BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 83A-1323-SW
SPECIALTY RESTAURANTS	)	
CORPORATION	)	

For Appellant: Stephen Kunkel
Certified Public Accountant

For Respondent: Anna Jovanovich
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 Specialty Restaurants Corporation against proposed assessments of additional franchise tax in the amounts of $12,096 and $25,922 for the income years ended June.30, 1977, and June 30, 1978, 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 five issues presented in this appeal:

(1) Whether subsidiary corporations which were in the process of formation during the years in question should be included within appellant's unitary business.

(2) Whether related corporations which are engaged. in distinctly separate enterprises should be combined within appellant's unitary business.

(3) Whether respondent's actions in reducing appellant's bad debt reserve constituted an abuse of discretion.

(4) Whether income from the sale of particular property should be included in the year the promissory note for payment was issued to appellant or in the year the proceeds were actually received.

(5) Whether the minimum franchise tax is payable when the apportioned tax due from certain unitary subsidiaries is less than the minimum tax.

The following facts give a general view of appellant's operations,. The facts which apply only to a single issue will be discussed in detail in the portion of thfs appeal which relates directly to that issue,

Appellant is engaged primarily in the restaurant business. Its founder and major shareholder is David C. Tallichet, St., a former World War II bomber pilot. Because of Tallichet's interest in vintage aircraft, many of appellant's restaurants are located at airports and feature restored aircraft. The majority of appellant's 50 restaurants and shopping villages are located in California and are on publicly owned land near harbors, railroad stations, and airports.

In addition to the restaurants and shopping villages, appellant also controls three subsidiaries which are involved in the aircraft business, One of these, Military Aircraft Restoration Corporation (M.A.R.C.), is engaged in the business of purchasing, restoring, and displaying antique military aircraft. It is M.A.R.C. which restores the planes for use in conjunction with appellant's airport restaurants.

Appellant owns 67 percent of another subsidiary, Euroworld, which was incorporated in California on

July 8, 1977, for the express purpose of importing a specified number of aircraft for resale primarily to Third World nations and airplane enthusiasts. Appellant's partner in this company is Visionair International, Inc., a foreign corporation which helped locate the airplanes for Euroworld's activities.

Appellant is also involved in a joint venture, entered into on February 21, 1975, with Vintage Aircraft International, Inc. As part of the agreement, 24 World War II fighter bombers were purchased from the government of Iraq. All of these planes have been kept in Florida, pending resale. One has undergone restoration in Texas, but none of them have been used in conjunction with appellant's restaurant business.

In 1980, appellant's franchise tax returns for the income years ended June 30, 1977, and June 30, 1978, were audited by respondent. Nine areas of potential discrepancies were found, and Notices of Additional Tax Proposed to be Assessed were sent to appellant on March 20, 1981. Appellant protested the proposed assessments and a hearing was held on October 26, 1982. Respondent affirmed its position on five of the issues and four were resolved in appellant's favor. Appellant was notified of this result by notices of action sent by respondent on October 17, 1983, in response to which appellant filed this timely appeal.

The first issue presented in this appeal is whether subsidiary corporations which were in the process of formation during the years in issue were includible in appellant's combined report.

Appellant has an Atlanta Hill restaurant which opened to the public in 1982. Appellant selected the site for the restaurant on January 24, 1977, and Atlanta Hill was incorporated on August 29, 1977. All other activities relating to Atlanta Hill were initiated after the appeal years. For example, the land was not purchased until 1979 and construction did not begin until, 1981.

Appellant, allegedly for internal purposes, considered Atlanta Hill to be an "inactive company" because it was in its development state. However, it is appellant's position that because it was involved with the financing and management of Atlanta Hill during its development, it should be considered part of appellant's unitary business.

Respondent does not dispute that Atlanta Hill was part of appellant's unitary business once it was fully operational, but in the income years at issue, it is respondent's position that Atlanta Hill had not commenced doing business. In support of its position, respondent notes that Atlanta Hill is not listed as a going concern in appellant's annual report for the years in issue.

We have held that a subsidiary can be part of a unitary business from the time it commences business in this state. (Appeal of Household Finance Corporation, Cal. St. Bd. of Equal., Nov. 20, 1968.) Section 23101 defines "doing business" as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. The regulations provide that a corporation may be considered to have commenced doing business at any time after its articles of incorporation are filed. (Cal. Admin. Code, tit. 18, reg. 23222.)

In the present case, Atlanta Hill's articles of incorporation were filed on August 29, 1977. The only activity conducted during the appeal years, however, was the selection of a site for the restaurant. The land was not purchased and construction did not begin until after the appeal years. Selecting a site, under these circumstances, seems clearly to constitute an act preliminary to doing business. (See Appeal of Devmar, Inc., Cal. St. Bd. of Equal., Feb. 6, 1973.) We must conclude, therefore, that Atlanta Hill was not "doing business" during the years at issue.

