90-SBE-015

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. **86R-1710-SS**
DR PEPPER BOTTLING COMPANY OF)
SOUTHERN CALIFORNIA, NATIONAL)
DRINKS LEASING CO., INC.,)
NATIONAL DRINKS BOTTLING CO.,)
INC.)

For Appellant: John M. Garrick,
Attorney at Law

For Respondent: Karl F. Munz
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 Dr Pepper Bottling Company of Southern California for refund of franchise tax in the amounts of $7,633.87, $27,674.00, and $40,644.72 for the income years 1973, 1974, and 1975, respectively; National Drinks Leasing Co., Inc.., for refund of franchise tax in the amounts of $83,623.00 and $57,647.00 for the income years 1977 and 1978, respectively; and National Drinks Bottling Co., Inc., for refund of franchise tax in the amounts of $441,493.42 and $187,819.01 for the income years 1977 and 1978, respectively.

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[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 issues presented by this appeal are the following:[2/]

(1) Whether National Drinks Leasing Company (NDL) proved that it was entitled to take additional depreciation on bottles and cans in 1977;

(2) Whether Dr Pepper Bottling Company of Southern California (DPSC) proved that the Franchise Tax Board (FTB or respondent) erred in adjusting its basis, as reported, in the stock of a subsidiary which was sold in 1975;

(3) Whether appellants have proved that they were not engaged in a unitary business with their parent, Dr Pepper Company (DPC), for the last two years at issue, 1977 and 1978;

(4) Whether appellants have proved that instant unity with DPC did not occur with the 1977 acquisition.

With respect to the first two issues, appellants have presented no evidence in rebuttal of respondent's determination. Because respondent's determinations are presumptively correct, appellants bear the burden of disproving them, and their failure to meet that burden compels us to sustain respondent's action on the first two issues. (Appeals of Lawrence S. and Joy A. Ames, Cal. St. Bd. of Equal., Feb. 28, 1984; Appeal of L. R. Smith, Cal. St. Bd. of Equal., Apr. 1, 1948.) The issue of unity, then, is the only issue to be discussed in this opinion.

Appellant DPSC is a California corporation which primarily produces, bottles, cans, and distributes soft drinks, including Dr Pepper, marketed mostly in Southern California. Appellants National Drinks Bottling Co., Inc. (NDB), and NDL are wholly owned subsidiaries of DPSC. NDB produced, bottled, and/or distributed a wide variety of soft drinks, including Dr Pepper, exclusively in Southern California. DPSC sold NDB in 1978.

[2/] Respondent has conceded that $82,840 in 1975 stock sales income should be apportioned as business income rather than characterized as California situs income. Appellant has not disputed the remaining adjustments made with respect to 1973 through 1975, impliedly conceding the correctness of the FTB's action for those income years.

On February 24, 1977, DPSC became a wholly owned subsidiary of DPC, a Colorado corporation headquartered in Dallas, Texas, which manufactures, markets, sells, and distributes nationwide soft drink concentrates and syrups, primarily Dr Pepper and sugar-free Dr Pepper. DPSC was a licensee of DPC for many years before the acquisition. Over 50 percent of its concentrate and syrup purchases were from DPC, and more than 50 percent of DPSC sales were of Dr Pepper soft drink products.

From 1971 until merger with DPSC, DPC filed its own unitary return incorporating its operations and the operations of its majority owned subsidiaries. Respondent contends that, as of the date on which DPC purchased DPSC, February 24, 1977, the two companies and their subsidiaries were engaged in a single unitary business and should have reported their income in a combined report for income years 1977 and 1978.

If a taxpayer derives income from sources both within and without California, its franchise tax liability is required to 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 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. McColsan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has held that the existence of a unitary business may be established by the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions; and unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColsan, 17 Cal.2d 664, [111 P.2d 3343 (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc., v. McColsan, supra, 30 Cal.2d at 481.) 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 Corn. 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).)

