BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF 'CALIFORNIA

In the Matter of the Appeal of)
)
TRIANGLE PUBLICATIONS, INC.)

Appearances:

For Appellant: Jules I. Whitman
Peter J. Picotte
Attorneys at Law

For Respondent: Gary M. Jerrit
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 Triangle Publications, Inc., against proposed assessments of additional franchise tax in the amounts of $225,503.71, $181,884.00, $141,817.20, $148,251.33, and $10,000.00 for the income years 1971, 1972, 1973, 1974, and 1974, respectively.

Four questions are presented by this appeal: (1) whether respondent properly included the gain from the sale of certain assets in appellant's apportionable business income; (2) whether appellant and its wholly owned subsidiary, Triangle Financial, Inc. (TFI), 'were engaged in a single unitary business; (3) whether respondent properly excluded the gain from the sale of certain assets from the sales factor of appellant's apportionment formula: and (4) whether the gain from the sale of certain assets, which is reported on the installment basis, should properly be apportioned using factors of the year of sale or the year of receipt.

Appellant is a Delaware corporation with its principal place of business in Pennsylvania. Before 1970, appellant operated a radio and television division, a trade publications division, a magazine division, and a TV publications division. During the year-s 1970 through 1973, the newspaper division, the radio and television division, and a building used by the trade publications division were all sold on separate installment contracts.

After appellant had received the initial payment on each contract, the contract was transferred to TFI. TFI had been formed as a wholly owned subsidiary of appellant in 1970. The officers and directors of TFI and appellant were identical. During the appeal years, TFI's major business activities consisted of collecting the installment payments (and interest) under the transferred contracts and investing the proceeds in various securities. The interest income from the contracts made up an average of 76.3 percent of TFI's income during this period.

Appellant reported its California franchise tax liability on the basis of a combined report, including in the report the income from its four divisions and two of its subsidiaries. TFI was not included in the combined reports. Appellant also excluded from apportionable business income the gain from the sales of its two divisions and the building.

Upon audit, respondent determined that the gain from the sales of the divisions and the building should have been included in business income and that TFI was part of appellant's unitary business. After action on appellant's protest against the proposed assessments, respondent determined that the gain from the installment sales should have been apportioned using the factors of the year of sale rather than those of the years in which the gain was actually reported under the installment

method. This resulted in an additional proposed assessment for 1974, the only year remaining open for assessment.

Sale of Assets

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.
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> (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); reg. 25120, subd. (a) (art. 2.5).) Generally, gain or loss from the sale of real or tangible or intangible person-a.l 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, oubd. (c)(2) (art. 2); reg. 25120, subd. (a) (art. 2.5).)

Appellant used a combined report, to report the income of all its divisions before they were sold. It apparently does not dispute that while it owned the divisions, they constituted part of its unitary business. However, it contends that income resulting from the sale of these assets is, nevertheless, nonbusiness income because the divisions were separate businesses which were liquidated when sold. As support for its position, appellant cites decisions from Kansas and New Mexico which held that gain from an extraordinary or occasional sale of an asset is not business income. (McVean & Barlow, Inc. v. New Mexico Bureau of Rev., 88 N.M. 521 [543 P.2d 489] (1975); Western Natural Gas Company v. McDonald, 202 Kan. 98 [446 P.2d 781] (1968).)*/ In the Appeal of Borden, Inc., supra, we specifically rejected the reasoning of the Kansas and New Mexico decisions, and we recently reaffirmed our Borden decision in the Appeal of Calavo Growers of California, decided by this board on February 28, 1984.

* Two other cases cited by appellant, Qualls v. Montgomery Ward & Co., Inc., 266 Ark. 207 [585 S.W.2d 18] (1979) and Larey v. Mountain Valley Spring Company, 245 Ark. 689 1434 S.W.2d 8201 (1968), involved such totally diffierent facts or addressed such-different legal issues, that we find them unpersuasive and irrelevant to the present discussion.

As explained previously, section 25120 contains two alternative tests for determining the character of income, the transactional test and the functional test. Under the functional test, income from the disposition of an asset is generally business income if the asset produced business income while owned by the taxpayer; there is no requirement that the transaction giving rise to the income occur in the regular course of the taxpayer's trade or business.

The income from the sales of the divisions and the building falls squarely within the ambit of the functional test. They were all reported by appellant as parts of its unitary business, and any income or loss from them while owned by appellant was apparently reported by appellant as business in character. Appellant's contention on appeal that the divisions were separate businesses directly contradicts, without basis, its own earlier characterization. Therefore, respondent was correct in characterizing the gain as apportionable business income.

The fact that this gain was reported on the installment basis does not affect its characterization as business income. The entire gain on each sale was fully realized and its character as business income fixed in the year of the sale: only the recognition and reporting of the gain was deferred by the election of installment reporting. (See Sun First Nat. Bank of Orland v. United States, 607 F.2d 1347 (Ct. Cl. 1979).)

In this particular case, however, even the recognition of the gain is not deferred because, with each contract, there was a disposition of the installment obligation triggering immediate recognition of the entire gain despite the previous election of installment reporting. (Former Rev. & Tax. Code, § 24670, repealed by AB 380 (Stats. 1981, Ch. 336), operative for income years beginning on or after January 1, 1981.) When appellant transferred the installment obligations to TFI, that constituted a disposition within the meaning of former section 24670, supra. Therefore, the gain from each sale must be included in appellant's apportionable business income for the year of that sale as provided in section 24670.

TFI

When a taxpayer derives income from sources both within and without this state, its franchise tax

liability is measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code., § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The existence of a unitary business may be established under either of two tests set forth by the California Supreme Court. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that a unitary business was definitely established by the presence of unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting, and management divisions, and unity of use in a centralized executive force and general system of operation. Later the court stated that a business is unitary if the operation of the portion of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores, Inc. v. McColgan, supra, 30 Cal.2d at 481.)

