



In the Matter of the Appeal of)
JOHNS-MANVILLE SALES CORPORATION)

For Respondent: Jon Jensen
Counsel

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 Johns-Manville Sales Corporation for refund of franchise tax in the amount of **\$5,609.00** for the income year 1970.

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The sole issue presented by this appeal is whether the capital loss on the sale of certain stock was properly included by respondent in appellant's, nonbusiness income.

Appellant is a New York corporation which is engaged in diversified manufacturing and mining operations in the United States and a number of foreign countries. Among other products, appellant manufactures a complete line of "friction materials" such as disc brake pads and clutch facings.

During the five years before 1966, appellant made some sales of friction materials to European purchasers and determined that there was a large potential European market for high performance friction materials. However, the European original equipment materials requirements were different from those in the United States and, therefore, appellant conducted a research program for developing materials for the European market. Appellant alleges it then decided that it would need to manufacture the products in Europe because major 'European accounts insisted that original equipment materials be locally produced.

Cape Asbestos Company, Limited (Cape), a United Kingdom corporation, had a wholly-owned subsidiary, Small & Parkes, Limited (S&P), which produced friction materials in the United Kingdom. Sometime before 1967, S&P began planning a friction materials plant in Belgium in order to sell to the Common Market countries. The plant was constructed by Don International, S.A. (Don), a Belgian corporation, which was also a wholly-owned subsidiary of Cape and a sister corporation of S&P.

Upon learning of the plant construction in Belgium, appellant began negotiations with Cape. In 1967, appellant agreed to purchase 48 percent of Don's shares. In addition, appellant became guarantor on loans to Don of over \$800,000. Production began in the fall of 1967, and by the end of 1969, Don's losses totaled approximately \$1,275,000. During this time, Don was apparently managed entirely by Cape. Although appellant was dissatisfied with the management, it contends that its 48 percent interest was insufficient to effect the changes it felt should be made. It also appeared that large additional capital contributions or loan guarantees would soon become necessary, and profitability in the near future was questionable. Therefore, in 1970, appellant transferred all its Don shares to Cape in return for Cape's assumption of appellant's loan guarantees for Don.

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Appellant filed its California franchise tax return on the basis of a combined report. For its 1970 income year, it included the capital loss on the Don stock in its business income, apportioning part of the loss to California. Respondent determined **that** the loss should be treated as a nonbusiness loss, allocable in whole to New York, and adjusted appellant's tax liability accordingly. Appellant paid the resulting additional tax and filed a claim for refund. Respondent's denial of the claim led to this appeal.

Since its adoption by California in 1966, the Uniform Division of Income for Tax Purposes Act (UDITPA) (Rev. & Tax. Code, **§§ 25120-25139**) 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 allocated to a specific jurisdiction according to the provisions of sections 25124 through 25127 of the Revenue and Taxation Code. Business and nonbusiness income are defined in Revenue and Taxation Code section 25120 as follows:

(a) "Business income" means 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.

* * *

(d) "Nonbusiness income" means all income other than business income.

The statutory definition of business income provides two alternative tests for determining the character of income. The "transactional test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. The "functional test" provides that income is business income if the acquisition, management, and disposition of the property giving rise to the income were integral parts of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary

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transaction. (Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

Capital gains and losses are apportioned by formula if they come within the definition of business income (Rev. 6 Tax. Code, § 25128) but are allocable to the state of the taxpayer's commercial domicile if they constitute items of nonbusiness income. (Rev. & Tax. Code, § 25125.) The labels customarily given items of income, such as dividends or capital gains, are of no aid in determining whether the income is business, or nonbusiness income; the gain or loss on the sale of property, for example, may be business or nonbusiness income, depending on the relation to the taxpayer's trade or business. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (art. 2).) Generally, gain or loss from the sale of real or tangible or intangible personal property is business income if the property while owned by the taxpayer was used to produce business income. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (2) (art. 2).)

Appellant states that the Don stock was acquired to permit access to Don's plant and manufacturing equipment in order to expand appellant's friction materials market in **Europe**. It argues that if the plant and equipment would be considered integral parts of its business, the stock through which these capital assets were acquired should also be considered integral parts of its unitary business. It apparently concedes that the stock transaction did not fall within the transactional test. Respondent contends that the loss must be classified as a nonbusiness loss because the stock was not integrally related to appellant's business activities, but was held solely as an investment, and because such **classification** is required by subdivisions (c) (2) and **(c) (4)** of regulation 25120.

