BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ARKLA INDUSTRIES, INC.)

Appearances:

For Appellant: Lawrence V. Brookes
Attorney at Law

For Respondent: Steven S. Bronson
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 Arkla Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $3,065.89 and $2,483.39 for the income years 1968 and 1969, respectively.

Appeal of Arkla Industries, Inc.

The issue for determination is whether appellant was engaged in a unitary business with its parent and the parent's other subsidiaries.

Arkla Industries, Inc. (hereinafter appellant) is a Delaware corporation with its home offices in Evansville, Indiana.. Appellant is qualified to do business in California and does do business here. Appellant is a wholly owned subsidiary of Arkansas Louisiana Gas Company (hereinafter parent) whose principal offices are in Shreveport, Louisiana. Parent is not qualified to do business in California and, in fact, does no business here. It is a regulated public utility, supplying gas in its five-state service area of Arkansas, Louislana, Kansas, Oklahoma and Texas. Parent has four additional wholly-owned subsidiaries: Arkla Chemical Corporation, Arkansas Cement Corporation, Arkla Exploration Company, and Arkansas Louisiana Finance Corporation. Of these four subsidiaries, only Arkansas Louisiana Finance Corporation is qualified to do business and does operate within California.

Appellant was formed by its parent in 1957 and purchased certain assets of Servel, Inc., located in Evansville, Indiana. Appellant manufactures and sells gas-burning equipment for home and industry such as: air conditioning units, heating equipment, gas lights and gas grills. These products are manufactured at appellant's Evansville plant. It sells its products to public utilities, including parent, and dealers in every state, including California. For this purpose appellant rents warehouse facilities and employs its own sales force. These facilities are separate from the facilities of its parent. In California appellant leases a warehouse and carries a full line of its gas-burning equipment as well as repair and replacement parts. Appellant ships to purchasers in this state both from its California location and its Evansville factory. Dealers who handle appellant's merchandise also handle competitors' gas-burning equipment.

Appellant also has a second division, Arkla Equipment Co., (hereinafter Equipment Division) which was originally acquired from the Ingersoll Company in 1961. This division designs, fabricates and markets natural gas compressors, air compressors, and gas engine-driven power packages for commercial and industrial use. The principal uses of the units fabricated by the Equipment Division are for the extraction and transmission of gas. Its plant is located in Shreveport. The Equipment

Division's sales occur principally in Texas, Louisiana, Oklahoma and Mississippi. The parent is also a principal customer of this division.

The parent is an integrated public utility engaged in the extraction, production, purchase, transmission and distribution of natural gas in its contiguous five-state *service* area. In its service area it sells gas-burning equipment purchased from appellant as well as other equipment purchased from unrelated manufacturers. Its rates for the sale of gas are subject to regulation by each state within its service area. These agencies do not include any investment in merchandise inventories in their determination of parent's rate base. Expenses and revenues from parent's sales of gas-burning equipment are considered "below the line" items and are not considered in determining parent's rate structure which is based on cost of service. Similarly, none of the subsidiaries' operations or earnings are considered by the state agencies in setting parent's rates.

During the appeal years, appellant, including the Equipment Division, made substantial sales to parent. In 1968 and 1969, appellant's sales to parent were **$4,334,756** and **$4,006,369,** respectively. These sales represented approximately 22 percent and 14 percent of appellant's total sales in 1968 and 1969. Appellant's sales to parent were at the same prices and on the same terms as its sales to third parties.

Parent made 28 loans to appellant during 1968 and 1969 in the total amount of **$6,771,000.** The intercompany loans were evidenced by demand notes and bore interest at rates ranging from six to eight and one-half percent. These loans represented over 66 percent of appellant's total loans during the two-year period.

Appellant and several of the other subsidiaries shared common directors and officers with parent. Parent's chairman and president, W. R. Stephens, and its executive vice president, D. W. Weir, also served as appellant's president and vice president, and were also members of appellant's board of directors. Mr. Stephens and Mr. Weir served in similar capacities as directors and officers of parent's cement, chemical and exploration subsidiaries.

