85-SBE-152

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of) Nos. 79A-22 and 83A-63-KS
O.S.C. CORPORATION, ET AL.)

Appearances:

For Appellants: Willard D. Horwich
Attorney at Law

For Respondent: Jon Jensen
Counsel

O P I N I O N

These appeals are made pursuant to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of O.S.C. Corporation, et al., against proposed assessments of additional franchise tax in the amounts and for the income years as follows:

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appellants	Income Years Ended	Proposed Assessments
O.S.C. Corporation	3/31/75	$ 4,849.99
	3/31/76	33,288.16
	3/31/77	9,599.00
	3/31/78	35,909.00
Galaxy Stores, Inc.	3/31/77	200.00
	3/31/78	200.00
O.S.C. Corporation of California	3/31/77	200.00
	3/31/78	200.00
National Market Search, Inc.	3/31/77	200.00
	3/31/78	200.00

Two issues are presented by these appeals. The first question is whether appellant and its subsidiaries had the right to file combined reports for the income years at issue. The second issue is whether a litigation settlement received by appellant in its 1976 income year was taxable income for that year.

At the beginning of the appeal years, appellant, O.S.C. Corporation,, a California corporation, was the parent of five wholly owned California subsidiaries. Only one of the subsidiaries engaged in any business or received any income from outside of this state during any part of the appeal years. During appellant's 1975 income year, this subsidiary was liquidated. After the liquidation, appellant and its remaining subsidiaries continued to operate exclusively within this'state. Both appellant and respondent agree that all of the corporations were dependent upon and contributed to each other. For all of the income years in question, appellant filed tax returns combining its income with that of every subsidiary in existence during each income year.

An audit was performed by respondent for the income years in question. As one of appellant's subsidiaries operated outside of California during part of the 1975 income year, respondent accepted that income year's combined report. On the other hand, respondent determined that during the remaining appeal years, appellant and its subsidiaries were engaged in business exclusively. within this state. Therefore, respondent decided that separate filings for each corporation were needed for those income years. Respondent's decision negated the beneficial offset of the subsidiaries' operating losses

against the parent corporation's income, and resulted in the proposed assessments for those years.

In an unrelated transaction, appellant settled a lawsuit for $130,000 during its 1976 income year that it had brought against Toshiba America in 1971. The suit charged Toshiba with various violations of the state and federal anti-trust laws as well as breach of contract. Based upon documents provided by appellant, respondent concluded that the majority of the settlement was related to lost profits, which are taxable as income, and should have been reported as income during its 1976 income year.

Appellant protested all of respondent's determinations, respondent denied the protests, and this appeal followed.

We begin with the issue of combined reporting. Section 25101 requires a taxpayer deriving income from sources both within and without this state to measure its franchise liability by its net income derived from or attributable to sources within this state. If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined operations of the affiliated companies. (Appeal of the Amwalt Group, Inc., formerly Allan M. Walter and Associates, Inc., Cal. St. Bd. of Equal., July 28, 1983.)

The California Supreme Court has set forth two alternative tests for determining whether a business is unitary. In Butler Biros. v. McColgan, 17 Cal.2d 664 [111 P.2d 3341 (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that the existence of a unitary business was definitely established by the presence of the unities of ownership, operation, and use. Later, in Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 161 (1947), the courtheld that a business is unitary if the operation of the business done within this state depends upon or contributes to the operation of the business outside the state.

Respondent accepts the unitary nature of appellant's corporations for the income year 1975 when one of its subsidiaries conducted business outside of this state. Respondent apparently based its assessment for that income year on other grounds. Although appellant filed an appeal against that assessment, it advances no

reason or argument why the assessment should be reversed. Accordingly, respondent's action for that year will be sustained,

In regards to the other years at issue, appellant argues that it is the unitary concept, i.e., the mutual dependence or contribution between the corporations, which is the theoretical basis of the combined report requirement, not the fact of interstate operation. In other words, appellant contends that it and its subsidiaries were such a highly integrated economic group that sound accounting practice demands that their taxable income be computed on a consolidated basis. Appellant contends that section 25102 supports its position by allowing a qualifying corporation to submit a combined report to the Franchise Tax Board which then must exercise its discretion in accepting or rejecting the report. The test appellant would apply is whether the combined report is necessary in order to reflect the proper income of the corporations. If this test were employed, respondent's exercise of discretion would be reviewable under the standard that it must not be unreasonable, arbitrary, or capricious.

