

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
 ) No. 89A-1010-MW  
BUSINESS EXCHANGE, INC. )

For Appellant: David Lee Rice  
Attorney at Law

For Respondent: John A. Stilwell, Jr.  
Counsel

OPINION

This appeal is made pursuant to section 25666<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Business Exchange, Inc., against proposed assessments of additional franchise tax in the amounts of \$32,221, \$58,900, and \$10,469 for the income years ended July 31, 1983, July 31, 1984, and July 31, 1985, respectively.

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<sup>1/</sup> Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The only issue in the appeal is whether appellant was engaged in a unitary business with its wholly owned subsidiary, Business Exchange Realty ("BXR") during the years in question.

During the appeal years, appellant was a publicly held company that provided a barter service for its members. Members could sell goods and services to other members in exchange for "BX credits" and then use those credits to purchase the goods or services offered by other members; in other words, the members did not have to make direct exchanges.

The appellant's role in the barter service was to publish membership directories, to assist the membership in increasing sales and in making purchases, and to provide a computerized accounting service to post the transactions made by the members. Appellant's revenues, in cash and BX credits, were derived primarily from providing services to its members.

In the 14 to 15 years preceding the appeal years, appellant had purchased tracts of land in Southern California, Washington, and Oregon which it divided or subdivided and sold to BX members and others. Appellant purchased most of this real estate from BX members with BX credits. Sales of the real estate to members were for BX credits and cash and sales to non-members were for cash. In 1981, appellant's real estate holdings made up about 30 percent of the value of appellant's total assets; however, gains from the sale of real property did not contribute significantly to appellant's revenues.

During the appeal years, it appears that appellant's real estate activity consisted of purchasing two properties, selling one, holding trust deeds, and receiving some amount of commissions in its capacity as a real estate broker. These transactions appear to have involved BX credits or BX credits and cash.

On April 1, 1983, appellant acquired 100 percent of the stock of Essex Realty, Inc., and changed its name to BX Realty, Inc. (BXR). Christopher Wheeler, Essex's president, stayed in place as BXR's chief executive officer and continued to handle the day-to-day operations of the company until he resigned in February 1984. Appellant's president, Marvin J. McConnell, served as chief executive officer for a brief time thereafter before Antoinette DeRose took over Wheeler's duties.

Appellant states that the purpose for acquiring BXR was to allow appellant to syndicate existing and future real estate projects. Appellant intended for its members to serve as not only a primary investor base, but also to develop and rehabilitate real properties. (App. Br. at 2.) During the three years on appeal, however, it appears that BXR made no sales or purchases of real estate. It intended to participate in the development of a 7.2 acre residential and commercial real estate project, but was unable to receive approval for the project from the Pomona Redevelopment Agency during the appeal years.

Appellant and BXR had three out of the four officers/directors on their boards in common. Marvin J. McConnell was appellant's president and was chairman of the board of directors

of both appellant and BXR. Prior to the formation of appellant in 1960, McConnell owned a swimming pool construction company and a construction company that built single family homes and did real estate renovation.

Most of BXR's activities, which during the appeal years apparently involved only the preliminary financing and advertising and the attempt to obtain approval for the Pomona development project, were conducted by personnel who worked both for appellant and BXR. Legal and accounting services and insurance for BXR were arranged by appellant, and some of these services, as well as other goods and services for BXR, were paid for by BX credits. From its acquisition in 1983 until April 1984, BXR operated from appellant's offices. At least one of the two signatures required on checks issued by BXR had to be by one of appellant's directors.

Appellant was the guarantor of BXR's construction loan of \$17,500,000 for its Pomona project, although it is not clear from the record whether this happened during the appeal years. In 1984, appellant paid \$25,000 (in BX credits) for radio advertising of the Pomona project. BXR's project was also mentioned in the newsletter that appellant sent to its members.

For appellant's income years ended July 31, 1983, 1984, and 1985, appellant filed combined reports as a unitary business that included BXR. After examination, respondent determined that appellant and BXR were not unitary and issued notices of proposed assessment. Appellant protested and, after its protest was denied, brought this timely appeal.

The California Supreme Court has held that the existence of a unitary business may be established by the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions; and unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), *affd.*, 315 U.S. 501 [86 L.Ed.991] (1942).) It has also stated that a business is unitary if the operation of the business 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 472, 481 [183 P.2d 16] (1947).) More recently, the United States Supreme Court has emphasized that a unitary business is an enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 [77 L.Ed.2d 545], *rehg. den.*, 464 U.S. 909 [78 L.Ed.2d 248] (1983).)

Appellant argues that it was engaged in a single unitary business with BXR because McConnell controlled the operations of both corporations, the two companies shared officers and directors in common, all administrative functions for BXR were performed by employees of appellant, the companies shared office space during part of the time under consideration, appellant helped provide financing for BXR, and appellant handled BXR's advertising. Appellant also points out that it had been engaged in real estate ventures previously in connection with its barter service.

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.) Respondent takes the position that the circumstances in this appeal do not demonstrate the "flow of value" or "substantial mutual interdependence" that is necessary for two companies to be considered unitary. It emphasizes that appellant and BXR were engaged in diverse lines of business. In addition, the "centralized control" allegedly exerted by McConnell is characterized by FTB as nothing more than the oversight that any prudent investor would give to his or her investments and does not indicate unity.

