

¹ Collectively, M.L. Watts, C.A. Watts, C. Watts, and M. Watts shall be referred to as appellants. M.L. Watts is the father in the family, C.A. Watts is the mother, C. Watts is the son, and M. Watts is the son's wife.

FACTUAL FINDINGS

Sumitomo Corporation (Sumitomo)

1. Sumitomo is a Japanese business conglomerate.
2. During 2008 and 2009, Sumitomo became interested in expanding its presence in the United States equipment rental market and identified Sunstate as a potential acquisition target.

Sunstate

3. Sunstate, an LLC headquartered in Arizona and treated as a partnership for income tax purposes, operated an equipment rental business throughout the United States, including California.
4. M.L. Watts and C. Watts both served as directors of Sunstate, as well as executive officers of Sunstate, with M.L. Watts serving as Executive Chairman and C. Watts serving as President/Chief Operating Officer.
5. Before December 1, 2009, C.A. Watts owned 0.01 percent of Sunstate and WHI owned the remaining 99.9 percent.

WHI

6. WHI, a holding company, was an Arizona corporation that elected to file as an S corporation for the 2012 tax year.
7. M.L. Watts owned approximately 98.96 percent of WHI, and C. Watts owned the remaining 1.04 percent of WHI.
8. M.L. Watts and C. Watts were California nonresident shareholders for the 2012 tax year.
9. Both M.L. Watts and C. Watts served as directors and officers of WHI.
10. WHI did business both within and without California for the 2012 tax year.

Sunstate Aviation and Leasing, LLC

11. WHI wholly owned Sunstate Aviation and Leasing, LLC (Aviation), a single-member LLC and a disregarded entity for income tax purposes. Aviation owned and leased aircrafts to Sunstate and to third parties.
12. WHI received \$149,900 in aircraft rental revenue from Sunstate during 2012.

Other WHI Businesses

13. During the 2012 tax year, WHI invested in various other businesses, in addition to Sunstate and Aviation, including: (1) SCM – Watts Holdings, LLLP, which held large parcels of land near Denver, Colorado; (2) Brooks 400, LLC, Brooks 600, LLC, and Brooks 700, LLC, which held tracts of land near Las Vegas, Nevada; and (3) Tallwave, LLC, which operated an internet marketing company.
14. Also, during the 2012 tax year, WHI's CFO, C. Nute, negotiated a sale of real property located in California.

Sumitomo's Staged Acquisition of Sunstate

15. M.L. Watts was not prepared to immediately give up full control of Sunstate. As a result, a staged acquisition of Sunstate was structured so that Sumitomo would initially acquire a minority interest in Sunstate, with the option of subsequently taking a controlling interest.
16. Sumitomo's initial ownership interest in Sunstate was purchased by its subsidiary, SMS International Corporation (SMS).
17. On December 1, 2009, SMS obtained a 35 percent preferred membership interest in Sunstate by purchasing 35,000 preferred units from WHI for \$50 million.
18. The terms of the preferred units are described in the Third Amended and Restated Limited Liability Company Agreement of Sunstate Equipment Co., LLC, dated as effective as of December 1, 2009 (3rd Amended Agreement).
19. Under the terms of the 3rd Amended Agreement, the preferred units owned by SMS were entitled to a preferred return and the right to convert the preferred units into common units. Upon the conversion date, Sunstate would be governed by a Fourth Amended and Restated Limited Liability Company Agreement of Sunstate Equipment Co., LLC (4th Amended Agreement).
20. The 3rd Amended Agreement also gave SMS the right to appoint two directors on Sunstate's six-member board of directors.
21. The 3rd Amended Agreement further provided, among other things, that Sunstate's board of directors was precluded from undertaking certain activities without consent of each SMS director, including the following:

- Amend, alter, repeal or waive any provision of the 3rd Amended Agreement in a manner that would be materially adverse to SMS.
- The dissolution, liquidation, merger, consolidation, or other business combination of any kind involving Sunstate.
- Acquisition of another entity by Sunstate where the other entity had a value in excess of \$3 million.
- Admission of a new member.
- Adjustments of a member's share of profits and losses.
- Any material change to Sunstate's accounting policies.

