BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1823-MW
ROBERT A. FABEL, INC.)

Appearances:

For Appellant: A. Kent Summers
Attorney at Law

For Respondent: Lorrie K. Inagaki
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Robert A. Fabel, Inc., for refund of franchise tax in the amounts of $3,560, $4,697, $3,874, and $3,723 for the income years 1977, 1978, 1979, and 1980, respectively.

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.

Appeal of Robert A. Fabel, Inc.

The issue presented for our decision is whether appellant's Nevada and California retail stores were engaged in a single unitary business during the four income years in question.

Appellant is a Nevada corporation, headquartered in Fallon, Nevada, whose stock is wholly owned by its president, Robert A. Fabel. Appellant owns and operates a store in Fallon and a store ninety miles away in Vinton, California, both called "Sierra Welding and Equipment Works." The California store, during the appeal years, was essentially a hardware and feed store which also held a "White" farm equipment franchise. During the appeal years, the Nevada store was exclusively a farm equipment dealership that marketed and sold "John Deere" and "New Holland" machinery.

Appellant's officers and board of directors were based in Nevada. As president, Mr. Fabel determined the general business policies and practices for the two stores, hired the managers, and set their salaries. On occasion, Mr. Fabel visited the California store and met with its manager to discuss general business matters. Appellant's secretary-treasurer, William C. Hughes, managed the Nevada store and maintained some business records for the two stores. He prepared the stores' monthly profit and loss statements, annual work sheets, and tax returns. Mr. Hughes obtained monthly financial information from the bookkeeper of the California store. Appellant did not charge the California store any administrative fees for the services rendered by Mr. Hughes. The president and secretary-treasurer made a total of about 40 visits to the California store each year. During the appeal years, the manager of the California store was appointed a director of the corporation.

In their daily operations, each store functioned as an autonomous enterprise in its respective locale. Each store had its own employees and used separate accounting systems, bank accounts, payroll systems, and books and records. The manager of each store independently prepared its budget, supervised its operations, and made purchases of goods and supplies. Neither manager was required to obtain the approval of the president for large expenditures. Only small amounts of goods and supplies were bought from common suppliers or by one store from the other. All intracompany purchases were at cost. Parts and equipment were also purchased from and sold to other dealers in the stores' respective areas at cost. Advertising was handled separately by each store, although two percent of all advertisements, amounting to a cost of about $150 a year, did contain references to both stores. The stores were covered by a common insurance policy for property liability and shared the same employee group health and accident plan. The California store, however, was billed separately for the property insurance and carried its own payroll insurance.

On its California franchise tax returns for the appeal years, appellant apparently reported only its income from the California store. The Franchise Tax Board determined that the Nevada and California operations constituted a single unitary business and recomputed appellant's franchise tax liability, applying an apportionment formula to the combined business income of the two operations.

When a taxpayer derives income from sources both within and without California, its franchise tax liability will be measured by its net income derived from or attributable to sources within this state, in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120 through 25139. (Rev. & Tax. Code, § 25101.) If the business conducted within and without this state is unitary, the portion of the business income from the unitary business which is attributable to California sources must be determined by formula apportionment. (Appeal of Gasco Gasoline, Inc., et al., 88-SBE-017, June 1, 1988; Appeal of Albertson's, Inc., Cal. St. Bd. of Equal., Sept. 21, 1982.) If, on the other hand, 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); Superior Oil Co. v. Franchise Tax Board, 60 Cal.2d 406 [34 Cal.Rptr. 545], (1963).)

The California Supreme Court has set forth two tests to determine whether a business is unitary. In Butler Bros. v. McColgan, supra, the court held that the unitary nature of a business may be 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 a centralized executive force and general system of operation. The court subsequently stated that a business is unitary if the operation of the business done within this state is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 481 [183 P.2d 16] (1947).) More recently, the United States Supreme Court has emphasized that a unitary business is a functionally integrated 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)). Respondent's determination that appellant was engaged in a single unitary business is presumptively correct, and appellant bears the burden of proving that the determination is erroneous. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961; Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.)

The Franchise Tax Board has contended that appellant's California and Nevada stores constituted a single unitary business under both the three unities test and the contribution or dependency test during the appeal years. However, we believe that appellant has presented sufficient evidence of a lack of functional integration to overcome the FTB's determination, which was based on the mechanical listing of so-called "unitary factors."