We agree with respondent that appellant and BXR appear to have been engaged in diverse lines of business. Prior to its acquisition of BXR, appellant did own real property; however, as noted in appellant's 1981 prospectus prepared in connection with an offering of its stock, such property was acquired for "investment purposes." (App. Reply Br., Ex. A at 15.) The holding of real estate for investment is very different from the active development of real property for resale. (Appeal of Hill and Dale Land Company, Cal. St. Bd. of Equal., Nov. 19, 1986.) However, determining that the businesses were diverse does not end, but merely begins, the inquiry we must make. In the Appeal of Sierra Production Service, Inc., et al. (90-SBE-010), decided September 12, 1990, we reiterated that there is no separate unitary test for diverse businesses and taxpayers engaged in such businesses do not have to satisfy a heavier burden of proof in order to obtain unitary treatment than taxpayers engaged in horizontally or vertically integrated businesses.

Appellant relies, at least implicitly, on the presumption that arises under respondent's regulation 25120, subdivision (b)(3), which provides guidance for determining the existence of a single unitary business in a diverse business situation. In relevant part, the regulation provides as follows:

(b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one "trade or business." In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

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The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good

indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

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(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

(Cal. Code Regs., tit. 18, reg. 25120, subd. (b).)

We addressed the requirements of this regulatory presumption in Sierra Production Service, supra. There we said, in dicta:

What constitutes "strong central management" will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of "common officers or directors" or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role, in the business activities of the various divisions or affiliates.

During the appeal years, which are the only years we consider in this appeal, we find that there was no centralized management as contemplated by Regulation 25120. McConnell had the final say on money matters, but the operations of BXR as a real estate development company were handled by its chief executive officer. The intent to integrate BXR with appellant is not enough to make a unitary business out of two commonly owned, but separately operated businesses. The question of unity must be based upon actual interrelationships which existed during the period at issue, not those which existed in later years or those which appellant intended should exist. (Appeal of W. K. Equipment Company, Cal. St. Bd. of Equal., Sept. 10, 1985; see F. W. Woolworth Co. v. Taxation and Revenue Department, 458 U.S. 354, 364 [73 L.Ed.2d 819] (1982).) ("[T]he potential to operate a company as part of a unitary business is not dispositive when, looking at the underlying economic

realities of a unitary business, the dividend income from the subsidiaries in fact is derived from 'unrelated business activity' which constitutes a discrete business enterprise.")

The appellant also relies on the case of Mole-Richardson Co. v. Franchise Tax Board, 220 Cal.App.3d 889 [269 Cal.Rptr. 662] (1990), in which the court found that a closely held California lighting company was unitary with its subsidiary that operated a cattle ranch in Colorado. However, that case is clearly distinguishable from the present one. In Mole-Richardson, the chief executive officer directly supervised the operations of both businesses, including the negotiation and purchasing of breeding stock and farm equipment. In the present appeal, McConnell had "final say over any and all projects" (App. Br. at 9), but it was BXR's president, Mr. Wheeler, who "was responsible for the redevelopment of the Pomona project . . . [including] obtaining bids, hiring and supervising contractors, dealing with the Pomona redevelopment agency, and working with BX Realty's lender in conjunction with financing the project." (Appeal Ltr. at 8.) Appellant also states that it was the Controller for the corporations, Mr. Winchell, who "negotiated with the bank regarding BX Realty doing its own contracting" (App. Br. at 3), and "the construction loan, as well as all financing, was negotiated and executed by Mr. Winchell and M[s]. DeRose" (App. Ltr. at 7). During the appeal years, the only instance of McConnell's active involvement with BXR referred to by appellant was that he "was present at and conducted all negotiations with the City of Pomona regarding the funding of the projects with redevelopment bonds." (App. Supp. Mem. at 3.) This belated and vague reference, first mentioned in appellant's last Supplemental Memorandum, is hardly enough for us to equate the circumstances in the present appeal with those in Mole-Richardson.

For the three years we are considering, BXR was engaged in commencing an activity which did not come to fruition during these years and which has not been shown to have had any substantial relationships with the business of appellant. This appeal is in many ways similar to the Appeal of Hooker Industries, (87-SBE-033) decided May 7, 1987, where we said:

The one item which had the potential to establish a significant unitary connection, the engineering research and development conducted for Superior by appellant's engineers, has not been developed sufficiently to show precisely when this work was done or whether it actually led to an operational interrelationship of any substance between the two companies.

Here, as in Hooker Industries, there simply was not a developed interrelationship between the two companies sufficient to result in a finding of unity.

The situation may perhaps be best summarized in appellant's own words: "[T]he facts also indicate that BEI was substantially 'gearing up' to integrate the real estate business even more in its business after the advent of BXR." (App. Br. at 3.) To continue the metaphor, appellant may have been "gearing up" but in this period it had not shifted into "drive."

Accordingly, the action of respondent 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 Business Exchange, Inc. against a proposed assessment of additional franchise tax in the amounts of \$32,221, \$58,900 and \$10,469 for the income years ended July 31, 1983, July 31, 1984 and July 31, 1985, respectively, be and the same is hereby sustained.

Done at Culver City, California, this 13th day of December, 1994, by the State Board of Equalization, with Board Members Brad Sherman, Ernest J. Dronenburg, Jr. and Windie Scott present.

Ernest J. Dronenburg, Jr., Member

Windie Scott\*, Member

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\*For Gray Davis, per Government Code section 7.9.