Conversion of Preferred Units to Common Units

22. On April 1, 2012, Sumitomo converted its preferred units in Sunstate into common units. Concurrently, pursuant to the terms of the 3rd Amended Agreement, the members of Sunstate, including SMS, executed the 4th Amended Agreement, granting additional management and approval rights to SMS.
23. In addition to the actions precluded in the 3rd Amended Agreement, the 4th Amended Agreement further restricted Sunstate's board of directors from undertaking certain activities without consent of each SMS director, including, in relevant parts, the following:
- Approval of Sunstate's annual budgets or annual business plans.
 - Incurrence of aggregate indebtedness above \$3 million that was not already included in the annual business plan.
 - Acquisition or disposal of any rental fleet that was not already included in the annual business plan.
 - Acquisition or disposal of any non-rental asset with a value in excess of \$1 million that was not already included in the annual business plan.
 - Any salary increases for M.L. Watts, C. Watts or any other executive officer who succeeds the aforementioned individuals.
 - The opening or closing of any branch office not already included in the annual business plan.
 - Any change to the size of Sunstate's board of directors.

- Appointment of Sunstate’s auditing firm.
 - Appointment of outside directors or officers.
 - Repurchase of Sunstate’s bonds.
 - Increase or reduce of Sunstate’s capital, including distributions.
 - Any material year-end adjustments made in connection with the preparation of the Company’s annual financial statements.
24. In addition to requiring SMS director approval for certain decisions, the 3rd and 4th Amended Agreement provided that two-thirds (2/3) of Sunstate’s membership interests must approve transactions between Sunstate on the one hand, and WHI, M.L. Watts and C.A. Watts or their respective affiliates on the other hand. Since SMS held a 35 percent common membership interest in Sunstate, the two-thirds approval requirement could not be obtained without SMS’s consent.
25. Various limitations placed on Sunstate’s operations by the 4th Amended Agreement were explicitly recognized by Sunstate’s board of directors. According to the Minutes of Sunstate’s Board of Directors Meeting dated July 25, 2012, it noted that the “Board discussed the approval process for certain matters requiring Sumitomo approval under the [4th Amended Agreement,] . . . including the pre-ordering of capital equipment[,] . . . year-end adjustments, estimates, and write-downs. . . . Regarding year-end accounting adjustments, etc., [Sunstate] will review proposed year-end financial statements with the Seconded [Sumitomo].”
26. The 3rd and 4th Amended Agreement contained a covenant not to compete, under which M.L. Watts, C.A. Watts, and WHI agreed not to compete with Sunstate during the period that C.A. Watts and/or WHI held an interest in Sunstate—and for a period of three years following termination of both such interests.

SMS Additional Purchase of Membership Interests in Sunstate

27. In December 2012, WHI sold (and SMS purchased) additional Sunstate membership units, representing a 44.935 percent membership interest in Sunstate.² The December 2012 sale/purchase gave rise to the matters on appeal.

² SMS increased its membership interest in Sunstate to approximately 80% (44.935% + 35%)

28. In 2017, SMS acquired the remaining membership interests in Sunstate and thereafter owned 100 percent of Sunstate. Matters relating to the 2017 sale/purchase are not in dispute on appeal.

2012 California Tax Return

29. On WHI's 2012 California return (Form 100S), WHI reported a Schedule D long-term capital gain of \$153,908,352 and ordinary gain of \$93,023,003, with both gains attributable to SMS's purchase from WHI of additional membership units in Sunstate in December 2012.
30. The 2012 California return treated WHI and Sunstate as unitary business enterprises and classified WHI's gain from the December 2012 sale of additional membership units in Sunstate as business income. However, WHI subtracted this gain from income for purposes of computing California source income on the Schedule K-1s issued to WHI's two shareholders—i.e., M.L. Watts and C. Watts.

Procedural History

31. During the audit, FTB determined that WHI and Sunstate were unitary business enterprises when the 44.935 percent membership interest in Sunstate was sold in December 2012.
32. Accordingly, FTB issued Notices of Proposed Assessment (NPAs) to M.L. Watts and C.A. Watts, and C. Watts and M. Watts.
33. Subsequently, WHI submitted an amended 2012 California return (Form 100X), stating that the return was being amended to properly reflect that WHI and Sunstate are non-unitary, such that the gain derived from the sale of additional membership units in Sunstate constitutes gain from the sale of a nonbusiness partnership interest.
34. Appellants protested the NPAs. FTB, however, later affirmed the NPAs in Notices of Action (NOAs) dated May 19, 2022. Appellants then filed timely appeals, which were consolidated by the Office of Tax Appeals (OTA).

