BEFORE TEE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of **WILLAMETTE INDUSTRIES,** INC.	) **No. 82A-1036-DB**

Appearances:

For Appellant: Lawrence. V. Brookes
Attorney at Law

For Respondent: **Jon** Jensen
Counsel

O P I N I O N

This **appeal** is made pursuant to section 26075, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of **Willamette** Industries, Inc., for refund of franchise tax in the amounts **of$17,302.67** and **$9,232.12** for the income years 1974 and 1975, 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.

The question presented is whether an unincorporated joint venture in which appellant owned a SO-percent interest was part of appellant's unitary business.

Appellant is an Oregon corporation which did business in California and other states both directly and through a number of subsidiaries. During the appeal years, appellant and its subsidiaries conducted their business operations through two operating groups which the parties agree formed a single unitary business. One group was the Western Kraft Paper Group, which manufactured paper products and had extensive facilities and operations in California. The other group was the Building Materials Group, which manufactured plywood and particleboard. This group operated in Oregon and the southeastern United States, but not in California.

Through one of its corporate predecessors, appellant was a SO-percent partner in a joint venture, Freres Veneer Company, which produced veneer, a component of plywood. Appellant's predecessor entered into the joint venture in order to establish an additional source of supply of certain grades of veneer for use in its plywood operations in Oregon. The other joint venture was an Oregon corporation named Freres Lumber Co., Inc., one of several corporations owned by the Freres family. Pursuant to the joint venture agreement, Freres Veneer built and operated a veneer plant in Lyons, Oregon, next to an existing facility owned and operated by the Freres interests. This plant was located some 40 miles from appellant's Griggs, Oregon, plywood plant.

Under the joint venture agreement, as amended over the years, the two partners had an equal right to approve the specifications of the venture's plant and equipment, including additions, modifications, and replacements. Operating funds were to be contributed equally by the partners, and any profits or losses were to be shared equally. Each party had an equal voice in determining policy and in conducting the business of Freres Veneer, but direct management of the venture, during the appeal years, was vested in the Freres interests. Appellant's personnel were to be available for consultation and advice, but they apparently were not called upon in this capacity. Appellant kept the joint venture's books and records, prepared periodic operating and financial 'reports, and provided insurance coverage for excess liability, excess fire-fighting, and contractor's property damage. In 1974, appellant purchased, at market prices, $1.6 million of veneers from Freres Veneer; in 1975, it purchased $1.4 million of veneers from the joint venture. These purchases amounted to approximately 29 percent of the joint venture's total sales of veneers in 1974, and about 24 percent of such sales in 1975. Appellant also purchased manufacturing waste products from Freres Veneer for use in making particleboard and as fuel for some of appellant's plants. These purchases amounted to $539,000 in 1974 and $794,000 in 1975, and they constituted 78 percent of the joint venture's sales of waste products in 1974 and 83 percent in 1975.

For the years 1974 and 1975, appellant filed combined California franchise tax returns which included all subsidiaries in which it had more than a SO-percent ownership interest. Appellant did not, however, include any part of the joint venture's income or apportionment factors in those combined reports. Respondent subsequently determined that appellant's distributive share of Freres Veneer's income and factors should have been included in the combined reports, because the joint venture was part of appellant's unitary business. Whether that determination is correct is the question we must resolve.

A taxpayer which derives income from sources both within and without this state 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.) The California-source income of such a taxpayer must be computed in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120-25139. (Rev. 6 Tax. Code, § 25101.) If the business conducted within and without the state is unitary, the portion of the business income from the unitary business which is attributable to sources within California must be determined by formula apportionment. (See Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).)

Two alternative tests are used for determining whether a business is unitary. The "three unities" test of Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), aff'd., 315 U.S. 501 [86 L.Ed. 991] (1942), provides that a unitary business exists when the unities of ownership, operation, and use are present. In Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947), the California Supreme Court said 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; this is the "contribution or dependency' test. Implicit in this second test is an ownership requirement. (Appeal of Revere Copper and Brass Incorporated, Cal. St. Bd. of Equal., July 26, 1977.)

In the case of affiliated corporations engaged in a unitary business, 100 percent of the net business income of all the affiliated corporations is combined to determine the apportionable income, and 100 percent of the property, payroll, and sales of all the affiliated corporations is used to determine the apportionment formula. This is done even if there is less than 100-percent ownership of another corporation, as long as there is controlling ownership. Controlling ownership is generally established by common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock. (Appeal of Revere Copper and Brass, Incorporated, supra. See also Appeal of Douglas Furniture of California, Inc., Cal. St. Bd. of Equal., Jan,, 1984.)

Under the UDITPA regulations, interests in partnerships are treated somewhat differently. Regulation 25137-1 provides that if the partnership activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of partnership income and apportionment factors is included in the taxpayer's combined report. (Cal; Admin. Code, tit. 18, reg. 25137-1, subd. (f) (art. 2.5).) This, of course, is the regulation which respondent has applied in this case. Appellant contends, however, that this regulation is invalid as applied to partnerships where the taxpayer-partner does not have more than SO-percent control of the partnership. Appellant's position is based on its analysis of sections 25101-25105 and rests in large part upon the proposition that section 25102, rather than section 25101, provides the statutory authority for filing combined reports and that only corporations or other "persons" which satisfy the more-than-SO-percent ownership requirement of section 25105 may be combined.

