89-SBE-007

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No . 83A-860-MW
TWENTIETH CENTURY-FOX)
FILM CORPORATION)

Appearances:

For Appellant: John S. Warren
Attorney at Law

For Respondent: Timothy W. Boyer
Supervising 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 Twentieth Century-Fox Film Corporation against proposed assessments of additional franchise tax in the amounts of $117,183 and $702,670 for the income years 1977 and 1978, respectively, and, pursuant to section 26075, subsection (a), from the action of the Franchise Tax Board in denying the claim of Twentieth Century-Fox Film Corporation for refund of franchise tax in the amount of $14,413 for the income year 1978.

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.

Two questions are presented by this appeal: 1) Was appellant engaged in a single unitary business with either of its subsidiaries, Coca-Cola Bottling Midwest, Inc. (Coke), or Aspen Skiing Corporation (Aspen): and 2) if appellant and Coke were not unitary, was the dividend paid by Coke to appellant business or nonbusiness income?

Appellant is a major producer and distributor of motion pictures and television programs. On September 27, 1977, appellant acquired Coke and Coke's subsidiaries. Coke was a major regional soft drink bottler. On June 28, 1978, appellant acquired Aspen and its subsidiaries. Aspen was the largest skiing operation in the United States.

After the acquisitions, the operating staffs of Coke and Aspen remained the same. Two of Aspen's 8 officers and 3 of Aspen's 14 directors were officers or directors of appellant. Three of Coke's 5 directors and 4 of Coke's 11 officers came from appellant after the acquisition.

The approval of appellant's board of directors was required for the subsidiaries' annual budgets and any major expenditures. Common insurance coverage for appellant and its subsidiaries was obtained as the subsidiaries' separate policies expired. Coke still had two separate policies at the end of 1978, and most of Aspen's separate policies were still in effect at that time.

Appellant's headquarters' staff provided the subsidiaries with some tax, personnel, employee benefit, and real estate investment services. Appellant routinely prepared and filed tax forms for all its subsidiaries, paid the taxes, and charged each subsidiary for its share. Coke and Aspen were included in this procedure in 1978.

Coke paid appellant a dividend of $6,864,646 in 1978.

Appellant included Coke in its combined report for 1977 and included both Coke and Aspen in the combined report for 1978. It excluded from income the dividend paid by Coke in 1978.

The Franchise Tax Board determined that neither Coke nor Aspen was engaged in a unitary business with appellant and, therefore, should not have been included in appellant's combined reports. The elimination of Coke from the combined report resulted in the 1978 dividend being treated as nonbusiness income allocable entirely to appellant's commercial domicile, California.

The first question to be addressed is whether Coke and Aspen were engaged in a single unitary business with appellant.

The California Supreme Court has set forth two tests to determine whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that the unitary nature of a business may be established by the presence of unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions, and unity of use in a centralized executive force and general system of operation. The court later stated that a business is unitary if the operation of the business done within this state depends upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).) More recently, the United States Supreme Court has emphasized the necessity that affiliated corporations, to be considered a unitary group, form a functionally integrated enterprise (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 179 [77 L.Ed.2d 545], reh. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983)) in which factors of profitability arise from the operation of the business as a whole (F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 [73 L.Ed.2d 819] (1982)).

The Franchise Tax Board's determination regarding the existence or nonexistence of a unitary business is presumptively correct, and appellant bears the burden of showing that it is incorrect. (Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982; Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) To demonstrate the existence of a unitary business, it is necessary to do more than simply list circumstances which are labeled "unitary factors." There must be evidence that the affiliated entities form a functionally integrated enterprise, rather than merely a group of investments whose operations are unrelated. (Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.)

Appellant cites three cases which, it contends, stand for the proposition that unity can exist between commonly owned corporations even though there is no significant flow of goods or services between them: Container Corp. v. Franchise Tax Board, supra; Earth Resources Co. of Alaska v. Dept. of Revenue, 665 P.2d 960 (Alaska 1983); and Russell Stover Candies, Inc. v. Dept. of Revenue, 204 Mont. 122 [665 P.2d 198], app. dism., 464 U.S. 988 [78 L.Ed.2d 675] (1983), reh. den., 465 U.S. 1014 [79 L.Ed.2d 247] (1984). Appellant states that "The evidence of unity in the instant case is as compelling as in the cases cited above.. (App. Br. at 5.) It concludes that it was correct in including Aspen and Coke in its combined reports.

