92-SBE-015

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 89A-0946-PS
THE HEARST CORPORATION	)	

Appearances:

For Appellant: Jeffrey M. Vesely
Attorney At Law

For Respondent: Janet Ballou
Counsel

O P I N I O N

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 The Hearst Corporation against proposed assessments of additional franchise tax in the amounts of $98,033, $220,949, and $266,051 for the income years 1979, 1980, and 1981, 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 single issue for determination is whether The Hearst Corporation was engaged in a single unitary business with its United Kingdom subsidiary, the National Magazine Company Limited.

During the years in issue, appellant The Hearst Corporation, a Delaware corporation, was engaged in various businesses such as television and radio broadcasting, cable communications, and real estate, as well as the publication of newspapers, books, and magazines such as Cosmopolitan and Good Housekeeping. In addition, appellant licensed the publishing rights for some of its publications to affiliated and nonaffiliated foreign entities. During this same period, appellant's wholly owned subsidiary, The National Magazine Company Limited (National), a company incorporated under the laws of the United Kingdom (U.K.) with its corporate offices in London, England, also engaged in the business of publishing books and magazines, including U.K. editions of Cosmopolitan and Good Housekeeping. National published its U.K. edition of Cosmopolitan under an exclusive licensing agreement with appellant. Pursuant to the agreement, the royalties were computed at 10 percent of the sales of the U.K. edition. During the period in issue, appellant received royalties from National amounting to .002 percent of the revenue of appellant's unitary group. National has owned the Good Housekeeping trademark in England since 1941, when the trademark was purchased from appellant.

The operations of National, other than operations that were the responsibility of National's board, were under the control of a local managing director. National's local management was solely responsible for editorial decisions, the purchasing of literary rights, the solicitation and selection of advertisers, the promotion and distribution of its publications, the filling of National's personnel needs, and the training of National's 375 employees. National's board of directors' duties included the approval of annual financial reports and dividend payments, the appointment of auditors, directors, and officers, the ratification of bank resolutions, and the use of the corporate seal.

Throughout the periods in issue, appellant held a majority of the seats on National's board (7 out of 9 in 1979, 10 out of 18 in 1980, and 10 out of 17 in 1981). All of National's board meetings were held in England, and during this period Hearst directors attended only three out of the six board meetings, and no more than two of Hearst's directors attended any of these meetings. None of National's directors sat on appellant's board, and there were no common officers between the two companies. Major corporate matters regarding National which were subject to review by Hearst included National's annual budget, National's annual and monthly financial reports, any change in the location of National's main office, dividend declarations, and new magazine or publishing proposals.

Hearst and National each had its own editorial staff and its own accounting, advertising, legal, purchasing, insurance, and marketing divisions. The cover designs, layouts and photographs of each magazine were done separately. Under its licensing agreement regarding Cosmopolitan, National was entitled to use essentially all of the material published in the American Cosmopolitan a month after its publication in the U.S., and there were articles and editorials, as well as some text and art, published by National that had been previously published by appellant. However, the parties appear to agree that during the years in issue, less than 4 percent of National's articles and editorials had been previously printed by appellant. (Tran. at 4, 6.) Common advertisements appearing in the U.S. and U.K. editions of the magazines were 1.1 percent and 2.8 percent, respectively, of each magazine's total ads, but each entity independently solicited its own advertisements. During the appeal period, there were

intercompany sales of books which amounted to .078 percent of appellant's total sales and .006 percent of National's total sales, and the joint publication of one book. The record indicates that Hearst imposed a general management charge on National of $120,000 in each of the appeal years. There were no intercompany loans between the entities, or loan guarantees of National's debt by appellant.

On September 1, 1981, appellant and National issued a joint release announcing the appointment of Thomas Hoving as editor-in-chief of The Connoisseur Magazine (Connoisseur), which had been acquired by William Randolph Hearst for National in 1927. The Connoisseur was an international art and antiques magazine that had limited appeal and circulation. National had decided to discontinue publication of The Connoisseur because it had been steadily losing increasing amounts of money. However, appellant decided that it could expand the appeal and circulation base of the magazine, while maintaining the primary advertisers, by publishing the magazine, with expanded coverage, in the United States. The February 1982 edition of The Connoisseur was the last edition of the magazine to be published in the U.K. Beginning with the March 1982 edition, the name of the magazine was changed to Connoisseur, and it was thereafter edited and printed in America.

