OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18010006
	)	
BANK OF AMERICA CORP. AND	)	Date Issued: February 21, 2019
	)	
ITS AFFILIATES	)	
	)	

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Carl Joseph, Ernst & Young, LLP

For Respondent: Thomas A. Lo Grossman, Tax Counsel III

Office of Tax Appeals: Mai C. Tran, Tax Counsel IV

J. JOHNSON, Administrative Law Judge: On November 14, 2017, the California State Board of Equalization (BOE) held an oral hearing on this matter. After considering the arguments and evidence presented, BOE determined that, for the 2008 tax year, the dividend income received by Bank of America Corporation and its Affiliates (appellant) from its investment in China Construction Bank (CCB) properly constituted nonbusiness income under California Revenue and Taxation Code (R&TC) section 25120(d), and therefore was not apportionable to California as business income under R&TC section 25120(a). In so holding, BOE reversed respondent Franchise Tax Board's (FTB's) denial of appellant's claim for refund of $5,692,009 for that year.

On December 14, 2017, FTB filed this timely petition for rehearing pursuant to R&TC section 19048. Upon consideration of FTB's petition for rehearing, we conclude that the grounds set forth therein do not constitute good cause for a new hearing, as established by *Appeal of Wilson Development, Inc.*, 94-SBE-007, decided by BOE on October 5, 1994, and

confirmed in *Appeal of Do*, 2018-OTA-002P, decided by the Office of Tax Appeals (OTA) on March 22, 2018.[1]

As relevant here, good cause for a new hearing may be shown where the decision is against law, and the substantial rights of the complaining party are materially affected. (*Appeal of Wilson Development, Inc.*, *supra;* see also *Appeal of Do, supra*.)[2] The question of whether the decision is contrary to law (or against law) is not one which involves a weighing of the evidence, but instead requires a finding that the decision is "unsupported by any substantial evidence." (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906 (*Sanchez-Corea*).) This requires a review of the decision to indulge "in all legitimate and reasonable inferences" to uphold the decision. (*Id.* at p. 907.) The relevant question is not over the quality or nature of the reasoning behind the decision, but whether the decision can or cannot be valid according to the law. (*Appeal of NASSCO Holdings, Inc*., 2010-SBE-001, Nov. 17, 2010.)

On its original California tax return for the 2008 tax year, appellant reported the subject dividend income as business income. Appellant subsequently filed a claim for refund, based on, among other items, a recharacterization of the dividend income as nonbusiness income allocable to appellant's commercial domicile, which was outside of California. Upon review, FTB determined that the income from appellant's investment in CCB should be classified as business income, but did not issue a formal refund claim denial letter. Appellant then treated FTB's inaction as a deemed denial of its refund claim, and filed an appeal with BOE.

As part of the appeal, BOE considered whether appellant's acquisition of its interest in CCB contributed to appellant entering into subsequent relationships with CCB, such as the joint leasing venture, the ATM reciprocal program, and the free wire transfer pilot program. BOE considered the briefing by the parties submitted prior to the hearing, as well as testimony from witnesses knowledgeable about appellant's investment in CCB. As noted above, after hearing the appeal, BOE determined that appellant properly characterized the dividend income as nonbusiness income.

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[1] BOE formal opinions are generally available for viewing on BOE's website: <www.boe.ca.gov/legal/legalopcont.htm>. Opinions of the OTA are generally available on its website: <www.ota.ca.gov/opinions>.

[2] The grounds for granting a rehearing can also be found in the OTA's Rules for Tax Appeals, section 30604 [formerly section 30602 of the OTA Emergency Regulations]. (Cal. Code Regs., title 18, § 30604).

In its petition, FTB contends that BOE's decision is contrary to law and, therefore, a rehearing is warranted. FTB asserts that, due in part to appellant's misstatement of law, BOE applied the incorrect legal reasoning that contradicted precedent established by previous decisions of BOE, the United States Supreme Court, and the California Supreme Court governing how to determine whether income is properly characterized as apportionable business income or allocable nonbusiness income. FTB contends that whether income is business income under the functional test set forth in R&TC section 25120(a) is determined by a two-part test, and argues the California Supreme Court's seminal case in *Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508 (*Hoechst Celanese*), supports its interpretation.[3] According to FTB, this two-part test consists of the following: (1) whether there is control and use of the asset; and (2) whether the asset materially contributed to the production of income. FTB contends that *Hoechst Celanese* noted that the asset must be integral with the taxpayer's trade or business operations in order to find business income. FTB further contends that *Hoechst Celanese* held that, if an asset materially contributes to the production of income, then the asset is integral to the taxpayer's trade or business operations.