However, each case must be decided on its own particular' facts, and we find that the record before us does not support a finding of unity. Appellant has simply presented a list of facts without explaining how these facts result in a functionally integrated enterprise.

Having officers and directors in common is not necessarily an indicator of unity. There must be some evidence that the common officers and directors actually contribute to the integration of the operations of the corporations. Appellant has not shown that its management exercised anything more than financial control over Coke and Aspen. Such limited oversight is not ordinarily a distinguishing feature of a unitary business, since it is to be expected in any parent/subsidiary relationship. (Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 180 (fn. 19); Appeals of Santa Anita Consolidated, Inc., et al., supra; Appeal of Hollywood Film Enterprises, Cal. St. Bd. of Equal., Mar. 11, 1982.)

Common insurance policies were purchased as the subsidiaries' individual ones expired, but this process was incomplete at the conclusion of 1978 and appellant has not indicated the number of policies or amounts involved. We cannot conclude that any benefit, financial or otherwise, which might have accrued to the group through the common policies was substantial. The sparse information in the record regarding staff services provided by appellant for the subsidiaries leads us to conclude that these also were not substantial. Many of these services also appear to be part of the financial oversight which a parent corporation ordinarily exercises over all of its subsidiaries.

Appellant has not demonstrated that it, Coke, and Aspen were functionally integrated, that their management was centralized, or that economies of scale existed with a degree of substantiality that would distinguish this group from any other group of investments whose operations are unrelated. We conclude that the Franchise Tax Board must be sustained in its determination that appellant was not engaged in a unitary business with either Coke or Aspen.

Having determined that Coke was not engaged in a unitary business with appellant, the dividend paid by Coke to appellant in 1978 cannot be-eliminated from appellant's income under section 25106 as an intercompany dividend. We must now consider appellant's alternative argument that the dividend was business income, apportionable among the various states in which appellant is subject to tax, rather than nonbusiness income, specifically allocable in its entirety to California, appellant's commercial domicile. (Rev. & Tax. Code, § 25126.)

Resolution of this issue is governed by the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is contained in sections 25120-25139. Section 25120 defines apportionable business 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.

Nonbusiness income is defined simply as all income other than business income. (Rev. & Tax. Code, § 25120, subd. (d).)

Section 25120 provides two alternative tests to determine whether income constitutes business income. The first is the "transactional" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the regular course of the taxpayer's trade or business. Under the second, or "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of DPF Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980.) If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, supra; Appeal of Fairchild Industries, Inc., supra.) Respondent's determination as to the character of income to a business under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983.)

Appellant contends that the standard to be met is that of Multistate Tax Commission Regulation IV.1.(c)(4) (hereinafter "MTC regulation"). At the time this appeal was briefed, the MTC regulation was not included in the regulations adopted by the Franchise Tax Board. Instead, Regulation 25120, subdivision (c)(4), provided that dividend income was business income generally only when a principal business activity of the taxpayer was dealing in securities. (Former Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(4) (art. 2), repealer filed Apr. 11, 1987 (Reg. 87, No. 15).) In 1983, this board held that subdivision (c)(4) was invalid since it did not conform to the statutory standards of section 25120. (Appeal or Standard Oil Company of California, Cal. St. Bd. of Equal., Mar. 2, 1983.) Recently, the Franchise Tax Board adopted the MTC regulation to replace the repealed subdivision (c)(4). (Amendment filed Sept. 10, 1987 (Reg. 87, No. 37).) The subdivision now provides:

> Dividends. Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations. [Examples omitted.]

(Cal, Admin. Code, tit. 18, reg. 25120, subd. (c)(4).)

