BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BORDEN, INC.)

Appearances:

For Appellant: L. Clarke Budlong
Corporate Tax Counsel

Robert Peterson
Price Waterhouse & Co.

For Respondent: Steven S. Bronson
Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Borden, Inc., for refund of franchise tax in the amount of $193,110.34 for the income year 1970.

Appeal of Borden, Inc.

Appellant Borden, Inc., is a New Jersey corporation that has its commercial domicile in Ohio. It is qualified to do business in California, and from 1929 through 1954 it acquired numerous dairies, creameries, and ice cream companies in this state. As of the beginning of the income year in question, these California milk processing operations constituted the Western District of appellant's Dairy/Services Division.

Because of a decline in the profitability of its California operations, appellant sold, all the tangible and intangible assets of the Western District to the Knudsen Corporation on February 25, 1970. The contract of sale specifically allocated $100,000 of the purchase price to the Western District's goodwill. The parties on appeal apparently agree that this sale of goodwill resulted in a loss of **$12,873,819,** and that the loss qualified as a long-term capital loss for federal income tax purposes. The question presented for our decision is whether the loss is "business income" to be apportioned by formula among California and other states, as respondent contends, or whether it is "nonbusiness income" specifically allocable in **toto** to California.

Appellant and the Western Division **concededly** operated **as a** unitary business subject to the provisions of the Uniform Division of Income for Tax Purposes Act (hereinafter referred to as "the Uniform Act" or "the Act"), Revenue and Taxation Code sections 25120 through 25139. Section 25120 defines the terms **"business** income" and "nonbusiness income" 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 parties initially disagree over the proper construction of the definition of "business income." Appellant contends that, under the statute, the test to determine whether gain or loss on the disposition of property constitutes business income is whether the "transaction or activity" which gave rise to the gain or loss occurred in the regular course of the taxpayer's trade or business. Respondent agrees that the first part of the statutory definition establishes such a transaction test. However, respondent contends that the second part of the definition, beginning with the words "and includes," creates an alternative test based on the function which the property giving rise to the income had in the taxpayer's business. Under the alternative or functional test, respondent argues, all income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction.

In deciding which of these constructions is correct, it is helpful to recall the concept of "unitary income" under prior California law. Under prior law income from tangible or intangible property was considered unitary income, subject to apportionment by formula, if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations. (Appeal of Houghton Mifflin Co., Cal. St. Bd. of Equal., March 28, 1946; Appeal of International Business Machines Corp., Cal. St. Bd. of Equal., Oct. 7, 1954; Appeal of National Cylinder Gas Co., Cal. St. Bd. of Equal., Feb. 5 1957.) Where that requirement was satisfied, income from such assets was considered unitary income even if it arose from an occasional sale or other extraordinary disposition of the property. (Appeal of American Airlines. Inc.; Cal. St. Bd. of Equal., Dec. 18, 1952; Appeal of Wesson Oil and Snowdrift Sales Co., Cal. St. Bd. of Equal., Feb. 5, 1957; Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961: Appeal of

Velsicol Chemical Corp., Cal. St. Bd. of Equal., Oct. 5, 1965; Appeal of Paramount Pictures Corp., Cal. St. Bd. of Equal., Jan. 6, 1969.) As we explained in the Appeal of W. J. Voit Rubber Corp., decided May 12, 1964:

> The underlying principle in these cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income.

The language of section 25120's definition of "business income" was patterned after the definition of "unitary income" as formulated in the above cited opinions of this board.' (Appeal of General Dynamics Corp., Cal. St. Bd. of Equal., June 3, 1975, rehearing denied, Sept. 17, 1975; Peters, The Distinction Between Business Income and Nonbusiness Income, 25 So. Cal. Tax. Inst. 251, 276-279 (1973).) This continuity between prior law and the Uniform Act lends substantial support to respondent's position, since the construction of "business income" urged by respondent is identical to the prior functional test for unitary income. Specifically, the continuity between the old and new law suggests that when the Legislature adopted the Uniform Act, it did not anticipate a change in the prior rule that income from assets which are an integral part of the taxpayer's business is subject to apportionment by formula, regardless of whether the income may arise from an occasional or extraordinary transaction. (See Keesling and Warren, California's Uniform Division of Income for Tax Purposes Act, 15 U.C.L.A. L. Rev. 156, 164 (1967).)

Respondent's construction is also supported by the regulation interpreting section *25120*, which is based on the original regulation adopted by the Multistate Tax Commission. For the year in question, the pertinent regulation provided:

> As a general rule, gain 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 to produce business *income*. However, the gain or loss will constitute nonbusiness income if such property was subsequently utilized principally for the production of nonbusiness income or otherwise was removed from the property factor. ... (Cal. Admin. Code, tit. *18*, reg. *25120*, subd. (c) *(2)* (art. *2)*; *see* also MTC Apportionment Regulations, reg. IV.1.(c)(*2)* [Prentice-Hall State and Local Taxes, All States Unit ¶6130.15].)

