BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)	
ENVIROCAL, INC., ET AL.)	Nos. 84A-623, 84A-621, 84A-624, 84A-626, 84A-633, 84A-634, 84A-635, 84A-637, and 84A-636-VN

Appearances:

For Appellants: Glenn A. Smith
Attorney at Law

For Respondent: David Lew
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 protests of Envirocal, Inc., and subsidiaries against proposed assessments of additional franchise tax in the amounts and for the 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.

Appeals Of Envirocal, Inc., Et Al.

	Income Years Ended	Proposed Assessments
Envirocal, Inc.		
	g-30-81	$ 13,606
Bay Scenes Investments, Inc.		
	9-30-77	$ 200
	9-30-78	200
	9-30-79	-200
	g-30-80	19,289
Envirocom Data Services, Inc.		
	9-30-77	$ 4,501
	9-30-78	5,503
	9-30-79	5,507
	9-30-80	5,513
Foothill Disposal Co., Inc.		
	9-30-77	$ 11,184
	g-30-78	14,910
	9-30-79	17,365
	9-30-80	10,653
South Valley Refuse Disposal, Inc.		
	9-30-77	$ 5,223
	9-30-78	26,504
	9-30-79	13,236
	g-30-80	11,210
Stockton Scavenger Assn., Inc.		
	9-30-77	$ 200
	9-30-78	200
	9-30-79	200
	g-30-80	200
Sunco Investments, Inc.		
	g-30-77	$ 2,550
	9-30-78	11,748
	g-30-79	16,546
	9-30-80	11,306

Sunset Properties, Inc.	9-30-77	$ 7,723
	9-30-78	8,157
	9-30-79	7,400
	9-30-80	5,626
Sunset Scavenger Company	9-30-77	$ 37,802
	9-30-78	69,523
	9-30-79	122,475
	9-30-80	200

The issue presented for our decision is whether unity of ownership existed between Envitocal, Inc., and its Oregon subsidiary, Rogue Disposal Service, Inc., for the purposes of filing a combined report.

Envirbcal, Inc. (Envirocal or appellant), is a Delaware corporation which began doing business in this state in 1973. Its commercial domicile is located in San Franciso. Prior to and during the income years under review, appellant operated eight wholly owned California subsidiaries, all of which were engaged in the business of garbage collection and waste disposal in this state.

Sometime before January 1977, appellant was considering the acquisition of exactly 50 percent of the stock in Rogue Disposal Service, Inc. (Rogue), from one of that company's three shareholders., Appellant, however, was reluctant to purchase a noncontrolling interest in the company. Rogue was a closely held Oregon corporation engaged in garbage collection in Medford. Its other shareholders were Anthony J. Boitano and his spouse Ann who together owned the remaining 50 percent of the company's stock. Since he was in his seventies and approaching retirement, Hr. Boitano was allegedly desirous that appellant acquire a financial interest in Rogue and use its resources to transform the company into a modern, more profitable enterprise. In order to persuade appellant that it would be worth its while to proceed with the stock purchase, Mr. Boitano allegedly agreed orally to assume a less active role in the company and allow appellant to manage Rogue's operations.

On January 14, 1977, appellant purchased 50 percent of the stock in Rogue for $750,000 from the third shareholder. Mr. Boitano remained president and a director of Rogue but voluntarily relegated himself to doing public relations work for the company and attending directors' meetings. The general manager of Rogue also retained his executive and directorship positions, but as appellant's employee, and subsequently became a shareholder himself in Envirocal as was customary under appellant's bylaws. The third member of Rogue's board of directors was the president and later the vice president of Envirocal.

On purchase of the stock in Rogue, appellant contends that it proceeded to review the various functions of the Oregon corporation and make major changes to its operations. During the appeal years, appellant alleges that it redesigned Rogue's collection process, introduced front-loading garbage trucks and other modern equipment; monitored finances and expenditures, introduced intercompany leasing and purchasing of equipment, provided financing for major purchases, instituted new accounting. procedures and a computer system, included Rogue in Envirocal's insurance and employees' benefit plans, and handled Rogue's rate applications, audits, and labor negotiations. It is appellant's position in this appeal that it managed Rogue much like one of its wholly owned subsidiaries. For these management and administrative services, Rogue paid. appellant an annual management-consulting fee of $34,400.