During the periods in issue, appellant filed combined reports, but excluded National's income and factors. Respondent Franchise Tax Board audited appellant's tax returns and determined that National was part of appellant's unitary business and should have been included in the combined reports.

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 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. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) The court 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. 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).)

It is axiomatic that business activities conducted in multiple taxing jurisdictions are not automatically unitary merely because they are commonly owned or controlled. Because of constitutional limitations, it is necessary to differentiate between a truly integrated, unitary business, whose income is appropriately apportioned among the jurisdictions in which it is conducted, and a group of commonly

owned businesses or activities, the operations of which really have no effect upon one another and the income from which is, therefore, not properly subject to apportionment. (Appeal of Sierra Production Service, Inc., et al., 90-SBE-010, Sept. 12, 1990, and the cases cited therein.)

Respondent contends that, during the years in issue, appellant and National were engaged in the same line of business, and, therefore, a presumption of unity between the entities arises. Regulation 25120, subdivision (b), provides in part that the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operation of the taxpayer as a whole. (Cal. Code Regs., tit. 18, reg. 25120, subd. (b).) The regulation further provides that there is a strong presumption that the activities of a taxpayer constitute a single trade or business when all of the activities are in the same general line. (Cal. Code Regs., tit. 18, reg. 25120, subd. (b)(1).) At the oral hearing in this matter, appellant essentially conceded that National and itself were in the same general line of business, but it contends that the presumption of unity has been overcome by the evidence in this case. (Tran. at 9.) We agree with appellant.

The record establishes that appellant and National had separate editorial, writing, and photographic staffs. The cover designs, layouts, and photographs of each company's magazines, although similar in appearance, were done separately, and intercompany sales and use by National of material available from appellant were extremely minimal. Appellant and National did not engage in common advertising or other common forms of promotion of the Cosmopolitan and Good Housekeeping names, the two companies did not have centralized departments for such functions as accounting, advertising, purchasing, and legal, and there were no intercompany loans or loan guarantees of National's debt by appellant. Given this record, we believe that appellant has provided concrete evidence sufficient to successfully rebut the regulation's presumption of unity based on the fact that the two companies were engaged in the same line of business. Even though this presumption thus disappears, however, appellant still bears the ultimate burden of persuading us, by a preponderance of the evidence, that National was not part of its unitary business. (Appeal of Sierra Production Service, Inc., supra.) On this record, we believe appellant has carried its burden.

Respondent relies primarily on the similarities in format between the U.S. and the U.K. editions of Cosmopolitan and Good Housekeeping as the basis for its determination of unity. We find respondent's focus on the magazines' format less than persuasive. While the covers and tables of contents of the two editions of Cosmopolitan were very similar, and National clearly used the format that had worked for the U.S. Cosmopolitan, it appears that this same format was used, and continues to be used, by a number of similar magazines published by competitors and other companies unaffiliated with and totally unrelated to either appellant or National. While Cosmopolitan may have been the precursor and standard for a new generation of magazines aimed at young women, its format was used so widely that we cannot say it created a flow of value between these two companies sufficient to negate all the other evidence of National's independent control of its editorial and publication processes.

Respondent also attempts to infer some flow of value from the shift of Connoisseur from a U.K. publication to a U.S. publication, appearing to believe that it was, at least for the last few months of the appeal period at issue here, a joint publication of the two companies. However, it was made clear at

the oral hearing in this matter that there was never any joint publication, but merely a change of name and location with enough semblance of continuity to retain the major international advertisers.

