

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-90-SS
SCOVILL, INC.)

Appearances:

For Appellant: Robert Joe Hull
Attorney at Law

For Respondent: Donald C. McKenzie
Counsel

OPINION

This appeal is made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Scovill, Inc., against proposed assessments of additional franchise tax in the amounts of \$102,442, \$97,004, and \$16,981 for the income years 1974, 1975, and 1976, 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 by this appeal is whether appellant was engaged in a single unitary business with seven of its foreign subsidiaries. A unitary relationship between appellant and four additional foreign subsidiaries is not contested by appellant.

Appellant is a multidivisional conglomerate headquartered in Connecticut, engaged in manufacturing a variety of products in this country and abroad. Appellant's product lines may be divided into five categories: (1) housewares, including the Hamilton Beach line; (2) sewing notions, including apparel fasteners; (3) metal and industrial products; (4) home and hardware products, including doors and windows; and (5) automotive and fluid power products, including tire valves. Each category has its own division in the corporate structure, headed by its own vice president. During the appeal years, appellant operated hardware and houseware affiliates in this state.

The seven foreign subsidiaries at issue are two Australian companies (Schrader Australia and Scovill Australia Pty.), two Mexican companies (Scovill Mexicana and Cierres Ideal de Mexico), one French company (Schrader S. A.), one Brazilian company (Schrader Brazil), and one English company (Whitecroft Scovill Ltd.).

The subsidiaries fall into two distinct groups: (1) the three Schrader companies, which produced tire valves substantially similar to those produced by the domestic division, except for the French company which produced 50 to 55 percent of its valves for Michelin tires, pursuant to Michelin specifications; and (2) the Australian, Brazilian, and Mexican Scovill companies, including Cierres Ideal, a subsidiary of Scovill Mexicana, which primarily produced zippers and other apparel fasteners, and the English Scovill company which produced apparel fasteners and several office products.

On its combined reports for the income years 1974-1976, appellant reported the income of the divisions and companies located in the United States, but did not include the income from any foreign subsidiaries. On audit, the Franchise Tax Board (respondent) determined that all eleven of appellant's foreign subsidiaries should have been included in appellant's unitary business.^{2/}

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, its income attributable to California 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

^{2/} No question has been raised by either party in this case regarding the propriety of combining appellant's five different product lines into a single unitary business. Accordingly, nothing we say in this case should be regarded as either approval or disapproval of that method of filing in this particular case.

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, *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 Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 [77 L.Ed.2d 545], *reh. den.*, 464 U.S. 909 [78 L.Ed.2d 248] (1983).)

Unity of ownership, required under any of the tests cited above for unitary businesses, is clearly satisfied in this case because Scovill owned 99.6 to 100 percent of all but the two Mexican subsidiaries, of which it owned 57 percent. We believe that the facts also demonstrate sufficient mutual interdependence and flow of value between the parent and seven subsidiaries to establish an integrated economic enterprise or unitary business. (See Container Corp. v. Franchise Tax Board, *supra*, 463 U.S. at 178-179.)

Respondent contends that the information submitted by appellant in support of its claim that the foreign subsidiaries are merely a group of investments only serves to reinforce the impression of a "domestic multidivisional corporation attempting to expand the manufacturing and distribution of products throughout the world." (Resp. Reply Br. at 10.) Appellant, while conceding that its domestic and foreign subsidiaries produce the same or similar products, points to the managerial autonomy of the foreign subsidiaries, the relative lack of intercompany sales or financing, and the reliance on local suppliers and markets for most of their products to support its contention that they are merely investments. We believe that the truth lies somewhere in between these two views, but find sufficient unitary characteristics to affirm the action of respondent.

The difficulty with this case is that, to some extent, each of the seven subsidiaries at issue shares different unitary characteristics with appellant. There are, however, certain unitary features common to all: (1) over 50 percent of the stock of each subsidiary is owned by appellant, which retains sole authority to approve capital expenditures, major purchases and expansion of plant operations; (2) each subsidiary has as its major product an item or items produced by one of appellant's domestic subsidiaries and more than one of its other foreign subsidiaries; (3) each of the seven falls into one of the major divisions in appellant's corporate organizational chart headed by one of appellant's group vice presidents; (4) each of the seven is required to adhere to the parent's corporate standard practice manual (Tran., p. 29) and is responsible for submitting detailed financial reports and account analyses, on monthly, quarterly, semi-annual, and year-end bases, which are almost as extensive as the reporting required for domestic units.

Other significant unitary factors apply in varying degrees to link the different subsidiaries to their parent, and although these factors do not apply universally to all seven, they shed

considerable light on the general nature of the flow of value between appellant and its foreign subsidiaries. One of the most significant factors is appellant's provision of important technical services to its subsidiaries, as evidenced by the fact that all but one of the subsidiaries paid substantial amounts of "technical service fees" to appellant during each of the appeal years. In the case of the Brazilian, French, and Mexican companies, appellant seeks to minimize the unitary significance of these fees by characterizing at least some of them as disguised dividends. However, when questioned at the hearing before this board, Dick Richards, appellant's assistant to the executive vice president in charge of finance, conceded that the payments were intended to compensate appellant "to take care of any costs that we incurred that they should help us pay." (Tran., p. 18.) Although no technical service fees were reported as having been paid by the English subsidiary, Whitecroft Scovill concededly did make use of appellant's technology and trade names in its snap fastener production.