A second subsidiary, Boatyard Village, was incorporated on May 15, 1978, just six weeks before the close of the last income year at issue. The site was selected on October 27, 1977, by appellant, but all other activities relating to this corporation did not commence until after the period in issue. For the reasons discussed in detail above, we conclude that respondent's action as to Boatyard Village must also be sustained.

The second issue is whether two of appellant's other subsidiaries, Euroworld and Sea Furies, were part of its unitary business. On its corporate franchise tax return, appellant included Euroworld as part of its unitary group. Euroworld is in the business of acquiring vintage aircraft for resale. Appellant contends that Euroworld is part of its unitary business because (1) it has majority ownership with appellant: (2) it has interlocking boards of directors and common officers with

appellant; (3) it has joint use of offices, facilities, equipment, and labor with appellant; (4) it has joint management functions and common accounting and budgeting with appellant; (5) it has centralized accounting and tax services with appellant; and (6) it has common legal counsel, accounting, tax services and financing with appellant.

Respondent concluded that Euroworld was not a part of appellant's unitary business because appellant did not provide any information which would indicate that Euroworld's operations were integrated in any way with appellant's unitary restaurant business.[2/] Respondent's position is that appellant was merely overseeing its investments and that Euroworld's activities were completely separate and apart from appellant's. Euroworld was formed to purchase 31 specific aircraft from the Royal Moroccan Air Force. The planes were to be sold, primarily, to the Honduran Air Force and to other interested parties. There is no evidence that any of the aircraft were used in connection with appellant's restaurants.

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 of Euroworld to appellant was of sufficient substance to demonstrate the existence of a single unitary business.

The existence of a unitary business is established if either of two tests is met. (Appeal of F. W. Woolworth Company, 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, 17 Cal.2d 664, 678 (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) The court has also stated that a business

2/ Respondent has agreed thdt another subsidiary, Military Aircraft Restoration Corporation, was part of the unitary business, because it restores and supplies airplanes which are used in conjunction with appellant's airport restaurants.

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, 30 Cal.2d 472, 481 [183 P.2d 16] (1947).) 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 (1983); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552] (1963).) In order for appellant to carry its burden of proof, it must show that it is functionally integrated with Euroworld and that Euroworld is more than an unrelated investment. (Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.)

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. Bd. of Equal., July 26, 1977.) Controlling ownership does not require 100-percent stock ownership, but simply common ownership, directly or indirectly, of more than 50 percent of a corporation's voting stock. (Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.) In the present case, unity of ownership did exist as appellant owned two-thirds of the outstanding stock of Euroworld. 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 with respondent,

> In the case of vertical or horizontal integration, the benefits to the group from certain basic connections are usually readily apparent. In a situation such as this one, however, where the appellant and Euroworld each engaged in a distinct type of business, without vertical or horizontal integration, we must scrutinize the connections labeled "unitary factors" to see if, in substance, they result in a single unitary business the income of which is appropriately reflected in a combined report. "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.; Appeal of The Amwalt Group, Inc., supra.)

Appellant contends that unity of operation was demonstrated by the financing provided by appellant and

the loans that appellant guaranteed for Euroworld. We agree with appellant that intercompany financing has been considered "substantial evidence of unity of operation." (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 503 [87 Cal.Rptr. 2391, app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (19701.) In this case, however, the financing and guarantees provided by appellant were not 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."

There is evidence that unity of staff functions did exist to the extent of common directors and officers, offices, legal counsel, tax and accounting counsel, and centralized corporate records. This, in itself, however, is not conclusive, As we stated in Appeal of Santa Anita Consolidated, Inc., et al., supra:

> To demonstrate the existence of a single unitary business, it is necessary to do more than simply list circumstances which are labeled "unitary factors." Such "factors" are distinguishing features of a unitary business only when they show that there was functional integration between the corporations or divisions involved. We must distinguish "between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise." (Appeal of Saga Corporation, Cal. St. Bd. of Equal-, June 29, 1982.)

The facts available show that the airplanes purchased by Euroworld were never used in appellant's restaurants or shopping centers. Rather, it appears that appellant's major shareholder, David Tallichet, Jr., was purchasing aircraft because of his interest in vintage airplanes. In sum, we find that the executive assistance provided, by appellant lacks unitary significance because it did not result in any integration between Euroworld and appellant. Likewise, the financial guidance provided

merely indicates appellant's interest in overseeing its investments and providing funds so that Euroworld could further its independent operations. There is also no evidence that the common directors or officers had any real control over Euroworld's actioites. It has not been shown that any of the officers, other than Tallichet, had any knowledge about the aircraft purchased by Euroworld. Unity of use and operation, therefore, cannot be said to have existed to any meaningful extent.

