92-SBE-022

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 87A-0895-MW
LAKESIDE VILLAGE APARTMENTS, INC.	)	

For Appellant: Thomas R. Guercio
Vice President & Treasurer
Reliable Stores Incorporated

For Respondent: Paul J. Petrozzi
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 Lakeside Village Apartments, Inc., against proposed assessments of additional franchise tax in the amounts of $365,772 and $51,837 for the income years ended January 31, 1979, and January 31, 1980, respectively.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

The question presented by this appeal is whether appellant was engaged in a single unitary business with its parent, Oprel Holding Company (Oprel), and a group of Oprel's other subsidiaries (Reliable Stores).

Julius Davis, a partner in Oppenheimer & Co., Inc. (Oppenheimer), and Dean Smith, his main investment advisor, were dominant members of a Minnesota group that purchased an apartment complex in California. This group incorporated the apartment complex and decided to convert it into condominiums. Davis sought to have the apartment complex acquired by Oprel Holding Company (Oprel), which was jointly owned at that time by Oppenheimer and Oppenheimer's director for special acquisitions. Davis purportedly desired the acquisition in order to provide management continuity and financial stability if the conversion attempt was unsuccessful, and Oprel's motive for the acquisition was to achieve the additional financial support which it needed to reduce debt that it had incurred in the acquisition of Reliable Stores, which was engaged in activities entirely unrelated and dissimilar to those of appellant. Oprel's acquisition of the apartment complex was completed on June 25, 1978, through a merger of the corporation that owned the apartment complex into appellant, which had been formed by Oprel for purposes of effecting the merger.

After the merger, Davis and Smith remained the main executive officers of appellant and also served, together with a number of Oppenheimer personnel, as directors of appellant. Davis and Smith also became directors of Oprel. Apparently, the condominium conversion was successful, and appellant distributed over $5 million in dividends and advances[2/] to Oprel during the pertinent period.

Appellant has submitted as an exhibit a document dated August 1978, entitled Centralized Functions and Services Agreement, which appears to have little or no other purpose beyond providing "evidence" of a unitary relationship between appellant and Oprel. Under this "agreement," appellant was required to look to its parent, Oprel, for decisions regarding appellant's financial activities, tax matters, and accounting policies. This short (two and one-half pages) document provides, in part, that

> Parent [Oprel] and Affiliate [appellant] recognize that the success of Affiliate is dependent on the providing of the services and functions included within the Centralized Functions and Services, and that business decisions as to Centralized Functions and Services are most advantageously to be made for all Affiliates combined (although not necessarily for each Affiliate) by Parent viewing all activities of all Affiliates as a single unitary group. Parent and Affiliate hereby acknowledge the foregoing and agree that the Centralized Functions and Services shall be provided in a fashion to provide for the best economic interest of Parent and all Affiliates combined without regard necessarily to the best economic interest of each Affiliate viewed on its

[2/] Respondent has stated, based on other information provided by appellant, and appellant has not denied, that the "advances" were never repaid and were considered to be part of the dividends paid.

own.

(App. Br., Ex. B, p. 2.)

Appellant was to pay Oprel $25,000 annually for making these decisions. No mention is made of any other of the companies owned by Oprel entering into such an agreement. The agreement was terminable by either party on 30-days' written notice to the other, and it was not to "be construed to interfere with or offset any currently outstanding agreement of [appellant] with respect to the management of its business." (App. Br., Ex. B, p. 3.) Appellant has not stated how long the agreement lasted or whether another management agreement existed at the time it entered into the agreement with Oprel.

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).)

Section 25120 of respondent's regulations also sets forth criteria to evaluate the unitary nature of an enterprise. (Tenneco West, Inc. v. Franchise Tax Board, 234 Cal.App.3d 1510, 1525 [286 Cal.Rptr. 354] (1991); Mole-Richardson Co. v. Franchise Tax Board, 220 Cal.App.3d 889 [269 Cal.Rptr. 662], (1990).) While appellant does not specifically rely on the regulation, its argument bears some resemblance to the part of the regulation which provides that there is a strong presumption of unity under the following circumstances:

> (3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or

> purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

(Cal. Code Regs., tit. 18, reg. 25120, subd. (b).)