Appellants contend that because the intercompany sales by DPC to DPSC and its subsidiaries during 1976, 1977, and 1978 amounted to only one percent of **DPC's** total annual sales and about 9-13 percent of **DPSC's** total purchases, the flow of value between the two entities was **de minimus** and did not meet the requirement of **"quantitative** substantiality." However, appellants ignore the fact that a vertically integrated business enterprise has consistently been regarded as a classic example of a unitary business. (See John Deere Plow Co. v. Franchise Tax Board, 38 **Cal.2d** 214 **[238 P.2d 569] (1951),** app. dism. 343 U.S. 939 **[96 L.Ed. 1345]** (1952); see also Cal. Code Regs., reg 25120, **subd.(b)(2)**[3/].

3/ Regulation 25120, subdivision (b)(2) provides, in pertinent part, as follows:

> The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are intesrated with, **dependent upon** or contribute to each other and the **operations** of the **taxpayer** as a whole. The following factors are considered to be good indicia of a single trade of [sic] business, and the presence of any of these factors creates a strong presentation that the activities of the taxpayer constitute a single trade of [sic] business:
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> (2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, 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. (Emphasis added.)

In the instant case, the operations of DPC and DPSC are truly vertically integrated. DPSC could not get its trade name syrup from any source other than DPC, and DPSC provided an outlet for **DPC's** product. DPC provided an essential component for a product which made up a substantial part of **DPSC's** sales. The two companies are clearly in the same soft drink business. The fact that DPC maintained licensing agreements with 500 different bottlers, most of which were not company owned, does not diminish the unitary significance of the arrangement. (See **Appeal** of Capitol **Industries-EMI,** Inc., 89-SBE-029, Oct. 31, 1989; **Appeal** of Coachmen Industries of California. Inc., Cal. St. Bd. of Equal., Dec. 3, 1985.)

Appellants also argue that there was no difference in the relationship between the two companies before and after the acquisition other than unity of ownership, and unity of ownership, by itself, cannot compel a finding of unity. Although appellants are correct in their statement that unity of ownership alone does not compel a finding of unity, this is not a situation where ownership alone was involved. Rather, as we concluded above, the companies were a vertically integrated enterprise which, with the addition of unity of ownership, became a unitary business. Accordingly, we will sustain the **FTB's** determination of unity.

Appellants' final contention, based on selective and incomplete citation to respondent's audit technique manual, is that, even if they were found to be unitary with DPC, they were not obliged to file a combined report until the income year after the year of acquisition. In fact, the determining factor in choosing the time for a combined report is the date when sufficient unitary ties existed to support a finding of unity. (See Atlas Hotels, Inc. and Picnic **'N** Chicken, Inc., Cal. St. Bd. of Equal., Jan. 8, 1985.) We agree with the FTB that this occurred in the present case on the date of acquisition. A vertically integrated enterprise was preexisting here, needing only unity of. ownership to result in a unitary business. In addition, immediately upon acquisition, DPC replaced all of the DPSC officers and directors with its own people and dispatched its San Antonio plant manager, Roman Snyder, to California to

serve as the DPSC president. (See Atlas Hotels Inc. and Picnic 'N Chicken, Inc., supra.)

For the reasons set forth above, we have concluded that appellants and Dr Pepper Company and its other subsidiaries constituted a single integrated economic enterprise for which a combined report should have been filed beginning in the income year 1977. Respondent's action in this matter, then, must be sustained, subject to respondent's concession relating to the apportionment of $82,840 for 1975.

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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 section'26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Dr Pepper Bottling Company of Southern California for refund of franchise tax in the amounts of $7,633.87, $27,674.00, and $40,644.72, for income years 1973, 1974, and 1975, respectively; National Drinks Leasing Co., Inc., for refund of franchise tax in the amounts of $83,623.00 and $57,647.00 for income years 1977 and 1978, respectively; and National Drinks Bottling Co., Inc., for refund of franchise tax in the amounts of $441,493.42 and $187,819.01 for income years 1977 and 1978, respectively, be and the same is hereby sustained, subject to respondent's concession for 1975 as set forth in the foregoing opinion.

Done at Sacramento, California, this 5th day of December, 1990, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, and Mr. Davies present.

Conway H. Collis, Chairman

Ernest J. Dronenbura. Jr., Member

William M. Bennett, Member

John Davies*, Member

____________, Member

*For Gray Davis, per Government Code section 7.9