Appellant's vice president and general manager, R. C. Bain, was formerly employed by parent before being promoted to his present position. Mr. Bain reports to

parent's executives in Shreveport on a daily basis concerning appellant's sales and financial statistics. Appellant's monthly and annual financial statements, as well as its cash flow requirements, are also closely monitored by parent. Each of appellant's capital expenditures in excess of $2,000 is subject to the approval of parent's executive vice president or president and chairman. Parent's executives also reviewed the wage and salary increases of appellant's, employees.

Appellant shared a number of other common features with parent. Parent provided appellant with computer services on a time sharing basis which included payroll and invoice processing and sales analyses. The same accounting firm audited the books. and records of both parent and appellant during the years in issue. Appellant and parent had mutual pension and health insurance plans. Parent purchased other types of insurance for appellant including: workmen's compensation, general liability, automobile liability, blanket crime, excess liability and umbrella liability insurance. Appellant and parent share the common name "Arkla." They also utilize the same advertising agency.

For the years in issue, appellant treated its California operations and the out of state operations of both its divisions as a single unitary business and computed its income attributable to California sources by the standard three-factor apportionment formula. Appellant did not include its parent or its parent's other subsidiaries as part of the unitary business. Respondent determined that appellant, parent and the other subsidiaries were engaged in a single unitary business. The resulting proposed assessments gave rise to this appeal.

When a taxpayer derives income from sources both within and without California it is required to measure its California 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 must be computed by formula apportionment rather than by the separate accounting method. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334] (1941), aff'd. 315 U.S. 501 [86 L. Ed. 991] (1942); Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has developed two general tests for determining whether a business is unitary. In Butler Eros. v. McColgan, supra, the court stated 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 divisions: and (3) unity of use in its centralized executive force and general system of operation. Subsequently, in Edison Californa Stores, Inc. v. McColgan, supra, the court held that a business is unitary when the operation of the business within California contributes to or is dependent upon 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 331 (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 401 (1963).)

It is appellant's position that, in order for respondent to prevail, it is not sufficient merely to show that appellant's business in California is unitary with the whole of its business, and that the whole of its business is unitary with the business of its parent. Appellant contends that it must be established that its California operations are unitary with its parent, and maintains that such showing has not been made. Appellant seeks support for its position from 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). Appellant argues that in Chase Brass the court held Chase not unitary with Kennecott with respect to the gold, silver and molybdenite operations because Chase did not market any of these metals. Since the flow of these metals did not go through or end in Chase, the source of Chase's income, including Chase's income in California, could not be any of these metals mined and sold by Kennecott. Chase did sell, in California, its brass products which were manufactured from copper, purchased in large part from the stock of ore mined and maintained by Kennecott. According to appellant, it was the vertical integration of the copper business which persuaded the court that Chase was unitary with Kennecott with respect to the copper operations: without vertical integration of the other metals, although produced from the same ore, the same facts led the court to a different result, that the businesses were not unitary. Applying this reasoning to this appeal, appellant argues that,

although appellant sells gas-burning equipment in California, none of the gas which this equipment can use in California can originate with its parent. Therefore, appellant concludes that it cannot be unitary with its parent.

It is apparently appellant's position that the aspect of Chase Brass which is controlling is the following holding:

> Kennecott's sales of gold, silver and molybdenite metals, which are not bought by Chase or Kennecott Wire, are not part of the unitary business. The fact that these metals come from the same ore as that which produces copper is not sufficient to cause their sales to be included in the computations which are to follow. (10 Cal. App. 3d at 506.)

