BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
Lumidor Manufacturing Company)

Appearances:

For Appellant: Charles F. Swisher
Attorney at Law

For Respondent: Mark McEvilly
Counsel

OPINION

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Lumidor Manufacturing Company against proposed assessments of additional franchise tax in the amounts of $6,562.07, $7,665.18, and $15,722.50 for the income years ended June 30, 1970, June 30, 1971, and June 30, 1972, respectively.

Appeal of Lumidor Manufacturing Company

The sole question presented by this appeal is whether appellant and its parent corporation were engaged in a single unitary business during appellant's income years ended in 1970, 1971, and 1972.

Appellant is a California corporation incorporated in 1943, with its principal place of business in Los Angeles, California.. Until 1956, appellant's largest single shareholder was Sears, Roebuck & Company (Sears), which owned 30 percent of appellant's stock. In 1956, Sears was concerned that appellant would be forced to liquidate because of large losses which Sears attributed to poor management and lack of resources. Sears persuaded Waterloo Industries, Inc., (Waterloo) to buy out certain shareholders related to appellant's management, promising to provide financing and additional business for Waterloo. After obtaining a majority interest in appellant's stock, Waterloo effected a reorganization of appellant's management. By 1964, when Waterloo acquired its present 81.17 percent interest' in appellant, appellant was showing a profit. During the years on appeal, the other shareholders of appellant were Sears (13.76 percent) and three individual shareholders (5.07 percent).

Waterloo is an Iowa corporation with its principal place of business in Waterloo, Iowa. During the years on 'appeal, all of Waterloo's stock was owned by members of one family and five of these shareholders filled most of the executive positions in that company.

During the appeal years,. four of Waterloo's directors sat on appellant's seven-member. board. Appellant's president and. two employees of Sears were the other members. Waterloo's chairman of the board and its secretary-treasurer served as chairman of the board and secretary/assistant-treasurer, respectively, of appellant. For the income year ended in 1970, Waterloo's president was appellant's vice-president; for the remaining two years, Waterloo's senior vice-president was appellant's vice-president.. Appellant's president and treasurer were long-time employees of. appellant who were not directors, officers, or shareholders of Waterloo. In 1971, an employee of Waterloo became director of manufacturing for appellant, replacing appellant's employee who left the company.

Both appellant and Waterloo manufactured tool boxes and related items primarily for sale to Sears, which sold these. items under its proprietary "Craftsman" trademark. (Sears also buys such products from other companies.) Sales to Sears constituted approximately 65 percent of appellant's sales during the appeal years and approximately 85 percent 'of Waterloo's sales during the same period. Appellant and Waterloo also manufactured various other products'which each marketed under its own name. At no time did appellant and Waterloo use any common trade name or trademark. Sales, both to Sears and others, 'were negotiated separately by the two companies. Neither company serviced the products of the other after the manufacture or sale by either company.

Appellant purchased some tool stands, "purchase parts" (hinges, locks, castors, etc.), and manufactured items from Waterloo during the appeal years because it sold insufficient quantities of these items to justify the tooling expense involved. These sales to appellant constituted between .6 percent and .8 percent of Waterloo's total net sales during the three years involved. Appellant also purchased some of the same types of items from other companies.

Waterloo purchased tool chests and cabinets from appellant to avoid the expense of shipping these items 1,500 miles to its customers in California. The sales to Waterloo were 4.2 percent of appellant's total net sales in the income year ended in 1970, 2.2' percent in the 1971 income year, and 2.7 percent in the 1972 income year.

Waterloo and appellant shared one patent during these years. It was for a recessed slide on a Sears roller cabinet and had been issued to Waterloo in 1968. No fees were paid by either company to the other for the use of the patent. Although each company had its own research and development department, developments relating to products for Sears were shared because Sears insisted 'that the products manufactured by the two companies be as nearly identical as possible.

Waterloo used appellant's warehousing services in Los Angeles, paying the same warehousing fees it paid at other warehouses. There were no other shared facilities, either free or rented.

Each company. maintained and handled separately its own advertising programs, accounting systems,- sales and distribution systems, 'billing and collecting, preparation and payment of payrolls, purchasing, personnel departments, and personnel analysis. There were no common annuity, profit-sharing, or other compensatory programs. Each maintained its own pension plans for its own employees, although all were insured by Aetna Insurance. Casualty, workmen's compensation, liability, and group medical and hospitalization insurance were also maintained separately by each company.

The annual audit and the income tax returns for both companies were prepared by Carney, Alexander, Harold, & Company of Waterloo, Iowa, but appellant used an independent Los Angeles certified public accountant for its other accounting services. Appellant sent monthly accounting reports to Waterloo. Both companies secured legal services from the law firm of Swisher & Cohrt, of Waterloo,, Iowa, although each also used-other law firms independently of the other.

