BEFORE TEE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1646-MA
POSTAL PRESS)

Appearances:

For Appellant: Barry Bundy and
David L. Miller
Certified Public Accountants

For Respondent: Donald C. McKenzie
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 Postal Press against proposed assessments of additional franchise tax in the amounts of $25,611 and $31,288 for the income years 1977 and 1978, respectively.

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.

Appeal of Postal Press

The first issue presented by this appeal is whether appellant's commercial printing operation is unitary with its subsidiary's operations. If we conclude that the two businesses are unitary, then we must decide whether the loss from renting 37 percent of appellant's building was a business or nonbusiness loss.

Appellant Postal Press is a large volume commercial printing shop located in Los Angeles. The business was purchased in 1942 by William LeVine who incorporated it in California in 1956 and became its president.

In the late 1960's, Mr. LeVine determined that appellant should expand its operation to include a small-volume fast printing service. He developed the necessary technology and established Postal Instant Press (PIP) as one of appellant's departments. When PIP proved successful, four more PIP locations were opened. In 1967, PIP began offering franchises for sale to independent operators throughout the United States and Canada. Soon thereafter, PIP incorporated, borrowed money from appellant and became publicly traded. Appellant retained ownership of 68.3 percent of the shares issued by PIP.

Appellant's original PIP location was converted into a franchise with appellant as franchisee. During the years at issue, this particular franchise produced gross printing sales for appellant of approximately $159,000 which was only seven or eight percent of appellant's total revenues. During this period, appellant paid franchise royalties of approximately $1,800 a year, to PIP (about one percent of the franchise's gross sales of $159,000).

In 1977 and 1978, a purchaser of a PIP franchise was required to make an investment of about $45,000. The franchise itself cost about $22,500 for which the franchisee received use of: the PIP name, advertising, and exclusive territory: financing; training; consultation; and expertise from PIP. The remaining $22,500 was used to purchase printing equipment and supplies. The typical franchisee also paid PIP

royalties of between six and eight percent of gross sales.2/

Respondent contends that unity between appellant and PIP is demonstrated by centralized management, use of a similar trademark and name, a common profit-sharing plan for employees, intercompany sales at less-than market prices, reduced royalties paid by appellant to PIP, intercompany financing, and engagement in the same general line of business. Appellant contends that the companies were engaged in different types of businesses and that the significance of the connections cited by respondent is insufficient to support a finding of a unitary business.

When a taxpayer derives income from sources both within and without this state, its franchise tax liability is measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, S 25101.) If the taxpayer is engaged in a single unitary busipess 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 unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The existence of a unitary business may be established under either of two tests set forth by the California Supreme Court. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), aff'd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that a unitary business was definitely established by the presence of unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions, and unity of use in a centralized executive force and general system of operation. Later the court stated that a business is unitary if the operation of the portion of the business done within California is dependent upon or contributes to the operation of the

2/ During the years at issue, there were 33 company owned franchises of which more than half were repossessed from franchisees who defaulted. Another eight stores were acquired from the bankruptcy of other franchising companies. By 1986, there were only four company-owned stores. During the years at issue, franchised units increased from 208 to a total of 403 in 1978.

business outside California. (Edison California Stores, Inc. v. McColgan, supca, 30 Cal.2d at 481.)

Respondent's determination is presumptively correct and appellant bears the burden of proving that it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Where, as here, the appellant is contesting respondent's determination of unity, it must prove that, in the aggregate, the unitary connections relied on by respondent were so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

In the case before us, the presence of unity of ownership, a prerequisite to the existence of a unitary business under either the three unities or the contribution or dependency test, does not appear to be contested. Appellant owned 68.3 percent of PIP, thus, unity of ownership is present.

The first area of *controversy* appears to be the degree of integration of the executive forces of the two groups which is considered an element of exceeding importance in determining whether unity of use is present. Generally, unity of use relates to executive forces and operational systems. Intercompany sales are also clear evidence of unity of use. The cornerstone of respondent's contention that the executive forces were closely integrated is that appellant and PIP shared the following common officers and directors:

	Appellant	PIP
William &Vine	President, Director	President, Director
Michael LeVine	Sales Manager	Vice-President, Director
Stanley Richards	Vice-President, Director	Secretary, Director

Respondent contends that William LeVine "as-the highest officer and founder of both companies made all major policy decisions for both companies [and] closely supervised and devoted most of his time to PIP ...." (Resp. Br. at 2 & 3.) Appellant argues that there is no basis for respondent's contention. We must agree with appellant. As in the Appeal of Vidal Sassoon of New York, Inc., decided by this board June 27 1984 , the record is devoid of any facts which would indicate that William LeVine set overall management policy or closely

supervised the implementation of policies, or that centralized management otherwise existed between both operations. During the years in question, there was no centralized management of the two companies. Appellant was managed by Michael LeVine and Stanley Richards, while William LeVine managed PIP. Although William LeVine received a salary from appellant as a consultant in each of the appeal years, operational control of appellant remained in the hands of Michael Levine, Stanley Richards and their executives. Their positions as officers and directors of PIP were more formal than substantive.