There is no dispute that unity of ownership was present since appellant owned both the California and Nevada stores. Respondent argues that operational unity is evidenced by the common preparation of financial reports and tax returns for both stores by appellant's secretary-treasurer and the existence of common advertising and insurance. Appellant, however, has established, through testimony of its two officers, that these factors did not result in "any substantial mutual advantage." (Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 31, 1982.)

The mere existence of a negligible amount of common advertising and two common insurance policies does not appear to have any particular significance, at least where, as here, there is no showing, or even allegation, that any significant economies of scale or other flow of value resulted. There was no evidence of centralized purchasing or financing for the two stores at all. The only centralized staff function appears to be the preparation of monthly and annual financial statements and tax returns for the two stores by the secretary-treasurer. There was not, however, a central accounting system or department, for the California store employed its own bookkeeper, accounting system, and payroll system.

Unity of use refers to an integrated executive work force and general system of operation. (Butler Bros. v. McColgan, supra.) Respondent has contended that appellant's president and secretary-treasurer exerted control over the California business by setting policies, preparing financial reports, and visiting the store. Although high-level executive assistance is considered an important element of unity of use (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970), appellant has demonstrated that it did not result in integration of the two operations.

The oversight of the two officers was primarily limited to reviewing financial information and reviewing general business practices for efficiency and profitability. These activities are typical of the chief executive officer and principal stockholder of any closely held corporation that operates more than one enterprise. (Appeal of Jaresa Farms, Inc., Cal. St. Bd. of Equal., Dec. 15, 1966.) They reveal nothing more than an owner's interest in overseeing his assets (Appeal of Mole-Richardson Company, Cal. St. Bd. of Equal., Oct. 26, 1983), which is insufficient to demonstrate unity of use and certainly does nothing to distinguish the operations in this appeal as a unitary business. (Appeal of C. H. Stuart, Inc., Nov. 14, 1984.)

Under the contribution or dependency test, the Franchise Tax Board has argued that, because appellant's two stores were engaged in the same line of business, the rendering of financial services by the secretary-treasurer, the sharing of a common name, and the existence of intercompany sales lead to the conclusion that the stores were engaged in a mutually dependent economic enterprise. The weakness in respondent's argument is that appellant has demonstrated that its stores were truly separate businesses in which the operations of one did not contribute to or depend upon the operations of the other. The Nevada business was strictly a farm equipment dealership offering John Deere and New Holland machinery while the California business was a hardware store which derived no more than five percent of its sales revenues from the sale of "White" farm equipment. Each manager was allowed to make his own budget and purchases and generally operated each business and its staff as an independent entity. The California store did not rely on the Nevada business for any significant administrative services. Moreover, there cannot have been any significant business advantage to the sharing of a common name with the Nevada store given the very small amount of common advertising, the distance between the two stores, and the fact that they operated in different farming communities.

In fact, the only possibly significant unitary characteristic that might be ascribed to appellant's two stores was their interchange of parts and goods at cost. This board has held intercompany product flow to be an important indicator of unity under the contribution or dependency test. (See Appeal of Nippondenso of Los Angeles, Inc., Cal. St. Bd. of Equal., Sept. 12, 1984.) However, in this case, the amount of sales was not substantial and did not create a significant advantage to either store, since the uncontroverted testimony established that the stores also obtained needed parts and equipment, at cost, from other dealers in their respective areas, in what is apparently a common practice among retailers in farming communities.

While the Franchise Tax Board has pointed out several connections between the California and the Nevada stores which appear, superficially, to correspond to the requirements of the three unities test or the contribution or dependency test, appellant has shown clearly that they were simply too insignificant to establish that the stores operated as a single functionally integrated enterprise. Therefore, respondent's action must be reversed.

Appeal of Robert A. Fabel, 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Robert A. Fabel, Inc., for refund of franchise tax in the amounts of $3,560, $4,697, $3,874, and $3,723 for the income years 1977, 1978, 1979, and 1980, be and the same is hereby reversed.

Done at Sacramento, California, this 24th day of January , 1990, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Carpenter, and Mr. Davies present.

Conway H. Collis*, Chairman

Paul Carpenter, Member

John Davies**, Member

_______________, Member

_______________, Member

*Abstained

**For Gray Davis, per Government Code section 7.9