BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81N-1021-SS
CAPITOL INDUSTRIES-EMI, INC.)

Appearances:

For Appellant: Valentine Brookes and
Lawrence V. Brookes
Attorneys at Law

For Respondent: Michael E. Brownell
Counsel

OP IN I ON

This appeal is made pursuant to sections 25666[1]/ and 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Capitol Industries-EMI, Inc., against proposed assessments of additional franchise tax in the amounts of $42,171, $118,946, $207,678, and $75,527 for the income years ended June 30, 1968, June 30, 1969, June 30, 1970, and June 30, 1972, respectively, and on the claim for refund of franchise tax in the amount of $30,465 for the income year ended June 30, 1973.

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.

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The issues presented for our decision are (1) whether appellant, Capitol Industries-EMI, Inc., was engaged in a single unitary music business with its British parent company, EMI, Ltd., and other EM1 subsidiaries: (2) whether combining a domestic corporate subsidiary with its foreign parent violates the federal constitution: and (3) whether the United States and United Kingdom Income Tax Convention or international law prohibits combined reporting involving a foreign parent corporation.

I

Unitary Business

During the appeal years, appellant was a California-headquartered corporation which owned, directly or indirectly, corporations engaged in production and sales of recorded music, sheet music and blank audio tape. Its principal subsidiary is Capitol Records, Inc. (Capitol), a major competitor in the recorded music industry, engaged in production, promotion and sale of recorded music.

In 1955, before the formation of appellant, Capitol was purchased b-y EMI, Limited (hereinafter EMI), Great Britain's leading record company which was undergoing serious economic distress. Licensing agreements with EMI's suppliers of American repertoire, CBS and RCA, had either terminated or were about to expire. EMI acquired approximately 96.4 percent of the stock of Capitol in order, apparently, to gain secure access to its American repertoire and market. The success of Capitol's recording artists, especially Frank Sinatra and Nat 'King Cole, was an important factor in revitalizing the troubled EMI. As EM1 described it, the success of Capitol provided the profit necessary to pay for the closing down of some of its inefficient manufacturing operations.

By 1968, EMI's interest in Capitol had increased to 98 percent. In that year, Capitol merged with Audio Devices, Inc., a manufacturer of recording and computer tape, to form appellant, Capitol Industries, Inc., essentially a management holding company. After the merger, EM1 owned 68.8 percent of appellant, and by 1973, EMI's ownership share increased to 70.84 percent. In 1972, appellant changed its name from Capitol Industries, Inc., to Capitol Industries-EMI, Inc. By 1978, EMI owned "substantially 100%" of appellant's stock.

During the appeal years, most of the intercompany transactions between appellant and EM1 were accomplished by means of "matrices" or master recordings acquired through the 1956 and successor "matrix" agreements between Capitol and EMI.

These were reciprocal agreements providing that one company had the right of first refusal to manufacture and distribute records from any master recordings produced by the other's patented process, paying a standard premium or royalty fee.

Appellant itself owned and controlled a number of subsidiaries which were engaged in various aspects of the recorded music industry. All members of this corporate group have filed a combined report, and their unity is uncontested in this appeal.

EM1 also owned and controlled a large number of subsidiaries throughout the world. Whereas EMI's United Kingdom subsidiaries were engaged in a diverse range of industries, including defense-related electronics, EMI's non-U.K. subsidiaries were primarily engaged in the record, magnetic tape and music publishing businesses.

Although appellant filed combined reports for the appeal years of all income of its own subsidiaries, it did not include the operations of its parent, EMI, or EMI's other subsidiaries. After completing its audit, the Franchise Tax Board (FTB or respondent) determined that appellant and its subsidiaries were engaged in a single unitary business with EMI and EMI's subsidiaries and recalculated appellant's California income using combined reporting procedures for the entire worldwide operations of EM1 and its subsidiaries. After consideration of appellant's protest, respondent revised its Notices of Additional Tax Proposed to be Assessed (NPA's) to allow combination of only the music-related- operations of EMI. While in protest, appellant also filed a formal section 25137 petition with respondent, which was denied. Appellant then paid the deficiency for the appeal year ended June 30, 1973, and filed a claim for refund, which was also denied. This appeal followed.

When a taxpayer derives income from sources both within and without California, its franchise tax liability will be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the 'income attributatle 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 California Supreme Court has set forth two tests to determine whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334](1941), affd., 315 U.S. 501 [86 L.Ed. 9911 (1942), the court held that the unitary

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nature of a business may be 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., supra, 30 Cal.2d at 481.) More recently, the United States Supreme Court has emphasized the necessity that affiliated corporations of a unitary group form a functionally integrated enterprise (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 179 [77 L.Ed.2d 545], reh. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983)), in which factors of profitability arise from the operation of the business as a whole. (F. W. Woolworth co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 [73 L.Ed.2d 819] (1982).)