For the 1977 through 1980 income years, appellant and its eight California subsidiaries filed their franchise tax returns on the basis of a combined report using the standard three-factor apportionment formula to determine their California income. The combined report included the operations of Rogue. On audit, the Franchise Tax Board determined that appellant did not own more than SO percent of the stock in the out-of-state corporation, Rogue, and concluded that appellant and its affiliated corporations were not engaged in a unitary business deriving income from both within and without California. In other words, the Franchise Tax Board takes the position that, even if all the allegations made by appellant are true, the taxpayer still fails because no unity of ownership exists. Respohdent therefore denied appellant's use of combined-reporting procedures and redetermined the California tax liabilities of the Envirocal group of corporations on the basis of separate accounting. Pot the income year ended September 30, 1981, respondent allowed appellant and its in;-state subsidiaries to file a combined report pursuant to section 25101.15 but did not allow Rogue to be included in that report.2/ The proposed deficiency assessments thus arise

2/ For income years beginning on or after January 1, 1980, section 25101.15 allows taxpayers to use combined reporting procedures if their income is derived solely from 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.

from respondent's disallowance of the use of combined reporting by appellant due to the absence of unity of ownership between appellant and Rogue..

When a taxpayer derives income from sources both within and wit-hout California, its franchise tax liability will be nsasured 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 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 unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 (18[illegible] (1941); see also Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).)

The California Supreme Court has set forth two alternative tests to determine whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal.2d 664 (111 P.2d 334] (1941), affd., 15 U.S. 501 [86 L.Ed. 9911 (1942), the court held that the unitary nature of a business is 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. The court subsequently added that a business is unitary if the operation of the business done within this state 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.) Unity of ownership is implicitly a requirement under the contribution or dependency test as well. (Appeal of Revere Copper and Brass Incorporated, Cal. St. Bd. of Equal., July 26 1977.) Therefore, a showing of the requisite degree of common' ownership is a necessary prerequisite to a determination that a business is unitary. (Container Corp. v. Franchise Tax Roard, 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), affd., 463 U.S. 159 [77 L.Ed.2d 545, 562] (1983).)

In Appeal of Revere Copper and Brass Incorporated, supra, this board set forth the standard for unity of ownership:

> The ownership requirement contemplates an element of controlling ownership over all parts of the business; the lack of controlling ownership standing alone requires separate treatment regardless of how closely the business activities are otherwise integrated . . . . Generally speaking, controlling ownership can only be

> established by common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock.

(Emphasis added.)

The element of 'controlling ownership" over the entire business is fundamental in the case of affiliated corporations, because if such corporations are found to be engaged in a unitary business, all the income and apportionment factors of each corporation are combined to determine their California taxable income. (Appeal of Albertson's, Inc., Cal. St. Bd. of Equal., Sept. 21, 1982.)

Subsequently, in Appeal of Douglas Furniture of California, Inc., decided on January 31 1984, we further delineated the outlines of the ownership requirement:

> The basic test to be met is that of controlling ownership over all parts of the business, In order to ensure that two or more corporations are appropriately treated as a single integrated enterprise, the controlling ownership must be held by one individual or entity. If no one individual or entity holds controlling ownership of all the corporations involved, there is no assurance that the corporations will be operated as a unit, and the requirement of controlling ownership over all parts of the business is not met.

We thus set out in Douglas Furniture a 'bright-line' test for unity of ownership, holding that unity of ownership does not exist unless controlling ownership of all involved corporations is held by one individual or entity.

In the present matter, appellant has cited Appeal of Signal Oil and Gas Company, decided by this board on September 14, 1970 for the proposition that Controlling Ownership can exist in the absence of majority stock ownership. In Signal Oil, the taxpayer sought to include in its unitary business a foreign corporation (Interaero) in which its wholly owned subsidiary (GISA) owned 50 percent of the common stock. The other 50 percent of Interaero stock was owned'by an individual, Hans Liebherr. The taxpayer showed that, when Interaeto became close to insolvency and Liebherr wanted to resign his managerial post and dispose of his stock, certain operating agreements were entered *into* by the taxpayer, GISA, Interaero, and Liebherr so that the taxpayer and GISA could continue-the operations of fnteraero and keep Liebherr as *an* owner of the company. Under these agreements, GISA was ostensibly granted control of Interaero activities and appointed an additional manager to direct its operations. Liebherr agreed to perform public relations services for the company and relinquish his interest-in the operational control of Interaero in exchange for which he received a commission based on the sales of the taxpayer of Interaero. We concluded in Signal Oil that the operating agreements, when coupled with GISA's SO-percent stock ownership, gave GISA controlling ownershhip over Interaero; therefore, unity of ownership existed and Interaero should have been included in the unitary business.

