BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
THOR POWER TOOL COMPANY)

Appearances:

For Appellant: James G. Leathers, Jr.
Attorney at Law

For Respondent: Robert L. Koehler
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Thor Power Tool Company for refund of franchise tax in the amount of $51,350.44 for the income year 1973.

The issue for determination is whether the gain from a 1973 sale of land constituted business income subject to formula apportionment or nonbusiness income specifically allocable to California.

Appellant is a Delaware corporation that owned and operated a manufacturing plant in Los Angeles. The land and the plant were originally acquired in 1954. From their acquisition, the assets were used solely in the conduct of appellant's unitary business which was the manufacture and sale of power tools. In August 1970, a decision was made to close the plant, transfer the manufacturing operations to Illinois and sell the property. Initially, due to the deterioration of the building, appellant received no reasonable offers to buy the land and building. In order to facilitate a sale, the building was completely razed in September 1972 and the land was sold in August 1973.

From the time of the initial purchase in 1954, the land and building were used in the unitary business and were consistently included in the property factor for apportioning business income to California. The loss on the demolition of the building was also treated as business income and apportioned by formula rather than specifically allocated to California.

Initially, appellant reported the gain from the sale of the land as nonbusiness income, specifically allocating the entire gain to California. Thereafter, appellant determined that the gain should have been reported as business income subject to formula apportionment and filed a claim for refund. Respondent denied the claim and this appeal followed.

It is appellant's posit ion that the sale of the land was the sale of property used in the conduct of a unitary business and the gain therefrom was business income subject to formula apportionment. Appellant argues that all the steps taken to facilitate the ultimate disposition of the land, including the demolition of the building, were reasonable and necessary and did not constitute an identifiable event permanently withdrawing the land from the property factor. Respondent, on the other hand, takes the position that the gain from the sale of the land was nonbusiness income, unrelated to appellant's unitary business, and is specifically allocable to California. Respondent contends that the removal of equipment and demolition of the

plant, coupled with the expressed intention to close the plant and transfer operations to Illinois, indicated that the plant and land were permanently withdrawn from the property factor.

Section 25120, subdivision (a), of the Revenue and Taxation Code defines "business income" as:

> [I]ncome 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.

"'Nonbusiness income' means all income other than business income. " (Rev. & Tax. Code, § 25120, subd. (d).)

California law has long provided that business income is subject to apportionment by a formula composed of three factors: property, payroll, and sales. Roth real and tangible personal property are included in the property factor if they are used to produce business income. (Rev. & Tax. Code, § 25129.) Gain from the sale of property included in the property factor is treated as business income subject to formula apportionment unless the property was used to produce nonbusiness income or was otherwise removed from the property factor prior to its disposition. Respondent's regulations provide that:

> [G]ain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. (See Regulations 25129 to 25131 inclusive.)

* * *

Example (B): The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example (C): Same as (B) except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example (D): Same as (B) except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example (E): The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old -building was rented to an unrelated **investment company under a five-year lease.** Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(2) (Art. 2. 5).)

Regulation 25129, dealing with the property factor and referred to in the regulation quoted above, provides further that:

Property shall be included in the property factor if it is actually used or is available for or capable of being used during the income year in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being

> processed are includihle in the factor. Property or equipment under construction during the income year (except inventoriable goods in process) shall be excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor. Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale. (Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2. 5).) (Emphasis added.)

Thus, in resolving the issue presented we must focus our inquiry on whether the land in question was permanently withdrawn from the property factor prior to its sale.

In arguing that the land in question was permanently withdrawn from the property factor prior to its sale, respondent relies, primarily, on the Appeal of Ethyl Corporation, decided March 18, 1975. In Ethyl respondent contended, and we held, that appellant's Pittsburg plant should have been included in the property factor until it was finally dismantled in 1965. Respondent conceded that once the plant was dismantled and no longer capable of production in 1965, its removal from the property factor was appropriate. Appellant, on the other hand, argued that the plant should have been removed from the property factor when it was first closed in 1963.

