BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-1248-SW
BERRY ENTERPRISES, INC.)

For Appellant: Arthur Young & Company

For Respondent: Gary M. Jerrit
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Berry Enterprises, Inc., against proposed assessments of additional franchise tax in the amounts of $30,190, $33,771, and $95,603 for the income years 1975, 1976, and 1977, respectively.

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

Appeal of Berry Enterprises, Inc.

The sole issue presented by this appeal is whether appellant, Sawyer Tanning Company, and Ocean Science and Engineering, Inc., were engaged in a single unitary business during the income years 1975, 1976, and 1977.

Berry Enterprises, Inc., (hereinafter "appellant" **or "Berry** Enterprises") was incorporated in 1973 by Berry **Holding** Company. The objectives in forming appellant, as stated in its 1975 annual report, were to further a program of corporate expansion and to "counteract the 'depleting asset' nature of the petroleum business through diversification. **..." (Resp. Ex,** D.) Another major criteria set out by appellant to be used in determining which type of business it would acquire was that **"[A]n** experienced management group must exist or be readily recruitable. This team must be capable of carrying out the projected expansion plan." **(Resp.** Ex. **A.)**

Following its formation, appellant, in July of 1974, acquired loo-percent ownership of Sawyer Tanning Company (hereinafter "Sawyer"), which is a manufacturer of sheepskin **coats.** *Appellant. obtained indirect ownership of Sawyer's 100 percent-owned affiliates, West Coast Hide **&** Skin, County Suede of London, Sawyer International A.G., Sawyer of **Napa,** Ltd., and Sawyer Export Sales Co., all of which are involved in the international distribution and sale of the coats.

On March 1, 1975, appellant acquired a controlling interest in Ocean Sciences and Engineering Corporation. Ocean Sciences and Engineering Corporation (hereinafter **"OSE")** at the time of acquisition **owned a** subsidiary, California Shipbuilding and Dry Dock Company, which operated as a commercial shipyard. This subsidiary (hereinafter **"Calship")** subsequently began leasing land and dry docks for its marine repair business from **Water-**street Properties, a company formed by appellant in I.976 for the sole purpose of holding the property used by **Calship.**

Following the acquisition of OSE, appellant acquired (1) T **&** H Compressor Repair Company (hereinafter **"T & H"),** a company engaged in the installation and repair of oil field compressors; **(2)** Texas Compressor Company, Inc., which operated outside of California in a manner similar to T **& H; (3)** Machine and Iron Works, Inc., which was involved in the petroleum industry through manufacture, sale, and service of oil field equipment; and **(4)** Photo Gravity Company, Inc., and its subsidiary Photo

Gravity Company, Inc., and its subsidiary Photo Gravity Surveys, Ltd., which were involved in the development of seismographic data. Each of the above-listed companies, after mergers, were allegedly operated as divisions of OSE.

The operations of both Sawyer and OSE were apparently conducted by the individuals who were either the former owners or managers, individuals who were promoted from within the organization, or individuals with. substantial experience in the industry who were hired subsequent to the acquisition. George Rosman and Imre Vizkelety, who were senior executives of Sawyer, retired in 1976, and John Kolozs, formerly from County Suede, was promoted to president. Several other men were either promoted to management positions or hired from the outside because of their experience. Of all the Sawyer managment personnel hired in 1976, only Ian Wordsworth had any responsibilities with appellant. Mr. Wordsworth was the secretary for appellant in 1975 and allegedly continued to maintain appellant's accounting records until mid-1977. The directors of appellant and Sawyer were identical.

The majority of the board of directors of OSE were the same individuals as those who served on appellant's board of directors. There were also some similarities in appellant's and OSE's staff. Beverly Huber was the assistant secretary for appellant in 1976 and 1977 and OSE's assistant secretary in 1977. Charles Hamlin was appellant's and OSE's secretary in 1975 and treasurer in 1976. Arne Kalm was president of both appellant and OSE during all the years in issue. He was also chairman. of the board of directors for Sawyer. Appeliant was compensated by its subsidiaries for the time Mr. Kalm spent working with both Sawyer and OSE. Compensation was in the form of monthly management fees. For example, in 1975, Sawyer paid appellant $26,643 in management fees and in 1977 it paid appellant $120,000 in management fees.

Appellant, in its tax returns for the years at issue, considered itself to be a single unitary business with both Sawyer, a profit-making business, and OSE, a business which was not at that time generating a profit. Appellant considered the businesses unitary because of the alleged contribution Arne Kalm made to Sawyer and OSE and because of OSE's and Sawyer's alleged financial dependence on appellant. Respondent determined that appellant, Sawyer, and OSE were not a single unitary

business and issued proposed assessments. This timely appeal followed.

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 the state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business, 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. (See Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) If, however, the business within this state is truly separate and distinct from the business without the state so that the segregation of income may be made clearly and accurately, the separate accounting method may properly be used. (Butler Bros. v. McColgan, 17 Cal.2d 664, 667 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).)

Respondent's determination is presumptively correct and the appellant bears the burden of proving that it is incorrect. (Appeal of The Amwalt Group; Inc., Cal. St. Bd. of Equal., June 25, 1985.) Appellant must show that the relationship of Sawyer and OSE to appellant was of sufficient substance to demonstrate the existence of a single unitary business.

