84-SBE-086

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CENTENNIAL EQUITIES CORPORATION)

For Appellant: Kenneth G. Lennon
Treasurer

For Respondent: Michael E. Brownell
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 Centennial Equities Corporation for refund of franchise tax in the amount of $5,073.62 for the income year 1974:

Appeal of Centennial Equities Corporation

The issues presented by this appeal are: (1) whether the gain on sale of partnership interests is "business income" to be apportioned by formula among California and other states, or whether it is "npnbusiness income" specifically allocable *in toto* to states other than California; and (2) if such gain is "business income," whether such gain can be excluded from taxable income on the basis of the tax benefit rule.

Appellant, a wholly owned subsidiary of Metropolitan Life Insurance Company, was incorporated in and is commercially domiciled in New York. Appellant wholly owns a New York corporation known as 2154 Trading Corporation and a Texas corporation known as Clay Avenue Building Management Company. The three corporations are all engaged in the business of real estate development and ownership. Appellant and 2154 Trading Corporation own and manage California real estate, while Clay Avenue has no California real estate. During the year at issue, these three corporations collectively owned four parcels of land, three buildings, and partnership interests in 39 partnerships. All the partnerships involved real estate properties.

Respondent audited appellant's franchise tax returns for the income years 1972, 1973, and 1974, and determined that the above noted corporations were engaged in a single unitary business within the meaning of Revenue and Taxation Code section 25101. Appellant did not contest this determination and, in fact, agreed that a combined report was required. Unitary treatment and other adjustments resulted in a refund for the income year 1972, no change for the income year 1973, and a proposed assessment for the income year 1974. The 1974 adjustment resulted from the inclusion of gain from-the sale of real estate partnership interests as "business income" which had been excluded from income on the returns as filed.

Appellant paid the proposed assessment under protest and claimed a refund of such amount, contending that the gain on the sale of the partnership interests was income from intangibles which should be allocated to appellant's New York domicile as "nonbusiness income" alleging that it did not continuously acquire and dispose of partnership interests in the regular course of its business. Appellant further contends that even if such gain is found to be "business income," such gain should be excluded from income under the tax benefit rule since the losses incurred by such partnerships in previous years had not produced a tax benefit. After the claim for refund was denied, appellant filed 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 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. & 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. 2.5).) 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. 2.5).)

Under the "functional" test, as outlined in Borden and Revenue and Taxation Code section 25120, income from tangible and intangible property is business income if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business. "When income is realized from. assets which are integral parts of a unitary business, it is considered business income, subject to apportionment by formula, even if it arises from an extraordinary disposition of the property." (Appeal of Fairchild Industries, Inc., supra, involving the sale of an exclusive license.) Under Fairchild, the frequency of such sales is not decisive. Therefore, appellant's allegation. that the subject gain is not business income because it did not continuously dispose of such interests is without merit. Moreover, nothing in the record would indicate the subject partnerships were not integral parts of appellant's admittedly unitary real estate business. As indicated above, 39 partnership interests were held, and the record reveals that they were of substantial dollar value. We have also held that gain realized from the disposition of an asset which "contributed materially to the production of business income" constitutes business income under the "functional" test. (Appeal of New York Football Giants, Inc., supra, involving the sale of a business franchise.) There is no dispute here that the distributable net income and loss from such partnership interests constituted business income. In addition, it is clear that these partnership interests contributed materially to such business income. Consequently, we must conclude that the income so realized by appellant from the sale of the subject partnerships constituted business income under the "functional" test. Accordingly, we are not called upon to decide if the alternative "transactional" test has also been satisfied.

Next, we turn to appellant's contention that the tax benefit rule, as outlined by Revenue and Taxation

Code section 24310, precludes the taxation of the subject gain since losses incurred in previous years (which reduced the partnerships' basis, thereby producing, or contributing to, the subject gain) produced no tax benefit. As we previously noted in Appeal of H. V. Management Corporation, et al., decided July 29, 1981, the mere fact that a taxpayer might be otherwise prevented "from recovering its original investment tax-free does not mandate use of the tax benefit rule to prevent such a result." We further noted that if the events which gave rise to the loss in the prior year and the recovery in the year at issue do not constitute a single, integrated transaction, the tax benefit rule has no application. Appellant has not identified what events caused the net operating losses which resulted in the reduction of its original investment. Like the taxpayer in H. V. Management Corporation, appellant has not established that those losses are related to the gains realized from the subject sales. Accordingly, we must conclude that appellant has failed to establish that it is entitled to use the tax benefit rule here and that respondent's action in this matter is correct.

For the above reasons, respondent's action in this matter will be sustained.

Appeal of Centennial Equities Corporation

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 Centennial Equities Corporation for refund of franchise tax in the amount of $5,073.62 for the income year 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day of June, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

_______________, Member