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 show that the operations of appellant and Euroworld contributed to or depended on each other in such a way as to compel the conclusion that both corporations were engaged in a single integrated ecoromic enterprise. They are merely two commonly owned enterprises which are unrelated operationally.

The other subsidiary, Sea Furies, is a joint venture entered into between Tallichet and a representative of Vintage Aircraft International to purchase, for resale, 24 Hawker Sea Furies from the Iraqi Air Force. A contract with Vintage was signed February 21, 1975. Appellant contends that itis unitary with Sea Furies because it provided financing for the business operation, general management, and other centralized services for Sea Furies.

For the reasons discussed in detail above in connection with Euroworld, we cannot conclude that appellant is unitary with Sea Furies. Buying airplanes to sell at retail is not a business that contributes or depends on appellant's restaurant business. Bather, this business, like Euroworld's, appears to be a personal interest of Tallichet's. In the absence of any integration between Sea Furies and appellant, we must conclude that the businesses are not unitary.

The third issue presented in this appeal is whether respondent's actions in reducing appellant's bad debt reserve constituted an abuse of discretion.

Appellant files its tax returns using the reserve method of deducting bad debts. The formula used to compute reserves is based upon an analysis of the aging accounts receivable and applying the known facts of each case. Generally, included in the reserve are all accounts past due 90 days, and over 50 percent of those

past due 60 to 90 days and all returned checks. Exceptions are made for certain factors based upon the taxpayer's knowledge of the customers and circumstances. All past due accounts are closely monitored and repeatedly billed after 30, 60, and 75 days. After 90 days, a written request for write-off is prepared for approval of a regional-manager. After 120 days, accounts are written off and forwarded to the central office for collection. Usually, another 120 days pass before the account is finally written off.

Respondent, using a six-year moving average formula as defined in Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), affd., 125 F.2d 977 (6th Cir. 1942), determined that appellant's reserve for bad debts was excessive. Appellant, however, believes that its method used to determine the bad debt reserve is reasonable and that its formula is better because it considers essential factors such as industry practice and experience, the general business and economic environment, and the facts and circumstances of each individual delinquent account. Appellant further contends that the Black Motor formula, which is dependent upon the timing of write-offs, results in an improper and unreasonable-year-end reserve.

Subdivision (a) of section 24348 provides: "There shall be allowed as a deduction debts which become worthless within the income year; or, in the discretion of the Franchise Tax Board, a reasonable addition to a reserve for bad debts." This language is substantially the same as that of Internal Revenue Code section 166(c). Consequently, federal precedent is persuasive in interpreting section 24348. (Meanley v. McColgan, 49 Cal.App.2d 203 f121 P.2d 45] (1942).)

As we have noted in previous opinions, respondent's determinations with respect to additions to a reserve for bad debts carry great weight because of the express discretion granted it by statute. When the Franchise Tax Board disallows an addition to a reserve for bad debts, the taxpayer must not only demonstrate that additions to the reserve were reasonable, but also must establish that respondent's actions in disallowing those additions were arbitrary and amounted to an abuse of discretion. (Roanoke Vending Exchange, Inc. v. Commissioner, 40 T.C. 735 (1963); Appeal of Brighton Sand and Gravel Company, Cal. St. Bd. of Equal., Aug. 19, 1981; Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975.) In other words, by choosing-to use the reserve method, appellant has

subjected itself to the reasonable discretion of respondent. (Union National Bank & Trust Co. of Elgin v. Commissioner, 26 T.C. 537 (1956).)

A bad debt reserve is essentially an estimate of future losses which can reasonably be expected to result from debts outstanding at the close of the taxable year. (Valmont Industries, Inc. v. Commissioner, 73 T.C. 1059 (1980).) Under the reserve method of handling bad debts, the reserve is reduced by charging against it specific bad debts which become worthless during the income year and is increased by crediting it with reasonable additions. What is reasonable will depend on the total amount of debts outstanding at the end of the year, including current debts, as well as those of prior years, and the total amount of the existing reserve.

As was previously stated, respondent used the Black Motor formula, which is a formula which applies appellant's own experiences with losses in prior years and establishes a percentage level for the reserve *in* determining the need for and amount of a current addition. Appellant has not shown that respondent's use of the six-year moving average formula was arbitrary or amounted to an abuse of discretion. Appellant contends that the Black Motor formula does not adapt itself to the method appellant uses to write off its delinquent accounts. The Black Motor formula is dependent upon the timing of write-offs. Appellant, therefore, contends that because its method of writing off debts is very slow, that the Black Motor formula results in an improper and unreasonable year-end reserve, We cannot agree. It is well established that if a taxpayer's most recent bad debt experience is unrepresentative for some reason, a formula using that experience as data cannot be expected to produce a "reasonable" addition for the current year. (Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979).) In this case, appellant has not shown either changes in conditions of business in general or changes in customers specifically, Unless appellant can establish conditions that will cause future debt collections to be less likely than in the past, we cannot conclude that the Black Motor formula is unreliable.