Respondent's determination that appellant was engaged in a single unitary business with affiliated corporations is presumptively correct, and appellant bears the burden of proving that the determination is erroneous. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.) Each appeal must be decided on its own particular facts and no one factor is controlling (Container Corp. of America v. Franchise Tax Board,, supra, 463 U.S. at 178, but respondent's regulations impose a "strong presumption" of unity where the companies are engaged in the "same type of business" or "in different steps in a large, vertically structured enterprise ... regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices ." (Cal. Code Regs.,' tit. 18, reg. 25120; subd. (b)).

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, functionally integrated economic enterprise did not exist. (See Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

In the present matter, respondent has focused on the contribution or dependency test to support its finding that EMI, appellant, and the other EM1 music industry subsidiaries were engaged in a single unitary business. Appellant argues that, other than unity of ownership, which it concedes was present, none of the unitary factors relied on by respondent existed

during the income years under appeal. Based on the record in this appeal, we are compelled to agree with respondent.

Upon examination of the numerous submissions, exhibits, and transcripts in this voluminous record, we are persuaded that the factors cited by respondent, as well as some additional factors established by appellant's own corporate submissions and reports, are substantial indicators that appellant, its subsidiaries, its parent, and some of its parent's subsidiaries constituted a unitary music business during the appeal years. The factors which we find significant are the following:

(1) matrix agreements providing exclusive first option rights to reproduction and distribution of each other's repertoire, accompanied by consultation and exchange of information to avoid duplication;

(2) substantial intercompany sales and exclusive marketing arrangements between Capitol and EMI's foreign subsidiaries;

(3) transfer of key company personnel from EM1 to Capitol, such as Bhaskar Menon, Graham Powell, and Mike Allen, and from Capitol to EMI, pursuant to company policy;

(4) the presence of at least three top EMI directors on appellant's board;

(5) joint use of several key labels (i.e., Apple and Angel) and appellant's adoption of the EMI name:

(6) the apparent importance to EM1 of an international image, necessitating access to the North American market and repertoire, facilitated by the relationship with appellant:

(7) substantial parent financing of appellant and subsequent conversion of a $10 million debt to stock ownership, all in furtherance of the operational function of expanding overseas operations and ensuring access to the overseas market and repertoire;

(8) mutual international promotion of repertoire by both appellant and EMI;

(9) evidence of extensive exercise of parental control on such key issues as distribution of Beatles music and the 1972 restructuring and rehabilitation of Capitol.

Appellant notes that Capitol is solely responsible for developing its own artists and repertoire and is free, under the matrix exchange agreement with EMI, to accept or reject the EM1 matrices. However, appellant does not contest respondent's estimate of a substantial percentage of profits for both companies generated by the matrix agreements.21

Also unpersuasive is appellant's argument with respect to its classical recordings. Appellant concedes a dramatic decline in self-produced classical recordings in the 30 years since the purchase by EM1 (from approximately 450 between 1950 and 1965 to 125 between 1970 and the present). Moreover, appellant's claim to have control over the creation, production and marketing of classical recordings on the Angel label conflicts with its characterization of Angel, in its brief to this board, as a tool of EM1 "for penetration of the American market", which EM1 conveyed to Capitol only as an "administrative convenience."

2/ From the data gleaned by respondent from the record in this case, respondent estimates that sales of Capitol artists by EMI represented approximately 20-25 percent of all of EMI's music (records, tape, publishing and instruments) sales worldwide for the last two appeal years, and that EM1 sold over $3 million of Capitol artists' records in the U.K. alone during the first two appeal years. In 1970, EM1 and its subsidiaries made total worldwide record sales of Capitol artists of over $8 million. Capitol's use of EMI's artists was especially heavy during the first three appeal years due to the success of the Beatles, although the exact number of record units of EMI artists sold during these years is not contained in the record before us. For the fiscal year ended June 30, 1970, the Beatles contributed 27.3 percent of the total gross profit of appellant and its subsidiaries for all lines of business, and for the combined fiscal years ended in 1971 and 1972, 20 percent of Capitol's gross record sales was attributable to EM1 artists. Finally, sales of Apple records (including the Beatles and other Apple artists) in the last two appeal years produced 45 percent and 49 percent, respectively, of appellant's gross profit.

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The FTB estimated sales of classical music from EM1 matrices as averaging 8.3 percent of "original price sales" during the appeal years. We note that appellant has also conceded in correspondence to respondent that "without [the EM1 classical matrices] Capitol might not have been able to afford the decision to reduce its own 'classical music line and rely entirely upon EMI's library of classical recordings." (Resp. Br., Ex. GG at 8.)

