

Appeal of A. Epstein and Sons, Inc.

The primary issue presented by this appeal is whether appellant A. Epstein and Sons, Inc., was engaged in a single unitary business with several affiliated corporations and was required to determine its California income by combined reporting procedures during the years on appeal. If we determine that appellant was engaged in a single unitary business, additional issues presented concern: (i) whether the income earned from the sale of meat-processing equipment as part of the contracts entered into with a state-owned entity of the Polish government (hereinafter referred to as the "Polish contracts") constituted business income; (ii) whether the interest income derived from the Polish contracts constituted business income; (iii) whether appellant's California income is fairly represented by the standard apportionment formula; and (iv) whether the New York partnership should be included in the unitary business.

Appellant A. Epstein and Sons, Inc., is a member of a group of closely held affiliated corporations (hereinafter referred to as the "Epstein Corporations") which are headquartered in Chicago, Illinois. Appellant's parent, A. Epstein Companies, Inc. (parent), owns all or a majority of the shares of all the subsidiary corporations. During the years in issue, the Epstein Corporations were principally engaged in the rendering of design services and, to a lesser extent, were engaged in the construction business. All activities were carried out on a worldwide basis. During the years in issue, appellant was specifically engaged in rendering architectural design services.

McKinley, one of parent's subsidiaries, was engaged in two activities. The first activity was the construction of commercial, industrial and multi-unit residential buildings from plans designed in some cases by appellant and in others by independent third parties. McKinley's other activity consisted of the purchase and resale of equipment pursuant to the Polish contracts. During all of the years in question McKinley maintained an office in California. Parent supplied management services to the design subsidiaries, but not to McKinley. Parent also established a construction division in connection with certain construction projects undertaken by McKinley in Poland because the Polish authorities required that the contracts be executed by parent rather than by the subsidiaries performing those contracts.

In 1972 and 1973, as part of their foreign operations, the Epstein Corporations entered into con-

Appeal of A. Epstein and Sons, Inc.

tracts with a state-owned entity of the Polish government involving the construction of several meat-processing plants in Poland. In addition to the design and construction of these plants, the Epstein Corporations were also responsible for the purchase and installation of the operating equipment and for testing the equipment and training the Polish personnel in the plants' operation. Several employees were specifically hired to fulfill the latter aspects of the contracts, including individuals with specialized accounting expertise in equipment sales. In most respects, however, the work on the contracts was similar to the design and construction done on a worldwide basis by the Epstein Corporations.

During the years in question, the principal shareholders of appellant's parent were two brothers, Raymond and Sidney Epstein, who each owned 41.9 percent of the outstanding shares of stock. The Epsteins and Mr. Garfield Rawitsch held the senior officer positions of the parent and were officers in all of the other Epstein Corporations. Actual control over the Epstein Corporations was maintained by having the Epstein brothers and Mr. Rawitsch constitute a majority of the board of directors of each Epstein corporation.

The headquarters office oversaw the business and concerned itself with the policy decisions involved in the various activities engaged in by the Epstein Corporations, including the design and construction aspects of the Polish contracts. A flat fee was charged by the parent company to the remainder of the Epstein Corporations for administrative overhead. There was also a substantial amount charged for other intercompany services (\$1,329,456 in 1973 and \$306,692 in 1974). Appellant's performance of significant activities for its affiliates is further reflected by the growth, during the income year 1973 from zero to over \$1.6 million, in appellant's asset account "Due From -Affiliated Companies."

During the years in question, the Epstein Corporations derived substantial amounts of interest income from excess funds which were generated by the business and invested on a short-term basis in United States Government securities pending a decision by management on what business use to make of the funds. Approximately sixty to seventy percent of the interest income in issue can be directly traced to progress payments on the Polish contracts.

Appeal of A. Epstein and Sons, Inc.

During the years at issue, a partnership composed of Raymond and Sidney Epstein operated in New York and rendered architectural services to parent. The New York partnership was formed to conduct the architectural activities of Epstein in New York because New York State law did not permit a corporation to practice architecture. According to appellant, the partnership agreed to perform all architectural services required in New York for Epstein at cost, thereby negating the possibility of profit to the partnership. Therefore, appellant maintains that any profit attributable to the architectural services rendered by the partnership became the profit of Epstein, although the property, payroll, and sales of the partnership were responsible for that profit. Furthermore, appellant asserts Epstein indemnified the partners of the partnership against claims arising out of the operation of the partnership. Although the architectural services were rendered solely to the Epstein Corporations, no Epstein corporation had any interest in the partnership.

