ADOPTED 8/2/95

95-SBE-006

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	
THE BANK OF TOKYO, LIMITED	)	No. 90R-1102
AND UNION BANK (FORMERLY	)	
CALIFORNIA FIRST BANK)	)	No. 90R-1313

Appearances:

For Appellants: Harvey L. Gould and
David Colker
Attorneys at Law

For Respondent: Karl F. Munz, Counsel

O P I N I O N

These appeals are made pursuant to section 19324, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of The Bank of Tokyo, Limited, for refund of franchise tax in the amounts of $115,468, $60,626, $172,102, $277,280, and $487,545 for the income years ended March 31, 1976, through March 31, 1980, respectively, and in denying the claims of Union Bank (formerly California First Bank) for refund of franchise tax in the amounts of $633,473, $858,989, and $420,989 for the income years ended December 31, 1975, 1976, and December 31, 1978, respectively.

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

Several issues are raised in these appeals. The main issue is whether appellant Union Bank was engaged in a single worldwide unitary business with its Japanese parent, The Bank of Tokyo, Limited. If we so conclude, then we must consider whether respondent (a) abused its discretion under Revenue and Taxation Code section 25137 when it refused either to permit the use of separate accounting or to adjust the formula factors to reach a "fairer" apportionment result, or (b) improperly classified as business income certain dividends and capital gains received by The Bank of Tokyo from its investments in unrelated nonbanking companies. Finally, appellants argued that the application of worldwide combined reporting (WWCR) to an alleged unitary group of banks headed by a foreign parent bank violates various federal constitutional principles, although they recognized at that time that we could not consider the constitutional question, and only raised it to exhaust their administrative remedies.[2/]

Appellant Union Bank (formerly California First Bank) (hereinafter referred to as CFB) is a California-chartered bank which has been engaged in the banking business in this state since 1953. During the appeal years, The Bank of Tokyo, Limited (hereinafter referred to as BOT), owned approximately 75 percent of CFB's stock. The remaining 25 percent of CFB's stock was owned primarily by individuals and companies not affiliated with BOT. During the appeal period, CFB was primarily a retail bank, emphasizing personal loans and lines of credit and loans to small and medium-sized businesses. CFB had 3,067 employees as of the end of 1975, but by the end of 1980 this number had grown to 3,723. In 1975, CFB had 75 branches in California; by 1979 this total had grown to 110. Much of this growth was attributable to the acquisition of Southern California First National Bank, which gave CFB a presence in southern California.

BOT is a Japanese bank which has always engaged in the wholesale banking business, including especially the financing of Japan's international trade. It has maintained two offices in California. BOT also had offices in several other major U.S. cities, as well as an extensive worldwide banking network. It had 52 overseas branch offices, 26 representative offices, and 26 principal overseas subsidiaries and affiliates in at least 13 countries besides the United States. It had banking relationships with over 2,400 banks worldwide. During the years in question, BOT had approximately 12 times the assets of CFB ($38 billion). BOT had an average of 6,300 employees.

CFB and BOT did not share what could be described as administrative functions. They did not have common accountants, accounting systems, lawyers, reporting methods, insurance, etc. They were also subject to different banking regulatory schemes. CFB had its own lending policies, and loans made were not subject to the approval of BOT. Major capital expenditures had to be approved by BOT but CFB's operating budgets were not under the review of BOT. CFB contends that it essentially operated independently of BOT.

During the years in question, between 1 and 3 of CFB's 21 to 25 directors were also directors of BOT. However, many more of the CFB directors appear to have been former BOT employees. Approximately 125 employees from BOT were transferred to CFB, and as many as 51 of

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[2/]The constitutionality of WWCR has now been settled by Barclays Bank PLC v. Franchise Tax Board, 512 U.S. ___ [129 L.Ed.2d 244] (1994).

them were employed by CFB at any one time. It appears that many of these employees were high-level CFB employees, including the president and chief executive officer of CFB. Appellant admits in its post-hearing brief that during two of the appeal years for which it could find information, 44 and 46 of the former BOT employees were CFB vice presidents.

In CFB's 1975 annual report, it stated:

On September 30, 1975, after careful analysis and planning, The Bank of Tokyo of California (BTC) acquired the assets and assumed the liabilities of Southern California First National Corporation (SCFNC), and those of its principal subsidiary, Southern California First National Bank (SCFNB).