It is well settled, however, that section 25101, not section 25102, constitutes the statutory authority for combined reports in the context of formula apportionment of the income of a multicorporate and multijurisdictional unitary business. (See, e.g., Edison

California Stores, Inc. v. McColgan, supra; Appeal of Revere Copper and Brass Incorporated, supra; Appeal of Douglas Furniture of California, Inc., supra.) Section 25102 and its companion sections, such as section 25105, are directed toward the problem of determining which one of a group of related entities is the proper source of particular items of income or deduction, while section 25101 is concerned with identifying the geographical source of the income of a unitary business. (See Appeal of Revere Copper and Brass Incorporated, supra.) Only the latter is at issue here. We conclude, therefore, that sections 25102 and 25105 are not applicable and that regulation 25137-1 does not conflict with them and is not invalid insofar as it provides for unitary combination of partnerships where the taxpayer owns less than a majority interest.

Disregarding the ownership question, then, the issue becomes whether the activities of the joint venture and appellant's activities constituted a unitary business under the established standards. On this issue, appellant has the burden of proving, by a preponderance of the evidence, that the unitary connections present were, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.) Appellant has not met its burden. The record shows that appellant's predecessor invested in the joint venture for the express purpose of securing a dependable source of supply for certain veneers to be used in its Oregon plywood operations. During the appeal years, the operation of appellant's unitary business was aided by substantial purchases of veneers from the joint venture. In addition, appellant purchased significant amounts of waste materials from the venture for use in making particleboard and as fuel. A substantial flow of goods and raw materials in this fashion is one of the hallmarks of a vertically integrated unitary enterprise. (See, e.g., Appeal of Nippondenso of Los Angeles, Inc.,, Cal. St. Bd. of Equal., Sept. 12, 1984; Appeal of Monsanto Company, Cal. St. Bd. of Equal., Nov. 6, 1970.) When coupled with the accounting services and insurance coverage appellant provided to the joint venture, these sales are certainly sufficient to establish the "flow of value" that is the prerequisite to a constitutionally acceptable finding of a unitary business. (See Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178 [77 L.Ed.2d 545](1983).

Appellant emphasizes two points in arguing that the necessary unitary connections were absent. First, appellant contends that our cases require controlling ownership over all the parts of a business which are combined in a single combined report, and that "control' over the joint venture rested with the Freres interests rather than with appellant. The cases cited, however, all involve corporations rather than partnerships or joint ventures . (See Appeal of Douglas Furniture of California, Inc., supra; Appeal of Taylor Topper, Inc., Cal. St. Bd. of Equal., Jan. 31, 1984; Appeal of Revere Copper and Brass Incorporated, supra.) The proper rule for partnership-type arrangements was set out in the Appeal of Albertson's, Inc., decided by this board on September 21, 1982, where we held that unitary combination does not require that a partner have control of the partnership that is combined. This holding followed from the fact that, unlike a corporate shareholder, only the partner's ownership interest in the partnership's income and apportionment factors may be combined, and that combination is proper even though that ownership interest is less than a majority interest.

Appellant's second contention is that the joint venture cannot be unitary unless it is *shown* to be directly connected with the portion of appellant's unitary business conducted in California. This position is contrary to a long line of cases beginning with the Appeal of Monsanto Company, supra, wherein we held that it is sufficient if the out-of-state operations in question are only indirectly connected with the specific portion of the unitary business carried on in California, and appellant requests that we reconsider these cases. We decline the invitation. In the first place, there is evidence of a direct connection in this case, since appellant's tax manager testified that appellant buys wood chips from the joint venture for use in appellant's paper-making operations, which are part of appellant's admitted unitary business and are carried on, in part, in California. In the second place, we do not agree that the Supreme Court's decisions in ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 [73 L.Ed.2d 787] (1982), and Container Corp. v. Franchise Tax Board, supra, support appellant's theory. As the court said in Container, the relationship between the in-state and out-of-state activities of the purported unitary business must simply amount to "some sharing or exchange of value not capable of precise identification or measurement - beyond the mere flow of funds arising out of a passive investment or a distinct business operation - which renders formula apportionment a reasonable method of taxation." (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 166.) In the present case, we have found an operational relationship between the joint venture and the rest of appellant's unitary business activities. Clearly, the joint venture was not merely a passive investment or distinct business operation whose only function was to serve as a source of funds to appellant.

We likewise disagree with appellant's contention that 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), requires that the Monsanto line of cases be overruled. Even if appellant is correct that the "other metals" were excluded from the unitary business only because they were not directly connected with Chase's copper-related activities in California, we do not believe that such a rationale would be consistent with the theory and holding of the California Supreme Court in Edison California Stores, Inc. v. McColgan, supra. In that case, the court sustained the application of the unitary combined report method to an entire group of corporations which had only one member doing business in California. The court nevertheless combined this California subsidiary with its out-of-state parent and all of the parent's other out-of-state subsidiaries, even though it was clear that the only unitary relationship between the California subsidiary and the parent's other subsidiaries was an indirect one through the parent. In our view, this decision continues to accurately reflect the law of this state and it suffices to dispose of appellant's argument.

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

Appeal of Willamette Industries, 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Willamette Industries, Inc., for refund of franchise tax in the amounts of $17,302.67 and $9,232.12 for the income years 1974 and 1975, respectively, be and the same is hereby sustained.

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