The annual reports of both appellant and EMI provide more than enough evidence that a significantly interdependent relationship existed between the parent and its American subsidiary as early as 1968. In 1967 and 1968, EM1 loaned $10,000,000 to Capitol to finance overseas expansion. The loans were then converted into Capitol common stock in 1969. EMI described its four main overseas operations - U.S. (i.e., appellant), Australia, Europe, Rest of the World, as "providing the means of effecting improved co-ordination of our various international activities." (Resp. Br., Ex. J.) According to the 1969 EM1 Chairman's Report and Accounts, all four of these "main operations" were supported by "Group Central Staffs--including our International Record Services ... based in London." In 1970, central coordination of the four operations was improved, with an International Management Team "concentrating upon the appointment of experienced men to key. executive positions." (Resp. Br., Ex. J.) The events of 1'971 and 1972, when EMI rescued appellant from a serious financial setback caused largely by the recession and the breakup of the Beatles, provide the most dramatic illustration of the interdependency of the two companies. Glenn Wallichs, one of the major Capitol shareholders before its acquisition by EM1 and its president from the time of the acquisition until his death in 1971, recruited former EM1 executive and International Service Director, Bhaskar Menon, to head the company. According to Menon, Wallichs then followed the EM1 protocol of asking permission of the EM1 board to transfer Menon to Capitol in order to resuscitate it. Menon was appointed president of Capitol and president and chief executive officer of appellant. He called EMI two to three times per week when he began the job at Capitol, discussing "operational and other matters," and traveled back and forth to London three to four times a year from 1972 through 1976. (App. Br., Ex. G.) Menon and two other "key appointments" from EM1 "restructured" and "drastically overhauled" Capitol's management and reduced its excessive reliance on the Beatles. (Resp. Br., Ex. C, E and L.) The control exerted by EM1 over Capitol and appellant is further evidenced by sworn testimony of Charles Phipps, general manager of appellant's international division from 1969-70 and Special Assistant to Menon in 1972, and by the description in EMI's 75th

Anniversary Publication of the "dovetailing of efforts" of EM1 and its overseas affiliates, including appellant, and of the pressure imposed by EM1 on Capitol to produce the music of the Beatles. (Resp. Br., Ex. A.) 3/

Appellant is in the same line of business with EM1 and its music industry subsidiaries--namely recording and record sales, production of sheet music and audio tape--and, through the matrix 'agreements, is involved in a vertically (although reciprocally) integrated production structure. The mutual benefit derived from the matrix agreement is analogous to the intercompany transactions and economies of scale found to be such significant indicators of unity in so many cases. (See, e.g., Appeal of Automated Building Components, Inc., Cal. St. Bd. of Equal., June 22, 1976; Appeal of Anchor Hocking Glass Corp., Cal. St. Bd. of Equal ., Aug. 7, 1967.) The fact that the matrix agreements were standard industry agreements "does not detract from their importance as a unitary factor." (Appeal of Coachmen Industries, Inc., Cal. St. Bd. of Equal., Dec. 3, 1985.) In addition to the general matrix agreement between EM1 and Capitol, a contract between the Beatles and EM1 provided that Apple Records was required to utilize appellant's manufacturing and distribution services. The phenomenal success of the Beatles in the North American market and the devastating effect of their break-up forced appellant and EM1 into a particularly dependent relationship and strengthened the indicia of unity by increasing the degree of exchange and integration of executive forces.

Appellant argues that the United States Supreme Court decisions of ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307

3/ Appellant objects to the admission of both of these sources on the grounds that they are hearsay. 'However, hearsay is admissible in our proceedings "if it is the sort of evidence upon which responsible persons are accustomed to rely in the conduct of serious affairs." (Cal. Code Regs., tit. 18, reg. 5035, subd. (c).) In our view, the 1973 Billboard "advertorial" and sworn testimony of a high-ranking company official are precisely the kind of evidence intended to be admitted under the regulations. Despite ample opportunity, appellant has failed to introduce any evidence in substantial conflict with the assertions in either source. Moreover, contrary to appellant's assertions, the transcript in the Cadena case (Cadena v. Capitol Industries, Inc., et al., C 79-2145 (CBR), N.D. Cal.), does not establish that the Phipps testimony was discredited by the judge.

