78-SBE-105

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
CASCADE DENTAL LABORATORY, INC., et al.)

For Appellants: Wayne A. Bertsch
Dental Division Controller

For Respondent: Bruce W. Walker
Chief Counsel

Robert L. Koehler
Counsel

OPINION

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Cascade Dental Laboratory, Inc. (Cascade), against proposed assessments of additional franchise tax in the amounts of $1,803.54, $3,739.23 and $1,671.40 for the income years 1971, 1972 and 1973, respectively; and on the protest of Lynd Dental Laboratories, Inc. (Lynd), against a proposed assessment of additional franchise tax in the amount of $1,757.64 for the income year 1973.

The issue for determination is whether appellants are engaged in a unitary business with their parent,, Medenco., Inc. (Medenco), and the parent's other dental l&oratory subsidiaries.

Medenco is primarily a health services company.. withits principal office in Houston, Texas. During the years in issue it owned and operated 14 to 19 dental laboratories and 5 to.10 hospitals in the form of subsidiary corporations. During the same period Medenco also owned a corporation that provided contract respiratory therapy Services and another corporation engaged in the production of oil and gas.

Appellants are dental laboratory subsidiaries of Medenco located and operating exclusively in California. For the years in issue appellants filed 'California franchise tax returns as separate corporations. As the result of ah audit, respondent determined that Medenco was engaged in a unitary business with its dental and hospital subsidiaries. Appellants protested the determination and this appeal followed respondent's denial of the protest. Respondent now concedes that, for the appeal years, Medenco's hospital division was not engaged in a unitary business with Medenco or appellants. As a result of that concession, respondent has conceded that the proposed' deficiency assessments cannot be increased over the amounts reflected in the notice of proposed assessment. However, if respondent's determination regarding the dental_ division is upheld, the resulting deficiencies' could be less than the proposed assessments which are' the subject of this appeal.

Medenco first entered the health services field in 1969. The stock of the dental laboratory subsidiaries, including appellants, was owned entirely by Medenco. Medenco acquired 100 percent of Cascade's stock in 1970, one year prior to its first appeal year, and acquired 100 percent of the stock of Lynd in 1972, one year prior to its appeai year. Typically, Medenco purchased the dental laboratories with its own stock. After the acquisition, the former owner was usually retained for a time as the president of the subsidiary. Part of the stock purchase price; generally 50 percent, was held in escrow for five years. If the subsidiary performed in an acceptable fashion during this period, the stock was released to the former owner.

Dental laboratories are involved in custom or specialty manufacturing. In general, most dental laboratories are small locally run businesses. Initially; each dental laboratory subsidiary conducted most of its day-to-day functional and administrative activities at its own location under the direction of its president. For the most part, each subsidiary purchased the necessary supplies, materials and equipment from outside vendors; supervised production; maintained quality control; and solicited and filled sales orders. -Any necessary financing was done locally. Most of the hiring, firing, training and other personnel matters were handled locally by each subsidiary. In most instances, financial statements and tax returns were prepared by local accounting firms since, initially, there was little uniformity in accounting and other financial controls.

After Medenco's entry into the health services field in 1969 and as more dental laboratories were acquired, many centralized features common to all the dental laboratory subsidiaries began to appear.

Medenco's 1971 annual report indicates that the mass purchasing power of the dental division had been effective in securing raw materials and equipment. An example of this mass purchasing power was Medenco's central purchasing of gold. All of the dental laboratories used gold for their denture inlays. Medenco entered into an agreement with a gold supplier to purchase gold at a reduced price for all the dental laboratories. Medenco paid the supplier directly and, in turn, billed each of the dental laboratories at its cost for the amount of gold they used. For 1973, Cascade's total purchases of materials and supplies were $185,739. Of this amount, $27,880, or 15 percent, was expended for central gold purchases. During the same year, Lynd's total purchases of materials and supplies were $238,806. Of this amount, $35,648, or 15 percent, was expended for central gold purchases. The record does not reflect Cascade's gold purchases for 1971 or 1972. Although acknowledging that some centralized purchasing did exist during 1971, appellants emphasize the fact that participation in the program was on an optional or voluntary basis. Appellants maintain that individual techniques and preferences were allowed to dictate materials used until accounts payable were centralized in 1973, making control over purchases possible. Appellant contends that effective centralized inventory and purchasing control was not established until 1975 when a director of purchasing was hired.