Appellant reported its income on a separate accounting basis for the years on appeal. After an audit, respondent determined that appellant and its affiliates were engaged in a single unitary business within and without California and redetermined appellant's California income on a formula apportionment basis. In addition, respondent determined that: (i) the income from the sale of meat-processing equipment pursuant to the Polish contracts and the interest income derived from the Polish contracts constituted business income; (ii) appellant's California income is fairly represented by use of the standard apportionment formula; and (iii) the New York partnership did not constitute part of the unitary business. In deciding that appellant and its affiliates were engaged in a single unitary business, respondent relied upon its finding that the following factors existed: centralized management; exchange of know-how; intercompany sales; sharing of administrative services; and common ownership.

Appellant has disputed either the existence or the significance of each of these factors. It also contends that the income from the purchase and sale of equipment and machinery under the Polish contracts and the interest income was nonbusiness income and that the **property**, payroll, and sales of the New York partnership should be taken into account in the apportionment formula.

Appeal of A. Epstein and Sons, Inc.

The question which must be decided initially is whether appellant was engaged 'in a single unitary business with the other affiliated corporations and was required to determine its California income by combined reporting procedures during the years under appeal.

When a taxpayer derives income from sources both within and without California, it is required to measure its California franchise tax liability by the net income derived from, or attributable to, sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer's business is unitary, the income attributable to California must be computed by formula apportionment rather than by the separate accounting method. (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942); Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has developed two general tests for determining whether a business is unitary. In Butler Bros., supra, the court held that the existence of a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation; **and** (3) unity of use. Subsequently, in Edison California Stores, Inc., supra, the court held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. More recent cases have reaffirmed these general tests and given them broad application. (Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal.2d 417 [34 Cal.Rptr. 552, 386 P.2d 40] (1963); RKO Teleradio Pictures, Inc. v. Franchise Tax Board, 246 Cal.App.2d 812 [55 Cal.Rptr. 299] (1966).) The California court has stated, "It is only if [a foreign corporation's] business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used." (Butler Bros. v. McColgan, supra, 17 Cal.2d 664, 667-668.)

If either of the above-stated tests are applied to the facts presented in this appeal, we are led to the conclusion that respondent has correctly determined that appellant was engaged in a single unitary business. with the several affiliated corporations in issue. Our conclusion is based on the presence of the following factors

Appeal of A. Epstein and Sons, Inc.

which indicate the existence of a unitary business under the established tests: (1) common ownership-by appellant's parent, A. Epstein Companies, Inc., of 'all or a majority of the shares of all the affiliated corporations; (2) the extensive interrelationship of officers and directors in that the Epsteins and Garfield Rawitsch are the principal officers of the Epstein Corporations and constitute a majority of the board of directors of each corporation; (3) the parent's exercise of control over the major policy decisions of the affiliated corporations; (4) centralization of management at the Chicago headquarters site; (5) the fact that there was a significant rendering of intercompany services between parent and the various subsidiaries; and (6) the existence of shared knowledge or "know-how" emanating from the central office of the parent and benefiting the various subsidiaries. When all of these factors are considered, it is apparent that respondent's determination is supported by sufficient evidence.

In support of its contention that it was not engaged in a single unitary business with-its affiliated companies, appellant advances two arguments. First, appellant contends that it was not engaged in a single unitary business with its affiliated companies but that the Epstein Corporations were engaged in three separate activities: (1) design, (2) construction, and (3) the purchase and sale of equipment. Appellant submits that these activities did not constitute a single trade or business, nor were they in the same general line of business or steps in a vertical process such as manufacturing, distribution, and sales.