DISCUSSIONI. Burden of Proof

FTB's proposed assessment of additional tax is presumed correct and the taxpayer bears the burden of proving it to be incorrect. (*Appeal of Smith*, 2023-OTA-069P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) To meet this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Smith, supra.*)

Here, the sole issue raised by the parties before OTA is whether WHI and Sunstate were engaged in a unitary business when WHI sold part of its membership interest in Sunstate in December 2012.³ FTB argues that since WHI and Sunstate were engaged in a unitary business, the gain from WHI's sale of membership interests in Sunstate is apportionable business income. Appellants counter that since WHI and Sunstate were not engaged in a unitary business, WHI's gain from the sale of Sunstate should be treated as nonbusiness income and allocated outside of California.⁴

II. Unitary Law

"[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." (*Mobil Oil Corp. v. Commissioner of Taxes of Vermont* (1980) 445 U.S. 425, 439.) If a unitary business is conducted within and without California, the income

³ See, e.g., *Appeal of Smith, supra* ["[T]he parties appear to agree that if the entities are engaged in a unitary business, Holdco's partnership interest in Shell is a unitary asset to Holdco and the gain from its sale should be properly classified as apportionable business income. OTA agrees with the parties on this point"]; *Jim Beam Brands Co. v. Franchise Tax Bd.* (2005) 133 Cal.App.4th 514 [gain on the sale of stock in unitary subsidiary generates business income]; *Appeal of Centennial Equities Corp.* (84-SBE-086) 1984 WL 16165 [gain on the sale of partnership interests in unitary partnerships generates business income]. OTA emphasizes that neither party made any alternative arguments in the event that the party loses its unitary argument. The record shows that other arguments were made at audit and protest, which were not raised in briefings before OTA. Therefore, in this appeal, OTA will only address the unitary business issue.

⁴ California Code of Regulations, title 18, section 17951-4(d) provides rules when "a nonresident is a partner in a partnership which carries on a unitary business, trade or profession within and without this state." In general, "the total business income of the partnership shall be apportioned at the partnership level in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, [R&TC] [s]ections 25120 to 25139 . . . and the regulations thereunder." (Cal. Code Regs., tit. 18, § 17951-4(d)(1).) "The source of a partner's distributive share of items which do not constitute business income shall be determined in accordance with the sourcing rules of [R&TC] [s]ections 17951 through 17955 . . . and the regulations thereunder, as if the income producing activity were undertaken by the partner in its individual capacity." (Cal. Code Regs., tit. 18, § 17951-4(d)(4).)

attributable to California must be determined by applying an apportionment formula to the total income of the unitary business. (R&TC, §§ 25121, 25128; *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481.)

The California Supreme Court has set forth two alternative tests for determining whether a business is “unitary”: the “three unities test” and the “dependency or contribution test.” (*Appeal of Smith, supra.*) Under the three unities test, a unitary business is “definitely established” when there is: (1) unity of ownership, (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions, and (3) unity of use in the centralized executive force and general system of operation. (*Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 678, *affd.* (1942) 315 U.S. 501.) Under the contribution or dependency test, a business is unitary if the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state. (*Edison California Stores, Inc. v. McColgan, supra*, 30 Cal.2d 472, 481.) Similar to the three unities test, the contribution or dependency test implicitly contains an ownership requirement. (*Appeal of Willamette Industries, Inc.* (87-SBE-053) 1987 WL 50176.) The three unities test and the contribution or dependency test are not mutually exclusive, and the application of either to a particular set of facts should result in the same conclusion. (*Dental Ins. Consultants, Inc. v. Franchise Tax Bd.* (1991) 1 Cal.App.4th 343, 348.) The United States Supreme Court has stated that a court can apply any judicially-created tests to determine unity as long as there is “a flow of value” between the segments of a unitary business. (*Container Corp. of America v. Franchise Tax Bd.* (1983) 463 U.S. 159, 178 & fn. 17.) No special test for a unitary business exists where a holding company is involved. (*Appeal of Smith, supra.*) OTA first addresses the contribution or dependency test because this is the parties’ main point of contention.

A. The Contribution or Dependency Test

As a practical matter, OTA is mindful the contribution or dependency test overlaps with the three unities test in many areas. (*Appeal of Smith, supra.*) In the holding company context, *Appeals of PBS Building Systems, Inc. et al.* (94-SBE-008) 1994 WL 719050 (*PBS Building*)⁵ and *Appeal of Smith, supra*, serve as useful guidance to aid in the unitary analysis.

