BEFORE THE STATE BOARD OF'EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PUP 'N' TACO DRIVE UP)

ORDER DENYING PETITION FOR REHEARING AND SUBSTITUTING OPINION

Upon consideration of the petition filed March 31, 1977, by the Franchise Tax Board for rehearing of the appeal of Pup 'n' Taco Drive Up, we are of the opinion that none of the grounds set forth in the petition or supplemental briefs constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of March 2, 1977, be and the same is hereby affirmed.

Good cause appearing therefor, it is also hereby ordered that our opinion of March 2, 1977, in the above entitled matter, except for the first two paragraphs thereof and the order, be deleted and replaced with the following:

> Appellant Pup 'n' Taco Drive Up was incorporated in California on May 10, 1965. Since then its principal business activities have been franchising and operating fast-food restaurants. By 1968 it had 18 restaurants, most of which were located in Los Angeles and Orange

Counties. In that year appellant decided to expand beyond California, and it therefore leased property and contracted for equipment to establish a Pup 'n' Taco Drive Up in Albuquerque, New Mexico (hereinafter sometimes referred to as the "Albuquerque Drive Up.") Since appellant did not have sufficient organization or management staff to carry out this expansion within the company, it planned to operate the Albuquerque Drive Up as a partnership rather than as a part of the corporation.

In May 1968 appellant entered into a partnership agreement with Martin R. Wendell, a brother of appellant's president. The agreement provided that appellant would own a 52 percent interest and Wendell would own a 48 percent interest in the Albuquerque Drive Up. Wendell was to serve as the new restaurant's manager, subject to appellant's direction and control, but appellant was authorized to remove him as manager at any time for cause. Failure to follow appellant's instructions was specifically described as cause for removal. As one condition of the agreement appellant promised to make interest-free loans to the partnership, if needed, and also to arrange for and guarantee a line of credit with suppliers- The agreement also directed the partnership to keep its books in a manner directed by an accountant to be selected by appellant. In addition, appellant granted the partnership a license to use the name "Pup 'n' Taco Drive Up #24." Appellant retained all ownership rights in the name, however, and was to receive royalties for the partnership's use of its name and system of operation.

The architectural style and operational system of appellant's California restaurants served as a prototype for the Albuquerque Drive Up. Twenty of the thirty items appearing on appellant's, menus were included on the Albuquerque menu, although the prices of some of those items were different. In addition, some of the menu items were prepared with a secret and distinctive blend of spices which appellant and the Albuquerque Drive Up purchased in common from a supplier in Chicago.

Apparently appellant seldom if ever took an active role in the day-to-day operation of the partnership, including such matters as the hiring of employees and the purchasing of supplies other than spices, but appellant's accounting firm did conduct periodic audits of the partnership's books to insure that such matters were being handled efficiently.

In 1972 appellant entered into a partnership agreement to operate a Pup 'n' Taco Drive Up in Denver, Colorado (hereinafter sometimes referred to as the "Denver Drive Up".) The record does not reveal the terms and conditions of this agreement. Respondent alleges, however, and appellant appears to concede, that the business of the Denver Drive Up was conducted Similarly to that of the Albuquerque Drive Up.

Appellant used a separate accounting method to compute its California income on its franchise tax returns for the income years 1969 through 1972. After an audit, respondent recomputed appellant's California income by formula apportionment, including in the formula appellant's distributive share of the partnerships' income and apportionment factors. When respondent issued proposed assessments reflecting these adjustments, appellant protested, but the protest was denied and this appeal followed.

A taxpayer which earns income from sources both within and without this state is required to measure its California franchise tax liability by its net income derived from or attributable to California sources. (Rev,, & Tax. Code, § 25101.) The California-source income of such a taxpayer must be computed in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act, Revenue and Taxation Code sections 25120 through 25139. (Rev. & Tax. Code, § 25101.) If the business conducted within and without the state is unitary, the portion of the business income from the unitary business which is attributable to California sources must be determined by formula apportionment. (See Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).)