The resulting bank was subsequently named California First Bank to more accurately reflect its emergence as a truly statewide banking force. The Bank now operates 101 banking offices in California plus three overseas. In terms of deposits, California First Bank is the eighth largest bank in California. On a national basis, it ranks 50th.

Unification of the two important banking institutions, both with long histories of California service, was undertaken in order to better equip the Bank to share in the future growth of both domestic and global business.

The marriage of BTC's proven expertise in international and wholesale banking with SCFNB's extensive consumer and trust services enables us to offer a more complete range of banking services than ever before. (Emphasis added.)

In 1976, CFB stated in its annual report that:

The Bank of Tokyo group, of which California First Bank is a member, has representation in New York, Chicago, Washington, D. C., Seattle, Portland, and Houston. Assistance to CFB corporate clients is also available through these offices.

But surely the major advantage California First Bank offers is the ability to serve the global needs of a U.S. customer, be it a firm heavily engaged in trade and overseas investment, or a small business with potential to enter lucrative foreign markets. At our complete disposal is the Bank of Tokyo network, represented on five continents and in every major capital in the world.

* * *

While specialized global services are available to American corporations through any U.S. office of the Bank of Tokyo group, access to those services in California is enhanced through our statewide CFB network, which now include 100 offices.

Sophisticated International Operations centers at CFB handle customer documentation efficiently and expertly, while Foreign Trade and Investment Information centers in San Francisco and Los Angeles maintain the latest data and regulations affecting commerce and investment. (Emphasis added.)

During the years in question, BOT earned approximately $285 million in dividends and gains from stocks and bonds it owned. The stock was apparently in companies to whom BOT had lent funds, but it is not clear whether all of the dividends and gains were from these companies. Under Japanese law, BOT could own stock in companies it lent funds to, and this was apparently a common practice in Japan.

For the appeal years, CFB and BOT each filed franchise tax returns on a separate accounting basis. Respondent audited the returns and determined that the two banks were engaged in a single worldwide unitary business. Deficiency assessments were issued, which CFB and BOT paid under protest, leading to the refund claims in issue.

Respondent's finding of unity was based on, among other things, the following connections: common directors; common customers; intercompany transfers of personnel from BOT to CFB, including dozens of individuals who served as CFB's branch officers and senior corporate executives; sharing of credit information concerning common customers; BOT's participation in lending activities initiated by CFB, and vice versa; BOT's sharing of customer lists with CFB; BOT's referrals of its customers to CFB and subsequent guaranteeing of loans CFB made to them; the conferring of titles by CFB on some of BOT's employees in California so that they could help CFB's customers with international transactions; and CFB's close consultation with BOT regarding CFB's capital requirements and future acquisitions. Appellants do not dispute the existence of these facts.

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 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).)

CFB and BOT argue that they were not conducting a unitary business during the appeal years because they did not have a unified operation, were not centrally managed, and operated in different markets. They contend that in these appeals they have done what this board said they did not do in their earlier appeals (Appeal of The Bank of Tokyo, Ltd., Cal. St. Bd. of Equal., June 25, 1985; Appeal of California First Bank, Cal. St. Bd. of Equal., June 25, 1985), namely, produce evidence that they were not unitary. Appellants essentially argue that while the many connections cited by respondent do exist, their quantitative and/or qualitative factors are insignificant. For example, they contend, rather disingenuously, that having only two common directors out of 22 is insufficient to indicate a unitary business.[3/]

Appellants' position is reminiscent of the old, discredited notion that respondent must show the "quantitative substantiality" of the unitary indicators it is relying on. As we said in the Appeal of Saga Corporation, decided by this board on June 29, 1982, the taxpayer's burden of proof requires appellants to "establish by a preponderance of the evidence that the unitary connections present in this case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist." (Emphasis added.) While some previous cases might well have contained more overwhelming evidence of unity than this case, it cannot fairly be said that, in the aggregate, appellants' unitary connections were "trivial and insubstantial." Far from it.

