BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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| In the Matter of the Appeal of | ) | |
| | ) | No. 88A-0317-MC:DB |
| MERRY MARY FABRICS, INC., ET AL. | ) | |

For Appellants: Kenneth A. Goldman
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 Merry Mary Fabrics, Inc., et al., against proposed assessments of additional franchise tax in the amounts and for the income years as follows:

[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.

| Appellant | Income Years Ended | Proposed Assessments |
|---|---|---|
| Merry Mary Fabrics, Inc. | 06-30-81 | $ 914 |
| | 06-30-82 | 107,903 |
| Hurricane Investment Corporation | 06-30-82 | 200 |
| Walden Realty Corporation | 06-30-81 | 200 |
| | 06-30-82 | 1,589 |

The question presented by this appeal is whether appellants Hurricane Investment Corporation and Walden Realty Corporation were involved in a unitary business with appellant Merry Mary Fabrics, Inc.

Merry Mary Fabrics, Inc. ("Merry"), and its subsidiaries Teddi of CA, Inc., South Sea Imports, and Masterdan were in the clothing business. (References hereinafter to Merry include Teddi, South Sea, and Masterdan, since these corporations were all engaged in the same unitary business.) This business involved the manufacture and sale of clothing, the distribution of fabric to retailers, and the importation and sale of fabrics and apparel to other garment manufacturers.

In 1981, appellants Hurricane Investment Corporation ("Hurricane") and Walden Realty Corporation ("Walden") (also hereinafter referred to together as "H&W") were formed. In several letters to respondent, appellants stated that the purpose for forming H&W was to diversify Merry's business and to procure showrooms and/or other real property assets that might be necessary to further the business needs of Merry. (See, e.g., Res. Br., Ex. C, at 3.)

According to the undisputed facts, although H&W were separate corporations all of their administrative functions were handled by Merry's employees. These functions related to banking, insurance, financing, legal and accounting, and employee benefits matters. The officers and directors of Merry were also (with one exception) the officers and directors of H&W. The one crucial exception was a Mr. Lebowitz, a vice president and the only employee of H&W. Mr. Lebowitz's duties related solely to the acquisition and management of any real estate which might have been owned by H&W, since the officers and directors of Merry had "no substantial previous experience" in the real estate business. (Res. Br., Ex. B, at 2.)

The record is totally silent as to the nature and extent of the real estate acquisition, development, or operational activities, if any, actually conducted by H&W during the appeal years.[2/] It

[2/] Appellants in their reply brief refer to the "volumes" of information submitted to respondent and this board. While "volumes" may have been submitted to the respondent, very little actual evidence has been submitted to this board. Appellants have made many factual allegations but virtually no evidence has been presented to support these allegations. It would appear that appellants are under the mistaken belief that this board has access to the evidence it

appears that the purpose of Hurricane was to invest in developed properties, while the purpose of Walden was to take on real estate construction and development projects. But, we cannot determine from the record whether H&W actually owned any real estate during the appeal years.

In 1981, Hurricane executed a contract to purchase for $40,000,000 what appellants describe as the premier building in New York City's garment district. This building housed approximately 101 tenants who were in the apparel business. Merry had an existing business relationship with 24 of these tenants and regarded many of the other tenants as potential customers. In addition, Merry's lease of other space in New York was about to expire, and acquisition of the building would have allowed Merry to move its operations into the building. Merry alleges that the acquisition of this building would have been extremely beneficial to Merry's garment business since Merry's name would have been on the building and Merry would have had access to the tenants of this building, such as designers Liz Claiborne and Perry Ellis.

Due to the deterioration of the credit market in the United States, Hurricane was unable to secure financing at an interest rate which made acquisition of the building economically feasible. Therefore, Hurricane did not complete the purchase and lost its nonrefundable $1 million deposit paid by a letter of credit which apparently had been guaranteed by Merry.[3/]

Merry and H&W filed their corporate franchise returns on a combined report basis. Respondent, after audit, determined that H&W were not part of Merry's unitary group. Appellant protested and, upon disallowance of the protest, appealed to this board.

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 appellants bear 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

(..continued)

presented to respondent. We are a separate state agency and unless the taxpayer submits the evidence to us, or respondent chooses to submit it in support of its own position, we will never see it. (See Appeal of Sierra Production Service, Inc., et al., 90-SBE-010, Sept. 12, 1990, fn. 4.)

