BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 87N-1689-MC
YELLOW FREIGHT SYSTEM, INC.	)	

Appearances:

For Appellant:	Prentiss Willson, Jr. Attorney at Law
For Respondent:	Karen D. Smith 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 Yellow Freight System, Inc., against proposed assessments of additional franchise tax in the amounts of $74,355, $71,529, $108,284, and $107,454 for the income years 1978, 1979, 1980, and 1981, respectively, and pursuant to section 26075, subdivision (a), from the action of the Franchise Tax Board in denying the claims of Yellow Freight System, Inc., for refund of franchise tax in the amounts of $72,866, $63,908, and $105,044 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.

Two questions are presented by this appeal. The first is whether appellant was engaged in a single unitary business with its wholly owned subsidiary, Overland Energy, Inc. (OEI), during the appeal years. The proposed assessments relate to this question. The second question is whether appellant is entitled to a deduction for a loss resulting from a reduction in value of its Interstate Commerce Commission (ICC) interstate motor carrier operating certificates. The claims for refund relate to this question.

Appellant, a public company, was an ICC-regulated interstate motor carrier operating throughout the United States. Appellant's entire operation was dependent on the availability and affordability of fuel, primarily diesel fuel. In 1972, fuel costs were approximately 2.7 percent of revenues. Fuel costs rose from 5.3 percent of revenues in 1974 to 8.1 percent of revenues in 1981, in part due to the events which triggered the national fuel shortage of 1973-1974.

During the fuel shortage crisis of 1973-1974, appellant suffered operational difficulties. Although it never was unable to acquire fuel during the shortage, appellant was required to devote a significantly larger portion of its resources (both time and money) to acquire fuel and to plan operations around the quantity and location of the fuel it did possess.[2/] In addition, the President of the United States apparently had the power to change existing supply contracts and to force the purchasers to accept less than a supply contract might provide. As a result of the crisis, appellant's board of directors decided to explore alternatives to develop appellant's own source of fuel so that, if another fuel shortage crisis were to occur, it would have sufficient fuel to operate.

Appellant's board of directors reviewed various alternatives to develop a supply of fuel and finally determined to pursue conventional oil exploration and drilling activities.[3/] Appellant created a new subsidiary, OEI, to develop and retain fuel supplies. Appellant's board of directors stated that OEI would:

> have as a primary objective the achieving of dependable sources of fuel over a period of time, that in searching for such goal, any entry by the company into any phase of production or refining should be limited to the company's own needs for integration rather than diversification of the company's operations; that wholly new sources of supply obviously offered special merit and consideration; that the present policy of storage of fuel should be maintained and investigation for new sources continued.

(Appeal Ltr., Ex. F [minutes of board meeting dated July 13, 1973].)

[2/] In fact, appellant was so successful at acquiring fuel during the shortage that it was able to loan fuel to local farmers so that they could harvest their crops.

[3/] One alternative which was considered was to purchase a refinery. However, this was not an appropriate solution since the problem was not refining capacity, but an adequate supply.

In excerpts from a summary of a long-range planning meeting, under the heading "Diversification," reference was made to appellant's interests in oil drilling:

> We reconfirmed our intention of staying in the transportation industry, concentrating on motor freight and freight forwarding operations. It was agreed that ventures in the energy field through [OEI] should be pursued with a long-range goal of producing as much energy as our trucking operation consumes. . . . We will also continue looking for other investment opportunities in the energy field. . . .
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> No particular interest was shown in any other areas of diversification outside of our surface transportation field. . . .

(Appeal Ltr., Ex. F [Summary of Meeting on Long Range Planning (Nov. 22, 1976)].)

The report of the November 1977 long-range planning meeting contained essentially the same language.

Initially, OEI was managed by one employee, who also was an employee and vice president of appellant. He devoted time to and was responsible for the activities of OEI, in addition to his duties with respect to appellant. In 1976, Nicholas Powell was hired as an energy analyst by appellant. In 1977, he began to become involved in the operations of OEI. In May of 1979, Mr. Powell relinquished his responsibilities with appellant and became the full-time manager of OEI. OEI had between two and nine employees during the appeal years. Other than Mr. Powell, OEI's employees were accounting clerks, an accounting supervisor, and a secretary. Some of these employees transferred from appellant and others were hired from outside. It is not clear if any of these employees, other than Mr. Powell, devoted full time to their OEI duties.

