BEFORE TEE STATE BOARD OF EQUALIZATION

OF TEE STATE, OF CALIFORNIA

In the Matter of the Appeal cf)
) No. 84A-1086-SW
THE NATIONAL DOLLAR)
STORES, LTD.)

For Appellant: Andrew W. Gotelli
Peat, 'Marwick, Mitchell & Co.

For Respondent: Kathleen M. Morris
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 The National Dollar Stores, Ltd., against proposed assessments of additional franchise tax in the amounts of $7,420.21 and $36,822.06 for the income years ended January 31, 1980, and January 31, 1981, respectively.

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.

There are several issues presented in this appeal. The first issue is whether The National Dollar Stores, Ltd., and its wholly owned subsidiary, Intercontinental Productions Company, were engaged in a single unitary business during the income year 1981. The second issue is whether losses in the amounts of $83,231 and $95,655 for the income years 1980 and 1981, respectively, that appellant incurred from a partnership engaged in oil drilling in Colorado, constituted business or nonbusiness income. The final issue is whether the source of these' losses, if they are determined to be nonbusiness Josses, was in California or in Colorado.

Appellant, The National Dollar Stores, Ltd. (NDS), is a California corporation engaged in retail sales. Its chain of stores, which sell primarily soft goods, is located in California, Hawaii, and Arizona. Its main warehquse is in Richmond, California.

Appellant's directors formed a wholly owned subsidiary company called Intercontinental Productions Company (IPC) for the purpose of increasing the profitable growth of NPS through the marketing or acquiring of films for resale.. This subsidiary, which was incorporated on March 20, 1980, was suspended by this state on May 3, 1982, for nonpayment of taxes. During income year 1981, IPC had no assets or liabilities other than an account payable of $321,540 to appellant.

For the income year ended January 31, 1981, appellant filed its California franchise tax return as a combined report which included IPC as part of its unitary business. Respondent determined that the two businesses were not unitary and issued proposed 'assessments. When respondent affirmed its determination after appellant's protest, appellant filed this timely appeal.

The first issue is whether appellant and IPC were engaged in a unitary business during the 1981 income year. Initially, we note that respondent's determination is presumptively correct and appellant bears the burden of proving that it is incorrect. (Appeal of The Amwalt Group, Inc., Cal. St. Bd. of Equal., June 25 1985.) Appellant must therefore show that the relationship between IPC and appellant was of sufficient substance to demonstrate the existence of a single unitary business.

When a taxpayer derives income from sources both within and without California, it is required to measure its California franchise tax liability by its net income derived from or attributable to sources within the state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business with an affiliated corporation, the amount of business 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).) If, however, the business within this state is truly separate and distinct from the business without the state so that the segregation of income may be made clearly and accurately, the separate accounting method may properly be used. (Butler Bros. v. McColgan, 17 Cal.2d 664, 667 [11 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).)

The existence of a unitary business is established if either of two tests is met. (Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972.) The California Supreme Court has determined that the existence of a unitary business is definitely established by the presence of: (1) unity of ownership; (2) unity of operation as evidenced by central Purchasing, advertising, accounting, and management divisions; and (3) unity of use in its centralized executive force and general system of operation. (Butler Bros. v. McColgan, supra.) The court has also stated that a business is unitary when the operation of the portion 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,) Subsequent cases have affirmed these tests and given them broad application. (Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545 (1963); Honolulu Oil Co. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552] (1963).)

We have held that,, in the case of affiliated corporations, both of the unitary tests require controlling ownership. (Appeal of Revere Copper and Brass, Inc., Cal. St. Rd. of Equal., July 26, 1977.) In the present case, unity of ownership did exist as appellant owned 100 percent of IPC. Respondent argues, however, that the unities of use and operation were not present and that contribution or dependency did not exist between the corporations. We agree.

In the case of vertical or horizontal integration, the benefits to the group from certain basic connections are usually readily apparent. In the present situation, appellant is engaged in the business of selling clothing, shoes, fabric, baby wear, and the like- The operations of IPC, however, involved the acquiring and marketing of Asian films in the United States. In situations such as this one, where appellant and IPC are each engaged in a distinct type of business without vertical or horizontal integration, we must scrutinize the connections labeled as "unitary factors" to see if, in substance, they really. result in a single unitary business. (Appeal of Berry Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 4, 1986.) "Where the businesses are distinct in nature, the mere recital of a number of centralized functions is not sufficient, in our opinion, to establish unity of operation, unity of use or contribution or dependency between the operations," (Appeal of Allied Properties, Cal. St. Bd. of Equal., Mar. 17, 1964.)

Appellant contends that unity of operation existed because all the accounting and legal professional services were performed by the same firms. It appears that appellant also provided funds to IPC. As to the fact that appellant provided financing for IPC, we cannot conclude that the funds provided by appellant were used for any common business activity. As we stated in Appeal of Simco, Incorporated, decided October 27, 1964, "[i]f such financing results in a unitary business virtually every business would be unitary no matter how unrelated were the various activities." As to the accounting and legal services, there is no indication that these relatively minor centralized functions carried on by outside agencies resulted in any substantial mutual advantage. We must conclude that unity of operation did not exist to any meaningful extent.