[3/] In this appeal we do not consider what deduction, if any, Merry might claim for the payment of the guaranteed debt of Hurricane. Our decision is limited to the issue of whether Merry is unitary with H&W.

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).)

More is required to demonstrate the existence of a functionally integrated 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. (Appeal of Sierra Production Service, Inc., et al., 90-SBE-010, Sept. 12, 1990.) 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.

The benefits to the group from certain basic connections are usually obvious in cases of vertical or horizontal integration. However, where the various affiliated entities engage in distinct lines of business, without any apparent vertical or horizontal integration, the alleged unitary connections must be carefully examined to see whether they resulted in an integrated unitary enterprise (Appeal of The Amwalt Group, Inc., etc., Cal. St. Bd. of Equal., July 28, 1983), rather than in mere diversification of the corporate portfolio through investments in affiliates whose operations were 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.) In this case, there is no evidence that H&W actually served any purpose other than diversification of the corporate portfolio during the appeal years.

Appellants argue that the acquisition of the garment district building would have been "of incalculable help in further increasing [Merry's] New York business and in further implementing its New York business plan." (Appeal Ltr. at 4.) Appellants argue that the acquisition of the "building was completely tied into appellant's garment business." (Appeal Ltr. at 5.) In addition, Merry intended to occupy some of the building itself. These considerations, Merry argues, are sufficient to make H&W unitary with Merry's garment operations.

However, the fact that the purchase was never consummated means that the building

was never used in Merry's unitary business. Even if we assume that purchasing this building would have been sufficient to cause Hurricane to be part of Merry's unitary business, until the purchase was completed there was only potential unity. The potential to operate a separate company as part of the unitary business is not enough; it must actually be operated as part of the unitary business. (See F.W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 362 [73 L.Ed.2d 819], rehg. den., 459 U.S. 961 [74 L.Ed.2d 213] (1982); Tenneco West, Inc. v. Franchise Tax Board, 234 Cal.App.3d 1510, 1530 [286 Cal.Rptr. 354] (1991); Appeal of Gasco Gasoline, Inc., et. al., 88-SBE-017, June 1, 1988.[4/]) In addition to the failure of this acquisition, there is also no evidence that Merry ever used in its unitary clothing business any real property owned by H&W. Thus, since there also is no indication of any contribution or dependency between Merry and H&W arising from any other aspect of their operations, it seems clear that the substantial mutual interdependence required for a unitary business was not present.

As additional support for its argument that Merry and H&W were unitary, however, Merry points to the various administrative functions performed by the officers and employees of Merry on behalf of H&W. The services performed by Merry for H&W, however, do nothing to establish that H&W's real estate activities were part of Merry's apparel business rather than either a discrete real estate business or a collection of extraneous investments. No doubt some economies of scale were achieved by combining these overhead services, but there is no evidence that the savings were more than "trifling in comparison with the income" involved, providing no justification for combining "what would otherwise, from an operational standpoint, be considered separate businesses." (Tenneco West, Inc. v. Franchise Tax Board, supra, 234 Cal.App.3d at 1529, fn. 8, quoting F.W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 369, fn. 22, in turn quoting Keesling & Warren, The Unitary Concept in the Allocation of Income, 12 Hastings L.J. 42, 52 (1960).) There apparently were no operational links between Merry and H&W. To the extent that H&W might have had day-to-day real estate operations during the appeal years, they were apparently handled by Mr. Lebowitz, since the officers of Merry had little or no real estate experience. Thus, we find no "sharing of expertise." (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178.) Of course, the executives of Merry exercised review and oversight of Mr. Lebowitz, but as the court in Tenneco West points out, these are "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.) Review and oversight are not indicative of unity.

For the reasons discussed above, we hold that H&W were engaged in discrete real estate operations or investment activities that were not part of Merry's unitary apparel business during the years on appeal.

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[4/] In an analogous situation, we have held that gain realized on the sale of stock of a corporation which would have been unitary with the selling corporation if the underlying company had been operated as part of the unitary business generated nonbusiness income, since the underlying company had never become part of the unitary group. (Appeal of Occidental Petroleum Corporation, Opn. on Pet. for Rehg., Cal. St. Bd. of Equal., June 21, 1983.)

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 Merry Mary Fabrics, Inc., et al., against proposed assessments of additional franchise tax in the amounts and for the income years cited above, be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of April, 1993, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9