Based on its interpretation of the applicable legal framework, FTB argues that, at the oral hearing, appellant incorrectly stated that *Hoechst Celanese* imposed a three-prong, as opposed to a two-prong, inquiry of (1) control and use, (2) materially contributing to the production of business income, and (3) an integral relationship for a finding of business income.[4] FTB asserts that this alleged misstatement of the law influenced BOE members' decision based on certain statements made by BOE members at the oral hearing. FTB asserts that this resulted in BOE applying the incorrect legal standard in determining whether appellant and CCB had an integral relationship and whether appellant had acquired, managed, and disposed of its stake in CCB in a way that generated business income.

At the hearing, appellant began its opening statements by reading the exact language from *Hoechst Celanese* regarding the concept of an "integral" relationship. When BOE members raised questions regarding the "integral" analysis and the functional test, appellant consistently referred BOE back to the language of *Hoechst Celanese*. At one point during the

[3] R&TC section 25120(a) provides for both a transactional test and a functional test. The parties dispute only whether the functional test is applicable.

[4] As discussed below, it appears the third "prong" was originally misstated and was intended to refer to an interwoven relationship rather than an "integral" one.

hearing, appellant discussed the definition of integral as used in *Hoechst Celanese*, and asserted that the functional test sets forth basically three parts, which are "control [and] use over the property" that "contribute[s] materially to the production of business income" and is "interwoven into the fabric of the taxpayer's business."[5] This statement is directly referencing *Hoechst Celanese* wherein it defined the functional test as requiring that "the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations." (*Hoechst Celanese, supra,* 25 Cal.4th at p. 532 [also specifically referenced by FTB during the hearing].)

Contrary to FTB's assertion, appellant's restatement of the language from *Hoechst Celanese* throughout the hearing tracked very closely to the actual language of the decision.[6] We do not find that appellant made a misstatement of law in its presentation to BOE members that caused BOE to make a decision contrary to law. Although FTB argues that the third part of the functional test listed by appellant is not truly a third factor but is instead a result of having the first two factors (or at least a byproduct of the second factor), the record still shows that appellant sufficiently provided accurate language from the *Hoechst Celanese* decision.[7] Regardless of whether the "interwoven" language exists as a separate factor or whether it must be found as a result of the material contribution, it is clear that the court sought the result of the income-producing property becoming "interwoven into and inseparable from the taxpayer's business

[5] To FTB's point above, appellant did at first list the 3rd part as "integral," which, when considering that appellant used the word integral in an apparent attempt to define integral, was a clear mistake. Appellant immediately apologized for mixing the words and then clarified the misstatement in the next sentence by instead using the "interwoven" language quoted above as a replacement for integral.

[6] It may be argued whether appellant's summary of *Hoechst Celanese* or FTB's summary of *Hoechst Celanese* is more accurate. During the hearing, FTB referred to a subsequent restatement of the functional test "two paragraphs down" in the decision from the part referenced by appellant. FTB relays the definition of the functional test by summarizing *Hoechst Celanese* as saying income is business income under the test if the taxpayer's acquisition, "control and use of the property contributed materially to the production of business income"; but, for some reason, FTB does not finish that sentence from *Hoechst Celanese*, which continues to say, "and became an indivisible part of the taxpayer's business." (*Hoechst Celanese*, at p. 533.)

[7] Appellant asserts in response to the petition for rehearing that "the mere fact that the Board was advised of the proper legal standard prior to and during the hearing is sufficient to deny FTB's petition;" however, knowledge of the proper legal standard is just one indicator that the decision is not contrary to law. Ultimately, it must be determined whether the decision itself runs contrary to that law or is unsupported by the evidence.

operations" as evidence of the functional test being met.[8] (*Hoechst Celanese, supra,* 25 Cal.4th at p. 532.) Accordingly, referring to this language from the decision at the hearing was not an unreasonable or misleading representation of the law.

BOE pondered the importance of the "interwoven" language, and directly asked FTB to further discuss its stance on the materiality element during the hearing and in particular the relevance of certain terms in *Hoechst Celanese*, such as, "interwoven," and how they applied to the functional test analysis. FTB provided its position that BOE needed to look at BOE decisions of the '80s and '90s for clarification, rather than relying on the language in *Hoechst Celanese* on its face. As such, FTB was provided an explicit opportunity to clarify any potentially inaccurate legal interpretation provided by appellant at the hearing. However, even if BOE disregarded FTB's suggested legal interpretation, the contrary to law standard for granting a rehearing would not be met simply because BOE members relied upon the direct language of the more recent, legally binding, California Supreme Court decision over the language from earlier BOE decisions that the court found to be persuasive in making its ruling.

