BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 91A-0271-MW
F. W. WOOLWORTH CO., ET AL.	)	

Appearances:

For Appellant:	Michael Bray Attorney at Law
For Respondent:	Michael T. Clancy 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 protests of F. W. Woolworth Co., et al., against proposed assessments of additional franchise tax in the amounts and for the income years ended as follows:

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

Appellants	Income Years Ended	Proposed Assessments
F. W. Woolworth Co.	01/31/78	$ 118,187
	01/31/79	175,619
	01/21/80	105,813
	01/31/82	51,076
Kinney Shoe Corporation	01/31/78	68,365
	01/31/79	70,732
	01/31/80	177,577
	01/31/81	984,843
	01/31/82	1,125,056
	01/31/83	1,108,529
The Richman Brothers Company	01/31/78	3,010
	01/31/79	8,152
	01/31/80	3,082

The issues to be decided in this appeal are: 1) Did F. W. Woolworth Co. ("Woolworth") conduct a unitary business with Kinney Shoe Corporation ("Kinney") for the income years ended 01/31/80 through 01/31/83;[2/] and 2) can dividend income received by Woolworth or Kinney from nonunitary subsidiaries be used to reduce or "offset" the interest expense deduction under Revenue and Taxation Code section 24344, subdivision (b), for the income years ended 01/31/78 through 01/31/83.[3/]

Woolworth was engaged in the retail sale of general merchandise and apparel throughout the United States and a number of foreign countries. Kinney, a wholly owned subsidiary of Woolworth, manufactured shoes and operated family shoe stores and specialty shoe and apparel stores. Through 1982, Kinney operated shoe departments in unrelated discount department stores and also in stores operated by the Woolco division of Woolworth. The operations in the Woolco stores were conducted under licensing agreements that were negotiated at arms' length and were the same as the license agreements under which the other Woolco licensees operated. During the appeal years, the Woolco division was in the process of taking over the operations of the departments run by licensees, which were generally more lucrative than the Woolco departments, and during 1982, Kinney was

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[2/] The appellants have agreed, for purposes of this appeal, to the assessments against The Richman Brothers Company on a separate filing basis. Therefore, only the relationship between Woolworth and Kinney will be discussed in connection with the issue of unity.

[3/] The parties entered into a Joint Stipulation, dated November 18, 1991, that sets out their agreement as to the issues that are before this board and as to the dollar amounts and methods of calculation with regard to the interest offset question that will be followed by them once this board decides the issues raised in this appeal.

apparently the only licensee left in Woolco stores. The Woolco division had totally ceased operation by the end of 1982. Kinney and Woolworth shared some common officers and directors, some insurance coverage, and employee stock option and stock purchase plans. In 1979, Woolworth entered into a sale/leaseback arrangement for IBM cash registers for itself, Kinney, and other affiliates and obtained a volume discount.

For the 1980 through 1983 income years, Woolworth filed combined reports that included Kinney. The Franchise Tax Board (FTB) "decombined" the two companies, and applied the "interest offset" provisions found in Revenue and Taxation Code section 24344, subdivision (b), resulting in a limitation being placed on a portion of the interest expense that would otherwise be deductible from apportionable income. The combination issue involves the 1980 through 1983 income years, while the interest offset issue involves all six years on appeal. Apparently, only the United States operations of Woolworth and Kinney are at issue here.

Appellants contend that they were in the same line of business, that of selling merchandise at retail through general merchandise and specialty store formats. They argue that this entitles them to the presumption of unity found in regulation 25120, subdivision (b)(1), which states that "[a] taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line." In addition, appellants contend that the unity of the companies is demonstrated by significant transfers of value arising out of key personnel transfers, the economies of scale created by the cash register sale/leaseback, and the Kinney licensing agreement with Woolco.

The FTB contends that the two companies were engaged in diverse lines of business, Woolworth operating general merchandise stores and Kinney operating shoe and specialty stores, and are not entitled to the "same line of business" presumption of regulation 25120, subdivision (b)(1). The management role played by Woolworth was, according to the FTB, the typical financial oversight engaged in by the parent corporation of any subsidiary, and does not show any kind of integration that would distinguish the companies as having a unitary relationship. It denigrates generally the voluminous evidence presented by the appellants, and specifically disagrees with the significance appellants attach to such items as the key personnel transfers (only two, and these were before the appeal years), the economies of scale arising from the cash register purchase (an isolated event taking place before the appeal years), and the license agreement Kinney had with Woolco (same as unrelated party licensing agreements).

We need not decide here whether or not appellants were entitled to the presumption of regulation 25120, since we find that, regardless of any such presumption, they were not engaged in a unitary business. The clear weight of all the evidence in the record shows that Woolworth provided nothing more than "the type of occasional oversight--with respect to capital structure, major debt, and dividends--that any parent gives to an investment in a subsidiary, [with] little or no integration of the business activities or centralization of the management of these . . . corporations." (F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 369 [73 L.Ed.2d 819] (1982).) On this basis, the United States Supreme Court in Woolworth found that the domestic Woolworth was not unitary with Woolworth operations in foreign countries, even though those were certainly all in the same line of business.

This limited oversight role was made particularly clear in the testimony of Woolworth's Assistant Vice President of Taxes. He described the management by Woolworth as consisting of control through budgets, five-year plans, and long-term bonuses. (Tr. at 56, 63.) The example he gave of management's overall corporate objective was the setting of a required return on investment. (Tr. at 64.) We find this to be no more than general parental financial oversight: looking at budgets and merely demanding that the subsidiary perform at a certain economic level. According to the Supreme Court, this is not sufficient to demonstrate the existence of a unitary business. (F. W. Woolworth Co. v. Taxation & Rev. Dept., supra.)