As the result of a study conducted late in 1971, a centralized marketing control program was fully implemented during 1972 under the direction of vice president James A. Perkins. Particular attention was directed toward basic market research, significant expansion of the sales force, and a centrally directed advertising campaign. Within the scope of this program the dental laboratories shared their most successful sales methods and tools with each other, avoiding unproductive efforts and expenditures that would be incurred through random individual programs. Medenco's 1972 annual report indicated that as a result of this program, improved production-techniques and processes contributed significantly to the profit and growth of the dental laboratories. The same report also stated that, under the direction of Carl Myklebust, director of production systems, the most successful production techniques and systems were evaluated for extension to each laboratory. By the end of 1973 this program resulted in a 10 percent increase in operating income, all of which was produced internally. Appellant seeks to minimize the importance of this program on the basis that, until 1975, it was conducted by only-lone person who visited each laboratory advising on methods and productivity. In 1975, an industrial engineer and management consultant was hired and began the task of job analysis and productivity measurement.

Medenco's annual report for 1971 states that Alfred J. Stern, formerly a vice president of one of the dental subsidiaries, had been appointed director of training: His first major program, which did not begin until 1972, involved the presentation of a concentrated and detailed course in management training at each of the dental laboratory subsidiaries. 'The program emphasized all phases of effective supervision of people by people and featured personal instruction by a recognized authority on management techniques and employee motivation.

Commencing in 1972, Medenco began to provide group benefit programs to both its own employees and the employees of the dental subsidiaries. Beginning in 1972, a central group insurance plan and a central stock purchase plan were instituted. In 1973 a central retirement program and a centralized profit sharing plan were instituted. There were no such programs in 1971, however.

During the appeal years, some of the directors and officers of Medenco were also either directors or officers, or both, of the dental subsidiaries. It appears from the record that the longer Medenco owned a dental subsidiary, the more it shifted its own personnel into the director or officer positions of the subsidiaries. In 1971 two of Cascade's three directors were also officers and directors of Medenco, although none of Cascade's officers were either officers or directors of Medenco. In 1972 and 1973 there were both common officers and directors. Lynd also shared both common officers and directors with Medenco during 1973, its only appeal year. Each year Medenco reviewed the salaries of the dental subsidiaries' officers.

During the appeal years there were some shifts of key personnel within the Medenco dental group in order to provide internal promotional opportunities as well as to fill existing vacancies. Other positions were filled from outside the Medenco dental group since, during the years in issue, a sufficient pool of promotable personnel had not been developed within the group.

Each dental subsidiary was responsible for its own cash management and accounting functions'prior to October 1973. A centralized management information system was instituted in 1972, but depended on input from each local'subsidiary. Initially, it was an attempt merely to interpret, centrally, information furnished locally,. rather than to control field operations. However, in October 1973, a centralized accounting system was installed which facilitated central control at division headquarters of accounts payable, payroll and cash. The institution of this system helped effectuate centralized line management throughout the dental division which had been instituted earlier in 1973.

When a taxpayer derives income from sources both within and without California, it is required to measure its California franchise tax liability by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with affiliated corporations, the amount of 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. (See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16] (1947); John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214 [238 P.2d 569] (1951), app. dism. 343 U.S. 939 [96 L. Ed. 1345] (1952).)

The California Supreme Court has determined that a unitary business is definitely established by the existence 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 a centralized executive force and general system of operation. (Butler Bros. 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 held 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, Inc. v. McColgan, supra, 30 Cal. 2d at 481.) These principles have been reaffirmed in more recent cases. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963).)

The existence of a unitary business may be established if either the three unities or the contribution or dependency test is satisfied. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) Implicit in either test, of course, is the requirement of quantitative substantiality. (Appeal of Public Finance Co., Cal. St. Bd. of Equal., Dec. 29, 1958; Appeal of Beatrice Foods Co., Cal. St. Bd. of Equal., Nov. 19, 1958; see also Superior Oil Co. v. Franchise Tax Board, supra.) In other words, corporations are engaged in a unitary business within the scope of either test if, because of the unitary features, the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporations.