⁵ “Although *PBS Building* dealt with the unitary combination of corporations, OTA discerns no reason why the rationale of that decision cannot be applied to pass-through holding companies, especially since the California courts have for many decades steadfastly adhered to well-settled unitary tax law.” (*Appeal of Smith, supra.*)

In *PBS Building, supra*, the Board of Equalization (BOE) held that a holding company corporation and its operating subsidiary were entitled to file a unitary combined report because there was evidence of a complete overlap of officers and directors, substantial intercompany financing, and a covenant not to compete. The BOE noted “[c]onsiderable unity of operation may exist, for example, by virtue of intercompany financing, including loans, loan guarantees, debt refinancing and debt reduction, and by virtue of large tax loss carryforwards owned by the holding company which are utilized by the operating subsidiary.” (*Ibid.*) The BOE went on to observe that a holding company may provide its operating company significant advantages, such as insulation from liability. (*Ibid.*) “[F]lows of value or contribution and dependency may take the form of shared tax benefits [], intercompany financing (loans, loan guarantees and debt retirement), or improved credit worthiness (bond security, more favorable insurance rating or interest rates on borrowed capital).” (*Ibid.*)

In *Appeal of Smith, supra*, OTA found that a holding company and its operating subsidiary constituted a unitary business because there was an integration of executive forces due to significant management overlap because the sole manager of the holding company was also the CEO of the operating subsidiary, there was substantial intercompany financing because the operating subsidiary looked to the holding company for approval on financial matters, and there was a non-compete provision in which the holding company agreed not to participate in any business activities that would be in competition with the operating subsidiary.

Here, the facts present a less compelling argument that a holding company was unitary with its operating subsidiary compared to the facts in *PBS Building, supra*, and *Appeal of Smith, supra*. There is no evidence of intercompany financing (loans, loan guarantees, debt refinancing, or debt reduction) between Sunstate and WHI.⁶ There was no complete overlap of officers and directors between WHI and Sunstate. FTB makes no arguments regarding tax loss carryforwards, insulation from liability, shared tax benefits, or improved credit worthiness (bond security, more favorable insurance rating, or interest rates on borrowed capital). Instead, FTB primarily argues that WHI and Sunstate constituted a unitary business for three reasons: (1) Sunstate used an aircraft owned by Aviation, WHI’s wholly owned entity; (2) M.L. Watts and

⁶ FTB states that it “has no evidence of intercompany financing between Sunstate and WHI.” FTB also states that “WHI[’s] 2012 tax return indicates loans to shareholders and from shareholders as well as [a]ppellant husband’s guarantee of a loan for an aircraft that was used in the business.” However, FTB has not explained the significance of how a loan or guarantee to or from WHI and appellants would show a unitary connection between WHI and Sunstate.

C. Watts served on the board of directors and as officers for both WHI and Sunstate; and (3) Sunstate was protected from competition from both WHI and appellants through a covenant not to compete. Since appellants are contesting FTB's determination of unity, appellants "must prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by [FTB] are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist." (*Appeal of Smith, supra.*)

1. Sunstate's Use of Aviation's Aircraft

Aviation is a single member LLC wholly owned by WHI. Aviation is in the aircraft rental business and rented aircrafts to Sunstate and to third parties. FTB argues that "[t]he use of the aircraft demonstrates a flow of value from WHI to [a]ppellants and Sunstate." Appellants counter that Sunstate's use of the aircraft was not a substantial flow of value.

To meet the contribution or dependency test to find two businesses to be unitary, the transactions or interrelations between those businesses must be substantial. (See *Appeal of Vidal Sassoon of New York, Inc.* (84-SBE-098) 1984 WL 16178 [the "operations in the United States were clearly distinct from those in Europe, and that there was no *substantial* contribution or dependency between the two," italics added]; *Appeal of Dart Container Corporation of California* (92-SBE-021) 1992 WL 202572 ["This board has found mutual contribution or dependency to exist in appeals where there was *substantial* interdivisional or intercorporate product flow and an integrated executive force . . . and where there was *substantial* vertical integration, an integrated executive force, and other indications of a unitary relationship," italics added].)