Respondent's determination that appellant was engaged in a single unitary business with its affiliated companies is presumptively correct. (Appeal of John Deere Plow Co. of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) The burden to produce sufficient credible evidence to negate the existence or significance of the unitary connections relied upon by respondent and thereby overcome the presumptive correctness of respondent's determination is upon appellant. (See Appeal of Saga Corporation, Cal. St. Bd. of Equal., June 29, 1982.) Appellant would like us to view each activity it undertook as separate and distinct. The lack of connection and diversity between its affiliated corporations, appellant maintains, dictates the conclusion that their operations are nonunitary. The identical question has been raised in prior appeals before this board. We have consistently held that the mere fact business entities

Appeal of A. Epstein and Sons, Inc.

are engaged, in diverse lines of businesses does not, standing alone, preclude a finding that such businesses are unitary. (See Appeal of Pittsburgh-Des Moines Steel Company, Cal. St. Bd. of Equal., June 21, 1983; Appeal of Wynn Oil Co., Cal. St. Bd. of Equal., Feb. 6, 1980.

Next, appellant maintains that each activity was managed and accounted for separately as indicated by the schedules of management and accounting personnel it submitted. (App. Ex. A) It contends that these schedules clearly demonstrate that there was no strong centralized management and that, although Raymond Epstein and Sidney Epstein generally oversaw the entire operations as its chief executive officers, their function was policy-making rather than managing the operations of the businesses. In fact, their unfamiliarity with the purchase and sale of equipment under the Polish contracts required that they hire a new vice president for the parent, Chaim Altbach, specifically to take charge of those activities on both policy and operational levels. Further, it was necessary to hire a significant number of employees with highly specialized experience in such equipment to handle the sales, and the Epsteins necessarily had to defer to those with the specialized skills in these areas.

The fact that Raymond and Sidney Epstein were not involved in the day-to-day operations is not the critical factor in determining whether affiliated corporations are integral parts of a unitary business. In fact, it is precisely the formulation of major policy decisions that is the important factor in determining whether affiliated corporations are integral parts of a unitary business. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496 [87 Cal.Rptr. 239], app. disp. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970); Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975; Appeal of F. W. Woolworth Co., Cal. St. Bd. of Equal., July 31, 1972; Appeals of Harbison-Walker Refractories Co., Cal. St. Bd. of Equal., Feb. 15, 1972; Appeal of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970,) Accordingly, appellant's argument must be rejected.

Having concluded that appellant was engaged in a single unitary business with its several affiliated corporations, the next issues which must be determined are (i) whether the income earned from sale of meat-processing equipment as part of the Polish contracts constituted business income; (ii) whether the interest

Appeal of A. Epstein and Sons, Inc.

income derived from the Polish contracts constituted, **business** income; and (iii) whether appellant's California income is fairly represented by using the standard. **UDITPA** formula.

Since its adoption in 1966, the Uniform Division of..Income for Tax Purposes Act (Rev. & Tax. Code, §§ 25120-25139) (UDITPA) has provided a **comprehensive** statutory scheme of apportionment and **allocation rules to measure** California's share of the income earned by a taxpayer engaged in a multistate or multinational unitary business. UDITPA distinguishes between "**business income,**" which must be apportioned by formula, and "nonbusiness income," which is specifically allocated by **situs or** commercial domicile. Business income is defined, as:

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.

(Rev. & Tax. Code, § 25120, **subd.** (a).)

Nonbusiness **income, on** the other hand, is defined as "all income other than business income." (Rev. & Tax. Code, § 25120, **subd.** (d).)

Although appellant would like to characterize the purchase and sale of the meat-processing equipment as a separate and distinct activity, to do so would ignore the fact that the equipment sales were part and **parcel of** the same contracts which included the overall design and construction of the meat-processing facilities. Clearly, the latter operations are at the **very heart** of the corporate group's regular operations. Accordingly, we must conclude that the purchase and sale of the **meat-**processing equipment encompassed "integral parts of the taxpayer's regular trade or business operations." (Rev. & Tax. Code, § 25120, **subd.** (a).) Therefore, it follows that respondent correctly categorized this income as business income.

Next, there is the question of the business or nonbusiness character of the interest income derived, from the investment of the excess of the progress billings received from the Polish contracts over the disbursements which were made. Appellant objects to the inclusion of

Appeal of A. Epstein and Sons, Inc.

interest income received during 1972 and 1973 on the basis that it is not business income. We disagree. It is clear that this, income is business income in that it arose out of or was created in the regular course of the taxpayer's trade or business operations, i.e., the Polish contracts. (See Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3)(E)(arts. 2 and 2.5).) Therefore, it follows that respondent also correctly categorized the interest income as business income.