During the 1971 income year, appellant paid the remaining $32,860.00 of a long-term note to Waterloo. The note had been executed in 1965, converting a then $165,000.00 account receivable owed by appellant to Waterloo. There was no other intercompany financing during the appeal years.

After an audit, respondent determined that appellant and its parent, Waterloo, were engaged in a single unitary business and that appellant's income from California sources should have been determined on the basis of a combined report. Appellant contends that the two companies were not engaged in a single unitary business.

When a taxpayer derives income from sources both within and without this state, its franchise tax liability is measured by its net income derived from or attributable to sources within, this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the 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).)

The existence of a unitary business may be established under either of two tests set forth by the California Supreme Court. 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 a unitary business was definitely 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. Later, the court stated that a business is unitary if 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.)

Respondent's determination is presumptively correct and. appellant bears the burden of proving that it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., -Dec. 13, 1961.) Each appeal rnust be decided on its own particular facts and no one factor is controlling. (Container Corp. of America, v. Franchise Tax Bd., 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), prob. juris. noted May 3, 1982, -- U.S. -- [72 L.Ed.2d 483] (Dock. No. 81-523).) Where, as here, the appellant is contesting respondent's determination of unity, it must prove by a preponderance of the evidence that, in the aggregate, the unitary connections, relied on by respondent were so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist.

Appellant concedes that unity of ownership was present since Waterloo' owned 81.17 percent of appellant's stock. It contends, however, that the remaining connections between Waterloo and appellant were insufficient to support a finding of either the unities of use and operation or contribution or dependency between the two corporations.

We agree with appellant that evidence of unity of operation, consisting primarily of common use of a law firm and an accounting firm, is slight. We are not as convinced of the absence of unity of use. A unitary 'business may exist, however, if the contribution or dependency test of Edison Califprnia Stores, Inc., supra, is met. Applying that test to the facts of this case, we must conclude that appellant and Waterloo were engaged in a single unitary. business during the appeal years.

In spite 'of the apparent autonomy emphasized by appellant, we find a number of strong connections between the two companies which indicate that they were sufficiently linked to be considered a single economic enterprise for purposes of taxation. We have no doubt that appellant's resident officers managed appellant's day-to-day operations. However, appellant states that the major policy decisions were made by appellant's board of directors, the majority of whom were also directors of Waterloo. In addition, appellant's operations, 'as well as its financial situation, were reviewed at least yearly during Waterloo's annual board of directors' meeting, and at the September 14, 1970, meeting, a committee of Waterloo directors was appointed to further review' appellant's 'reports, carry out recommendations, and report back, to Waterloo's board at its next meeting. An, integratea executive force making major policy decisions, such as existed here, is a significant indication -of unity. (Chase Brass. & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 504 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970).)

Waterloo and appellant were, to a large extent, engaged in almost identical businesses and had interlocking officers and directors. 'This situation leads almost inevitably to the conclusion that a mutually beneficial exchange of information occurred between the two companies. (Appeal of Anchor Hocking Glass Corporation, Cal. St. Bd. of Equal., Aug. 7, 1967.) We find such a conclusion well-supported by the evidence in this appeal, Appellant and Waterloo not only produced a large percentage of the same products, but they produced them for the same customer, Sears. A number of trips were made by officers of each company to visit the other, at least half of which were primarily to discuss the companies' business with Sears. Although each company maintained, its own research and development department, they shared information and technology on products which they both made for Sears, the major customer of both: All of these are factors indicating contribution and interdependence between appellant and Waterloo.

A further strong indication of contribution and dependence is also a' result of the companies' relationship with their common major customer. It appears that Sears required appellant and Waterloo to maintain a full complement of certain items even though at times Sears could not purchase all of these items. Rather than both companies making all the items in the quantities required by Sears, appellant and Waterloo arranged to supply each other to meet those requirements. In this way, the stock of each company was maintained at the required level with a minimum of manufacturing costs..

Appellant emphasizes the lack of substantial intercompany sales' and financing. We' agree that intercompany financing was minimal and that the percentage of intercompany sales to total sales of each company was not large. We note, however, that 100 percent of the tool stands and manufactured parts which appellant purchased were from Waterloo and that 100 percent of the tool chests and cabinets which Waterloo purchased were from appellant.

Whether or not any of the factors previously mentioned are individually of overwhelming significance, when the record is viewed as a whole we find substantial evidence of contribution and interdependence between these two companies. Although there are elements of independence present in this appeal which appellant has "emphasized, they are simply insufficient to convince us that appellant and Waterloo were not engaged in a unitary business. Respondent's action, therefore, must be sustained.

Appeal of Lumidor Manufacturing Company

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 Lumidor Manufacturing Company against proposed assessments of additional franchise tax in the amounts of $6,562.07, $7,665.18, and $15,722.50 for the income years ended June 30, 1970, June 30, 1971, and June 30, 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of March, 1982, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Nevins and Mr. Harvey Present.

_______________, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code Section 7.9