Here, appellants submit Sunstate's unaudited 2012 financial statements, Sunstate's flight logs, a declaration from C. Nute, and a declaration from Sunstate's VP of Strategy and Finance, Y. Matsui. These documents indicate that Sunstate's use of Aviation's aircraft does not demonstrate a substantial flow of value for several reasons. First, Sunstate's \$149,900 expenditures for aircraft rental from Aviation, was less than 10 percent of Sunstate's total 2012 travel expenditures of \$1,605,764. Second, Sunstate's use of Aviation's aircraft for business purposes was limited and declined from 2010 through 2012. In 2010, of the total flight seats used by Sunstate, only 17 percent were provided by Aviation. That number declined to 15 percent in 2011, and 8 percent in 2012. In addition, Sunstate did not have exclusive use of Aviation's aircraft because the aircraft was also rented to third parties. Third, because of the

staged acquisition of Sunstate by Sumitomo, Sumitomo monitored Sunstate's transactions to ensure they were conducted on an arm's-length basis with Aviation. (See *Container Corp. of America v. Franchise Tax Bd.*, *supra*, 463 U.S. 159, 180, fn. 19.) Despite appellants' robust evidence on this issue, FTB did not address or provide OTA with a contrary characterization of appellants' evidence. Accordingly, OTA finds that Sunstate's use of Aviation's aircraft was not a substantial flow of value, and thus this fact does not support a finding that Sunstate and WHI were engaged in a unitary business.

2. Integration of Executive Forces

The integration of executive forces is "an element of exceeding importance" in determining unity. (*Chase Brass & Copper Co. v. Franchise Tax Bd.* (1970) 10 Cal.App.3d 496, 504.) In *PBS Building*, *supra*, one unitary indicator was "a complete overlap of officers and directors" between the holding company and its operating subsidiary. (But see *Appeal of Insul-8 Corp.* (92-SBE-007) 1992 WL 92342 ["[t]o establish unity, more must be shown than the existence of common officers and directors, since this situation frequently exists whenever one corporation owns or is affiliated with another and it implies no more than 'the type of occasional oversight . . . that any parent gives to an investment in a subsidiary . . .'"].) "It is top level management which is credited (or, in case of failure or indifferent results, debited) with the effects of corporate enterprises." (*Chase Brass & Copper Co. v. Franchise Tax Bd.*, *supra*, 10 Cal.App.3d 496, 504.) "[M]ajor policy matters" should be a court's focus when determining whether various entities have an integrated executive force:

The "major policy matters" are what count in our estimation of integration. Day-to-day operations are made at various levels by many executives in any organization. They are made, no doubt, by a multitude of officials Major policy is another thing. (*Ibid.*)

FTB argues that although "there was not a complete overlap of officers and boards of directors between Sunstate and WHI," and although "WHI appears to have given up control of Sunstate by losing a large share of Board seats to Sumitomo," an integration of executive forces still exists because M.L. Watts and C. Watts held positions in both Sunstate and WHI as officers and directors. However, a partial overlap of officers and directors between Sunstate and WHI is not enough to find that WHI and Sunstate had an integrated executive force. OTA must evaluate

how much control M.L. Watts and C. Watts had over the major policy matters of Sunstate based on the record before us.

Here, M.L. Watts's and C. Watts's control over Sunstate's major policy matters was restricted. As part of Sumitomo's staged acquisition of Sunstate, Sumitomo (through SMS) acquired an interest in Sunstate that included significant management control rights that increased over time, as Sumitomo sought to protect its interest and ultimately obtain 100 percent ownership in Sunstate.

On December 1, 2009, SMS, Sumitomo's subsidiary, obtained a 35 percent preferred membership interest in Sunstate by purchasing 35,000 preferred units for \$50 million. Concurrently, Sunstate executed a 3rd Amended Agreement. The 3rd Amended Agreement gave SMS the right to appoint two directors on Sunstate's six-member board of directors. These two directors obtained disproportionate management and consent rights because certain actions on major policy matters could not be undertaken without the approval of both directors appointed by SMS. The 3rd Amended Agreement required each SMS director's consent for Sunstate's board of directors to: amend, alter, repeal, or waive any provision adverse to SMS; dissolve, liquidate, merge, consolidate, or engage in any business combination involving Sunstate; acquire any entity valued over \$3 million; admit a new member; adjust a member's share of profits and losses; and make any material change to accounting policies.