Next, appellant contends that its California-source income is distorted by applying the standard UDITPA formula to the interest income and the income from the sale of the meat-processing equipment. The heart of appellant's argument is that neither item nor income constitutes business income. However we have already decided this question adversely to appellant. In any event, appellant has offered no credible factual evidence to support its argument that the standard UDIPTA formula provisions do not fairly represent its activities in California. Based upon the record in this appeal, we must conclude that the standard UDITPA formula as applied to appellant's various activities, including the equipment sales pursuant to the Polish contracts and the interest income derived therefrom, was a fair and reasonable method of taxation and fairly reflected appellant's California-source income.

The final issue to be resolved is whether the New York partnership should be included in appellant's unitary business.

The New York partnership was formed to conduct the architectural activities of Epstein in New York because New York State law did not permit a corporation to practice architecture. Appellant alleges that the partnership agreed to perform all architectural services required in New York for Epstein at cost; therefore, there was no possibility of profit to the partnership. According to appellant, any profit attributable to the architectural services rendered by the partnership became the profit of Epstein, although the property, payroll, and sales of the partnership were responsible for that profit. Allegedly,, Epstein indemnified the partners of the partnership against claims arising out of the operation of the partnership. Appellant concludes that these facts illustrate that the role of the partnership was merely as a nominee for Epstein and that, in such a case, to fail to take into account the property, payroll, and

Appeal of A. Epstein and Sons, Inc.

sales of the partnership and at the same time including the income attributable to the services rendered by the partnership *causes*; a clear distortion of the income attributable to California. Appellant contends that the inequity can only be rectified by either excluding the New York income or taking into account the property, payroll, and sales of the New York partnership and that respondent should consider additional factors as provided in Revenue and Taxation Code section 25137 in-order to reach an equitable apportionment of income to California.

Respondent contends that the New York partnership activities of the Epstein brothers should not be included as a part of appellant's unitary business. It argues that appellant has failed to provide a sufficient factual foundation for concluding that the partnership was, a nominee of the Epstein Corporations. In this context, respondent *argues* that appellant has not shown that the standard UDITPA provisions fail to fairly represent its business activity in California. For the reasons expressed below, we agree with respondent.

We have consistently held that the special procedures authorized by Revenue and Taxation Code section 25137 may not be employed in any situation unless the party invoking that section first proves that UDITPA's basic provisions "do not fairly represent the extent of the taxpayer's business activity in this state." (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb 3, 1977; Appeal of Danny Thomas Productions, Cal. St. Bd. of Equal., Feb. 3, 1977.) The party seeking to deviate from the statutory formula bears the burden of proving that such exceptional circumstances are present. (Appeal of New York Football Giants, Inc., *supra*.) While appellant's allegation has an initial appeal, we must conclude that appellant has failed to **establish** that the partnership was, in fact, a nominee of the Epstein Corporations. (See Moline Properties v. Commissioner, 319 U.S. 436 [87 L.Ed. 14991 (1943).]) Additionally, we must presume that there were sound business reasons-why the partners structured the partnership to function as a nonprofit operation if, in fact, it did so. The fact **that appellant was forced to** establish the New York partnership in order to comply with the laws of New York **State** serves to emphasize the separate existence of the partnership. (Moline Properties v. Commissioner, *supra*, New Colonial Ice Co. v. Helvering, 292 U.S. 441 (78 L.Ed. 1348] (1934).) As a consequence, appellant must accept the negative as well as the positive aspects of the situation. Finally, appellant has failed to provide any

Appeal of A. Epstein and Sons, Inc.

evidence that the existence of the partnership caused any distortion when the standard formula was applied. Accordingly, we conclude appellant has not established that there is a need to apply a special formula pursuant to section 25137.

For the reasons set forth above, respondent's action is sustained.

Appeal of A. Epstein and Sons, Inc.

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 A. Epstein and Sons, Inc., against proposed assessments of additional franchise tax in the amounts of \$9,154, \$2,672, and \$44,951 for the income years-1972, 1973, and 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of October, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg; Mr. Collis, Mr. Bennett and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9