[73 L.Ed.2d 787] (1982), and F. W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico, 458 U.S. 354 [73 L.Ed.2d 819] (1982), support its claim to be a "discrete business enterprise", not unitary with its British parent. Both cases bear crucial distinction from the instant case. The management agreement limiting control of the majority shareholder in ASARCO flavors the court's treatment of all additional indicia of unity. The chain retailing companies involved in Woolworth were not integrated at an operational or functional level, and there was no centralization of management, despite the potential for the parent to operate the company as part of a unitary business. The Supreme Court decision most apposite to the fact pattern at issue is Container Corp. v. Franchise Tax Board, supra, where the subsidiaries were in the same line of business and vertically integrated with the parent, but were operated autonomously primarily by local executives and personnel. As in the case of appellant, the relatively "hands off attitude" displayed by the parent in Container reflected the group's organizational structure as well as the industry's inherent sensitivity to local differences in consumer habits and taste. (See Container Corp. v. FTB, supra, 463 U.S. at 172, fn. 8.) The local difference factor is even more apparent in the music industry than. in the paper industry of Container. The factors that the Container court found to be of unitary significance-are also present in the instant case, although manifested in different forms because of the differences in the paper and music industries. The significance of EMI's 1968 loan to appellant is magnified by the 1972 rescue strategy accomplished by Bhaskar Menon and other EM1 "secondments", to use Menon's own term. (App. Br., Ex. G.) The parent's contribution of technical advice-and the consultation and assistance in procuring equipment which occurred in Container is paralleled in the instant case by both a contribution and dependency relationship between EM1 and appellant, fostered primarily by the matrix exchange agreements. Contrary to appellant's argument that the unitary significance of the matrix agreements is vitiated by their reciprocity, we believe that a mutually beneficial relationship is even stronger evidence of unity than simple contribution or dependency.

Appellant also cites to two decisions of this board in support of its contention that it is not unitary with EMI. However, as appellant itself points out, the relatively autonomous relationship of the parents and subsidiaries in Appeal of Scholl, Inc., decided by this board on September 27, 1978, and Appeal of Mohasco, decided by this board on October 14, 1982, was unmitigated by any arrangement even approaching the importance of the matrix exchange agreements.

II

Foreign Commerce Clause

Appellant argues that respondent's use of combined reporting and formula apportionment for unitary businesses with foreign parents violates the foreign commerce clause of the United States Constitution. Essentially, then, appellant is requesting this board to refuse to enforce the Revenue and Taxation Code provisions relating to unitary businesses on the ground that they are unconstitutional. As we stated in Appeal of Aimor Corp., decided by this board on October 26, 1983, because article III, section 3.5 of the California Constitution precludes us from determining that the statutory provisions are unconstitutional, we cannot decide constitutional issues.[4/] Furthermore, this board has a well-established policy of abstention from deciding constitutional issues in an appeal involving proposed assessments of additional tax. (Appeal of New Home Sewing Machine Company, supra; Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.) This policy is based on the absence of any specific statutory authority which would allow the Franchise Tax Board to obtain judicial review of a decision in such cases and our belief that judicial review should be available for questions of constitutional law. Therefore, at least with respect to the first four appeal years, we would abstain from deciding the constitutional issue, regardless of our interpretation of article III, section 3.5.

III

The U.S. - U.K. Tax Treaty and International Law

Appellant argues that the unitary method employed by respondent violates the U.S. - U.K. Income Tax Convention and international law. As noted by the Ninth Circuit in EMI Limited v. William Bennett, et al., 738 F.2d 994, 998 (1984), "the treaty by its explicit terms does not even cover taxes

4/ Article III, section 3.5 of the California Constitution provides, in pertinent part:

> An administrative agency ... has no power:
>
> (a) To declare a statute unenforceable, or refuse to enforce a statute on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional.

imposed by a state. [footnote omitted.]" Given appellant's presumed familiarity with that decision, its argument to this board can only be characterized as frivolous.

Also without merit is appellant's argument that unitary combination violates international law by violation of the international custom of arm's-length accounting. As the Container court noted, "taxation is in reality of local rather than international concern" (Container Corp. v. FTB, supra, 463 U.S. at 196), especially when the tax is being imposed on a corporation headquartered in California.

Conclusion

Similarity in the lines of business and overlap of officers and/or directors leads almost inevitably to the conclusion that a mutually beneficial exchange of knowledge occurred between two entities. (Appeal of A. M. Castle & Co., 89-SBE-005, Mar. 2, 1989.) Where, as here, contribution and dependency is so well established by virtue of a formal arrangement such as the matrix exchange agreements, the conclusion is foregone. Appellant's attempt to convey significance upon the many small ways in which it diverges from the classic model of vertical or horizontal integration is insufficient to carry its burden of proof.

Accordingly, the action of the FTB must be sustained.

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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 sections 25667 and 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Capitol Industries-EMI, Inc., against proposed assessments of additional franc.hise tax in the amounts of $42,171, $118,946, $207,678 and $75,527 for the income years ended June 30, 1968, June 30, 1969, June 30, 1970, and June 30, 1972, respectively, and on the claim for refund of franchise tax in the amount of $30,465 for the income year ended June 30, 1973, be and the same is hereby' sustained.

Done at Sacramento, California, this 31st day of October,' 1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis, Member

Ernest J. Dronenberg, Jr., Member

John Davies*, **, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

**Abstained