This regulation clearly adopts the functional rather than the tranaction test .for business income. Although intangible personal property owned by the taxpayer is not included in the property factor (see Cal. Admin. Code, tit. 18, reg. 25129(art. 2)), under the regulation gain or loss on the disposition of such property will generally be considered business income if the intangible was, used to produce business income. There is no requirement that the transaction giving rise to the gain or loss must itself occur in the-regular course of the taxpayer's trade or business.

We are aware that recent decisions in Kansas and New Mexico have rejected the functional test for business income under those states' versions of the Uniform Act. (Western Natural Gas Co. v. McDonald, 202 Kan. 98 [446 P.2d 781](198); McVean & Barlow, Inc.v. Bureau of Revenue, 88 N. M. 52; [543 P.2d 489](1975).) Since the

Uniform Act is intended "to make uniform the law of those states which enact it" (Rev. & Tax. Code, § 25138), these decisions are entitled to great weight in determining the proper construction of section 25120. In reaching their decisions, however, the Kansas and New Mexico courts did not consider the fact that the Uniform Act's definition of "business income" was derived from prior California law; Nor did they examine the uniform regulations interpreting that definition, and in fact the decisions are directly contrary to the regulations of the Multistate Tax Commission. Under these circumstances we do not find the opinions of the Kansas and New Mexico courts persuasive and therefore respectfully decline to follow their decisions.

For the above reasons, we agree with respondent that section 25120 authorizes a functional test for business income. This decision does not conflict with our opinion in the Appeal of General Dynamics Corp., supra, since that case arose under the first part of section 25120's definition of "business income." Our approval of the transaction test in that case does not preclude use of the functional test in cases, such as the present one, which are governed by the second part of the definition.

The parties next disagree over whether the loss on the sale of the Western District's goodwill constitutes business income under the functional test. We have concluded that it does. Goodwill may be described as:

> . . .the advantage or benefit which is acquired by an establishment beyond the mere value of its capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental

> circumstances or necessities, or even from ancient partialities or prejudices. (Story, Partnerships, §99, quoted in Masquelette's Estate v. Commissioner, 239 F.2d 322, 325-326 (5th Cir. 1956).)

Whether acquired by purchase or built up over a period of time, the advantage or benefit of goodwill makes possible the profitable operation of a business. Indeed, goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole. (Grace Bros. v. Commissioner, 173 F.2d 170, 175-176 (9th Cir. 1949).) In this case, the Western District's goodwill was undeniably an important asset of appellant's business and contributed materially to the production of business income. Under the functional test of section 25120, therefore, the loss on the sale of that goodwill is properly includable in appellant's business income. (See Appeal of Velsicol Chemical Corp., supra.)

Appellant argues, however, that the loss on the sale of goodwill should not be considered business income because appellant never claimed any depreciation or other deductions in respect of the goodwill. In support of this position, it relies on the previously quoted statement from the Appeal of W. J. Voit Rubber Corp., supra, where we indicated that one reason for including income from the sale of business assets in unitary income was to account for deductions previously charged against unitary income. 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.

Appellant also relies on Revenue and Taxation Code section 23040, which provides:

> Income derived from or attributable to sources within this State includes income from tangible or intangible property located or having a situs in this 'State,. ...

In appellant's opinion, this section requires income from intangibles which have a situs in California to be allocated to this state rather than -apportioned by formula, even though the income may 'be business income. We disagree. Revenue and Taxation Code section 25128 provides that all business 'income,, including business income from intangibles, shall be apportioned by formula. Section 25128 was adopted in 1966, while section 23040 was adopted in its present form in 1949.. To the extent that there is a conflict between these two statutes, therefore, section 25128, being the later in time,, should control.. (See Candlestick Properties, Inc. v. San Francisco Bay -Conservation Etc. Com., 11 Cal,. App. 3d 557, 565 [89 Cal. Rptr.897](1970).) Fiberboard Paper Products Corp.v. 'Franchise 'Tax Board, 268 Cal. App. 2d 363 [7Cal. Rptr. 46] (1968), is not to the contrary, since that case dealt with a taxable year prior to the adoption Of section 25128.

Finally, appellant relies on Revenue and Taxation Code section 25137, which authorizes discretionary adjustments to the <apportionment provisions of the 'Uniform Act if those provisions "do not fairly represent the extent of the taxpayer's business -activity in 'this state." However, the party who seeks to invoke section 25137 'bears the 'burden of showing that exceptional circumstances exist to justify deviating 'from the Act's regular apportionment provisions. (Appeal of 'New York Football Giants, 'Inc.,, decided this -day.) Appellant has not met this burden. Indeed, as suggested by the Foregoing discussion,, attributing the loss 'on the sale of goodwill to appellant's business as a whole -quite accurately reflects the fact that the Western District's 'business activities in California were part of appellant's unitary business operations.

For the above reasons., we sustain respondent's action in this case.

Appeal of Borden, Inc.

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 Borden, Inc., for refund of franchise tax in the amount of $193,110.34 for the income year 1970, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of February, 1977 by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Executive Secretary