Appellant relies on the second part of this subdivision, arguing that the stock of Coke and Aspen was acquired and held for a purpose related to or incidental to appellant's trade or business. Appellant interprets the language of subdivision (c)(4) as setting a very broad rule for including virtually all dividends in apportionable business income. It argues that "[a]ll that is required is that the stockholding be managed and utilized in the regular course of the taxpayer's business, not that it be an extension of the principal business." (App. Supp. Br. at 3.) In other words, appellant is advocating the position that any dividends are business income when they are from investments in subsidiaries and affiliates in which "the acquiring corporation becomes involved in the. activities of the acquired corporation in ways that go significantly beyond what an ordinary investor would do." (App. Reply Br. at 10.)

Appellant's position was rejected well before now, in Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 510] (1980) and ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 [73 L.Ed.2d 787] (1982). The decision in Mobil was based on the principle that dividends are business income where they "reflect profits from a functionally integrated enterprise." (Mobil Oil Corp. v. Commissioner of Taxes, supra, 445 U.S. at 440.) ASARCO, supra, specifically rejected the argument that income from intangibles "should be considered a part of a unitary business. (i.e., business income) where the acquisition, management, or disposition of intangible property was merely "'for purposes related to or contributing to'" the taxpayer's business and where "'the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State . . . .'" (ASARCO Inc. v. Idaho State Tax Commission, supra. 458 U.S. at 326, 327 (quoting Mobil, supra, 445 U.S. at 442).) 2/ Given the clear language in these cases, appellant's interpretation of the regulation is far too broad, and we cannot accept it as a standard for determining the business or nonbusiness character of dividend income.

The decisions of this board have applied a rule consistent with the requisites of the United States Supreme Court - that of an integral relationship between the stockholding and the taxpayer's unitary business. Appellant's position totally ignores the operative language of the Appeal of Standard Oil, supra ('integrally related to the unitary business activities of the taxpayer'); the Appeal of Occidental Petroleum Corporation, decided by this board June 21 1983 ('integrally related to the unitary business activities'); the Appeal of Johns-Manville Sales Corporation, supra, ('integrally related to appellant's unitary business operations"); the Appeal of Westlake Petroleum, Inc., decided June 10, 1986 ("integrally related to appellant's trade or business"); the Appeal of Fibreboard Corporation, decided January 6, 1987 ("integrally related to appellant's unitary business operations'); and the Appeal of Louisiana-Pacific Corporation, decided January 6, 1987 ('integrally related to appellant's unitary business'). These decisions also follow the statutory standard of the *functional test" of section 25120 - that the intangible constitutes an integral part of the taxpayer's regular trade or business operations, i.e., the unitary business. (See Cal. Admin. Code, tit. 18, reg. 25120, subds. (a) and (b).)

Appellant has not demonstrated that the Coke stock was integrally related to appellant's business activities as required by the Supreme Court, this board, and the functional test of section 25120. We cannot agree with appellant's contention that its acquisition of 100 percent of Coke "so that it could run that company to suit [appellant's] own business objectives" (App. Reply Br. at 6) leads inevitably to the conclusion that the stock produced business income. An integral relationship with the unitary business must still be demonstrated. We also do not agree that the facts show that Coke was acquired and managed as more than an investment,

2/ For an extensive discussion of Mobil and ASARCO and their impact on this issue, see the Appeal of Standard Oil Company of California, supra.

certainly not to the extent that the stock could be said to be integrally related to appellant's unitary business operations. Clearly, the mere flow of funds from Coke to appellant does not make the stock integrally related to the unitary business or cause the dividend to be business income. (Appeal of Masonite Corporation, Cal. St. Bd. of Equal., Mar. 3, 1987.) We must conclude that the dividends paid by Coke to appellant in 1978 were properly characterized as nonbusiness income. Therefore, the action of the Franchise Tax Board 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Twentieth Century-Fox Film Corporation against proposed assessments of additional franchise tax in the amounts of $117,183 and $792,670 for the income years 1977 and 1978, respectively, and pursuant to section 26077, that the action of the Franchise Tax Board in denying the claim of Twentieth Century-Pox Film Corporation for refund of franchise tax in the amount of $14,413 for the income year 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of. March, 1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Bennett, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis**, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

John Davies*, **, Member

*For Gray Davis, per Government Code section 7.9

**Abstained