



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
WESTERN ICEE CORPORATION)

Appearances:

For Appellant: Nina Chomsky and
Berneice **Anglea**
Attorneys at Law

For Respondent: Brian W. **Toman**
Counsel

O P I N I O N

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 Western **Icee** Corporation against proposed assessments of additional franchise tax in the amounts of \$434.65 and **\$1,435.00** for the income years 1970 and 1971, respectively.

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Appellant Western **Icee** Corporation, formerly known as **Icee** of Los Angeles, Inc., is a California corporation which was incorporated in 1967 to act as a distributor of the frozen carbonated product known as "**Icee**." This distinctive product is produced in a complex machine which compresses and refrigerates, almost to the freezing point, a mixture of **syrup**, water, and carbon dioxide. When the machine's spigot is turned, the mixture expands and drops into a cup as soft ice.

The unique **Icee** machine was developed in the early 1960's by the John E. Mitchell Company of Dallas, Texas. At first, Mitchell had trouble marketing the machines until it instituted a two-tiered franchise plan involving "Developers" and "Subdevelopers." Essentially, the Developers and Subdevelopers both paid fees and rentals (Subdevelopers to Developers, and Developers to a subsidiary of Mitchell) for the right to use specified numbers of **Icee** dispensers and for rights within exclusive territories to distribute the machines and to promote the sale of the **Icee** drink. This marketing scheme apparently worked well for several years, but by 1966 profits were declining, and the **Icee** business was in financial trouble at all levels.

Mitchell's financial difficulties eventually came to the attention of Walter Rognlien, the chief executive officer of The Runmlin Company, a very successful manufacturer's representative whose principal product was the Mark IV auto air conditioner manufactured by Mitchell. Mr. Rognlien became concerned that the **Icee** business was jeopardizing Mitchell's very existence, and he discussed the situation with Mitchell's management on numerous occasions. Since Mr. Rognlien had successfully marketed other Mitchell products for many years, Mitchell solicited his advice on how to improve its **Icee** business and eventually suggested that he would be in a better position to help them if he entered the business himself. Mr. Rognlien agreed with that assessment and decided to enter the **Icee** operation as it then was organized. The principal motivating factor for this decision seems to have been Mr. Rognlien's desire to protect the source of supply for his company's major auto air conditioning business.

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Mr. Rognlien entered the **Icee** business in October 1967 by incorporating appellant and causing it to pay \$20,000 to an **Icee** Developer for subdevelopment rights to 45 **Icee** dispensers located in Los Angeles county. In August 1968 appellant paid an additional \$18,900 for subdevelopment rights to another 22 dispensers located in Fresno and certain other central California counties. In the interim, Mr. Rognlien had begun to study the **Icee** business by traveling all over the country to interview Developers **and Subdevelopers** about their problems. He found that their common complaint was an inability to promote and expand their businesses aggressively because of a lack of capital. Since they did not have title to the dispensers, banks were unwilling to **loan them** any money. One of Mitchell's largest Developers, who was then delinquent to the extent of **\$1,900,000** in his obligations to Mitchell and was about to go bankrupt, told Mr. Rognlien that his bank would loan him **\$1,000,000** if Mitchell would transfer title to the machines and apply past rental payments to the -purchase price.

After confirming that his own bank would not make any loans to appellant unless it held title to the dispensers, Mr. Rognlien told Mitchell's management what he had learned. He advised Mitchell to transfer title to the machines to the Developers and give them credit against the purchase price for all previous lease payments on the machines. That way the Developers could obtain financing to promote their businesses and to buy additional dispensers, and Mitchell's air conditioning and whole business might survive.

Although Mitchell initially refused to follow his advice, Mr. Rognlien became convinced that eventually it would relent, either voluntarily **or** as a result of a number of lawsuits filed by Developers and Subdevelopers attacking Mitchell's refusal to **sell** the dispensers as a violation of the antitrust laws. Since he believed that the **Icee** business could be very successful if Mitchell made the suggested changes in the program, Mr. Rognlien had appellant continue to penetrate the business in California. In October of 1968, Mitchell agreed to upgrade appellant's status to that of Developer, and in the years 1968-1970, appellant purchased development rights to additional dispensers in Southern California **for** a total consideration of \$205,557. All together, appellant paid \$244,457 for operating rights to 364 machines.