Prior decisions of this board have upheld the position taken by respondent that corporations engaged solely in intrastate businesses have no inherent right to file a combined report merely because they are carrying on what would be regarded as a unitary business if it were a multistate operation. (Appeal of E. Hirschberg Freeze Drying, Inc., Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Kim Lighting and Manufacturing Co., Inc., Cal. St. Bd. of Equal., June 2, 1969; Appeals of Pacific Coast Properties, Inc. et al., Cal. St. Bd. of Equal., Nov. 20, 1968.) Further, as stated in Appeals of Pacific Coast Properties, Inc., et al., supra, "[a] taxpayer cannot compel the Franchise Tax Board to act, that is, to permit or require submission of a combined report. If the board does not act, then under section 25102, there is no reviewable exercise of discretion."

The above-cited decisions are buttressed by Handlery v. Franchise Tax Board, 26 Cal.App.3d 970 [103 Cal.Rptr. 465] (1972), which held that the unitary business concept is applicable only with respect to interstate operations. Consequently, corporations engaged solely in intrastate business activities have no

right, at least for income years beginning prior to 1980,[2] to file a combined report and be treated as a unitary business, even though they would have been considered as such had the business activities been interstate.

Appellant takes the position that California Administrative Code, title 18, regulation 24303, which provided the rules for combined reporting, was the basis for the Handlery decision. Accordingly, appellant contends that the subsequent repeal of regulation 24303 changes the Handlery rule.

This attempt to discredit the Handlery decision is misguided. As stated by respondent, the repeal of regulation 24303 would not change the result of Handlery because the decision was based upon other authority. A cursory reading of the opinion reveals that the only reason the regulation was discussed was because the appellant in that case argued that the regulation, combined with section 25102, made combined reporting discretionary. That argument was rejected by the court. Consequently, we find that appellant has not shown why it should be entitled to file combined reports for the years at issue.

Appellant demands that if we find that respondent was correct in requiring separate returns for each corporation, this board must make an allocation of income and expenses between the corporations. It is not the province of this board to do as appellant requests, however, because such an allocation is solely within the discretion of the Franchise Tax Board. (Rev. & Tax. Code, § 24725.)

2/ Section 25101.15, enacted by chapter 398 of the 1980 statutes, permits intrastate "unitary" businesses to file combined reports for income years beginning on or after January 1, 1980. Consequently, it is of no assistance to appellant here: Section 25101.15 provides:

> If the income of two or more taxpayers is derived solely from sources within this state and their business activities are such that if conducted.within and without this state a combined report would be required to determine their business income derived from sources within this state, then such taxpayers shall be allowed to determine their business income in accordance with Section 25101.

We turn to the issue of appellant's settlement received in income year 1976. Appellant argues that the majority of the award was not taxable income due to the fact that the settlement labeled those damages "loss of business reputation." It is appellant's position that the damages received for the loss of business reputation are analogous to nontaxable damages derived from the loss of personal reputation.