On April 1, 2012, Sumitomo converted its preferred units in Sunstate into common units. Concurrently, Sunstate executed a 4th Amended Agreement. In addition to the actions that Sunstate's board of directors was precluded from undertaking under the 3rd Amended Agreement, the 4th Amended Agreement granted additional management and approval rights to SMS over major policy matters. In particular, the 4th Amended Agreement required each SMS director's consent for Sunstate's board of directors to: approve annual budgets or business plans; incur aggregate debt above \$3 million not in the annual business plan; acquire or dispose of any rental fleet not in the annual business plan; acquire or dispose of any non-rental asset over \$1 million not in the annual business plan; increase salaries for M.L. Watts, C. Watts, or their successors; open or close any branch office not in the annual business plan; change the size of the board of directors; appoint an auditing firm; appoint outside directors/officers; repurchase Sunstate's bonds; increase or reduce capital, including distributions; and make any material year-end adjustments to Sunstate's annual financial statements.

Not only did Sumitomo have the *potential* to control the major policy decisions of Sunstate via the voting provisions in the 4th Amended Agreement, but, more importantly, Sumitomo *actually had control* over Sunstate's major policy decisions. (See *F.W. Woolworth Co. v. Taxation and Revenue Dept. of State of N. M.* (1982) 458 U.S. 354, 362 ["the potential to operate a company as part of a unitary business is not dispositive"].) Various limitations placed on Sunstate's operations by the 4th Amended Agreement were explicitly recognized by Sunstate's board of directors. Sunstate's July 2012 board of directors' meeting minutes noted that the "Board discussed the approval process for certain matters requiring Sumitomo approval under the 4th Amended [Agreement] . . . including the pre-ordering of capital equipment . . . the approval process regarding year-end adjustments, estimates, and write-downs Regarding year-end accounting adjustments, etc., [Sunstate] will review proposed year-end financial statements with the Seconded [Sumitomo]."

Furthermore, Y. Matsui's declaration, signed under penalty of perjury, provides further support for Sumitomo's actual control over Sunstate's major policy decisions. Y. Matsui asserts that he has personal knowledge of the relevant facts in this case because in February 2010, he was assigned to Sunstate as a "Seconded." As the Seconded to Sunstate, he asserts his full-time position in Sunstate was the VP of Strategy and Finance. These assertions are corroborated by Sunstate's July 2012 board of directors' meeting minutes that listed Y. Matsui as present and Sumitomo's February 2012 Investment Committee Minutes Summary that listed Y. Matsui as an attendee who was assigned to Sunstate.

Y. Matsui states that he worked closely with Sunstate's senior management. He explains that he represented Sumitomo's interests and opinions on key operational matters. Y. Matsui reports that he was involved with Sunstate's business plan preparation meetings, where Sunstate's senior management would meet with each of the regional managers to go over their business plans. He asserts that by the time Sunstate's budgets were prepared, he would have already prepared his own summary of Sunstate's business plan. He maintains that if he noticed any issues that might raise a concern for Sumitomo, he discussed such matters with a Sunstate director before any Sunstate board of directors meeting. He asserts that he had significant influence over Sunstate's accounting decisions and entries that pertained to accruals/reserves and depreciation to minimize the adverse impact on Sumitomo. Y. Matsui assertions are corroborated with the restrictions placed on Sunstate by Sumitomo, as discussed in the 3rd

Amended Agreement, the 4th Amended Agreement, and Sunstate's board of directors' meeting minutes.

Despite the partial overlap of executive forces, Sunstate operated on an arm's-length basis with WHI. Y. Matsui contends that as part of his role, he was instructed by Sumitomo to monitor transactions between Sunstate and entities controlled by M.L. Watts, including WHI, to ensure that: (1) all such transactions were related to the business of Sunstate, (2) all such transactions were conducted on an arm's-length basis, and (3) there was no excessive use of the entities controlled by M.L. Watts or the assets of those entities. Y. Matsui's contention is supported by the 3rd and 4th Amended Agreements, which grant SMS approval rights over Sunstate's transactions with WHI. The Agreements state that the "Board shall not . . . without the written consent of the Members representing at least two-thirds (2/3) of the Membership Interests of [Sunstate] . . . enter into or approve entering into any transaction between [Sunstate] or any direct or indirect subsidiary of [Sunstate], on the one hand, and any of [M.L.] Watts, [WHI] or [C.A. Watts] or their respective Affiliates on the other hand" The Agreements also require member consent for transactions by Sunstate with Aviation if "the terms of any such transaction are not on arms length terms" At this time, SMS had a 35 percent membership interest in Sunstate and therefore the two-thirds approval of the membership interests requirement could not be obtained without the approval of SMS.