The California Supreme Court has held that a business is unitary where the following factors are present: (1) unity of ownership; (2) unity of 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 Brothers v. McColgan, 17 Cal. 2d 664, 678 [111 P.2d 334] (1941), affd. 315 U.S. 501 [86 L. Ed. 991] (1942).) The court has also stated 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 v. McColgan, 30 Cal. 2d 472, 481. [183 P.2d 16 (1947).) "It is only if [a corporation's] business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used." (Butler Brothers v. McColgan, supra, 17 Cal. 2d at 667-668.) These general principles have been reaffirmed in several more recent cases. (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 40] (1963); RKO Teleradio Pictures, Inc. v. Franchise Tax Board, 246 Cal. App. 2d 812 [55 Cal. Rptr. 299] (1966).)

Since appellant owns a 52 percent interest in the Denver and Albuquerque partnerships, the unity of ownership requirement is satisfied in this case. Unity of use is also present since appellant establishes overall policy for the business, as evidenced by the fact that the partnerships' managers are subject to dismissal for failure to follow appellant's instructions. (See Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3d 496, 504 [87 Cal. Rptr. 239] (1970) app. dism. and cert. den., 400 U.S. 961 [27 L. Ed. 2d 381] (1970).) Unity of operation is evidenced by the use of a single trade name and system of operation, similar architectural styles and menus, common purchasing of distinctive spices, and the use of appellant's accounting firm to conduct periodic audits of

the partnerships. Moreover, appellant leased property for the partnerships, offered them interest-free loans, and arranged for and guaranteed lines of credit, The infusion of capital, knowledge and business reputation into the partnerships presumably contributed greatly to their success. Taken together, these circumstances establish that appellant and the partnerships are a unitary business, despite the alleged autonomy in their day-to-day operations. -(See Appeals of Servomation Corp., et al., Cal. St. Bd. of Equal,, July 7, 1967; Appeals of Simonds Saw and Steel Co., et al., Cal. St. Bd. of Equal., Dec. 12, 1967; Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.)

Respondent has raised an additional issue with regard to the unity of ownership requirement. In the Appeal of Jack Harris, Inc., decided January 3, 1967, respondent argued and we agreed that the ownership requirement is not satisifed as to a corporation and a partnership in which it participates unless the corporation owns a "controlling" interest in the partnership. Respondent now asks us to overrule Jack Harris on this point. It argues that unity of ownership exists per se between a corporation and a partnership to the extent of the corporation's actual ownership interest in the partnership, without regard to control. In support of this position respondent points out that a partnership is not a separate taxable entity, and that the income and apportionment factors of a corporation and a partnership in which it participates are combined only to the extent of the corporation's actual ownership interest. (See Cal. Admin. Code, tit, 18, reg. 25137, subd. (e).)' [1/]

1/ Regulation 25137 was adopted in its original form on June 30, 1973, applicable to income years beginning after December 31, 1972, and ending after the regulation became effective. The regulation therefore does not apply to

(continued on next page)

Although respondent's arguments may have some merit, a decision on this point is not necessary to the resolution of this appeal. Since appellant owned a 52 percent interest in each partnership, the unity of ownership requirement is satisfied both under respondent's theory and under the rule of Jack Harris. A decision as to which of these approaches is correct would therefore not affect the outcome of the appeal. Understandably, appellant has not filed a brief on this point. Because the matter has not been fully briefed, and because the result on appeal would not be changed, we find it neither necessary nor appropriate to overrule Jack Harris at this time.

For the above reasons, respondent's action in this matter is sustained.

Done at Sacramento, California, this 11th day of January, 1978, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

1/ (continued from page 5)
the years involved in this appeal. However, subdivision (e) was added to the regulation on November 16, 1974, without any mention of the years to which it would apply. Although there is accordingly some question as to the retroactive effect of subdivision (e) (see Rev. & Tax. Code, § 26422), it is unlikely that it was intended to have broader application than the regulation into which it was incorporated. Therefore, while subdivision (e) apparently illustrates respondent's treatment of partnerships during the appeal years, we do not regard it as controlling for those years.