

Appeal of P and M Lumber Products, Inc.

There are two issues presented for decision. They are: (1) whether P and M Lumber Products, Inc., and its subsidiaries, Coopers Mill, Inc., and Calcedar Export, Inc., were engaged in a unitary business with Duraflame, Inc., and its subsidiaries, Boom Boom Enterprises, Inc., and Eastern Firelog Corporation; and (2) whether the Little St. Simon's Island division of P and M Lumber Products, Inc., was part of the unitary business.

The corporations discussed in this factual situation are all owned by various members of the Berolzheimer family. For ease of discussion, we divide them into three groups according to ownership. There is the P and M Lumber group, the California Cedar Products' group, and the Duraflame group.

P and M Lumber Products, Inc., (hereafter "P and M Lumber") is a California corporation, incorporated on January 3, 1969. It is owned 50 percent each by two brothers, Michael and Philip Berolzheimer. Its principal place of business and main office is located in Stockton, California. The corporation operates a sawmill at Mt. Shasta, California, where it acquires incense cedar logs and mills them into pencil blocks or stock. It has a wholly owned subsidiary, Coopers Mill, Inc., which also operates a sawmill at Mt. Shasta. Coopers Mill, Inc., in turn, has a wholly owned subsidiary, Calcedar Export, Inc. This corporation acts as an agent for foreign sale; for all of the Berolzheimer corporations. In addition to its lumber business, P and M Lumber operates a cattle breeding division on Little St. Simon's Island in Georgia,

The second group is the California Cedar Products group. It is not contended by either appellant or respondent that the California Cedar Products group is part of the unitary business. However, a description of this group's activities is necessary to more completely explain the activities of the P and M Lumber and Duraflame groups. California Cedar Products is owned 100 percent by Charles Berolzheimer, the father of Michael and Philip Berolzheimer. California Cedar Products has a wholly owned subsidiary, Calmills, Inc. Calmills, Inc., buys the pencil blocks milled by P and M Lumber and Coopers Mill, Inc. The pencil stock is then stored at the mill sites or transported to yards in the central valley area of California to dry. Eventually, the dried pencil stock is delivered to California Cedar Products, which mills the pencil blocks into slats suitable for manufacture into pencils.

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The third group is the Duraflame group. Duraflame, Inc., is a California corporation incorporated on July 31, 1970. It is owned 45 percent by Michael Berolzheimer, 35 percent by Philip Berolzheimer, and 20 percent by trusts for the Berolzheimer brothers' minor children. Duraflame, Inc., distributes Duraflame **firelogs** and firesticks, which are manufactured from wood waste obtained as a by-product of California Cedar Products' pencil slat milling operations. The Duraflame **firelog** was distributed in California by Boom Boom Enterprises, Inc., a wholly owned subsidiary of Duraflame, Inc. In addition to distributing **firelogs** manufactured by California Cedar Products, Duraflame also distributed **firelogs** manufactured by Eastern **Firelog** Corporation.

Eastern **Firelog** Corporation was incorporated on June 7, 1974. The corporation was formed to manufacture **firelogs** in Pennsylvania for more convenient distribution to the East coast and Europe. Until June 30, 1975, it was owned 80 percent by Duraflame, Inc., and 20 percent by trusts established for the Berolzheimer brothers' minor children. On June 30, 1975, the shareholders of Eastern **Firelog** Corporation exchanged their stock for a **16-percent** stock interest in P and M Lumber. Following the stock exchange, Eastern **Firelog** was merged into P and M Lumber and operated as a division of that company.

P and M Lumber, **Coopers** Mill, Inc., **Calcedar** Exports, Inc., Duraflame, Inc., and Boom Boom Enterprises filed their 1973 and 1974 California franchise tax returns on a separate basis. In 1975 these corporations joined with Eastern **Firelog**, Inc., in filing a combined report using a single apportionment formula. They also filed amended combined refund returns for income years 1973 and 1974. Upon examination of the 1975 return and the amended 1973 and 1974 returns, respondent determined that the appellants should file in two unitary groups. The first group included P and M Lumber, its wholly owned subsidiary, **Coopers** Mill, Inc., and **Coopers** Mill, **Inc.'s** wholly owned subsidiary, **Calcedar** Export, Inc. The second unitary group included Duraflame, Inc., and its two controlled subsidiaries, Boom Boom Enterprises, Inc., and Eastern **Firelog**, Inc. Respondent's reason for splitting the corporations into two filing groups was the lack of unity of ownership between the P and M Lumber group and the Duraflame group.

Respondent contends that for unity of ownership to exist, one individual or entity must own more than 50 percent of the voting stock of the corporations.

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Appellants argue that the ownership requirement is satisfied where the aggregate interests of several family members constitute more than 50 percent of the voting stock in the corporations.

The second issue is whether the Little St. Simon's Island division of P and M Lumber is part of the 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 this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a unitary business, the amount of income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations. (See 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 [111 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 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, 17 Cal.2d at 678.) 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., supra, 30 Cal.2d at 48.)

The parties do not dispute that the unities of operation and use exist between the P and M Lumber group and the Duraflame group. The sole issue is whether unity of ownership is present. In support of its position, appellant relies on the Appeal of Shaffer Rentals, Inc., decided by this board on September 14, 1970. In the Appeal of Douglas Furniture of California, Inc., decided

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by this board on January 31, 1984, however, we overruled our decision in Shaffer Rentals and held that unity of ownership generally requires that a single individual or entity must own more than 50 percent of the voting stock of each corporation involved.