While appellant and National both served the same general markets with their respective editions of Cosmopolitan and Good Housekeeping--Cosmopolitan to young middle-class women, and Good Housekeeping to housewives--there is no evidence that the publication of either magazine in either country in any way benefited the competitive position of its namesake in the other country. (See Appeal of Vidal Sassoon of New York, Inc., Cal. St. Bd. of Equal., June 27, 1984.) With respect to respondent's emphasis on the restrictions contained in National's licensing agreement concerning Cosmopolitan, it is clear that the restrictions were common to each of appellant's licensees, whether affiliated or not. Respondent, citing our decisions in Appeal of Capitol Industries-EMI, Inc., 89-SBE-029, October 31, 1989, and Appeal of Coachmen Industries of California, Inc., decided by this board on December 3, 1985, contends that the similarity of the licensing agreements here "does not detract from their importance as a unitary factor." The cases cited by respondent, however, involved vertically integrated businesses in which the flow of value was obvious and was not dependent primarily on such a licensing agreement. Contrary to respondent's contention, the entities here are not involved in "a classic vertically integrated unitary business" (Appeal of Coachmen Industries of California, Inc., supra) which compels the finding of a single, integrated economic enterprise. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.) Thus, the licensing agreement here does not rise to the level of unitary significance ascribed to it by respondent. (See, e.g., Appeal of Postal Press, 87-SBE-050, June 17, 1987.)

As previously stated, throughout the periods in issue, appellant was the sole shareholder of National and held a majority of the seats on National's board, and also had responsibility for some of National's major policy decisions. Therefore, the potential for appellant to control the operations of National was clearly present. However, in Container Corp. v. Franchise Tax Board, supra, the Court reiterated its position established in F.W. Woolworth v. Taxation & Rev. Dept., 458 U.S. 354, 362 [73 L.Ed.2d 819] (1982), that, while relevant to issues of ownership and control, the potential to control is not dispositive of the unitary business issue. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 177, fn. 16.) Here, it does not appear that any of either appellant's or National's officers were current or former employees of the other,[2/] or that there was any rotation or exchange of personnel. It also appears that appellant did not conduct training programs to educate National's personnel in its method of operation, or devote a department, individual, or section to oversee National's publication operations.[3/] The oversight of National's operations by appellant appears to have been of the nature

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[2/] Mr. Gilbert C. Maurer, who is appellant's current executive vice president and chief operating officer and who was president of appellant's magazine division during the years in issue, testified that there has been only one American managing director of National, an individual who was sent over by Mr. William Randolph Hearst in 1910, and who held the position from 1910 to possibly 1912. (Tran., at 38, 46.)

[3/] Mr. Maurer also testified that during the periods in issue Mr. Marcus Morris, a very reputable, experienced, and strong-minded British editor, was in charge of National's operations in the U.K., and because of Mr. Morris' in-depth knowledge of National's operations, there was no reason, either editorially or operationally, for appellant's management to spend any significant time with Mr. Morris. (Tran., at 34-36.)

and type as would be performed by any parent in the oversight of the operations of a wholly owned subsidiary. (F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 368-369; see also F. W. Woolworth Co. v. Franchise Tax Board, 160 Cal.App.3d 1154, 1161 [207 Cal.Rptr. 149](1984).) The managerial link demonstrated by appellant's representation on National's board is not sufficient to overcome the evidence here that no phase of National's operation was actually integrated with appellant's operations. (Cf. F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 368-369; F. W. Woolworth Co. v. Franchise Tax Board, supra, 160 Cal.App.3d at 1161.)

In summary, it appears that National had complete autonomy in its publication of the U.K. editions of Cosmopolitan and Good Housekeeping magazines and that, at all relevant times, National operated as a distinct operation. Thus, on the record before us, we must conclude that, during the years in issue, appellant and National operated as "discrete business enterprises" (Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 [63 L.Ed.2d 510] (1980)), and that National was not includable in appellant's combined reports. In view of the above, we must reverse respondent's action in this matter.

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 The Hearst Corporation against proposed assessments of additional franchise tax in the amounts of $98,033, $220,949, and $266,051 for the income years 1979, 1980, and 1981, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 18th day of June, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, 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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