

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
THE SIGNAL COMPANIES, INC.) No. 86A-1469-MW

Appearances:

For Appellant: Paul H. Brownstein
Tax Counsel

For Respondent: Paul Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 25666¹/₁ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of The Signal Companies, Inc., against a proposed assessment of additional franchise tax in the amount of \$856,615 for the income year 1975.

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

Appeal of The Signal Companies, Inc.

The questions in this appeal are: 1) when did UOP, Inc. (UOP), become part of appellant's unitary business, and 2) if UOP became part of the unitary business before the end of 1975, were certain losses claimed by UOP as deductions for 1975 apportionable business losses?

During the year at issue, appellant was the parent of a group of diversified companies which were treated by both appellant and the Franchise Tax Board (FTB) as a single unitary business which filed a combined report. On May 1, 1975, appellant acquired a majority (50.5%) of the outstanding stock of UOP, a corporation engaged in commercialized research and development for the energy and environmental improvement markets. Through its Procon subsidiary, UOP was involved in the design, engineering, construction, and financing of oil refineries.

In June 1975, three of appellant's directors were appointed to UOP's board, and UOP's chairman was elected to Signal's board. In July, Signal directors formed a majority of UOP's directors. Signal directors also gained control of the most important UOP committees: Executive, Finance, Compensation, and Incentive Plan Administration. In October 1975, Mr. James V. Crawford was elected as president and CEO of UOP, replacing Mr. John O. Logan, who continued on solely as chairman, with minimal responsibilities. Mr. Crawford was formerly Senior Executive Vice President of The Garrett Corporation (Garrett), a wholly owned subsidiary of appellant. At the time of his election as president of UOP, he was also elected to the Signal board and its Executive Committee.

Appellant began a review of UOP's insurance coverage at least as early as June 1975, with an eye to streamlining and consolidating coverage with its own where feasible. When acquired, UOP had already arranged, through Lehman Brothers, a private placement of \$30 million of debt obligations. Within a few days after acquisition, Signal's Chief Financial Officer, Mr. Andrew J. Chitias, consulted with Lehman Brothers regarding the placement and in October 1975 the offering was abandoned at Signal's insistence. In May 1975, shortly after the acquisition, representatives of Garrett began meeting with people in UOP's Research Division to explore areas of mutual interest and research. Over the course of the year, UOP and Garrett exchanged technical and research information on several projects.

In September and October 1975, UOP's Signal-controlled board rejected two corporate acquisitions which had been planned by UOP's management before UOP was acquired by Signal. In October, the previously planned expansion of UOP's Chemical

Appeal of The Signal Companies, Inc.

Division was suspended and in December the planned relocation of that division was abandoned. The Signal-controlled board also refused to declare a fourth-quarter dividend for 1975 that had been recommended by UOP's management, caused the assets of UOP's Fragrances Group to be put up for sale in October, and caused the Forest Products Division to be put up for sale in December.

After acquisition by appellant, UOP was subject to appellant's reporting and centralized accounting rules and UOP was included in the central planning being done for the affiliated group by a task force set up by appellant. This task force considered many aspects of the group's business, including financing, environmental concerns, capital outlays, and resource allocation. UOP was subject, along with appellant's other subsidiaries, to the control and support of the Signal Board of Directors and its Executive Committee, Investment Committee, Audit Committee, and Stock Option and Executive Compensation Committee.

For the 1975 income year, appellant included UOP in its combined report as of the acquisition date, May 1, 1975. The FTB, while it agreed that UOP did, at some point, become unitary, it believed that UOP was not "instantly" unitary with appellant's unitary group. Rather, the FTB believed that some time passed during which the unitary ties between the companies developed. For want of any earlier clear demarkation time, the FTB treated UOP as unitary beginning on January 1, 1976.

