, property that is affixed to land becomes a part thereof and belongs to the owner of the land. (See, e.g., <u>Brush v. E. R. Bohan & Co.</u>, 102 Cal. App. 457, 460 [283 P. 126] (1929); Civ. Code, § 1013.)

such costs should be reflected only to the extent not compensated for by progress payments, since this approach would more clearly reflect the contractor's working capital commitment that was helping to produce business income. These rules were incorporated in respondent's 1967 apportionment guidelines for the industry, and were later codified in the construction contractor regulations adopted in 1974 as part of regulation 25137. (See Cal. Admin. Code, tit. 18, reg. 25137, subd. (f)(1)(iv)(art. 2.5).)

The authority respondent relies on to support its special rules for contractors is Revenue and Taxation Code section 25137, which permits deviation from UDITPA's standard apportionment provisions if they "do not fairly represent the extent of the taxpayer's business activity in this state." As we held in the Appeal of Borden, Inc., decided on February 3, 1977, the party invoking the application of section 25137 bears the burden of proving that exceptional circumstances exist which warrant the use of the special procedures authorized by that section. In light of the considerations enumerated in the preceding paragraph, we believe respondent has carried its burden of proof. The remaining question, therefore, is whether the special property factor respondent has adopted for contractors is reasonable and thereby constitutes a proper exercise of respondent's discretion, under section 25137, to effect an equitable apportionment of appellant's income.

Appellant argues that reducing the value of work in progress by the amount of progress payments received is inequitable and produces an unreasonable result. The essence of appellant's position appears to be that the normal rules of section 25129 can, and should, be applied in this case. Appellant alleges that it is the owner of its construction in progress, and it contends that this property is comparable to a manufacturer's inventoriable goods in process, which are included in the standard property factor without reduction for advance payments applied against them. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (art. 2).) There are several problems with appellant's argument. First, despite appellant's repeated statements regarding its ownership of its work in progress, there is no evidence in the record that would support a finding in appellant's favor on this point. As far as we can determine, appellant's construction projects were no less subject to the common law rules of accession than the projects of other contractors. Moreover, we are not persuaded that appellant can be treated as "owning" its work in progress; for purposes of section 25129, merely because its contracts require it to bear the risk of loss in the event of destruction of its work prior to completion.

The second difficulty with appellant's argument is that its comparison of inventoriable goods in process with construction in progress is incomplete. Although construction in progress is excluded from a contractor's property factor to the extent of progress payments, these payments are included in the sales factor when received. Thus, progress payments attributable to an out-of-state project will be included in the denominator of the sales factor, resulting in a lesser apportionment of income to California. (This was the case with respect to the progress payments from Earl Corporation of Delaware's Ohio project.) The same rule does not apply, however, to advance payments attributable to inventory in process. Such payments are excluded from the manufacturer's sales factor, and thus have no immediate impact on the apportionment of income. When the property and sales factors are considered together in this fashion, we believe it is clear that respondent has acted reasonably in its treatment of construction in progress. Unfavorable treatment in one factor has been balanced by favorable treatment in another.

One final matter regarding appellant's apportionment formula must be mentioned. During oral argument appellant's counsel stated that respondent's special formula clearly reaches an unreasonable result in this case because in each year it taxes well over 90 percent of the unitary income from the Ohio project, while the State of Ohio has taxed 100 percent of the same income. Obviously, this is one of those unfortunate situations which illustrate the need for the various states to adopt uniform rules of taxation for corporate enterprises operating in more than one state. While we sympathize with appellant's plight, however, we believe that its criticism of respondent is misdirected. Respondent's formula has made a reasonable effort to measure the contribution of the Ohio activities to the earning of the total unitary income. The law of the State of Ohio, on the other hand, apparently does not recognize that appellant's California operations (particularly those of its architectural and engineering department) made any contribution at all to the income realized from the Ohio project. It seems to us, therefore, that respondent's formula is -- the source of any unfairness that may exist in this case.

For the reasons stated above, we find that appellant is liable for the deficiencies in question. This conclusion requires us to consider appellant's final argument, which relates to the proper computation of the interest due on the deficiencies. Appellant contends that interest should run only from the time respondent first proposed these assessments and not from the dates prescribed for the filing of appellant's returns for the years in issue. The governing statute is Revenue and Taxation Code section 25901b, which provides that interest on a deficiency "shall be assessed...from the date prescribed for the payment of the tax." The date prescribed for payment is the time fixed for filing the return. (Rev. & Tax. Code, § 25551.) Despite the clear, mandatory language of section 25901b, appellant argues that partial abatement of the inferest should be permitted since even the most diligent and scrupulous taxpayer could not have anticipated the way respondent would compute appellant's unitary business income. We have no reason to doubt either appellant's diligence or its scruples, but that is beside the point. Fault, or the absence thereof, on the part of a taxpayer is irrelevant. As we said in a recent appeal involving the Personal Income Tax Law's counterpart to section 25901b:

> [I]nterest is not a penalty imposed on the taxpayer: it is merely compensation for the use of money. Thus, interest accrues upon the amount assessed as a deficiency regardless of the reason for the assessment. (Appeal of Audrey C. Jaegle, Cal. St. Bd. of Equal., June 22, 1976.)

Interest will be assessed in accordance with section 25901b.

Appeal of The O.K. Earl Corporation

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 The O.K. Earl Corporation against proposed assessments of additional franchise tax in the amounts of $8,061.38 and $1,100.71 for the income years 1968 and 1969, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of April, 1977, by the State Board of Equalization.

William M. Bennett, Chairman

George R. Reilly, Member

Richard Nevins, Member

__________, Member

__________, Member

ATTEST: W. W. Dunlap, Executive Secretary