The record shows that current and former BOT employees completely controlled CFB's board of directors. More than 100 former BOT personnel were transferred to CFB, including CFB's chief executive officer and at least 44-46 vice presidents, as well as lower-ranking personnel. It strains credulity to believe that these employees did not bring valuable knowledge with them to CFB or carry newly acquired knowledge back to BOT when their tours of duty ended at CFB. The idea that employee transfers of this magnitude were undertaken on a whim, or had no business purpose of value to these affiliated banks, simply cannot be taken seriously.

The record also shows that CFB formed a Japanese Corporate Division (JCD) "primarily to handle banking relationships with U.S. subsidiaries of Japanese corporate customers referred by BOT." (Letter of June 15, 1989, from appellant's accounting firm to respondent, found at Resp. Br., Exhibit F.) Separate financial information was not maintained for JCD prior to 1982, but for the appeal years JCD apparently existed to handle the banking relationships for referred Japanese corporate customers.

Other evidence establishes that BOT and its other affiliates placed deposits with CFB

[3/] Leaving aside that the two directors in question were among BOT's most senior executives, and thus were hardly figureheads, the number of common directors is irrelevant. Unitary combination of affiliated entities does not require any common directors, much less a certain magical number of them. In any event, the record here shows that, in every appeal year, current and former BOT personnel constituted a majority of CFB's directors.

ranging from 3-8 percent of CFB's total deposits during the years in question. BOT also issued loan quarantees to CFB ranging from $19-80 million for those years. When added to the other unitary connections mentioned above, connections which appellants do not deny, these factors establish clearly that the unitary relationships between CFB and BOT were anything but "trivial and insubstantial." This is a classic example of mutual interdependence and a flow of value which cannot be measured in dollar amounts, and which clearly makes it inappropriate to use separate accounting to measure the income of each bank.

Even if they were unitary with each other, appellants argue, respondent should have allowed either separate accounting or adjustments to the standard apportionment formula to prevent an unfair distortion of income, in California's favor, caused by the fact that BOT's out-of-state operations were much more profitable than CFB's in-state business. Appellants also argue that BOT had 12 times the assets and one-half the number of employees that CFB had, and thus the standard formula is inapplicable. However, such isolated comparisons do nothing to show that the standard formula misrepresents the California portion of the entire worldwide unitary business. (Appeal of Kikkoman International, Inc., supra; see also Container Corp. v. Franchise Tax Board, supra.) Under section 25137, the party who claims that the normal apportionment factors produce a distorted result has the burden of proving that use of the normal formula does not fairly represent the extent of the taxpayer's activity in this state. (See Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc., 89-SBE-017, June 2, 1989; Appeal of Coachmen Industries, Inc., Cal. St. Bd. of Equal., Dec. 3, 1985; Appeal of Donald M. Drake Company, Cal. St. Bd. of Equal., Feb. 3, 1977.) Since appellants have not shown how the normal apportionment formula distorts the reflection of their business activity in California, they cannot prevail.

Finally, appellants contend that BOT's capital gains and dividends should have been treated as nonbusiness income since a California bank would have been prohibited from holding the investments giving rise to them and, thus, the income should not be regarded as having come from a "banking function" within the meaning of respondent's regulation 25137-4. (Cal. Code Regs., tit. 18, § 25137-4.) We think the fact that a California bank could not have made the same type of investments under California law does not mean that the income is not business income. Business income is defined as:

> income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(Rev. & Tax. Code, § 25120, subd. (a).)

Based on the arguments of CFB's counsel that Japanese banks regularly invested in the stock of companies that they lent funds to, and lacking any evidence that the income and gains were earned from a separate portfolio of "investment" funds wholly unrelated to BOT's banking business, we conclude that respondent's characterization of the income as business income 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 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of The Bank of Tokyo, Limited, for refund of franchise tax in the amounts of $115,468, $60,626, $172,102, $277,280, and $487,545 for the income years ended March 31, 1976, through March 31, 1980, respectively, and in denying the claims of Union Bank (formerly California First Bank) for refund of franchise tax in the amounts of $633,473, $858,989, and $420,989 for the income years ended December 31, 1975, December 31, 1976, and December 31, 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of August, 1995, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Dronenburg, Mr. Sherman, and Mr. Halverson present.

_____, Chairman

Dean F. Andal, Member

Brad J. Sherman, Member

Rex Halverson*, Member

_____, Member

* For Kathleen Connell, per Government Code section 7.9.