

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
United Mizrahi Bank) No. 92A-0955
)
)

Representing the Parties:

For Appellant: Timothy J. Sweeney, Attorney

For Respondent: James E. Durkee, Counsel

Counsel for Board
of Equalization: Tommy Leung, Staff Counsel

OPINION

This appeal is made pursuant to section 19045 (formerly section 25666)^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of United Mizrahi Bank against proposed assessments of additional franchise tax in the amounts of \$3,808 and \$62,504 for the income years ended December 31, 1981, and December 31, 1982, 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.

The questions presented in this appeal are whether appellant is engaged in a unitary business with its branch office (UMB-LA) and whether respondent properly utilized worldwide combined reporting to determine appellant's tax liability.

Appellant is a foreign bank headquartered and incorporated in Israel. Appellant formed UMB-LA, which is located in Los Angeles, in 1981 with a \$350,000 capital contribution. UMB-LA is engaged in general banking activities in California; however, it emphasizes the financing of domestic and international trade in extending appellant's international financial activities to California.

Initially, UMB-LA's management included one of appellant's senior vice presidents (who was in charge of appellant's West Coast operations), and a vice president who was transferred to UMB-LA from appellant's home office to be in charge of UMB-LA's international operations. Many of UMB-LA's officers are officers of appellant. All major decisions of UMB-LA's management team require consultation with and approval by appellant's New York office (UMB-NY). Top management from both the home office in Tel Aviv and UMB-NY periodically visit UMB-LA to ensure that appellant's policies and procedures are followed. Top management of UMB-LA periodically travel to New York and Tel Aviv for similar meetings. UMB-LA filed a statement with its federal income tax returns which reflects deductions for expenses for travel to areas outside of North America.

During the appeal years, UMB-LA's operating funds were furnished by appellant in the form of loans, time deposits, and federal funds. Appellant and its affiliates made time deposits and sold federal funds to UMB-LA in amounts totalling \$10,125,000 and \$7,550,000 in 1981 and 1982, respectively. During this same period, appellant and its affiliates made loans to UMB-LA totalling \$1,277,778 and \$2,000,053 in 1981 and 1982, respectively. In addition to various time deposits and loans received from appellant's home office, UMB-LA used appellant's name to obtain various financial lines to meet UMB-LA's direct international trade and other financial needs.

UMB-LA used appellant's name and logo. UMB-LA and appellant's home office referred potential business to each other. Appellant maintained an account with UMB-LA, and all remittances from appellant's home office to the West Coast were done via that account. All transfers from UMB-LA to Tel Aviv were handled in a similar manner by appellant's home office, which then made further transfers to other Israeli banks when required.

UMB-LA filed separate California franchise tax returns for the appeal years which reflected only the income or loss of UMB-LA's operations in California. During this same period, UMB-LA filed consolidated federal income tax returns with UMB-NY. Respondent determined that UMB-NY functioned as appellant's regional headquarters and oversaw UMB-LA's operations. UMB-LA prepared quarterly financial reports and submitted them to UMB-NY for review and preparation of consolidated annual reports. UMB-LA filed amended returns for subsequent years claiming to be unitary with appellant in order to obtain a refund.

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 (1) unity of ownership, (2) unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions, and (3) unity of use in a centralized executive force and general system of operation (the three unities test). (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 (the contribution or dependency test). (Edison California Stores, Inc. v. McColgan, *supra*, 30 Cal.2d at 481.) More recently, the United States Supreme Court 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 spite of the facts described hereinabove, much of which are gleaned from UMB-LA's financial statements and tax returns, appellant's annual reports, and respondent's audit statement, appellant contends it and UMB-LA do not rely on each other for customers, UMB-LA's and its home office's operations are independent of each other, and, except for periodic reporting to its head office, UMB-LA is managed by domestic personnel. We do not find such assertions to be persuasive, especially in light of the fact that UMB-LA is not an entity separate and distinct from appellant but is merely a branch office which is engaged in the same line of business. In such circumstances, a strong presumption of unity is created, which appellant has failed to overcome. (Cal. Code Regs., tit.18, § 25120, subd. (b)(1).)

With respect to appellant's contentions that respondent's use of the worldwide combined reporting method violates both the United States and California Constitutions (e.g., violation of due process, commerce and foreign commerce clauses), as well as the terms of certain federal treaties, we initially note article III, section 3.5 of the California Constitution precludes us from deciding constitutional issues. (Appeal of Aimor Corp., Cal. St. Bd. of Equal., Oct. 26, 1983.) Moreover, virtually identical claims were considered and rejected by the United States and California Supreme Courts. (See Barclays Bank PLC v. Franchise Tax Board, 512 U.S. ___ [129 L.Ed.2d 244] (1994), Container Corp. v. Franchise Tax Board, *supra*, and Barclays Bank International, Ltd. v. Franchise Tax Board, 2 Cal.4th 708 [8 Cal.Rptr.2d 31] (1992). For these reasons, appellant's constitutional arguments must fall.

Finally, appellant contends application of worldwide combined reporting will distort its income and, instead, advocates the use of arm's-length separate accounting. However, the party seeking to deviate from the statutory scheme bears the burden of proving that the method does not fairly represent

the extent of the taxpayer's business activity in this state. (Appeal of Dart Container Corp. of California, 92-SBE-021, July 30, 1992; Appeal of Kikkoman International, Inc., supra.) In this appeal, not only does appellant fail to meet its burden of proof, but it also embraces the worldwide combined method of reporting when it suits its purposes (i.e., when filing amended returns seeking refunds for income years following the appeal years).

Accordingly, respondent's actions in this matter must be sustained.

ORDER

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 19047 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protests of United Mizrahi Bank against proposed assessments of additional franchise tax in the amount of \$3,808 and \$62,504 for the income years ended December 31, 1981, and December 31, 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 31st day of August, 1995, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Dean F. Andal _____, Member

Brad J. Sherman _____, Member

Rex Halverson* _____, Member

*For Kathleen Connell, per Government Code section 7.9.