We do not need to discuss the taxability of damages recovered for the loss of business reputation. In O.S.C. Corp. v. Commissioner, ¶ 82,280 T.C.M. (P-H) (1982), the United States Tax Court dealt with the issue now before us and reached the decision that the settlement damages were in compensation for lost profits, not the loss of business reputation as stated in the settlement agreement. In reaching its decision, the tax court found that no evidence was presented which indicated that the loss of reputation was ever in issue in the suit prior to the signing of the settlement agreement. All of the documentation presented during the litigation focused on the lost profits suffered by appellant. Finally, a letter from appellant's counsel to the defendant in the suit indicated that the amount allocated to the loss of appellant's business reputation was due to the defendant's tax considerations. Therefore, the settlement was taxable income. (O.S.C. Corporation v. Commissioner, supra.) We note that the disposition of appellant's case on the federal level is highly persuasive of the result which should be reached on this appeal. (Appeal of William C. and Kathleen J. White, Cal. St. Bd. of Equal;, June 23, 1981; Appeal of Dorothy C. Thorpe Glass Mfg. Corp., Cal. St. Bd. of Equal., Sept. 17, 1973.) Consequently, we find that the tax court's decision is persuasive and adopt its treatment of the settlement monies as recovery for lost profits and, hence, taxable income.

Generally, in the case of income the right to which is to be determined through litigation, the income is not considered to be received by a taxpayer until he has a right to demand payment of the funds. (North American Oil Consolidated v. Burnet, 286 U.S. 417 [76 L.Ed. 1197] (1932), Appeal of David D. and Linda D. Cornman, Cal. St. Bd. of Equal., Feb. 28, 1984.) When this right to demand payment arises, the value of the settlement or award becomes income to the recipient. (Rev. & Tax. Code, § 24661.)

Appellant argues that the settlement cannot be taxed as income received during its 1976 income year because an exception to this rule is provided by section 24678, subdivision (a), which states that:

> If an amount representing damages is received or accrued during an income year as a result of an award in, or settlement of, a civil action [brought under the anti-trust laws commonly known as the Clayton Act] ... then the tax attributable to the inclusion of such amount in gross income for the income year shall not be greater than the aggregate of the increases in taxes which would have resulted if such amount had been included in gross income in equal installments for each month during the period in which such injuries were sustained by the bank or corporation.

Appellant contends that since the case was grounded in an anti-trust violation, the settlement appellant received should be treated in accordance with section 24678.

We note that section 24678 is applied exclusively to anti-trust actions. (Rev. & Tax. Code, § 24678, subd. (a).) Upon review of the complaint filed in the above-mentioned case, it is apparent that there are two causes of action alleged by appellant: an anti-trust action and a breach of contract action. The settlement agreement makes no mention of how much or to which cause of action the settlement should be applied. Appellant has not provided any information as to the amount of the settlement, if any, which may take advantage of section 24678. Without such information, we are unable to apply section 24678 to any of appellant's settlement. Therefore, respondent's action including the entire settlement amount as income during the income year 1976 must be sustained.

Finally, appellant contends that it should be relieved of interest on the tax because of the time involved in awaiting the result in the federal tax litigation mentioned above and delays in receiving respondent's replies to appellant's briefs. We disagree.

As stated in Appeal of The Inn at La Jolla, Inc., decided by this board on December 18, 1964:

> Section 25901 of the Revenue and Taxation Code provides, in mandatory language and without

> exception, for the payment of interest at the rate of [12] percent a year on any amount of unpaid tax. After filing its protest, appellant could have prevented the accrual of interest by paying the amount in issue at any time, without sacrificing its right to a refund together with [12] percent interest in the event of a determination in its favor. [Citations.]. With this alternative available, appellant has no ground for objecting to the payment of interest.

For the above-stated reasons, respondent's action in this matter will be sustained.

Appeals of O.S.C. Corporation, et al.

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 O.S.C. Corporation, et al., against proposed assessments of additional franchise tax in the amounts and for the income years as follows:

Appellants	Income Years Ended	Assessments
O.S.C. Corporation	3/31/75	$ 4,849.99
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	3/31/78	200.00
National Market Search, Inc.	3/31/77	200.00
	3/31/78	200.00

be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day Of December, 1985, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Nevins, and Mr. Harvey present.

_______________________, Chairman

Conway H. Collis, Member

Richard Nevins, Member

Walter Harvey*, Member

_______________________, Member

*For Kenneth Cory, per Government Code section 7.9