Respondent also relies heavily in its argument on the fact that appellant shared key officers and directors. It then makes a series of suppositions about the "attendant mutual cooperation and exchange of information [which] was of obvious benefit to both companies.' (Resp. Br. at 9). It falls however to offer any evidence that this in fact occurred. Additionally, there were no direct intercompany sales other than a "pass-through" transaction to start-up franchises. (App's. Erg. Br. at 6.)

There has also been no showing that any great degree of unity of operations was present. The requirement of unity of operations, first mentioned in Butler Bros. v. McColgan, supra, includes such centralized features as purchasing, advertising, accounting, legal services, and financing. The two companies did not have any central purchasing due to the differences in their printing processes. PIP had a separate advertising department which advertised franchises for sale. Appellant used a separate advertising firm and advertised printing. Each company had its own accounting department and accounting system, with the exception of the same certified public accountant who prepared their annual financial statements and tax returns. Insurance and legal problems were also handled separately by the two companies.

Respondent contends that appellant and PIP had virtually identical trademarks and names. We agree that while a common use of names and trademarks may be one indication of unity, it certainly is not the only one. (Appeal of Vidal Sassoon of New York, supra.) Under the facts of this appeal, however, we find little, if any, unitary significance to the use of allegedly common trademarks and names by appellant and PIP.

Other factors cited by respondent prove to be equally inconclusive. Based upon information provided by appellant, respondent is mistaken in its characterization of a shared pension plan. The profit sharing plans were separate plans with separate statements, filings and funds. (See App's. Erg. Br. at 5.) And while some intercompany financing did occur, it was relatively minor and non-recurring.

The last factor which must be considered is that appellant is in the commercial printing business, a highly specialized field, requiring large presses, cutters and expensive cameras costing approximately $239,000. A typical PIP store, on the other hand, requires an AB Dick press and small camera costing approximately $11,600. A large-volume commercial printer such as appellant specializes in printing menus, business forms, stationary, and other large-scale commercial jobs. A PIP store specializes in instant printing of documents which requires little printing expertise. The companies had vastly different customer bases. Appellants' customers were large well-known companies with specialized large-volume printing needs. The customers of the 33 stores owned by PIP were small service businesses, wholesalers, churches, and social groups requiring small-volume copying. In 1978, only $3 million of PIP's $9 million in revenue came from instant printing sales and only $3 million of $7 million in 1977. The remainder of the revenue earned came from franchise related sales. It is readily apparent that the printing activities of appellant and PIP's franchisees are radically different. More importantly, however, is that PIP is, in reality, in a *very* different business of selling franchises and serving its franchisees by providing them with continuing cooperative advertising, education, and financing.

In view of the foregoing analysis, we must conclude that the three unities test has not been met in the instant case.

We recognize, however, that a unitary business may exist if the alternative Edison test is satisfied, i.e., if the business carried on within the state contributes to or is dependent upon the operation of the business outside California. To find for respondent under this test, we must be convinced that PIP contributed to or was dependent upon appellant's operations within this state. After applying this test to the facts presented to us, we must conclude that appellant and PIP were not engaged in a single unitary enterprise.

Respondent has attempted to demonstrate the existence of contribution and dependency by using much the same criteria as used for the three unities test, i.e. centralized management, similar trademark, and name, intercompany sales, financing and royalties. There is little merit to respondent's allegations since the relationships relied on lack substance. Accordingly, we must conclude that appellant and PIP did not constitute a single integrated economic enterprise during the appeal years.

For the reasons stated above, we conclude that respondent's determination that appellant and PIP were engaged in a unitary business is erroneous. In view of our determination on the primary issue, it follows that all of the loss incurred by appellant from the rental of its headquarters building should be specifically allocated to its California situs.

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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 Postal Press against proposed assessments of additional franchise tax in the amounts of $25,611 and $31,288 for the income **years** 1977 and 1978, respectively, be and the same is **hereby** reversed.

Done **at Sacramento,** California, this 17th day of June , 1987, by the State Board **of** Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., **Member**

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

***For** Gray Davis, per Government Code section 7.9