Respondent's determination is presumptively correct, and appellant bears the burden of proving that it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Each appeal must be decided on its own particular facts, and no one factor is controlling. (Container Corp. of America, v. Franchise Tax Bd., 117 Cal.App.3d 988 [173 Cal.Rptr. 121] (1981), affd., -- U.S. -- [77 L.Ed.2d 545] (1983).)

There is no dispute that the ownership requirement for unity is met, since TFI was wholly owned by appellant. Appellant contends, however, that unity did not exist because the two companies were engaged in completely different businesses, there was no intercompany product flow or other intercorporate activity, and there was no operational unity.

We find that we must agree with appellant in this case. As respondent points out, TFI acted as appellant's collection arm with regard to the installment contracts, and this function could have been done without forming a new corporation. However, appellant has presented uncontradicted evidence that TFI was engaged in investment activities which apparently had nothing to do with the operations of appellant and its unitary subsidiaries.

Although appellant's board of directors made the major policy decisions for TFI just as it did for appellant, this is insufficient to justify a finding of unity. With no evidence of any operational ties or functional integration between the two, we simply cannot say that they were engaged in a single unitary business.

We find unconvincing and contrived respondent's contention that contribution and dependency existed between appellant and TFI because appellant provided a continuous supply of work to TFI and TFI provided a collection, service for appellant. While appellant did periodically contribute installment contracts to TFI, we do not find providing a source of capital to be analogous to intercompany product flow. Nor do we find TFI's collection of the installment payments to be a significant service for appellant when there is no evidence that the proceeds were used in or made available to appellant for use in its unitary business operations. There is not even any evidence of TFI paying dividends to appellant which might be used to fund unitary operations. In short, there is nothing of any significance that shows the type of contribution or dependency characteristic of a single unitary business. Therefore, respondent's determination that TFI was part of appellant's unitary business was incorrect.

Sales Factor

Appellant contends that, if the gain from the sale of its divisions is characterized as apportionable business. income, it must be included in the computation of the sales factor. Respondent disagrees, arguing that such gains are excluded from the sales factor by regulations. Revenue and Taxation Code section 25134 defines the sales factor as:

> a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

"Sales" are defined in Revenue and Taxation Code section 25120, subdivision (e), as "all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code."

Respondent relies on regulation 25137, subdivision (c), which states, in part:

> (A) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, such gross-receipts shall be excluded from the s-ales factor. For example, gross receipts from- the sa-le of a factory or plant will be excluded.

(Cal. Admin. Code, tit. 18, reg. 25137, subd. (c)(A) (art. 2.5) (applicable for income years beginning after Dec. 31, 1972.).)

Substantially similar language was used'in regulation 2'5134, applicable to the first two years on appeal,, (Cal. Admin. Code, tit. 18, reg. 25134, subd. (b) (art 2).)

It does appear that appellant's sales would come within respondent's regulation. However, respondent's regulation appears to contradict the plain meaning of Revenue and Taxation Code sections 25120, subdivision (e), and 25134, supra. The regulation, therefore, purports to authorize a deviation from the statutory apportionment procedures by excluding some gross receipts from the sales factor which under the statutory procedures would clearly be included. Deviations from the statutory allocation and apportionment procedures are authorized by Revenue and Taxation Code section 25137, but only in exceptional circumstances where those procedures "do not fairly represent the extent of the taxpayer's business activity in this state," and the party seeking to deviate from the statutory formula bears the burden of proving that such exceptional circumstances are present. (Appeal of Donald M. Drake Company, Cal. St. Bd. of Equal., Feb. 3, 1977.)

Although respondent's regulations are ordinarily accorded substantial weight, we do not believe that it can simply rely on its own regulation to meet the burden of proof under section 25137, at least where that regulation contradicts clear statutory language. (Accord, Twentieth Century-Fox Film Corporation v. Department of Revenue, 2 Or. Tax Rep. (CCH) ¶ 203,443, Or. T.C. No. 1987 (March 21, 1984).) Respondent must show that the usual statutory formula does not "fairly represent the extent of the taxpayer's business activity in this state." Far from presenting any evidence which might show this, respondent has not even argued that such an exceptional circumstance exists. Since respondent has failed to show that a special formula is necessary pursuant to section 2513'7, the standard sales factor must be used.

Because of the determination of the other issues in this appeal, we need not decide which factors were proper for apportioning installment sale gain.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Triangle Publications, Inc., against proposed assessments of additional franchise tax in the amounts of $225,503.71, $181,884.00, $141,.817.20, $148,251.33, and $10,000.00 for the income years 1971, 1972, 1973, 1974, and 1974, respectively, be and the same is hereby modified to reflect the determinations made in the preceding opinion.

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

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
TRIANGLE PUBLICATIONS, INC.)

ORDER CORRECTING CLERICAL ERROR

It is hereby ordered that the following be added to the first paragraph on the first page of the opinion and order issued by this Board on June 27, 1984:

> Subsequent to the filing of this appeal, appellant paid the proposed assessments in full. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of a claim for refund.

It is further ordered that the second paragraph on the tenth page of the opinion and order mentioned above be corrected to read as follows:

> 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 Triangle Publications, Inc., for refund of franchise tax in the amounts of $225,503.71, $181,884.00, $141,817.20, $148,251.33, and $10,000.00 for the income years 1971, 1972, 1973, 1974, and 1974, respectively, be and the same is hereby modified to reflect the determinations made in the preceding opinion.

Done at Sacramento, California, this 1st day of August, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9