Another consideration for integration of executive forces is whether a holding company devoted all of its activity to the partnership it held. (*Appeal of Smith, supra* ["In short, it appears Holdco, through its sole manager [], devoted all of its activity, however small, to Shell."].) "[I]n the typical case where a group of corporations conduct only one unitary business, it would be expected that the requisite contribution or dependency would exist between the 'ultimate parent' holding company and its operating subsidiary or subsidiaries." (*PBS Building, supra*; see also *Blue Bell Creameries, LP v. Roberts* (Tenn. 2011) 333 S.W.3d 59, 71 [holding company corporation and its operating partnership were unitary because they both derived their income from "a single underlying activity"].)

Here, WHI did not devote all of its activities to Sunstate's equipment rental business. During the 2012 tax year, WHI invested in various other businesses, including the following: (1) Aviation, which, as discussed above, owned and leased aircraft; (2) SCM – Watts Holdings, LLLP, which held large parcels of land near Denver, Colorado; (3) Brooks 400, LLC; Brooks

600, LLC; and Brooks 700, LLC, which held tracts of land near Las Vegas, Nevada; and (4) Tallwave, LLC, which operated an internet/website business. Also, during the 2012 tax year, C. Nute declared under penalty of perjury that he negotiated a sale of real property located in California. C. Nute's declaration is supported by: (1) a planning application, which is dated August 24, 2012, and signed and notarized by C. Nute as WHI's CFO; (2) an October 2, 2012 letter regarding the negotiations, which is signed by C. Nute as WHI's CFO; and (3) a real estate purchase agreement between WHI and a third-party, dated November 20, 2012, and signed by C. Nute as WHI's CFO. Thus, the record shows that WHI did not devote all of its activities to Sunstate, indicating no expectation of requisite contribution or dependency between WHI and Sunstate. (See *PBS Building, supra*.)

In conclusion, appellants have demonstrated by a preponderance of the evidence that, despite the partial overlap of executive forces, there was no integrated executive force such that would warrant a finding of a unitary relationship between WHI and Sunstate.

3. Covenant Not to Compete

The presence of a covenant not to compete is one indicator of unity. (*PBS Building, supra*.) Here, both the 3rd and 4th Amended Agreements include a covenant not to compete, under which M.L. Watts, C.A. Watts, and WHI agreed not to compete with Sunstate during the period that C.A. Watts and/or WHI held an interest in Sunstate and for a period of three years following termination of both such interests. A covenant not to compete contributes to a finding of unity; however, on its own, it is insufficient in this appeal to determine that WHI and Sunstate conducted a unitary business. (See *PBS Building, supra* [which found a unitary relationship existed due to many factors such as the complete overlap of officers and directors in the holding and operating companies, the presence of substantial intercompany financing between the entities, and the agreement to enter into a covenant not to compete by the holding company for the benefit of the operating subsidiary]; *Appeal of Smith, supra* [which found a unitary relationship existed based on the integration of executive forces, intercompany financing and a covenant not to compete].)

In summary, appellants have proven by the preponderance of the evidence that the unitary connections relied on by FTB are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

B. The Three Unities Test1. Unity of Ownership

In the affiliated corporation context, unity of ownership requires more than 50 percent of the voting power of a corporation's stock be owned, directly or indirectly, by another corporation. (R&TC, § 25105.) But in the partnership context, the unitary determination is applied “disregarding ownership requirements.” (Cal. Code Regs., tit. 18, § 25137-1(a), (f), (g).) “[U]nlike a corporate shareholder, only the partner’s ownership interest in the partnership’s income and apportionment factors may be combined, and that combination is proper even though that ownership interest is less than a majority interest.” (*Appeal of Willamette Industries, Inc.*, *supra*.) Since Sunstate is an LLC that elected to be treated as a partnership, the ownership requirement is disregarded.

2. Unity of Operation

Unity of operation is evidenced by central purchasing, advertising, accounting and management divisions. (*Butler Bros. v. McColgan*, *supra*, 17 Cal.2d 664, 678.) Although unity of operation and unity of use are concepts that may overlap to some degree, unity of operation is generally represented by functions that are normally labeled “staff” in administrative theory. (*Container Corp. of America v. Franchise Tax Bd.* (1981) 117 Cal.App.3d 988, 995.) “Staff” functions include, but are not limited to, purchasing, personnel, advertising, accounting, legal services, financing, retirement plan, research and development, and insurance. (*Chase Brass & Copper Co. v. Franchise Tax Bd.*, *supra*, 10 Cal.App.3d 496, 502–503; *A.M. Castle & Co. v. Franchise Tax Bd.* (1995) 36 Cal.App.4th 1794, 1807.) Unity of operation is present when there is significant integration between the day-to-day administrative operations of two companies. (*A.M. Castle & Co. v. Franchise Tax Bd.*, *supra*, 36 Cal.App.4th 1794, 1807.)