In addition to oversight by appellant's vice presidents, all but one of the subsidiaries had officers or directors of the parent on their boards of directors. Only Schrader Brazil had no Scovill personnel on its board, due to national legislation restricting the role of nonnationals on Brazilian boards of directors. Again, Richards' testimony that the subsidiaries adhered to Scovill's corporate standard practice manual belies appellant's claim that the foreign subsidiaries are no more than investments.

Further, inspection of appellant's shareholder and SEC reports reveals more examples of the flow of value between appellant and its foreign subsidiaries. Although several subsidiaries produced for a local market, only Cierres Ideal did not make use of appellant's trade names. Moreover, three of the seven subsidiaries were actually organized by Scovill, and Scovill technology and equipment were used by all but Cierres Ideal and the French Schrader and Australian Scovill companies. In one case, that of the Nygard zipper, appellant paid substantial royalties to its Australian Scovill subsidiary, which had developed and patented the zipper before acquisition by appellant. Appellant's shareholder reports highlight the importance of the Nygard zipper to appellant's international apparel fastener product line.

Additional evidence of integration is provided by appellant's own description of its operations in its reports to its shareholders and the Securities and Exchange Commission. In its Form 10-K submitted to the SEC for its fiscal year ended December 29, 1974, appellant stated "[e]ach of the foreign operations is under the management supervision of the domestic division producing the same line of product." (Emphasis added.) Evidence that appellant considered itself to be an integrated unitary operation also emerges from its annual reports to its shareholders which portray its foreign affiliates as part of a worldwide unified corporate network. International operations accounted for one-half of the group's total business, and the Schrader tire valve is touted as "used on all types of vehicles throughout the world," and used "interchangeably in any country where tires are produced." Appellant also reported that it had "expanded into new market areas through acquisitions and by establishing our own production facilities." A parent's own view of its operation as a unitary business is a relevant factor in making the unitary determination. (Container Corporation of America v. Franchise Tax Board, 117 Cal.App.3d 988, 1000 [173 Cal.Rptr. 121] (1981), *affd.*, 463 U.S. 159 [77 L.Ed.2d 545] (1983) hereinafter "Container.")

Appellant cites to F. W. Woolworth Co. v. Taxation and Rev. Dept., 458 U.S. 354 [73 L.Ed.2d 819] (1982), and Appeal of Mohasco Corporation, decided by this board on October 14, 1982, in support of its contention that its foreign subsidiaries were operating as "distinct business enterprise[s] at the level of full-time management." Aside from the differences in industries, the overlapping directorships and substantial technical assistance provided by appellant distinguish this case from those cited. Appellant's argument that the potential for beneficial exchange of know-how, information, and research is "less important in the context of a mature industry, such as Scovill's, than in a high-tech field" is not persuasive in light of the substantial royalty and technical service fee figures reported by appellant.

As in Container, our finding of unity rests not upon a flow of product between the corporations, but upon a flow of value. Where a parent and its subsidiaries engaged in the same or similar line of business have interlocking directors, supervision by group vice presidents, common use of trade names and patents, and substantial technical assistance, the fact that intercompany sales and financing are minimal does not suffice to defeat a finding of unity.

Appellant also contends that application of the unitary apportionment method results in unfair distortion of appellant's California income, in violation of the fairness requirement of the United States Constitution as set forth in Container. Like the appellant in Appeal of Coachmen Industries of California, Inc., decided by this board on December 3, 1985, appellant's allegation of distortion, based as it is on separate accounting figures,

'disregards the basic concept of a unitary income - namely, that the unitary income is the result of the function of the entire unitary business to which each element contributes.' (Chase Brass and Copper Co. v. Franchise Tax Board, 70 Cal.App.3d 457, 468-469 [138 Cal.Rptr. 901] (1977).)

As we stated in Appeal of Kikkoman International, Inc., decided by this board on June 29, 1982, "isolated comparisons which take into account less than the whole of the unitary business do nothing to show that formula apportionment does not fairly reflect the California portion of the activities of the entire unitary business."

In any event, we must decline to entertain constitutional issues in these proceedings. Section 3.5 of article III of the California Constitution prevents this board from determining that the statutory provisions of the Revenue and Taxation Code are unconstitutional or unenforceable. Moreover, 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, Cal. St. Bd. of Equal., Aug. 17, 1982; Appeal of Shachihata, Inc., U.S.A., Cal. St. Bd. of Equal., Jan. 9, 1979.) This policy is based upon 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 upon our belief that judicial review should be available for questions of constitutional importance.

For the reasons set forth above, we conclude that the respondent's action in this matter must be sustained.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Scovill, Inc., against proposed assessments of additional franchise tax in the amounts of \$102,442, \$97,004, and \$16,981 for the income years 1974, 1975, and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of May, 1991, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Bennett, and Mr. Dronenburg present.

Brad Sherman _____, Chairman

William M. Bennett _____, Member

Ernest J. Dronenburg, Jr. _____, Member

_____, Member

_____, Member