More than \$34 million in losses claimed by UOP for the fourth quarter of 1975 were included in the combined report as apportionable business losses. Most of these losses arose out of the construction of a refinery in Newfoundland which was operated by Provincial Refining Company, Ltd. (Provincial), an unrelated customer. When it first arranged to construct the refinery, UOP agreed to guarantee certain debts of the refiner, a practice that appellant states is common in the industry. In the fourth quarter of 1975, the refiner, Provincial, went into receivership and UOP, in accordance with generally accepted accounting principles, accrued a liability on its books to reflect the fact that it might have to pay the debts of Provincial that it had guaranteed. It deducted this \$18 million reserve it had created. In the fourth quarter of 1975, UOP also determined that certain accounts receivable attributable to the refinery project might not be collected. Again in accordance with generally accepted accounting principles, UOP wrote off these receivables from its books and took a corresponding deduction in the amount of \$16 million.

Appeal of The Signal Companies, Inc.

Having determined that UOP was not unitary with appellant during any part of 1975, the FTB disallowed the treatment of the \$34 million loss as an apportionable business loss. Alternatively, the FTB argues that, if this board finds that UOP was part of the unitary business in 1975, the loss still cannot be a business loss because the transactions leading to the losses occurred prior to UOP's acquisition by appellant and, therefore, could not be considered part of unitary income and expense.

The first issue we must determine is whether UOP became unitary with appellant's unitary group before January 1, 1976. 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. 991] (1942), the court held that the unitary 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 later stated 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 California. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) More recently, the United States Supreme Court has emphasized that a unitary business is a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 [77 L.Ed.2d 545], rehg. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983)).

The Franchise Tax Board's determination regarding the existence or nonexistence of a unitary business is presumptively correct, and appellant bears the burden of showing that it is incorrect. (Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) To demonstrate the existence of a unitary business, it is necessary to do more than simply list circumstances which are labeled "unitary factors." There must be evidence that the affiliated entities form a functionally integrated enterprise, rather than merely a group of investments whose operations are unrelated. (Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.)

Appeal of The Signal Companies, Inc.

The FTB admits that UOP became unitary with appellant at some time, but argues that it was not instantly unitary on May 1, 1975, and appellant has shown no clear date on which unity was achieved during 1975. It concedes that unity existed on January 1, 1976, stating that "It appears from the facts that by that date most of the integrating ties urged by appellant were in place." (Resp. Reply Br. at 2.) Appellant argues that the factors resulting in integration necessary for a unitary business were put in place immediately upon appellant's acquisition of UOP, when it became subject to the control of appellant's board of directors and its several committees. Alternatively, appellant argues that UOP should be considered unitary at least by the last quarter of 1975, i.e., by October 1, 1975, since there were no real differences in the integrating ties between appellant and UOP at that date and at January 1, 1976, when the FTB concedes that unity existed.

We agree with appellant's alternative argument--that UOP was unitary with appellant during the last quarter of 1975. There was insufficient evidence of functional integration existing immediately upon appellant's acquisition of UOP for us to conclude that UOP was "instantly" unitary with appellant. While the potential existed as of that time simply because of appellant's majority ownership of UOP, the realization of that potential clearly developed over the months following acquisition. Appellant's review of UOP's operations and administration and its institution of changes, such as appellant's control over UOP's board and its committees; the consolidation, where feasible, of insurance coverage; and the exchange of technical information between UOP and Garrett; eventually resulted in the integration of UOP with the rest of the unitary group, as conceded by the FTB. This gradual exploration and institution of appropriate integrating ties between the companies, which apparently did not begin until acquisition, is in contrast to the situation we found in the Appeal of Atlas Hotels, Inc., et al., decided by this board on January 8, 1985. There we found that a subsidiary became "instantly unitary" with the parent's unitary business from the date of its acquisition where there was evidence that many of the managerial and operational changes which demonstrated the subsidiary's integration with its parent not only were implemented immediately upon acquisition, but were planned or commenced well before the actual acquisition date. No such evidence has been presented here.

While it is true, as the FTB argues, that the ties between the two companies developed over a period of several months and that there is no single event which established a specific date when functional integration occurred, it appears clear to us that all significant integrating factors upon which

Appeal of The Signal Companies, Inc.

the FTB based its conclusion that UOP was unitary with appellant as of January 1, 1976, were actually in existence by the beginning of the last quarter of 1975. Unity is almost never demonstrated by some single event, but is a conclusion drawn from the aggregation of connecting factors between entities. We find no basis for distinguishing between the unifying factors which existed at October 1, 1975, and those which existed at January 1, 1976. We believe that appellant's position on this issue is better supported by the facts and by logic than is that of the FTB. We conclude, therefore, that unity existed between UOP and appellant at least by October 1, 1975.

