BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 85A-0075-MW
INSUL-8 CORPORATION	)	

Appearances:

For Appellant: Timothy A. Nelson
Senior Tax Manager
Peat Marwick Main

For Respondent Kathleen M. Morris
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[2/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Insul-8 Corporation against proposed assessments of additional franchise tax in the amounts of $6,458, $13,034, $11,111, and $11,128 for the income years 1975, 1976, 1977, and 1978, respectively.

[2/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year(s) in issue.

The question presented by this appeal is whether Delachaux Corporation (Delachaux), appellant's parent corporation, was engaged in a single unitary business with appellant and its subsidiaries during the appeal years.

Delachaux was incorporated in Delaware on June 1, 1975, and borrowed funds to purchase assets of a division of another company. Immediately, Delachaux transferred these assets to appellant, which had also been incorporated in Delaware and began doing business in California on that date. The parties agree that, during the appeal years, appellant and its subsidiaries were engaged in the single unitary business of manufacturing and selling electrical products. After its transfer of assets to appellant, Delachaux engaged in no activities, had no employees, and provided no financing for appellant or its subsidiaries. Appellant distributed funds from its operating profits to Delachaux which were used to make payments on the debt that Delachaux had incurred to purchase appellant's assets. Appellant at one point in the record refers to these transfers of funds as loans but provides no substantiation supporting this characterization. In addition, appellant states that it provided Delachaux with certain accounting and other services. Delachaux, appellant, and appellant's subsidiaries had overlapping officers and directors during the appeal years.

On audit, respondent excluded Delachaux from the unitary group consisting of appellant and its subsidiaries and from the combined report of that group. As a result, Delachaux's interest expense on the acquisition debt and deductions for taxes paid to Delaware were not able to be offset against the income of the unitary group consisting of appellant and its subsidiaries.

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. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has held that the existence of a unitary business is definitely 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. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed.991] (1942).) It has also held 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. 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], rehg. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983).)

Appellant contends that Delachaux was unitary with appellant and its subsidiaries because of centralized management, centralized services, and intercompany financing. The "centralized

management" to which appellant refers is no more than the commonality of officers and directors of the two corporations. To establish unity, more must be shown than the existence of common officers and directors, since this situation frequently exists whenever one corporation owns or is affiliated with another and it implies no more than "the type of occasional oversight . . . that any parent gives to an investment in a subsidiary . . . ." (F.W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 369 [73 L.Ed.2d 819] 1982); see also Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 180, n. 19.) In addition, with no operations in Delachaux to manage, it is meaningless to speak of centralized management. The only "common services" that appellant alleges were performed were the maintenance of Delachaux's internal accounting records (presumably the records of payments made on the acquisition debt) by appellant's accounting department; appellant's hiring of outside accounting firms to prepare consolidated financial statements and tax returns; and appellant's hiring of outside legal counsel for any required legal services.[3/] The same types of "factors" have been held to lack unitary significance (see F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 369, n. 22; Tenneco West, Inc. v. Franchise Tax Board, 234 Cal.App.3d 1510 [286 Cal.Rptr. 354] (1991); Appeal of Sierra Production Service, Inc., et al., 90-SBE-010 (Sept. 12, 1990)) because they, like interlocking officers and directors, are to be expected in any corporate common ownership situation and so do not serve to distinguish a corporate relationship as unitary.

Intercompany financing can be, as appellant says, an important indicator of unity. However, by itself it cannot support a finding of unity. The mere use of profits from one corporation to pay the debts of another does not indicate a unitary business, but merely the exercise of the rights of a corporate owner to manipulate the financial resources at its disposal. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S.at 166; F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 363-364.)

In the Appeal of Power-Line Sales, Inc., decided by this board on December 5, 1990, it was concluded that unity did not exist between a holding company parent corporation and its operating subsidiary, where the parent, after a "leveraged management buyout," had no paid employees and did not conduct any operations. The lack of employees and operations meant that there could be no centralized services or management functions or any of the other usual indicia of unity of operation. We went on to hold that, even if that appellant had shown that an integrated executive force, rather than just interlocking officers and directors, had existed, that would not be sufficient by itself to show the requisite contribution or dependency. Therefore, neither the "three unities" test nor the "contribution or dependency" test was met in Power-Line. The only relationship that appeared to be present in that case was, at most, that of a passive holding company's ownership of an investment. The relationship between appellant and Delachaux in the present appeal was essentially the same as that between the parent and subsidiary in Power-Line. The emphasis that appellant lays on the allegation that the "management" in this appeal flowed from the subsidiary to the holding company parent rather than vice versa is irrelevant. We see no reason to reach a different result in this case than we did in Power-Line.

[3/] There is no evidence in the record that appellant in fact hired any outside legal counsel during the appeal years.

Appellant's argument that a unitary relationship existed between it and Delachaux because Delachaux depended on the profits from appellant to pay its debts and because appellant would not have existed as a separate entity if Delachaux had not purchased assets for it is almost too disingenuous to take seriously. However, we would point out that the acquisition of a corporation and the siphoning off of its profits is clearly not the kind of "sharing and exchange of value" (Container Corp. v. Franchise Tax Board, supra) that the Supreme Court had in mind for a constitutionally acceptable standard for determining whether or not a unitary business exists. (See also F. W. Woolworth Co. v. Taxation & Rev. Dept., supra.)

Appellant objects to the use of the ordinary unitary tests and analyses in considering this leveraged buyout holding company situation, where the holding company is left with nothing but debt and must look to its operating subsidiaries to pay that debt. Appellant contends that this board should consider a passive holding company such as Delachaux to be per se unitary with the operating companies with which it is affiliated. It argues that, if the debt had been transferred to appellant along with the assets for which the debt was incurred, the interest expense would have been deductible by appellant and that a determination of unity in this appeal should be made in order to achieve this result.

Even if we were to assume that this result would follow had the debt been transferred as described by appellant, we must point out the longstanding principle of tax law that the taxpayer, having chosen the structure of a particular transaction, must live with the tax consequences of it. More importantly, however, the unitary business principle is not designed to be used to create a tax result to which a taxpayer is not otherwise entitled. The unitary business principle is, ideally, a neutral one, designed to ensure that a taxpayer pays its appropriate tax to the appropriate jurisdiction. Under this system, some taxpayers pay less tax to California than they otherwise might and some pay more, but this tax result is properly based on the taxpayer's relationship with its affiliates and with the taxing jurisdiction, not on the taxpayer's (or the tax administrator's) need or desire to achieve a particular tax result.

Based on the foregoing, we conclude that respondent properly excluded Delachaux from appellant's unitary group and combined report.

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 Insul-8 Corporation against proposed assessments of additional franchise tax in the amounts of $6,458, $13,034, $11,111, and $11,128 for the income years 1975, 1976, 1977, 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

_____, Chairman

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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