OEI employees were subject to the same uniform rules and conditions of employment as were employees of appellant and its other affiliates. Hiring was performed by appellant's personnel department. Payroll checks were issued by appellant. Benefit plans and personnel policies were all administered by appellant.

Legal services, payroll processing, accounting, and financing services were all provided by appellant. The same independent certified public accountants audited appellant and OEI. OEI's checks were signed only by officers of appellant who were also officers of OEI. OEI's bank accounts were zero-balance accounts, with funds being transferred from appellant to OEI as OEI checks were written. All financing of OEI's activities was provided by appellant through intercompany lending. OEI had no independent source of funds and relied solely on appellant for its funds.

OEI was not an operating company. It existed solely to facilitate the funneling of Yellow Freight funds into various oil and gas ventures. OEI was a nonoperator participant which acquired working interests in several oil and gas drilling ventures in the continental U.S. OEI had no geologists or petroleum engineers as employees. These duties were handled by the employees of the drilling venture operators. OEI's involvement in the drilling was basically limited to providing money to the operator. The venture operator would present the opportunity to OEI, which would then decide whether or not to commit funds. However, all of the day-to-day management and operational decisions related to the drilling activity were made by the venture operator. OEI had no right to manage or control any of the ventures.

The sale of oil and gas discovered was handled by employees of the drilling programs. However, OEI possessed a "call on production" which apparently would have allowed it to physically obtain a portion of the production had it so elected.[4/] It is not clear if appellant could take the production in kind instead of its allocable share of income or if appellant simply had a right to buy the oil from the partnership, before the sale to a third party, at some predetermined price. However, to date, OEI has never actually exercised this call, and all oil and gas produced by the ventures has been sold at the wellhead to parties unrelated to appellant.

Appellant asserts that the call on production existed as a potential source of fuel for it because of the common industry practice of exchanging fuel. Whether appellant's call on production entitled it to high grade oil, low grade oil, or natural gas, it believed it could trade this for an equivalent amount of B.T.U.'s of needed fuel. There is evidence in the record indicating that, in B.T.U. equivalents, appellant's oil production call rights were sufficient to account for 5 percent of its use of fuel in 1978 and 19 percent in 1981. However, appellant's president testified before this board that there were no written agreements with any party regarding a swap nor was there any guarantee that a swap would have been possible during another fuel shortage crisis.

Appellant was regulated by the ICC under the authority of the Motor Carrier Act of 1935, as amended. Under that act, interstate carriers were required to secure operating certificates from the ICC. These certificates were quite valuable when issued because the ICC, for a variety of reasons, restricted entry into the interstate trucking business, which created monopolies for possessors of the operating certificates. Appellant alleges that its adjusted cost basis in these certificates was $36 million.

In 1979, the ICC reversed its position of restricted entry into the trucking field, effectively eliminating the monopolies previously enjoyed by owners of operating certificates. As a result, the value of existing operating certificates was reduced. Congress followed the ICC's action with the Motor Carrier Act of 1980 which, by legislation, confirmed the decision of the ICC. The 1980 act essentially eliminated restricted entry into the trucking business because new licenses could be acquired

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[4/] We say "apparently" because appellant did not provide us with a sample agreement. However, respondent does not dispute that OEI had a call on production.

easily. In 1982, appellant apparently applied for a nationwide operating authority which replaced its old operating certificates.

Respondent examined appellant's returns for the income years 1976 through 1981 and determined that appellant and its subsidiaries were not unitary with OEI. Appellant protested and, after due consideration by respondent, the protests were denied. Appellant has conceded the deficiencies with regard to 1976 and 1977 and only appealed those for the years 1978 through 1981. In addition, appellant filed refund claims for the years 1979 through 1981, claiming a loss deduction as a result of a reduction in value of the ICC operating certificates. Respondent denied the refund claims and appellant appealed.