The present case falls squarely within the rule that was approved in Douglas Furniture. No one person or entity had more than a 50-percent ownership interest in the P and M Lumber group and the Duraflame group. Therefore, under the holding of Douglas Furniture, *supra*, we find that unity of ownership is not present in this case. Because there is no unity of ownership, the P and M Lumber group and the Duraflame group are not one unitary business.

We must now decide whether the Little St. Simon's Island division is part of the unitary business of the P and M Lumber group, .

The cattle breeding operation on Little St. Simon's Island is run as a division of P and M Lumber. It came into existence at the end of 1971, when P and M Lumber entered into a five-year lease for property located on Little St. Simon's Island off the Georgia coast. During 1971 and 1972, the island properties were managed by Mr. George Owen, who supervised the acquisition and improvement of a cattle herd and the repair of facilities on the island. Mr. Owen was succeeded as manager in 1973 by Mickey Fountain, a wildlife specialist. Mr. Fountain instituted a program to increase and protect the deer herd located on the island. Upon Mr. Fountain's departure in early 1974, Mr. Carroll Schoolcraft was appointed temporary manager of the property. In August 1974, Mr. Schoolcraft was succeeded as manager by Mr. Charles Nunley. Mr. Nunley was employed to manage an expanded cattle program. Mr. Nunley continued as on-site manager of the island operations for the balance of the appeal period. During this time, he was involved in the purchase of additional cattle for stocking the ranch. The majority of these cattle were purchased in Tennessee with only limited involvement by Mr. Philip Berolzheimer and other employees of the corporation.

Day-to-day operations of the ranch were supervised by the on-site manager. Decisions governing the operations of the division were the responsibility of Philip Berolzheimer, vice president of P and M Lumber. Prior to the appeal years, the corporation established and maintained a general bank account in Georgia. During the appeal years, the corporation maintained only a small

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balance in the bank account (\$500). The ranch foreman was authorized to draw checks on the account to purchase food supplies and pay day laborers.

The Little St. Simon's Island division is covered under P and M Lumber group insurance policies. Operations are financed by surplus funds and loans borrowed by P and M Lumber. Accounting services and general overhead functions are performed by the corporation's central office in California. Legal services for the division are normally performed by P and M Lumber's legal counsel.

Respondent contends that appellant has not established that there is the type of economically significant integration between the Georgia cattle business and the West Coast lumber products business to warrant treatment of the two activities as a single unitary business. Appellant, on the other hand, asserts that the Little St. Simon's division was an inseparable part of P and M Lumber.

Unity of ownership is clearly present since Little St. Simon's Island is operated as a division of P and M Lumber. Appellant argues that operational unity is also present because all accounting, legal, banking, financing, and insurance services were handled at P and M Lumber's headquarters in Stockton. For unity of use, appellant argues that Philip Berolzheimer exercised complete management control of the Little St. Simon's Island division. Appellant contends that this degree of centralization of management also shows a dependency and contribution between divisions.

Respondent's determination is presumptively correct, and appellant bears the burden of proving that it is incorrect. Appellant has stated that a number of services were centralized. However, where, as here, the businesses are distinct in nature, the mere recitation of a number of centralized functions is insufficient to establish unity. (Appeal of Allied Properties, Inc., Cal. St. Bd. of Equal., Marc 17, 1964.) In a case of vertical or horizontal integration, benefits to the group from the connection are usually apparent. In cases such as the present one, where the **businesses** engaged in are diverse, appellant must produce evidence to show that in substance the factors present demonstrate the existence of a single, integrated economic unit. (Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., March 31, 1982.)

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Appellant has not shown that its centralized services resulted in operational integration of the two businesses. The services were not used for any common **business** activity, and there is no evidence that either appellant's lumber business or its cattle business gained any substantial mutual advantage from them. Appellants, allege that financing for the island division's cattle operation was obtained through the corporation's California banking contacts. As we stated **when** a similar argument was raised in the Appeal of Simco, Inc., decided by this board on October 27, 1964:

When any entity conducts more than one business the profits from one activity often are used to aid its other enterprises. **Any** expansion or change by a corporation of its business activities is financed by its own funds or by the use of its credit. If such financing results in a unitary business virtually every business would be unitary no matter how unrelated were the various activities.

With respect to the centralized executive force, while Mr. Berolzheimer did provide management guidance for the cattle business, there is no evidence that it contributed to any significant integration between the two businesses. Mr. Berolzheimer had no prior experience in the cattle breeding business, and there is no indication that he had the expertise to provide the Little St. Simon's Island division with the type of assistance that is associated with the integrated executive force of a unitary business. The record shows that the operations were locally managed by individuals with expertise in either recreation or cattle raising, who were charged with developing a cattle herd on the island and developing the island's recreation and hunting potential. There is no evidence that the type of executive assistance provided by Mr. Berolzheimer was anything more than that which is ordinarily found where a closely held corporation operates a number of enterprises, that of an owner overseeing its assets. (See Appeal of Mole-Richardson Co., Cal. St. Bd. of Equal., Oct. 26, 1983.) We find that appellant has not shown that there was unity of use or operation during the appeal years.

Appellant relies on the same factors of centralized management and services to show contribution or dependency existed between the two businesses. **How-**ever, as the preceding discussion shows, these factors did not act to economically integrate the two businesses.

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Appellant has not shown that the operation of the Little St. Simon's Island division contributed to or depended upon appellant's lumber business. There was no exchange of technical know-how or intracompany product flow. Nothing in the record indicates that the Little St. Simon's Island division was anything more than a cattle business housed under the same corporate shell as a lumber business. This does not provide the integration necessary to **constitute** a unitary business. Under these circumstances, respondent's action. must be sustained.