This brings us to the second question in this appeal: whether the losses deducted by UOP for 1975 in connection with its construction of the Newfoundland refinery were apportionable business losses. Resolution of this issue is governed by the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is contained in sections 25120-25139. Section 25120 defines apportionable business income as follows:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Nonbusiness income is defined simply as all income other than business income. (Rev. & Tax. Code, § 25120, subd. (d).)

Section 25120 provides two alternative tests to determine whether income constitutes business income. The first is the "transactional" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the regular course of the taxpayer's trade or business. Under the second, or "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of DPF Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980.) If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, supra; Appeal of Fairchild Industries, Inc., supra.) Respondent's determination as to the character of income to a

Appeal of The Signal Companies, Inc.

business under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983.)

The FTB argues that the losses cannot be business losses, even though UOP was part of the unitary business in 1975, because: 1) appellant has not demonstrated that the transactions leading to the losses fulfill either the transactional or functional tests for business income or loss, and 2) in any case, these tests cannot be applied because UOP was not part of appellant's unitary business when the transactions leading to the losses occurred, and those tests apply only in a unitary business situation.

As to the first argument, appellant has provided sufficient proof that it has consistently and accurately described the basis of the losses deducted, in spite of the FTB's vague and unsupported statements that the losses were merely an accounting device agreed to by appellant in its contract to purchase UOP. Appellant's description convinces us that the losses clearly arose in the regular course of UOP's trade or business. Part of the regular course of UOP's business was building oil refineries and the losses clearly arose in connection with UOP's construction of an oil refinery. Thus, the losses appear to fall squarely within the transactional test for business income or loss.

The FTB's second argument we find similarly unconvincing and, indeed, rather confusing. It mentions several times that UOP's obligations "accrued" before UOP was acquired by appellant. However, it also states that "appellant's arguments concerning accrual of obligations is [sic] irrelevant." (Resp. Reply Br. at 8.) We must assume that when respondent used the word "accrued" it used it loosely, in the sense of "arose," terminology which it appears to use interchangeably. It does not appear that the FTB actually disputes that the losses were properly accrued in the strict accounting and tax sense, in the last quarter of 1975. The crux of its argument appears to be simply that "the transactions which produced the losses occurred before UOP was acquired by appellant" (Resp. Reply Br. at 8-9.) Respondent fails, however, to elucidate the manner in which it makes the leap from that statement to the conclusion that the losses cannot be business income. It cites no authority whatsoever in support of its conclusion and we certainly can find none, either legal or logical.^{2/} We agree with appellant's statement that the tracing of deductions of every new member of a unitary group to their origins to determine their deductibility on a combined report is neither logical or workable, and, apparently, not applied by respondent

Appeal of The Signal Companies, Inc.

with respect to any other deductions of UOP for 1975 or 1976. Appellant's point is also well taken when it states that consistency would require that items of income would also need to be traced and we cannot imagine that that procedure would be workable or even palatable for the FTB.

The only conclusion we can reach is that appellant has provided sufficient evidence and argument, which the FTB has not attempted to contradict, to convince us that UOP was a part of appellant's unitary business at least as early as October 1, 1975, and that UOP properly accrued losses in that quarter that were properly characterized as apportionable business losses. The action of the Franchise Tax Board in this matter, therefore, must be reversed.

2/ This situation is unlike that of the recently decided Appeal of Willamette Industries, 89-SBE-008, decided by this board on March 2, 1989. In that appeal, we considered the question of whether certain dividends paid by an acquired subsidiary were includible in the parent's income in the year of distribution or whether they were excludible from the parent's income by virtue of section 25106. We agreed with the contention of the FTB in that case that dividends were excludible under section 25106 only if they were "paid out of business income generated in the course of the unitary business . . ." and not if they were paid from income earned by the corporation before it became part of the unitary business. Our agreement in that case, however, was founded on the particular language found in section 25106, which provides that exclusion is allowable only "to the extent such dividends are paid out of such income of such unitary business" No such particular language is before us here.