I. UNITARY BUSINESS

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).)

Respondent's determination regarding the existence 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.) 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).) 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. 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).)

In situations were the Franchise Tax Board has made a determination of nonunity, more is required of the taxpayer to demonstrate the existence of a unitary enterprise than the recitation of a number of so-called "unitary factors." One must be able to differentiate a unitary business from a group of commonly owned businesses or activities, the operations of which really have no effect upon one another. As we said in the Appeal of Saga Corporation, decided by this board on June 29, 1982, we must distinguish:

> between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise.

In a case of clear vertical or horizontal integration, the benefits to the group from certain basic connections are usually obvious. Where the various affiliated entities engage in distinct lines of business, however, without apparent vertical or horizontal integration, any alleged "unitary factors" must be supported by sufficient evidence to show that they resulted in a true flow of value among the commonly owned entities rather than the mere diversification of the corporate portfolio by investment in affiliates whose operations are unrelated to the rest of the business. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178; Appeal of Twentieth Century-Fox Film Corporation, 89-SBE-007, Mar. 2, 1989; Appeal of J. B. Torrance, Inc., Cal. St. Bd. of Equal., May 8, 1985; Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.)

Appellant contends that it is unitary under both the three unities test and the contribution or dependency test. It contends that respondent's sole reason for rejecting appellant's claim of unity is that there was "an absence of functional integration from either side of the relationship" because no fuel was ever provided by OEI to appellant and none of appellant's business experience helped OEI produce oil and gas. (Appeal Ltr. at 11.) Appellant responds by contending that the fact that appellant did not take fuel from OEI is not relevant where the very reason for the formation of OEI was so central and critical to the needs of appellant. Appellant contends that OEI was formed as a business necessity, that a product flow is unnecessary in a hedging position (Appeal of John T. and Jean Prohoroff, et al., 87-SBE-008, Jan. 6, 1987), and that there was "strong centralized management," all leading to its conclusion that OEI was unitary with appellant. Appellant contends that its oil ventures were similar to "insurance." Appellant's purpose for investing in the ventures was to ensure a supply of a product crucial to its operations - fuel. It argues that business interruption insurance would have been a deductible expenditure of a unitary business, and, since the oil venture expenditures were made for the same purpose, the losses arising therefrom should likewise be deductible from the income of the unitary trucking business.

Appellant concludes by arguing that the activities of OEI would have generated business income if they were conducted by appellant, and thus the separate corporate shell of OEI should not make a difference. Appellant contends that the test for determining whether to combine corporations is the same as the test for determining whether income is business or nonbusiness income. It cites Appeal of Armour Oil Co., decided by this board on June 10, 1986, which holds that interest income on purchased promissory notes did not generate business income because the taxpayer failed to prove its factual contention that purchasing the notes was required to ensure good relations with the promisor of the notes. Appellant states that this case suggests that, if the taxpayer had proven the premise that the purchase was important to business relations, the taxpayer in Armour Oil Co. would have prevailed. Appellant contends that ensuring a source of fuel is clearly important to its trucking, that its investments in the various oil ventures were made with the purpose of guarding against future fuel supply shortages,

and that such an expenditure is clearly an expenditure of the unitary business.

Each of the above arguments, from the basic argument that OEI and appellant are unitary to the more esoteric, such as the analogy to the deductibility of insurance, rests upon one basic factual premise. The premise is that appellant, through its oil venture investments, had assured itself of a supply of fuel, through the ability to swap petroleum products based on B.T.U.'s, in the event there was another fuel shortage crisis. It is this factual premise that we reject.

First, appellant did not invest in known producing wells. Instead, it made investments in drilling ventures it hoped would produce oil. While the ventures appellant ultimately selected were successful at an apparently better-than-average percentage, the fact remains that the drilling was speculative. Consequently, the oil drilling ventures did not grant appellant the absolute right to receive fuel. Appellant could contractually receive the production from the wells only if the wells actually produced.