Appellant further contends that Mr. Shoong, president of appellant, and appellant's board of directors made the managerial decisions for both businesses. Appellant states that frequent trips were made by them to Taiwan to review the operations of IPC. While it appears that Mr. Shoong was overseeing the operations of IPC, there is no evidence that Mr. Shoong had any expertise in the marketing of foreign film+. Similarly, there is no evidence that this alleged "common management" resulted in any integration between the corporations. Bather, the executive oversight present here "reveals nothing more than an owner's interest in overseeing its investments and does nothing to distinguish the group as a unitary business.' (Appeal of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984; see also

Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 31, 1982.) We must conclude, therefore, that there was no unity of use arising from a centralized executive force.

The lack of unity is also clear when judged by the contribution or dependency test. The preceding discussion shows that the unitary factors propounded by appellant do not establish that the operations of appellant and IPC contributed to or depended upon each other in such a way as to compel the conclusion that the corporations were engaged in a single integrated economic enterprise. These factors are ones which may be expected to exist in almost any case of commonly owned enterprises, no matter how unrelated operationally. (Appeal of Simco, Incorporated, Cal. St. Bd. of Equal., June 29, 1932.) They do not demonstrate that the operations of either of these companies contributed to or depended upon the operation of the other.

As appellant has not met its burden of showing that appellant and IPC were a single unitary business, we will sustain respondent's action as to the first issue.

The second issue presented in this appeal is whether losses that appellant incurred from a partnership engaged in oil drilling in Colorado constituted business or nonbusiness income.

In 1979, appellant invested as a limited partner in H. B. Private Drilling Program, Ltd. (HBPD). The partnership is engaged in oil drilling in Colorado. Appellant is not actively involved in operating or managing the oil and gas properties. During its 1980 and 1981 income years, appellant incurred partnership losses in the amounts of $83,231 and $95,655, respectively. Appellant deducted these losses as nonbusiness losses wholly attributable to California and respondent disallowed the losses finding that they had their source in Colorado rather than in Calfornia.

Appellant now contends that the investment is a part of its trade or business. When transportation costs increased substantially, appellant allegedly invested in HBPD so that monies received from the investment would offset the rising transportation costs. Thus, it is appellant's position that the investment in HBPD was an asset used in its trade or business and that the losses, therefore, were "business" losses.

Section 25120 defines the terms "business income" and "nonbusiness income" as follows:

> (a) 'Business income" means 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.
>
> • ⊠⊠
>
> (d) "Nonbusiness income" means all income other than business income.

The statutory definition of business income provides two alternative tests for determining the character of income. The "transactional test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. The 'functional test" provides that income is business income if-the acquisition, management, and disposition'of the property giving rise to the income were integral parts of the taxpayer's regular business operations, regardless of whether the-income was derived from an occasional or extraordinary transaction. (Appeal of Fairchild Industries, Inc., Cal, St. Bd. of Equal., Aug. 1, 1980; Appeal of New York Football Giants, Inc., Cal. st. Pd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

We must conclude that the losses from HBPD constitute nonbusiness income under either the transactional test or the functional test. Quite clearly, the oil and gas drilling business conducted by HBPD was not in any way related to appellant's retail sales business, which is the sale of soft goods. Appellant contends that income from this partnership was intended to offset the rising costs of transportation; however, the partnership undoubtedly was a "tax shelter" rather than an income-producing investment, since it provided only losses. These losses cannot be said to have come from a business which was an integral part of the retail soft goods business.

The final issue presented is whether, in computing its income subject to taxation in California, appellant, a California corporation, may deduct its distributive share of the partnership losses incurred by HBPD.

The net income by which the franchise tax is measured is restricted to net income from California sources. (Rev. & Tax. Code., § 25101.) Conversely, any losses from California sources are deductible while losses attributable to out-of-state sources are not deductible. (Appeal of H. F. Ahmanson & Co., Cal. St. Bd. of Equal., Apr. 5, 1965.) In this case, the oil and gas drilling took place in Colorado. There is no evidence that any of the partnership activities occurred in California. We must conclude that the Ahmanson case is directly applicable. In Ahmanson, the corporate appellant was engaged in the insurance business in California but was also a limited partner in two partnerships engaged in oil exploration in Turkey. The partnership incurred losses in the oil venture, and the taxpayer attempted to deduct those losses from its California income. In denying the taxpayer's claim, we concluded that the source of a partner's income is where the partnership property is located and where the partnership activity is carried on. This reasoning was subsequently reaffirmed by this board in the Appeal of Angelus Hudson, Inc., decided on December 13, 1983. As the present case is indistinguishable from Hudson and Ahmanson, respondent's actions must be sustained.

Appeal of The National Dollar Stores, Ltd.

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 The National Dollar Stores, Ltd., against proposed assessments of additional franchise tax in the amounts of $7,420.21 and $36,822.06 for the income years ended January 31, 1980, and January 31, 1981, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of September, 1386, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conwav H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_______________ Member

*For Kenneth Cory, per Government Code section 7.9