When viewed in the aggregate, the unitary characteristics presented in this appeal demonstrate a degree of mutual dependence and contribution sufficient to establish that Cascade, for the years 1972 and 1973, and Lynd, for the year 1973, were engaged in a unitary business with their parent, Medenco, and the parent's other dental laboratory subsidiaries. However, we cannot conclude that, for the year 1971, Cascade was engaged in a unitary business with its parent and the other dental laboratory subsidiaries.

The ownership requirement is satisfied since Medenco owns 100 percent of the stock of all the dental subsidiaries.

In 1972 the centralized marketing control program was implemented. The program involved central marketing research, a centrally directed advertising campaign, and the sharing of successful methods and tools among the dental subsidiaries. For 1972 Medenco was able to report that this program contributed significantly to the profit and growth of the dental laboratories.

the profit and growth of the dental laboratories. By 1973 Medenco was able to report a 10 percent increase in operating income, all generated internally, which was directly attributable to this program. We have consistently held that a material increase in profits directly attributable to the common ownership and common operational methods tends to establish the existence of contribution and dependence. (Appeal of Swift and Co., Cal. St. Bd. of Equal., April 4, 1970; Appeal of Sudden & Christenson, Inc., Cal. St. Bd. of Equal., Jan. 5, 1961.)

The mutual benefits obtained from overall management supervision and control at the highest level, as evidenced by common officers and directors which are present in this appeal, are considered a substantial indicator of contribution and dependence. (See 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).) The presence of common officers and directors enabled Medenco to control the board of directors and, therefore, the overall operations of all the dental subsidiaries. Further control over the subsidiaries' operations is evidenced by Medenco's salary review of all officers. While day-to-day operations may have been directed locally during the appeal years, as evidenced by the fact that centralized accounting and management information systems facilitating overall central control were not fully implemented until late 1973, it is the supervision and control of major policy decisions which is significant. (Chase Brass & Copper Co. v. Franchise Tax Board, supra.)

The presence of central purchasing and the resulting savings have been considered strong indicators of contribution and dependence. (See Butler Bros. v. McColgan, supra; Appeal of Servomation Corp., Cal. St. Bd. of Equal., July 7, 1967.) In this appeal 15 percent of the total material and supply purchases of both Cascade and Lynd for the year 1973 were central purchases of gold. There also may have been some central gold purchases made by Medenco on behalf 'of some of the dental subsidiaries during 1971 and 1972. Although no information was presented to indicate that Cascade participated in the central purchase of gold during those years, respondent has "estimated" that such purchases were "substantial". Since participation in the program was optional and since no information was offered to establish the extent, if any, of Cascade's participation in the central purchasing program, we cannot conclude that Cascade's participation in the program was significant in either 1971 or 1972.

Other factors, which tend to establish the existence of contribution and dependence are: establishment of a centralized training program in 1972.; institution of group employee benefit plans in 1972; and shifting of some key personnel within the group.

We cannot conclude that Cascade was unitary with Medenco and the other dental subsidiaries during 1971. Other than common ownership, the only existing indicators of unity during that year were two common directors, the promotion of two dental division officers, neither of whom were officers of Cascade, and the possibility of an insignificant amount of centralized gold purchases. 1/ These indicators present a totally insufficient basis to conclude that a unitary business existed during 1971.

1/ We have concluded that the central purchase of gold was insignificant for both 1971 and 1972. However, for 1972 sufficient other unitary characteristics, as discussed above, were present to support a conclusion that a unitary business existed for that year.

Appeals of Cascade Dental Laboratory, Inc., et al

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 Cascade Dental Laboratory, Inc., against a proposed assessment of additional franchise tax in the amount of $1,803.54 for the income year 1971, be and the same is hereby reversed; and that the actions of the Franchise Tax Board on the protests of Cascade Dental Laboratory, Inc., against proposed assessments of additional franchise tax in the amounts of $3,739.22 and $1,671.40 for the income years 1972 and 1973, respectively, and on the protest of Lynd Dental Laboratories, Inc., against a proposed assessment of additional franchise tax in the amount of $1,757.64 for the income year 1973 be and the same are hereby sustained subject to possible modification to reflect lower assessments due to the combination of Medenco and its dental division only.

Done at Sacramento, California, this 5th day of December, 1978, by the State Board of Equalization.

George R. Reilly, Chairman

[signature], Member

Iris Sankey, Member

__________, Member

__________, Member