Second, appellant avers that it could acquire needed fuel in times of shortage through the process of swapping. Appellant states that well production of one type of fuel could be swapped for another type of fuel based on equivalent B.T.U.'s. However, appellant has not shown that if all types of fossil fuels were in short supply, resulting in refiners and suppliers being unable to fulfill existing contracts, that it would have nevertheless been able to swap based on B.T.U.'s. Appellant had no contracts allowing it to swap, and its president testified that there was no guarantee that appellant would have been able to make a swap during a fuel crisis.

Thus, while appellant's various arguments ultimately rest on the premise of the ability to swap fuel, it has not demonstrated that it could actually have made such a swap in the event of a fuel shortage crisis. All appellant had was the potential to satisfy its goal of developing a source of fuel equivalent to its daily use of fuel. Potential is not enough, whether the issue is unitary combination (Appeal of W. K. Equipment Company, Cal. St. Bd. of Equal., Sept. 10, 1985) or business versus nonbusiness income (Appeal of Occidental Petroleum Corporation, Cal. St. Bd. of Equal., June 21, 1983). Consequently, we conclude that respondent has properly determined that OEI was not part of appellant's unitary business.

II. DEVALUATION OF OPERATING CERTIFICATE

Appellant filed refund claims based on a reduction in the value of its operating certificates. It argues that based on the decision of the ICC in 1979, fully confirmed by Congress in the Motor Carrier Act of 1980, the rights conferred by the operating certificates were no longer useful in appellant's business and thus a loss was sustained. While appellant has filed refund claims for 1979, 1980, and 1981, appellant is actually only seeking a refund for the one year in which the loss actually occurred. If we determine a loss deduction is allowed in one year, appellant will drop the refund claims for the other years. (Appeal Ltr. at 23.)

A taxpayer is entitled to a deduction for any loss sustained during the income year and not compensated for by insurance or otherwise. (Rev. & Tax. Code, § 24347, subd. (a).) For the loss to be deductible, it must be evidenced by a closed and completed transaction and fixed by an identifiable event. (Cal. Code Regs., tit. 18, reg. 24347-1, subd. (b).) Section 24347 is virtually identical to Internal Revenue Code (I.R.C.) section 165(a), and thus decisions interpreting the federal statute are given great weight in interpreting the state statute. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941).)

As part of the Economic Recovery Tax Act of 1981, the U.S. Congress enacted Act (as a noncode) section 266, which specifically provided for a five-year amortization period for the diminution in value of ICC operating certificates. California did not conform to this provision; therefore, appellant's entitlement to a loss deduction must rest upon general principles of taxation under I.R.C. section 165.

Appellant's argument is that its continuing expectation of restricted entry by others into its industry was a property right akin to goodwill; that this right had value separate and apart from the de minimis value of the bare operating license; and that this value was completely lost when the ICC removed restrictions on entry into the industry. Appellant relies on Parmelee Transportation Company v. U.S., 351 F.2d 619 (Ct.Cl. 1965) and First Victoria National Bank v. U.S., 620 F.2d 1096 (5th Cir. 1980).

In Parmelee Transportation Company, supra, the court held that the taxpayer's century-old exclusive informal arrangement to provide transfer services to privately owned railroads was a property right akin to goodwill and that, upon the loss of the arrangement, the taxpayer suffered a deductible loss. In First Victoria National Bank, supra, the court held that a "rice acreage history" which essentially allowed a farmer to cultivate the same number of acres during periods when the total acreage under production was restricted by the Secretary of Agriculture was "property" for purposes of the I.R.C and therefore must be included in the taxpayer's gross estate for estate tax purposes.

While we do not disagree with the analysis and rationale of Parmelee Transportation Company and First Victoria National Bank, we think they are inapplicable to the "monopoly rights" conferred by the ICC's former policy of restricted entry. This "monopoly right" was created by the government. No individual has the right to expect that the law will not change nor may the person insist that it not be changed to his detriment. (New York Central R. Co. v. White, 243 U.S. 188, 198 [61 L.Ed. 667] (1917).) Without the right to expect the law to stay the same, we do not think appellant had any "property" with respect to the separate monopoly "right." (Consolidated Freight Lines, Inc. v. Commissioner, 101 F.2d 813 (9th Cir.), cert. den., 308 U.S. 562 [84 L.Ed. 472] (1939).) In Consolidated Freight Lines, Inc., supra, the taxpayer owned certificates of public convenience and necessity to operate trucks over certain routes in the State of Washington. The state later abolished the licensing system to stimulate competition. The court ruled that the taxpayer had no right to a monopoly under its certificates. It was the state's manner of administering the statute which effectively created a monopoly and, since the monopoly was created by the government, the taxpayer had no right to expect the monopoly to continue. Without such a right, the taxpayer had no property interest in the monopoly.