Assuming, arguendo, that this appeal is reconcilable factually with Chase Brass, we still cannot conclude that appellant's argument is well taken. Unfortunately, the court in Chase Brass did not articulate the basis for its holding with regard to the by-products mined by Kennecott. 1/ If it was the court's position that Chase was not unitary with Kennecott with respect to the by-products because there was no intercompany flow of the by'-products to, or through, Chase the holding is in apparent conflict with prior decisions of the California Supreme court. (See Superior Oil Co. v. Franchise Tax Board, supra; Honolulu Oil Corp. v. Franchise Tax Board, supra.) In Superior Oil co. the court determined that an intercompany flow of goods was not an indispensable element to a finding of unity, stating:

> It is true that in Butler Brothers the goods sold in California were acquired from sources both from without and from within California but this was only a factor in determining that the business was unitary. None of the three unities announced in that case as determinative necessarily require the interstate movement of products. (60 Cal. 2d at 415.)

1/ This aspect of the holding was criticized in Chase II as being erroneous. (See Chase Brass & Copper Co. v. Franchise Tax Board, 70 Cal. App. 3d 457 (1977).)

In any event, we note that, although there is no intercompany flow of natural gas from parent to appellant, there is a transfer of gas-burning equipment from appellant to parent.

Furthermore, with respect to appellant's contention that it must he established that its California operations are unitary with the operations of its parent, we have resolved that issue adversely to the taxpayer in prior appeals. (Appeal of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970; Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975; Appeal of Beecham, Inc., Cal. St. Bd. of Equal., March 2, 1977.) For example, in Appeal of.Monsanto Company, supra, 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 other words, it is not necessary to find a direct unitary relationship between the California operations and the out of state operations; it is sufficient if the unitary relationship is indirect. (Edison California Stores, Inc. v. McColgan, supra.) In Edison California Stores the California Supreme Court held that where a parent corporation performed centralized management, purchasing, advertising and administrative services for its fifteen selling subsidiaries located throughout the United States a unitary business existed. It is readily apparent that there was no direct unitary relationship between the California selling subsidiary and the other selling subsidiaries located throughout the country. Nevertheless, the court found that they were all part of the same unitary business. Thus, respondent must prevail if it is established that appellant's operations, wherever located, are unitary with the operations of its parent and the parent's other subsidiaries.

Application of either the three unities test or the contribution or dependence test to the facts in this appeal lead to the conclusion that appellant was engaged in a unitary business with its parent and the parent's other subsidiaries.

The presence of unity of ownership, a prerequisite to the existence of a unitary business, is not contested.

It is generally considered that unity of operation concerns staff functions while unity of use involves line functions. (Chase Brass & Copper Co. v. Franchise Tax Board, supra.)

The instant appeal presents several factors which establish unity of operation. The existence of intercompany financing is substantial evidence of operational unity. (Chase Brass & Copper Co. v. Franchise Tax Board, supra.) As we have noted, two-thirds of appellant's $10 million borrowings during the appeal years was from parent. It readily may be concluded that it was mutually advantageous for appellant to obtain the majority of its financing from parent rather than from private lending institutions. The ready availability of capital from its parent greatly facilitated appellant's short and long range planning, while parent benefited from a ready outlet for its excess cash flow.

Additional evidence of operational unity include: parent's purchase of insurance for its subsidiaries to obtain more favorable rates or better coverage; use of a common advertising agency; sharing the trade name "Arkla"; use of a common accounting firm; common retirement plans; and sharing computer services.

The existence of intercompany sales as an indicator of unity of use has been given substantial weight in prior court decisions as well as in our determinations. (See, e.g., Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of Browning Manufacturing Co., Cal. St. Bd. of Equal., Sept. 14, 1972.) Here, appellant's sales to parent in both of the appeal years exceeded $4 million. Contrary to appellant's assertion, the fact that these sales were at the same prices and on the same terms as sales to other customers does not detract from their importance as a unitary factor. The importance is that they created an assured market for a substantial amount of appellant's products, thus permitting appellant to benefit from the economics of larger scale production while guarantying parent an available source of gas-burning products.