As was stated above, when the Franchise Tax Board disallows an addition to a reserve, the taxpayer must not only establish that respondent's actions in disallowing the additions were arbitrary, but the taxpayer must also establish that the additions to the

reserve were reasonable. Here, we must conclude that appellant has failed on both requirements.

The fourth issue presented in this appeal is whether income from the sale of property should be included in the year the promissory note received in payment was issued to appellant or in the year the note was actually paid off.

On September 27, 1977, appellant sold to an unrelated third party all leasehold improvements located at Portland Village. Payment for the leasehold improvement consisted of the assumption of a mortgage payable in the amount of $1,042,500 and issuance of a promissory note. The promissory note was for the face amount of $300,000; however, the terms of the obligation provided for a substantial discount if paid off early, and principal payments were contingent upon the amounts of rental income received by the buyer. Subsequently, in accordance with the provision of the note relating to the discount, $200,000 was received in the calendar year ended December 31, 1979, as payment in full, and was included in the corporate franchise tax return for the income year ended June 30, 1980.

Appellant contends that due to the contingency involved and the uncertainty of collection, the obligation had no fair market value at the time of the sale. It did not include the amount of the note in its return for the income year ended June 30, 1978. Respondent's audit staff included the entire $300,000 as income in the year the note was executed. 3/

Section 24651, subdivision (a), provides that income shall be computed "under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books." Appellant maintains its records on an accrual method. It is elementary that where a taxpayer keeps its books on an accrual basis, it is the right to receive and not the actual receipt of such income that determines the year in which it is includible in gross income. (Spring City Foundry Co. v.

3/ At the administrative protest level, respondent agreed to allow the final figure to be $200,000, as that was the amount appellant actually received, according to the terms of the note, in its fiscal year ended June 30, 1980. However, respondent maintains its position that the amount is includible on the 1978 return.

Commissioner, 292 U.S. 182 [78 L.Ed. 12001 (1934); Appeal of Dant Investment Corporation, Cal. St. Bd. of Equal., Mar. 2, 1977.) In the case of gains from the sale of property, the accrual basis taxpayer realizes gain when a sale is completed and the right to receive payment becomes unqualified because the buyer is unconditionally liable to pay the purchase price. (Lucas v. North Texas Lumber Co., 281 U.S. 11 [74 L.Ed. 668] (1930); Commissioner v. Union Pacific Railroad Co., 86 F.2d 637 (2d Cir. 1936).) For tax purposes, a completed or closed transaction results from a contract of sale which is absolute and unconditional on the part of the seller to deliver title to the buyer upon payment of the considera-tion, and by which the purchaser secures immediate possession and exercises all the rights of ownership. (Appeal of N.S.B. Corporation, Cal. St. Bd. of Equal., Dec. 5, 1960.) A delay in actual payment does not prevent the earlier accrual of income, *as long as* the contract gives the seller the unqualified right to receive the purchase price. (See Consolidated Gas & equipment Co, of America, 35 T.C. 675 (1961).)

In this case, appellant received the note which was binding on the issuer in the income year ended June 30, 1978. Quite clearly, this is the year in which the income must be reported. Appellant contends that because of the uncertainty of collection, the note had no fair market value at the time of the sale. We cannot agree. While we recognize that under some circumstances a taxpayer is not required to accrue income which it knows to be uncollectible, there is nothing in the facts of *this* case which indicates that by June 30, 1978, appellant had any reason to believe that the note would not be paid. (See Appeal of Alum Rock Development Company, Cal. St. Bd. of Equal., Dec. 29, 1958.) In the absence of this evidence, we must conclude that because appellant had the right to enforce a collectible debt during its fiscal year, the value of the note was accruable in the income year ended June 30, 1978,.

The final issue presented in this appeal is whether the minimum franchise tax is payable when the apportioned tax due from certain unitary subsidiaries is less than the mininum tax.

In its brief, appellant states that respondent has held that certain of its subsidiaries are not part of its unitary business. In fact, respondent acknowledges that these subsidiaries are part of appellant's unitary

business. Respondent, however, has assessed the minimum franchise tax on each of these corporations.

Section. 23151 provides that, with the exception of financial corporations,. every corporation which does business in California must pay a tax for the privilege of exercising its corporate franchise. Section 23153 provides that each corporation must pay at least a minimum tax for the privilege conferred. Since each corporation in question did business in California, we must conclude that the action by respondent is appropriate.

In sum, for the reasons discussed in detail above, we conclude that the action taken by respondent in this appeal must be upheld.

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 Specialty Restaurants Corporation against proposed assessments of additional franchise tax in the amounts of $12,096 and $29,922 for the income years ended June 30, 1977, and June 30, 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of September, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9'