FTB makes no allegation that WHI and Sunstate shared staff functions, such as purchasing, personnel, advertising, accounting, legal, financing, retirement plan, research and development, or insurance. Instead, FTB’s only specific argument⁷ is that “[b]oth [M.L. Watts] and [C. Watts] served on both board of directors for WHI and Sunstate. They also served as officers of both entities.” However, shared executive work force at the top management level is

⁷ FTB also generally alleges that “WHI exists to support Sunstate and hold its stock,” without specifically describing what support WHI provides to Sunstate and how that supports a finding of unity of operation.

not a function normally labeled “staff” in administrative theory. Thus, unity of operation has not been established.

3. Unity of Use

Unity of use relates to centralized executive force and general system of operation. (*Butler Bros. v. McColgan*, *supra*, 17 Cal.2d 664, 678.) “Unity of use is reflected by an integrated executive work force at the top management level.” (*Appeal of Automatic Data Processing West, Inc.* (89-SBE-001) 1989 WL 37899, citing *Chase Brass & Copper Co. v. Franchise Tax Bd.*, *supra*, 10 Cal.App.3d 496.) While “staff” functions fall within the unity of operation category, “line” functions fall within the unity of use category. (*Container Corp. of America v. Franchise Tax Bd.*, *supra*, 117 Cal.App.3d 988, 995.)

Unity of use presents a closer question. Nevertheless, OTA need not decide this issue. To satisfy the three unities test, all three factors must be present. (*Butler Bros. v. McColgan*, *supra*, 17 Cal.2d 664, 678.) Because unity of operation has not been established, WHI and Sunstate were not unitary under the three unities test.

C. Other Argument

FTB argues that for tax years prior to 2012, WHI’s California returns treated Sunstate and WHI as unitary business entities. FTB contends that “on a conceptual level, [a]ppellants do not explain why a relationship between Sunstate and WHI that admittedly generated unitary business income for years prior to the disposition should not also generate business income when it sold Sunstate.” However, “[e]ach taxable year stands on its own terms and must be separately considered.” (*Appeal of Kwon, et al.*, 2021-OTA-296P.) Furthermore, appellants provide a compelling reason as to why WHI’s California returns treated WHI and Sunstate as unitary business entities prior to 2012. As discussed, Sumitomo engaged in a staged acquisition of Sunstate. The record shows that the unitary ties between WHI and Sunstate decreased over time, correlating with Sumitomo’s initial acquisition of a minority interest in Sunstate in 2009 and through Sumitomo’s eventual acquisition of 100 percent ownership in Sunstate in 2017.

III. Conclusion

OTA finds that appellants have carried their burden of demonstrating by a preponderance of the evidence that WHI and Sunstate were nonunitary business enterprises in December 2012.

HOLDING

WHI and Sunstate were not engaged in a unitary business in December 2012.

DISPOSITION

FTB's action is reversed, as appropriate, to be consistent with OTA's holding that WHI and Sunstate were not engaged in a unitary business in December 2012, and thus WHI's gain from the sale of Sunstate was nonbusiness income allocable outside of California.⁸

DocuSigned by:

Huy "Mike" Le

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Huy "Mike" Le

Administrative Law Judge

We concur:

DocuSigned by:

Eddy Y. H. Lam

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Eddy Y.H. Lam

Administrative Law Judge

DocuSigned by:

Susana Seyller

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Sheriene Anne Ridenour

Administrative Law Judge

For

Dated: 2/28/2025

⁸ Neither party provided OTA with the NPAs related to the NOAs at issue in this appeal. Thus, OTA cannot state with absolute certainty that finding WHI and Sunstate were nonunitary resolves the entire proposed assessments at issue (e.g., whether the NPAs include other issues unrelated to the unitary issue). Accordingly, OTA directs FTB to make the appropriate adjustments consistent with this Opinion. OTA also notes that in this appeal, FTB did not make any alternative arguments in case it loses its unitary argument; therefore, FTB cannot now raise alternative arguments.