The existence of a unitary business is established if either of two tests is met. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) The California Supreme Court has determined 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. (Butler Bros. v. McColgan, supra, 17 Cal.2d at 678.) The court has also stated that a business is unitary when the operation of the portion of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison-California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.) Subsequent cases have affirmed these tests and given them broad application. (Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545 (1963); Honolulu Oil Co. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552] (1963.)

Appellant contends that Sawyer, OS&, and itself can be shown to be a single unitary business under either of the two tests above. We have held that, in the case of affiliated corporations, both of the unitary tests require controlling ownership. (Appeal of Revere Copper and Brass, Inc., Cal. St. Bd. of Equal., July 26, 1977.) Controlling ownership does not require loo-percent stock ownership, but simply common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock. (Appeal of Saga Corp., Cal. St. Bd. of Equal., June 29, 1982.) In the present case, unity of ownership did exist as appellant owned 100 percent of Sawyer in July of.1974 and controlled approximately 79 percent of OSE's stock as of March 1, 1975. Respondent argues, however, that the unities of use and operation were not present and that contribution or dependency did not exist among the corporations. We agree with respondent.

In a case of vertical or horizontal integration, the benefits to the group from certain basic connections are usually readily apparent. In a situation such as this one, however, where the Sawyer and OSE each engaged in a distinct type of business, without vertical or horizontal integration, we must scrutinize the connections labeled "unitary factors" to see if, in substance, they really result in a single unitary business, the income of which is appropriately reflected in a combined report. "Where the businesses are distinct in nature, the mere recital of a number of centralized functions is not sufficient, in our opinion, to establish unity of operation, unity of use or contribution or dependency between the operations." (Appeal of Allied Properties, Cal. St. Bd. of Equal., Mar. 17, 1964.)

Appellant contends that unity of operation was demonstrated by the financing provided to the subsidiaries by appellant and the control Arne Kalm had over all the companies. We agree with appellant that intercompany financing has been considered "substantial evidence of unity of-operation." (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 503 [87 Cal.Rptr. 2391 ape. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970).) In this case, however, the financing and guarantees provided by appellant were not used for any common business activity. As we stated in A eal of Simco, Incorporated, decided October 27, 1 9 - h such financing results in a unitary business virtually every business would be unitary no matter how unrelated were the various activities." Furthermore, appellant concedes that there were no centralized departments for accounting,

personnel, legal work, insurance, or advertising. There is evidence that the negotiations with banking and investment personnel were subject to Arne Kalm's approval and were done under his guidance. However, there is very little indication that this relatively minor centralized function resulted in any substantial mutual advantage. In sum, although appellant held notes from both OSE and Sawyer, there is no evidence that these loans contributed to the operational integration of the three companies. Furthermore, there were no centralized departments for managing the three companies. Unity of operation or unity of staff functions, therefore, cannot be said to have existed to any meaningful extent.

Appellant further argues that Mr. Kalm, and to a lesser degree Mr. Wordsworth, Mr. Hamlin and. Ms. Buber, constituted a centralized executive force which made the ultimate management decisions for all three corporations. By its own annual reports, appellant is a small organization which works with skilled operating people in each of the company's subsidiaries. Appellant's small corporate staff set as one of its goals the purchase of operating businesses which had management that was willing to stay. The facts indicate that appellant did purchase existing businesses and did retain many of the key personnel. There is no evidence that Mr. Kalm or any other officer of appellant had more than minimal input on the actual operations of Sawyer or OSE. Rather, it appears that Mr. Kalm was functioning as a financial or planning specialist. His duties were to oversee the operations of Sawyer and OSE and to be of assistance if the operating personnel needed assistance in their plans for expansion or their outside dealings with financial institutions. There is no indication that Mr. Kalm was doing anything other than trying to keep appellant's assets functioning in a profitable manner. Central financial management is "to be expected in almost any case where a closely held corporation operates a number of enterprises." (Appeal of Jaresa Farms, Inc., now Harris Farms, Inc., Cal. St. Bd. of Equal., Dec. 15, 1966.) The record does not indicate that Mr. Kalm had any expertise in the tanning business, the marine repair business, or the oil field service business. On the contrary, when vacancies arose in the various corporations, personnel were found to fill the vacancies. The duties were not merely performed by Mr. Kalm. We find this general oversight insufficient to support a finding of unity of use. (See Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 31, 1982 (no unity of use where executive control merely made the subsidiary a more productive independent

asset.) Likewise, the fact that the boards of directors for all three were similar is not conclusive evidence of strong central management. These members appear to be figureheads and there is no evidence that they ever participated in the day-to-day operations of the business. Unity of use, therefore, cannot be said to have existed to any meaningful extent.

The lack of unity is also clear when judged by the contribution or dependency test. The preceding discussion shows that the unitary factors propounded by appellant do not show that the operations of appellant, Sawyer, or OSE contributed to or depended upon each other in such a way as to compel the conclusion that the three corporations were engaged in a single integrated economic enterprise. This is simply another example of a result which is to be expected in almost any case of commonly-owned enterprises, no matter how unrelated operationally. (Appeal of **Simco, Incorprated, supra.**) It does not demonstrate that the operations of any of these companies contributed to or depended upon the operation of any of the other companies.

As appellant has not met its burden of showing that appellant, Sawyer, and OSE were a single unitary business, we will sustain respondent's actions.

Appeal of Berry Enterprises, 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 Berry Enterprises, Inc., against proposed assessments of additional franchise tax in the amounts of $30,190, $33,771, and $95,603 for the income years 1975, 1976, and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of March , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

_____ , Member

*For Kenneth Cory, per Government Code section 7.9