The question of the treatment of any gain or loss on the ultimate disposition of the land on which the Pittsburg plant was situated was not before this board in Ethyl. The thrust of the holding in Ethyl was simply that the plant remained in the property factor until it was dismantled and no longer capable of production. In the present appeal, there is no issue concerning the proper disposition

of appellant's razed plant. Appellant treated the loss resulting from the demolition of the plant as business income apportionable by formula rather than as nonbusiness income specifically allocable to California. Respondent did not challenge this treatment. The interpretation of Ethyl which respondent urges us to accept is too broad. Contrary to respondent's assertions, Ethyl does not compel a decision in its favor in this appeal.

Respondent also argues that appellant's decision to close the plant and put the property up for sale is evidence of appellant's intent to withdraw the land from the property factor at the time such decision was made. Certainly, the taxpayer's decision to terminate operations at a particular location and dispose of the property may be one factor to consider when determining whether property has been withdrawn from the property factor. (Cf. Appeal of St. Regis Paper Co. , Cal. St. Bd. of Equal., Dec. 16, **1958.**) By necessity, however, a decision of this nature by corporate management always precedes the ultimate disposition of any major corporate asset. Every such decision, standing alone, does not immediately and automatically cause property to be withdrawn from the property factor. To accept respondent's position would require a conclusion that every time a management decision is made to close a facility and to sell the assets such property is immediately withdrawn from the property factor. Such conclusion is too broad and is contrary to respondent's regulations. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2. 5), Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(2), Exam. (B)-(D) (Art. 2. 5).)

Next, relying on the Appeal of W. J. Voit Rubber Corp. decided May 12, 1964, respondent suggests that the rationale for treating gains from the sale of unitary assets as business income is that much of the gains stem from the reduction of the assets' bases by depreciation and amortization which have been charged against business income. **Since,** in this appeal, appellant sold bare land which cannot be depreciated, respondent apparently concludes that the gain cannot be business income. With respect to this argument we initially observe that, although land does not have a depreciation component, all other charges, such as; property taxes, interest on the purchase price, maintenance costs, and other miscellaneous expense are charged against business income. In any event, respondent's reliance on Voit overlooks our recent decision in Appeal of Borden, Inc., decided February 3, 1977, which involved a loss on the sale of goodwill. In Borden we stated:

> In Voit, however, we also pointed out that '...all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business as a whole should be attributed to the business as a whole. ' Here appellant acquired and maintained the Western District's goodwill in furtherance of its unitary business operations. Therefore, although appellant may not have taken deductions for the goodwill in reduction of unitary income, the loss on the sale of the goodwill may appropriately be attributed to appellant's business as a whole.

In the present appeal, appellant made continual efforts to dispose of the land until a sale was finally consumated. In view of the deteriorated condition of the building, the steps taken by appellant in demolishing it were reasonable and necessary to facilitate the ultimate sale of the land. Here, the Los Angeles property was consistently used in appellant's unitary business from the time of its acquisition. The land was never converted to the production of nonbusiness income. An extended period of time did not elapse while the land was held for sale. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2. 5).) While we do not consider the examples of identifiable events sufficient to cause property to be permanently withdrawn from the property factor contained in respondent's regulations to be all inclusive, in this appeal we are unable to conclude that such an identifiable event occurred with respect to the land prior to its sale.

Respondent argues that demolition of the plant coupled with the expressed intent to close the plant and transfer operations indicated that both the plant and the land were permanently withdrawn from the property factor. It is undisputed that razing the plant was an identifiable event causing the plant to be permanently withdrawn from the property factor. However, these acts do not compel the same conclusion with respect to the land. Although demolishing the plant would effect a change in the immediate use to which the land could be put, the land, nevertheless, remained available for whatever unitary business use appellant desired. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2.5).)

For the reasons set forth above, we conclude that under the facts of this appeal, reasonable efforts to sell land, which at all times prior to its disposition was used only in appellant's unitary business, including the demolition of a deteriorated building in order to facilitate the ultimate sale of the land, did not constitute an identifiable event resulting in the land's permanent withdrawal from the property factor prior to its sale. It follows, therefore, that the gain from the ultimate disposition of the land constituted business income subject to formula apportionment. Accordingly, respondent's action in this matter must be reversed.

ORDER

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 Thor Power Tool Company for refund of franchise tax in the amount of $51,350.44 for the income year 1973 be and the same is hereby reversed.

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

_____, Chairman

_____, Member

_____, Member

_____ Member

_____, Member