Appellant contends that it was unitary with Oprel and Reliable Stores because of centralized management provided by Oprel and intercompany financing. With regard to the central management allegedly provided by Oprel, there is absolutely nothing in the record to indicate that Davis and Smith managed anything other than appellant's condominium conversion operations, just as they had done before the acquisitions, or that any of Oprel's other officers and/or directors were involved in managing the condominium conversion operations. Although Davis and Smith were also directors of Oprel, and there were others who served as directors of both Oprel and appellant, interlocking boards of directors are characteristic of any parent and its wholly owned subsidiary and, without more, are not indicative of unity. (Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d at 1528.) The financial decision-making power, which was the only involvement Oprel's board of directors had with appellant, is insufficient to support a finding of unity since it was "the type of occasional oversight--with respect to capital structure, major debt, and dividends--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).)

This clearly does not constitute "strong central management" as required by Regulation 25120, both because of the restricted and nonoperational role played by Oprel's board of directors and because there is no indication that there were any "central executive officers [who were] normally involved in the operations of [both appellant and Oprel and/or Reliable Stores] . . . ." (Cal. Code Regs., tit. 18, reg. 25120, subd. (b)(3).) (See also Appeal of Sierra Production Service, Inc., et al., 90-SBE-010, Sept. 12, 1990.) Oprel's corporate organization did not have the "management divisions" contemplated by unity of operation nor the "centralized executive force" characteristic of unity of use. Rather, it "simply evidenced such corporate activities as would exist in most parent-subsidiary relationships." (Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d at 1528.)

The Centralized Functions and Services Agreement does not affect this conclusion, since it does no more than outline the types of decisions that any parent corporation makes for its subsidiaries. As we indicated previously, we can see no other use for this document other than to create apparent evidence of unity. Therefore, we find the credibility of this document to be questionable. The fact that appellant was required to pay $25,000 annually for what Oprel would have done anyway seems to be simply another means of siphoning off funds from the appellant.

The intercompany financing upon which appellant relies also lacks unitary significance. The only "financing" alleged is the payment of dividends from appellant to Oprel. If the payment of dividends

were to be considered as intercompany financing sufficient to support a finding of unity, every dividend-paying subsidiary would be engaged in a unitary business with its parent. That this is not true is shown by the courts' exclusions from unitary business groups of some dividend-paying subsidiaries, and the inclusions in such groups of others. (See, e.g., ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 [73 L.Ed.2d 787] (1982); Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d 1510.) The U. S. Supreme court made this point clear:

> [T]he principles we have quoted require that the out-of-state activities of the purported 'unitary business' be related in some concrete way to the in-state activities. The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement--beyond the mere flow of funds arising out of a passive investment or a distinct business operation--which renders formula apportionment a reasonable method of taxation. [Emphasis added.]

(Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 166; see also Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d at 1531.)

Appellant's role as Oprel's subsidiary was essentially to diversify Oprel's portfolio of subsidiaries and, as a result, to reduce the financial risk that Oprel incurred by acquiring Reliable Stores. Oprel's relationship with appellant did not achieve any benefits from economies of scale, operational integration, or sharing of expertise. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178.) A "cash cow," no matter how necessary in order to pay off the acquisition debt of another of the parent's subsidiaries, does not create the sharing or exchange of value that is indicative of a unitary business. (See F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 363-364.) We must conclude that appellant has not shown that any "intercompany financing" which may have existed "had a substantial operational function rather than simply an investment function." (Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d at 1533; see Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 180, n. 19.)

Because the factors on which appellant relies lack unitary significance and appellant has provided no evidence of any other distinguishing unitary features here, we conclude that appellant was not unitary with Oprel or any of its other subsidiaries during the pertinent period under either the "three unities" or the "contribution or dependency" test. Accordingly, respondent's action 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 Lakeside Village Apartments, Inc., against proposed assessments of additional franchise tax in the amounts of $365,772 and $51,837 for the income years ended January 31, 1979, and January 31, 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 30th day of July, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9
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