Without any property, the taxpayer was not entitled to a loss deduction when the statute changed and the taxpayer effectively lost its monopoly.[5/]

It is possible that the instant case might be different if appellant completely lost the right to engage in interstate trucking. (See Parmelee Transportation Company v. U.S., supra, 351 F.2d at 624, fn. 3; see also Beatty v. Commissioner, 46 T.C. 835, 841 (1966).) However, the fact is that appellant continued to possess the right to engage in the interstate trucking business. The change in ICC policy, followed by the Motor Carrier Act of 1980, did not alter this. All that changed was that appellant's operating certificates no longer had an additional monopoly value since certificates were now easily attainable. This is in contrast to Parmelee Transportation Company, where the taxpayer was no longer able to conduct its business at all and the expectation of a continued monopoly was created by a private party. Since this case involves a government-created monopoly, we think that this appeal is governed by the principles of Consolidated Freight Lines, Inc..

The Internal Revenue Service applied the Consolidated Freight Lines, Inc. principle in Revenue Ruling 84-145, 1984-2 C.B. 47, to airline "route authorities" which lost value when Congress deregulated the airline industry. The IRS stated that:

> In the instant situation, the taxpayer did not sell or abandon as completely worthless its route authorities. Although the value of its route authorities was substantially reduced after the Deregulation Act became law, the mere diminution in value of the operating rights does not constitute the elimination or abandonment of a completely worthless asset. In addition, there was no closed and completed transaction fixed by identifiable events because the taxpayer's operating rights remained unchanged even though more competition was introduced.

We think this rationale and conclusion are applicable to the instant case. Thus, although the value of appellant's ICC license may have gone down, there was no identifiable loss of any separate property interest for which appellant would be entitled to a loss deduction under section 24347.[6/]

[5/] In First Victoria National Bank, supra, the court found that the taxpayer had a legally enforceable right to receive future allotments if they were issued by the government in the future, and therefore the rice acreage histories were property. The taxpayer argued that the government could cancel the program and therefore the taxpayer only had an expectancy. The court concluded that the fact that the rice program might evaporate overnight was insufficient to find that it was not property for estate tax purposes. (First Victoria National Bank v. U.S., supra, 620 F.2d at 1106-1107.) We think the rice acreage history is analogous to the underlying operating license, but not to the expectation of a monopoly. Whether the license itself is property is not before us. What is before us is whether the loss of the monopoly value previously attached to the operating licenses is somehow a separate property right.

[6/] The fact that Congress enacted a specific provision authorizing a deduction for the loss of value is, in our opinion, strong support for our conclusion that no deduction would otherwise be allowable for the diminution in value.

Appellant also argues that in 1982 its old operating certificates were replaced by a nationwide operating authority. Thus, it argues, it should be entitled to a loss deduction. While appellant has not made it entirely clear how the new authority is a different right sufficient to allow a loss deduction for the old operating certificates, it is clear that the year 1982 is not before this board. Appellant's claims for refund are for 1979, 1980 and 1981. What may have happened in 1982 cannot justify a deduction for one of these earlier years.

For the reasons discussed above, the action of the Franchise Tax Board 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 Yellow Freight System, Inc., against proposed assessments of additional franchise tax in the amounts of $74,355, $71,529, $108,284, and $107,454 for the income years 1978, 1979, 1980, and 1981, respectively, and pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Yellow Freight System, Inc., for refund of franchise tax in the amounts of $72,866, $63,908, and $105,044 for the income years 1979, 1980, and 1981, respectively, be and the same is hereby sustained.

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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