The transcript from the hearing, read as a whole, does not reveal that BOE based its decision on any misunderstanding of the law. First, the applicable law at issue was not only amply discussed at the oral hearing, but the law was also provided to BOE members in the parties' briefs and the Appeals Division's hearing summary prior to the oral hearing. Accordingly, a review of the decision reached by BOE should include an understanding that individual statements and queries raised during the oral hearing may represent specific aspects of the legal analysis considered by BOE members, and discrete quotes from the hearing would not represent the totality of the members' legal analysis leading to their ultimate decision. For example, questioning how easily appellant divested itself of the CCB investment represents just one fact used in considering whether the CCB investment was integral to appellants' business operations. This line of thought does not necessarily mean that the BOE member discussing this topic based his or her decision only on ease of divestment, in lieu of the definition of "integral" as provided in *Hoechst Celanese*. Instead, the line of questioning represented consideration of

[8] The terms "interwoven," "inseparable," and "indivisible" are not sparingly used by the court, as they appear in the context of defining the functional test a collective dozen times throughout the decision.

evidence inferring that the endeavor was incidental as opposed to integral.[9] This example is illustrative for our finding that FTB's use of specific excerpts from the oral hearing transcript fail to show that BOE members misunderstood and misapplied the law, let alone that the decision was contrary to law.

The standard of whether BOE's decision was contrary to law requires an analysis of whether the decision was unsupported by any substantial evidence, which is an objective review of the outcome of the appeal, rather than an analysis of statements made at the hearing to decipher the quality or nature of the reasoning behind the decision. (*Appeal of NASSCO Holdings, Inc.*, *supra*.) Under this standard, as discussed below, we find that there was substantial evidence to support BOE's decision that the dividend income at issue constituted nonbusiness income. BOE considered whether appellant had control and use of its interest in CCB and whether appellant's investment in CCB materially contributed to the production of income from appellant's trade or business. BOE members noted that appellant's interest in CCB may have resulted in some contribution, but it did not rise to the level of a material contribution as required by *Hoechst Celanese*.

Regarding the question of whether its investment in CCB resulted in the increase in its loan portfolio, appellant's witnesses testified that the increase in appellant's loan portfolio was due to general economic factors. Appellant's witnesses testified that the investment in CCB was conditioned upon appellant entering into the Strategic Assistance Agreement (SAA) between appellant and CCB whereby appellant provided expertise to CCB in banking issues, but stated that appellant did not gain anything operationally because CCB's banking was rudimentary. Testimony regarding the exchange of employees between appellant and CCB asserted that appellant provided employees to CCB to assist CCB with its "best practices." According to the SAA, appellant agreed to provide 50 employees to CCB annually for this purpose. Testimony asserted that this was a one-way exchange of information where appellant's employees provided expertise to their CCB counterparts.

[9] Furthermore, contrary to FTB's assertion that "[t]he ease of divestment is not relevant," we find no error in considering the ease of divestment as an indicator of whether a business endeavor is interwoven into and inseparable from the taxpayer's business operations. (See *Hoechst Celanese*, *supra,* 25 Cal.4th at p. 532.)

Testimony also stated that no joint business efforts resulted from the SAA. Evidence including testimony supported a finding that the joint leasing venture,[10] the ATM reciprocal program,[11] and the free wire transfer pilot program[12] were not the result of appellant's investment in CCB and were not material contributions to appellant's business. In making this determination, BOE considered the entire record, which includes, among other things, testimony from witnesses knowledgeable about appellant's investment in CCB, contracts between appellant and CCB, press releases, annual reports, and statements made by Mr. Lewis, appellant's Chief Executive Officer. The record also includes evidence that appellant's share ownership in CCB never exceeded 20 percent and appellant never had more than one seat on the 15-member CCB Board of Directors.

Accordingly, we find that there was sufficient evidence to support BOE's conclusion that appellant's interest in CCB did not materially contribute to appellant's production of income and it was therefore not integral to appellant's business.

[10] Testimony stated that the joint leasing venture was entered on CCB's request and with the intent to "protect [appellant's] investment and mitigate [appellant's] risk," and was a stand-alone entity and did not contribute to appellant's global leasing business. The testimony stated that, the amount of income produced from the joint leasing venture was "less than one percent of [appellant's] global earnings from the leasing business." Further, witnesses testified that appellant did not receive knowledge or any other benefit to its operations from the joint leasing venture.

[11] Testimony stated that the reciprocal ATM program was identical to terms that appellant had with other multinational banks across the world with which appellant did not have any investments.

[12] The evidence in the record shows that the free wire transfer pilot program was limited to a few West Coast cities, predominantly benefited CCB's clients, and ultimately ended after a limited period.

BOE's decision is not contrary to law as evaluated by the standard set forth in *Sanchez-Corea*.[13] Therefore, FTB has not shown good cause for a new hearing under the *Appeal of Wilson Development, Inc*., *supra*, for obtaining a rehearing, and its request for a rehearing is denied.

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John O. Johnson
Administrative Law Judge

We concur:

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Kenneth Gast
Administrative Law Judge

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Douglas Bramhall
Administrative Law Judge

[13] "[W]e examine the record to determine whether the [decision] was, as a matter of law, unsupported by substantial evidence. In our examination[,] we apply the well established rule of appellate review by considering the evidence in the light most favorable to the prevailing party, here the Sanchez-Coreas, and indulging in all legitimate and reasonable inferences indulged in to uphold the [decision] if possible." (*Sanchez-Corea*, 38 Cal.3d at p. 907.)