Here, appellant takes the position that the oral agreement it entered into with Mr. Boitano to facilitate its purchase of the Rogue stock gave it operational control of the Oregon corporation; Appellant has submitted two letters signed by the Boitanos evidencing the oral agreement which state that they agreed to let Envirocal manage Rogue and that they transferred their voting rights as SO-percent shareholders and directors of Rogue to Envirocal's representative on the board. Appellant points out that Mr. Boitano, like the individual co-owner in Signal Oil, then assumed a public relations position for the company which paid him an annual salary. Pursuant to the agreement, appellant argues, Envirocal took over the management of Rogue and effected major changes to its garbage collection activities which demonstrate that it, in fact, controlled the operations of the Oregon subsidiary during the appeal years. Appellant therefore contends that by virtue of this agreement and its SO-percent stock ownership, it had, like the taxpayer in Signal Oil, controlling ownership over the foreign corporation, Rogue, and satisfied the unity of ownership requirement.

Appellant's reliance on Appeal of Signal Oil and Gas Company, supra, while not erroneous since that decision has not been formally overruled, is untenable in light of our subsequent decisions regarding controlling ownership in Revere Copper and Douglas Furniture. The opinions in Signal Oil and in the companion case decided the same day, Appeal of Shaffer Rentals, Inc., looked to sections 24725 and 25102 and the federal counterpart to those provisions, Internal Revenue Code (I.R.C.) section 482, for guidance to define unity of ownership. These statutes give the California and federal taxing agencies the authority to allocate gross income or deductions among affiliated taxable entities to clearly reflect their income, and their statutory scope is defined in terms of taxable entities "owned or controlled directly or indirectly by the same interests . . . . . Signal Oil and Shaffer Rentals employed a concept of control which was based on federal case interpretations of similar language found in I.R.C. section 482.

In Revere Copper, this board criticized the analysis in Signal Oil and Shaffer Rentals, citing the well-settled principle that section 25101, not section 25102, constitutes the statutory authority for formula apportionment of the net income of a unitary business where corporations are included in a combined report. (See Edison California Stores, Inc. v. McColgan, supra; Appeal of Warner Bros. Pictures, Inc., Cal. St. Bd. of Equal., May 5, 1969.) We observed that sections 24725 and 25102 are concerned with determining which one of a group of related entities is the proper source of income or deductions whereas section 25101 deals with the method for determining the geographical source of the net income of a unitary business conducted within and without California. Because of the basic difference between section 25101 on one hand and sections 24725, 25102, and I.R.C. section 482 on the other, we opined in Revere Copper that the interpretations of the latter sections were not authoritative in deciding whether unity of ownership existed and rejected the argument that majority stock ownership was unnecessary if it were shown that a 50-percent owner had control over the corporation. We held that the taxpayer who owned 50 percent of the stock in the subject corporation did not have controlling ownership. Subsequently, in Douglas Furniture, we reiterated that sections 24725 and 25102 were irrelevant in determining the existence of unity of ownership and overruled the decision in Shaffer Rentals.

Based on our discussions in Revere Copper and Douglas Furniture regarding the proper statutory authority for the formula apportionment of the business income of a unitary business, we believe that our decision in Signal Oil must be similarly overruled to eliminate any further uncertainty about the proper standard for unity of ownership. As we stated in Revere Copper, unity of ownership requires controlling ownership which can only be established by common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock. In the instant case, since appellant owned exactly 50 percent of the stock in Rogue, it is clear that it did not have controlling ownership of the Oregon corporation during the appeal years notwithstanding its oral agreement with the other 50-percent shareholder and any changes that it made to Rogue's operations pursuant to said agreement. Accordingly, we hold that unity of ownership did not exist between appellant and its out-of-state subsidiary, and appellant and its California subsidiaries were therefore not entitled to file a combined report as a unitary business. Respondent's action is sustained.

Appeals of Envirocal, Inc., Et Al.

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 protests of Envirocal, Inc., et al. against proposed assessments of additional franchise tax in the amounts and for the years as follow:

	Income Years Ended	Proposed Assessments
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Sunset Scavenger Company

9-30-77	$ 37,802
9-30-78	69,523
9-30-79	122,475
9-30-80	200

be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of November 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Carpenter, Hr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

Paul Carpenter, Member

Conway H. Collis, Member

John Davies* **, Member

_______________. Member

*For Gray Davis, per Government Code section 7.9

**Abstained