

Appeal of A. Epstein and Sons, Inc.

tracts with a state-owned entity of the Polish government involving the construction of several meat-processing plants in Poland. In addition to the design and construction of these plants, the Epstein Corporations were also responsible for the purchase and installation of the operating **equipment** and for testing the equipment and training the Polish personnel in the plants' operation. Several employees were specifically hired to fulfill the latter aspects of the contracts, including individuals with specialized accounting expertise in equipment sales. In most respects, however, the work on the contracts was similar to the design and construction done on a world-wide basis by the Epstein Corporations.

During the years in question, the principal shareholders of appellant's parent were two brothers, Raymond and Sidney Epstein, who each owned 41.9 percent of the outstanding shares of stock. The Epsteins and Mr Garfield **Rawitsch** held the senior officer positions of the parent and were officers in all of the other Epstein Corporations. Actual control over the Epstein Corporations was maintained by having the Epstein brothers and Mr. Rawitsch constitute a majority of the board of directors of each Epstein corporation.

The headquarters office oversaw the business and concerned itself with the policy decisions involved in the various activities engaged in by the Epstein Corporations, including the design and construction aspects of the Polish contracts. A flat fee was charged by the parent company to the remainder of the Epstein Corporations for administrative overhead. There was also a substantial amount charged for other intercompany services (**\$1,329,456** in 1973 and \$306,692 in 1974). Appellant's performance of significant activities for its affiliates is further reflected by the growth, during the income year 1973 from zero to over \$1.6 million, in appellant's asset account "Due From Affiliated Companies."

During the years in question, the Epstein **Cor-**porations derived substantial amounts of interest income from excess funds which were generated by the business and invested on a short-term basis in United States Government securities pending a decision by management on what business use to make of the funds. Approximately sixty to seventy percent of the interest income in issue can be directly traced to progress payments on the Polish contracts.

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The question which must be decided initially is whether appellant was engaged in a single unitary business with the other affiliated corporations and was required to **determine its** California income by combined reporting procedures during the years under 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), affd., 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 Bros., supra, the court held that the existence of a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation; and (3) unity of use. Subsequently, in Edison California Stores, Inc., supra, the court 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. More recent cases have reaffirmed these general tests and given them broad application. (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); RKO Teieradio Pictures, Inc. v. Franchise Tax Board, 246 Cal.App.2d 812 [55 Cal.Rptr. 299] (1966).) The California court has stated, "It is only if [a foreign 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 Bros. v. McColgan, supra, 17 Cal.2d 664, 667-668.)

'If either of the above-stated tests are applied to the facts presented in this appeal, we are led to the conclusion that respondent has correctly determined that appellant was engaged in a single unitary business with the several affiliated corporations in issue. Our conclusion is based on the presence of the following factors

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are engaged in diverse lines of businesses does not, standing alone, preclude a finding that such businesses are unitary. (See Appeal of Pittsburgh-Des Moines Steel Company, Cal. St. Bd. of Equal., June 21, 1983; Appeal of Wynn Oil Co., Cal. St. Bd. of Equal., Feb. 6, 1980.

Next, appellant maintains that each activity was managed and accounted for separately as indicated by the schedules of management and accounting personnel it submitted. (App. Ex. A) It contends that these schedules clearly demonstrate that there was no strong centralized management and that, although Raymond Epstein and Sidney Epstein generally oversaw the entire operations as its chief executive officers, their function was policy-making rather than managing the operations of the businesses. In fact, their unfamiliarity with the purchase and sale of equipment under the Polish contracts required that **they** hire a new vice president for the parent, Chaim Altbach, specifically to take charge of those activities on both policy and operational levels. Further, it was necessary to hire a significant number of employees with highly specialized experience in such equipment to handle the sales, and the Epsteins necessarily had to defer to those with the specialized skills in these areas.

The fact that Raymond and Sidney Epstein were not involved in the day-to-day operations is not the critical factor in determining whether affiliated corporations are integral parts of a unitary business. In fact, it is precisely the formulation of major policy decisions that is the important factor in determining whether affiliated corporations are integral parts of a unitary business. (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); Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975; Appeal of F. W. Woolworth co., Cal. St. Bd. of Equal., July 31, 1972; Appeals of Harbison-Walker Refractories Co., Cal. St. Bd. of Equal., Feb. 15, 1972; Appeal of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970.) Accordingly, appellant's argument must be rejected.

Having concluded that appellant was engaged in a single unitary business with its several affiliated corporations, the next issues which must be determined are (i) whether the income earned from sale of **meat**-processing equipment as part of the Polish contracts constituted **business** income; (ii) whether the interest

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interest income received during 1972 and 1973 on the basis that it is not business income. We disagree. It is clear that this, income is business income in that it arose out of or was created in the regular course of the taxpayer's trade or business operations, i.e., the Polish contracts. (See Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3)(E)(arts. 2 and 2.5).) Therefore, it follows that respondent also correctly categorized the interest income as business income.

Next, appellant contends that its California-source income is distorted by applying the standard **UDITPA** formula to the interest income and the income from the sale of the meat-processing equipment. The heart of appellant's argument is that neither item nor income constitutes business income. However we have already decided this question adversely to appellant. In any event, appellant has offered no credible factual evidence to support its argument that the standard **UDITPA** formula provisions do not fairly represent its activities in California. Based upon the record in this appeal, we must conclude that the standard **UDITPA** formula as applied to appellant's various activities, including the equipment sales pursuant to the Polish contracts and the interest income derived therefrom, was a fair and reasonable method of taxation and fairly reflected appellant's California-source income.

The final issue to be resolved is whether the New York partnership should be included in appellant's unitary business.

The New York partnership was formed to conduct the architectural activities of Epstein in New York because New York State law did not permit a corporation to practice architecture. Appellant alleges that the partnership agreed to perform all architectural services required in New York for Epstein at cost; therefore, there was no possibility of profit to the partnership. According to appellant, any profit attributable to the architectural services rendered by the partnership became the profit of Epstein, although the property, payroll, and sales of the partnership were responsible for that profit. Allegedly, Epstein indemnified the partners of the partnership against claims **arising out** of the operation of **the partnership**. Appellant concludes that **these** facts illustrate that the role of the partnership was merely as a nominee for **Epstein** and that, in such a case, to fail to take into account the property, payroll, and

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evidence that the existence of the partnership caused any distortion when the standard formula was applied. Accordingly, we conclude appellant has not established that there is a need to apply a special formula pursuant to section 25157.

For the reasons set forth above, respondent's action is sustained.

In the Matter of the **Appeal** of)
A. EPSTEIN AND SONS, INC;)
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ORDER DENYING PETITION FOR REHEARING

Done at Sacramento, California, this 5th day of February, **1985**, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett, **Mr. Nevins** and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman
William M. Bennett, Member
Richard Nevins, Member
Walter Harvey*, Member
_____, Member

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