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In 1970 Mitchell finally yielded to the pressure and agreed to sell the **Icee** machines to Developers. Although all the Developers were in poor financial condition, Mitchell insisted that it receive something from them for each dispenser. After negotiating with Mitchell, appellant and some other Developers were **able to buy the** dispensers for \$2,746 each, plus a title transfer fee of \$50 per machine and sales tax. Moreover, Mitchell agreed to credit against this price all the rental payments which had ever been made by anyone on each machine. Thus, **for** its 364 dispensers, appellant paid **to Mitchell** a net purchase price of \$662,721, computed as follows:

364 dispensers @ \$2,746	\$ 999,544
Sales tax @ 5%	49,977
Transfer fees @ \$50	<u>13,200</u>
	\$1,067,721
Less: Credit for rental payments (including \$192,240 paid by appellant)	<u>(405,000)</u>
	\$662,721

The **issue** in this case concerns appellant's proper cost basis in the dispensers for depreciation purposes. Although it is not entirely clear **what basis** appellant used in filing its returns for the income years 1970 and 1971, respondent determined after an audit that appellant should have used \$474,945. **Respondent** apparently arrived at this figure by reducing the net purchase price **of** \$662,721 a second time for the \$192,240 in rentals paid by appellant, and then increasing it by \$4,464 in rental income which appellant received in the year of purchase. On appeal, appellant contends that if its basis in the machines is to be reduced **by both** the general **\$405,000** credit and the \$192,240 in rents it paid to Mitchell, then it should be allowed to increase the agreed basis of **\$474,945** by the \$244,457 which it had paid for operating rights, because that was the "cost" appellant paid to enable itself to buy the **Icee** dispensers on favorable terms. While respondent contends that the operating rights did not have a limited useful life, and therefore were nondepreciable, it does now concede that appellant's basis in the machines should not have been reduced twice

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for the \$192,240 in rents **that** appellant itself paid to Mitchell. The question, therefore, is whether appellant's basis should be \$719,402 (\$474,945 + **\$244,457**), or \$667,185 (\$474,945 + \$192,240).

The crux of **appellant's** argument is that, from the outset in 1967, all of its payments to enter the **Icee** business in various parts of California were made with the intention of later acquiring ownership of the dispensers, and it emphasizes-that the so-called "operating rights" which it acquired had no intrinsic value separate and apart from the dispensers themselves. In substance, appellant contends that its acquisitions of operating rights and title to the machines, pursuant to separate contracts over a period of some three years, were all integrated steps in a single transaction that should be viewed as a whole.

The problem of deciding whether to accord the separate steps of a complex transaction independent significance, or to treat them as related steps in a unified transaction, is a **recurring** problem in the field of tax law. (King Enterprises, Inc.-v. United States, 418 **F.2d** 511, 516 (Ct. Cl. 1969).) Although there is no universal test applicable to step-transaction situations, the courts have enunciated two basic tests. The "interdependence test" inquires whether the steps were so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series. (King Enterprises, Inc. V. United States, supra; ACF-Brill Motors Co. v. Commissioner, 189 **F.2d** 704, 707 (3d Cir. 1951).) The "end result test," on the other hand, holds that purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. (King Enterprises, Inc. v. United States, supra.)

Under either test, the facts of the particular case are all-important, and in this case we think appellant's evidence falls short of establishing that all of its **Icee** transactions were part of a single, unified transaction. In the ACF-Brill Motors case, where the court of appeals sustained the Tax Court's application of the interdependence test, the court said that "at the very least it must appear that the entire series of

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transactions has been carried out in accordance with a prearranged plan." (189 F.2d at 707.) Mr. Rognlien's testimony indicates that he entered the Icee business before his investigations led him to the conclusion that the success of the enterprise depended on the Developers having title to the dispensers. It was only after he had already, acquired the rights to 67, machines, at an investment of some \$39,000, that he began to think in terms of buying the machines. Thus, he clearly had no prearranged plan to buy the machines when he first entered the business. For this same reason, we cannot find, under the "end result test," that all of appellant's investments in the Icee business were "intended from the outset" to lead ultimately to appellant's purchase of the dispensers in 1970. The most reasonable inference we can draw from Mr. Rognlien's testimony is that his initial purpose, upon investing in the Icee business, was simply to protect his existing air conditioning business from losing its supplier.' Sometime later it became clear to him that he could do that and make a success of the Icee business itself. Subsequent events have confirmed the accuracy of his judgment.

Based on all the evidence, we conclude that appellant's investments in the Icee business were not all related steps in a single, unified transaction because the possibility of acquiring ownership of the dispensers arose sometime after appellant first entered the business. We find, therefore, that respondent did not err in determining that the cost of the intangible operating rights should not be added to the depreciable basis of the dispensers.

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,

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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 Western Icee Corporation against proposed assessments of additional franchise tax in the amounts of \$434.65 and \$1,435.00 for the income years 1970 and 1971, respectively, be modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 8th day of January, 1980, by the State Board of Equalization.

Dudley Lewis, Chairman
George J. Sully, Member
Delmar W. Burkett, Member
_____, Member
_____, Member