The existence of integrated executive forces at the top management levels has received special emphasis by the court. (Chase Brass & Copper Co. v. Franchise Tax

Board, supra; see also Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Here, appellant and its parent shared common officers and directors. However, the top level executive forces were integrated in fact as well as form. Each of appellant's capital expenditures in excess of $2,000 was subject to approval or rejection by one of parent's top level executives. The integration of top management is further evidenced by the fact that appellant's general manager, who was employed by parent before his promotion to his present position, discussed, daily, appellant's production, sales and financial statistics with parent's top executives. Furthermore, parent exercised control of appellant's wage and salary increases. While it may be true, as appellant contends, that parent did not concern itself with appellant's day-to-day operations, it is equally apparent that parent exercised executive control at the highest level. (Chase Brass & Copper Co. v. Franchise Tax Board, supra; Appeal of F. W. Woolworth Co., supra.)

We also believe that the dependency or contribution test of Edison California Stores is satisfied. Appellant depended on its parent for substantial financing, the purchase of a significant percentage of its products and executive guidance. Appellant, in turn, contributed to parent's operations by providing it with a readily available source of gas-burning products. Parent thereby profited not only from the resale of the gas-burning products but also from the increased demand for natural gas within its service area.

We reach this conclusion notwithstanding the fact that parent's rates for the sale of natural gas are controlled by the various public agencies within its service area. It is true that the rates which parent may charge for the sale of gas is prescribed by the various regulatory agencies which do not consider either the operations of the subsidiaries or parent's sales of gas-burning equipment. However, the fact remains that parent's resale of the gas-burning products supplied by appellant increases the demand for natural gas in parent's service area and thereby increases parent's income from the sale of gas. Of course, parent's income is also increased by the sale of the gas-burning products themselves.

Appellant relies on our decision in Appeal of Lear Siegler, Inc., decided April 24, 1967, to support its position that it is not engaged in a single unitary

business with its parent. We believe Lear Siegler is readily distinguishable from the present appeal. In Lear Siegler there were no intercompany sales, while in this appeal a substantial amount of appellant's sales was to its parent. In Lear Siegler central financial control was limited to significant expenditures such as those involving new plants or the introduction of new products. In the present appeal all of appellant's capital expenditures in excess of $2,000 were subject to the approval of its parent. Additionally, parent reviewed appellant's salary and wage increases. Finally, appellant and parent had mutual retirement and health insurance plans and parent also purchased a great deal of appellant's insurance. In Lear Siegler the taxpayer's participation in common retirement plans was optional and not widespread.

Appellant argues that the Equipment Division is not unitary with appellant. However, if the Equipment Division's operations as well as those of appellant are unitary with their common parent who is engaged in a single unitary business, their operations justifiably cannot be separated. (Appeal of Monsanto Co., supra.) We believe that the unitary factors which caused us to find appellant unitary with parent compel us to conclude that the Equipment Division is also unitary with parent. These major factors include: intercompany financing; intercompany sales: and integrated executive forces at the top level. Additional factors include: common purchase of insurance; use of a common advertising agency: sharing the trade name "Arkla"; use of a common accounting firm; common retirement plan; and sharing computer services.

Apparently, it is appellant's position that if it is concluded that appellant and parent are engaged in a single unitary business it would not contest the inclusion o:f the remaining subsidiaries in the unit. In any event, appellant has failed to rebut the presumptive correctness of respondent's determination that'the other affiliates were engaged in a single unitary business with parent. (Appeal of Household Finance Corp., Cal. St. Bd. of Equal., Nov. 20, 1968; Appeal of Dohrmann Commercial Co., Cal. St. Bd. of Equal., Feb. 29, 1956.)

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

Appeal of Arkla Industries, 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 Arkla Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $3,065.89 and $2,483.39 for the income years 1968 and 1969, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 16th day of August, 1977, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member