The appellants make much of the fact that a division of Kinney operated as a licensee in some of the Woolco division stores during these years. This does not rise to unitary significance, in our opinion, for at least two reasons. First, there were other, unaffiliated, licensees in the Woolco stores, not all the shoe departments in the Woolco stores were licensed to Kinney (at least not until 1982, the year that Woolco ceased operations entirely), and Kinney also had licensed shoe departments in other discount department stores. The arrangements with Woolco were arm's length and have not been distinguished by appellants as any different from the arrangements Woolco had with its other licensees or from the arrangements Kinney had with its other licensors. Secondly, the licensee operations in Woolco stores have not been shown to be substantial, either with regard to Kinney's operations or Woolworth's. The licensee operations averaged only 7 percent of Kinney's sales during the fiscal years ended in 1980, 1981, and 1982, and amounted to less than .04 percent during the fiscal year ended in 1983. The Kinney licensee sales were approximately one percent, 1.6 percent, 2 percent, and .02 percent of the total Woolworth sales for the years ended in 1980, 1981, 1982, and 1983, respectively. Even though Kinney was in the process of taking over the licensed shoe departments in Woolco stores during this period, this appears to have had little or no proportionate beneficial effect on its sales. This also did not appear to provide any particular benefit to the Woolco division, which was in a decline during this period and finally ceased operations during 1982, the year that Kinney took over the remainder of the licensed shoe departments.

These entities, while obviously having some financial connections, do not appear to have had the "substantial mutual interdependence" contemplated by the U.S. Supreme Court. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 179 [77 L.Ed.2d 545] (1983) [quoting from F. W. Woolworth v. Taxation and Rev. Dept., supra].) Instead, they operated as separate entities, with the parent corporation overseeing only the bottom line on the ledger sheet. The licensee connection between Woolco and Kinney does not appear to have been significant for either Woolworth or Kinney. Aside from the extremely minor financial effect, the relationship was no more than that of landlord and licensee, operating at arm's length.

Not only do we find Woolworth and Kinney to be nonunitary in absolute terms, looking just at the relationship that existed during the years in issue, but also in relative terms, comparing their appeal-years' relationship to that which existed in the prior years when appellants themselves had treated Kinney as nonunitary. Appellants allege that the management philosophy instituted in 1978 by the new Chairman of the Board, Mr. Edward Gibbon, produced a dramatic difference in the operations of Kinney and Woolworth and their relationship to each other, distinguishing the post-1977 years from the earlier years. However, we have not seen any evidence of a significant difference, for unitary purposes, in the relationship of Kinney and Woolworth to each other after Mr. Gibbon became

chairman. Appellants state that Mr. Gibbon brought in the concept of the "corporate office" to manage Woolworth and its subsidiaries, but they have not explained how that differed significantly from the management before Mr. Gibbon became chairman. The management before appeared to be purely financial oversight, and the management after, while it may have acquired a new name and some new techniques, was still purely financial oversight.

We agree with respondent that, in spite of the hundreds of pages of documents produced by the appellants, there is little or no evidence that is relevant to or helpful in proving unity between Woolworth and Kinney during the appeal years and, in fact, much of it supports the opposite view. Based on the record before us, including the testimony at the oral hearing, we are unable to conclude that Kinney and Woolworth were part of the same unitary business.

With regard to the interest offset issue, section 24344, subdivision (b), provides:

> If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

(Rev. and Tax. Code, § 24344, subd. (b).)

Appellants contend that, by including in the interest offset formula "dividend income . . . not subject to allocation by formula," the FTB has taxed income which is constitutionally not taxable by California. The dividend income to which appellants refer is that received from nonunitary affiliates. By including those dividends in the computation of the interest offset formula, appellants assert, the income will be indirectly taxed because its inclusion will result in the disallowance of an interest deduction to the extent of such dividend income. Appellants also argue that the section 24344 interest offset formula is arbitrary and capricious on its face.

The FTB argues that, because of the prohibition of article III, section 3.5, of the California Constitution, our board cannot refuse to enforce the statute as written. Even if the board were to consider the argument made, the FTB argues that the California Supreme Court already decided the question adversely to appellants in Pacific Tel. & Tel. Co. v. Franchise Tax Board, 7 Cal.3d 544 (102 Cal.Rptr. 782) (1972). The FTB contends that appellants' "arbitrary and capricious" argument was also answered adversely to the appellants in Pacific Tel., supra.

We agree with respondent on this issue as well. Despite appellants' attempts to make this issue into one without constitutional dimensions, we find that, at bottom, the appellants are asking us to refuse to enforce the statute as written, which we are clearly precluded from doing. To the extent

that appellants' arguments raise issues not of constitutional dimension, we agree that the decision in Pacific Tel., supra, disposes of them adversely to appellants.

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 F. W. Woolworth Co., et al., against proposed assessments of additional franchise tax in the amounts and for the income years ended as shown below be and the same is hereby sustained:

Appellants	Income Years Ended	Proposed Assessments
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	01/21/80	105,813
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The Richman Brothers Company	01/31/78	3,010
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	01/31/80	3,082

Done at Sacramento, California, this 24th day of June, 1993, by the State Board of Equalization, with Board Members Matthew K. Fong, Ernest J. Dronenburg, Jr., and Windie Scott present.

_____, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9