Respondent states that subdivisions **(c) (2)** and (c) (4) of regulation 25120 require that most gains or losses from dispositions of stock be considered nonbusiness in character. In support of this statement, respondent merely quotes those two subdivisions. **Subdivision** (c) (2), as noted above, states that income from the disposition of property, including intangible personal property, will constitute business income if it was used to produce business income while owned by the taxpayer. (Cal. Admin. Code, tit. 18, reg. 25120, subd. **(c) (2)** (art. 2).) Subdivision (c) (4) states:

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Dividend income is business income when dealing in securities is a principal business activity of the taxpayer. Most other dividends are nonbusiness income. (Cal. Admin. Code, tit. 18, reg. **25120**, subd. (c)(4) (art. **2**).)

Although respondent has not fully articulated its reasoning in reaching the conclusion that these subdivisions require a finding that the loss on the stock was a nonbusiness one, we assume it is the same as its reasoning in Appeal of Occidental Petroleum Corporation, Opinion on Petition for Rehearing, decided June **21, 1983**. Its argument in Occidental Petroleum was summarized as follows:

Since appellant and its affiliates were not dealers in securities, any dividends they might have received on their stockholdings would have constituted nonbusiness income under subdivision (c)(4) of regulation 25120. Consequently, since the stock, while owned by the taxpayers, would have produced nonbusiness income, any gain or loss from the sale of that stock would be non-business income by virtue of subdivision (c)(2) of regulation 25120.

We rejected this reasoning in Occidental Petroleum, supra, based on our holding in Standard Oil Company of California, decided by this board on March 2, 1983. In Standard Oil, we held that subdivision (c)(4) is invalid to the extent that it purports to lay down a general rule for the treatment of dividends received by taxpayers other than dealers in securities and that, under the functional test, the classification of all types of income from intangibles must be made on the basis of the relationship between the intangibles and the taxpayer's unitary business operations.^{1/} Therefore, respondent's argument based on subdivision (c)(4) is rejected and the characterization of the income as business or nonbusiness income will depend upon whether or

1/ Respondent also contends that the Legislature gave its express approval to respondent's interpretation of section 25120 as embodied in subdivision (c)(4) of regulation 25120, and that subdivision, therefore, has the force and effect of law and must be followed here. This argument was also rejected in Appeal of Standard Oil Company of California, supra.

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not the stockholding was integrally related to appellant's unitary business operations. Respondent's determination, of course, is presumptively correct and appellant **must** present sufficient evidence of an integral relationship between the Don stockholding and the unitary business operations to show that respondent's determination was erroneous. Appellant has failed to do so.

Appellant argues vociferously that the acquisition, management, and disposition of the Don stock were integral parts of its unitary business in the same way that the acquisition, management, and disposition of plants and equipment were. Whatever the appeal of appellant's argument in the abstract, we find it unpersuasive simply because not one shred of evidence was presented to support it. The mere statement that appellant bought and later sold stock in a corporation which constructed a friction materials plant is insufficient to show that the acquisition, management, and disposition of the stock **were** integral parts of appellant's regular business operations. Appellant's argument, comprising only unsupported allegations of its intent and a general discourse on the reasons one corporation might acquire the stock of another, would require us to speculate about the relationship between the Don stock and appellant's business operations. The nature of this relationship, however, is a factual question and can only be determined from the facts presented to us. The record in this appeal contains no evidence of the actual relationship between this particular stock and appellant's business operations. Appellant is the party which has control of the supporting evidence and the responsibility of presenting it. Lacking such evidence, we are unable to conclude that respondent's determination is incorrect, and we cannot find that the loss must be characterized as an apportionable business loss. Respondent's action, therefore, must **be** sustained.

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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 Johns-Manville Sales Corporation for refund of franchise tax in the amount of **\$5,609.00** for the income year 1970, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of August, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, ~~Mr.~~ Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Walter Harvey* Member

*For Kenneth Cory, per Government Code section 7.9