



86-SBE-105

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
AMERICAN MEDICAL) No. **84A-620-KP**
BUILDINGS, INC.)

For Appellant: John W. Stampfl
Certified Public Accountant

For Respondent: Patricia I. Hart
Counsel

O P I N I O N

This appeal is made pursuant-to section **25666¹/** of the Revenue and Taxation Code from the action of the Franchise Tax Board on **the protest** of American Medical Buildings, Inc., against proposed assessments of additional franchise tax in the amounts of **\$18,193.39** and **\$18,096.32** for the income years 1979 and 1980, respectively.

1/ Unless otherwise specified, all section references **are** to sections of the Revenue and Taxation Code as in effect for the income years in issue.

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The issue presented by this appeal is whether interest income earned by appellant and its subsidiary from investments in short-term marketable securities is business income.

Appellant is a service corporation formed to "design, build, develop, finance, and lease medical buildings for hospitals and doctors for one guaranteed price." (**Resp. Br., Ex. A at 2.**) Although incorporated in Delaware, appellant's home office is in Wisconsin.

In 1978, appellant raised \$3.3 million by the sale of its common stock. Over \$2.2 million of the proceeds from the sale were invested in short-term investments pending a decision by appellant's management as to how the funds were to be used. The funds were not utilized during the **appeal** years and remained **invested** in short-term securities.

In January and February 1979, appellant made a public offering of \$10 million worth of corporate bonds. The stated purpose of the offering was to "fund a **wholly-owned** subsidiary of the Company which will make loans and commitments to construct medical buildings developed by the Company." (**Resp. Br. at 2.**) The subsidiary was named the **American Medical Finance Corp.** In February 1979, appellant distributed just over \$8 million to its financial corporation while it retained almost \$1.5 million for its own use. During the appeal years, both appellant and its subsidiary kept their respective bond proceeds in short-term marketable securities. In 1981, appellant invested over \$4 million in a satellite communications business. It is unclear how much, if any, of the investment came from the subsidiary's coffers.

During the income years at issue, appellant filed California franchise tax returns on a separate basis, thereby excluding all of the finance corporation's income from this state's franchise tax. Appellant treated all of the income it earned from the short-term marketable securities as nonbusiness income specifically allocable, **p**resumably, to its commercial domicile in Wisconsin.

In 1982, respondent audited appellant's California tax returns for the income years 1978 through 1980. Respondent determined that appellant and **American Medical Finance** Corporation were engaged in a unitary business and that appellant's tax returns should have been filed **on a combined basis.** It also determined that

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all of the income earned on the short-term marketable securities by both corporations was business income and, therefore, subject to apportionment. While not objecting to respondent's determination that the two businesses were operating as a unitary business, appellant did protest respondent's reclassification of the securities income from nonbusiness to business income. Respondent denied the protest and affirmed its assessments. This appeal followed.

A taxpayer which derives income from sources both within and without California is required to measure its California franchise tax liability by its net income derived from or attributable to California sources. (Rev. & Tax. Code, § 25101.) "[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." (Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 [63 IL.2d 510] (1980).) Both parties agree that appellant and its subsidiary were engaged in a unitary business. Consequently, the only issue on appeal is whether the interest income was properly classified as business income by respondent and is, thereby, apportionable under the Uniform Division of Income for Tax Purposes Act (UDITPA) contained in sections 25120-25139.

Section 25120 defines "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.

* * *

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

Section 25123 states that, to the extent that they constitute nonbusiness income, certain classes of income, including interest, shall be allocated as provided in sections 25124 through 25127. Nonbusiness interest is allocable to this state only if the taxpayer's commercial domicile is in California. (Rev. & Tax. Code, § 25126.) As appellant's domicile is in Wisconsin, appellant would

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not owe additional tax to this state should the interest income be found to be nonbusiness. Conversely, if it is business income, the interest is to be apportioned among the various states in which appellant's income may be taxable, including California;- (See Appeal of Occidental Petroleum Corporation, Op. on Pet. for Rehg., Cal. St. Bd. of Equal., June 21, 1983.)

Respondent's regulations provide, in pertinent part:

(3) Interest. Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (art. 2.5).)

Appellant argues that the determination of whether the funds were business or nonbusiness income depends upon the relationship of the source of the funds, i.e., the sale of stock, to appellant's primary business of building medical facilities. Accordingly, as the sale of stock and the issuance of the notes are unrelated to the development of medical buildings, appellant concludes that the funds derived from those sales and the interest on the investment of those funds are properly characterized as nonbusiness. We disagree.

Appellant's argument is rooted in pre-UDITPA law and has been rejected as invalid since the passage of UDITPA. (See Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., Mar. 2, 1983.) Presently, section 25120 provides two alternative tests to determine whether income constitutes business income. The first is the "transaction" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the interest income occurred in the regular course of the taxpayer's trade or business. Under the second, or "functional," test, all income is considered business income if the acquisition, management, and disposition of the intangible property 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 DPF

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Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.) **If either of the** two alternative tests provided in section 25120 is met, the income will constitute business income. (Appeal of DPF Incorporated, supra; Appeal of Fairchild Industries, Inc., supra.) As we find this case fits under the functional test, there is no need to discuss the transactional test.

On its face the functional test requires that consideration be given to the relationship between a taxpayer's intangible property--whether it **is** stock, debt instruments, patents or copyrights--and the taxpayer's unitary business operations in order to determine whether the income arising therefrom is business income subject to **formula** apportionment or nonbusiness income subject to specific allocation. Such consideration is intended to provide a jurisdictional nexus between a taxpayer's income and its **multistate business** operations.

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The concept of "business income" . . . generally concerns the differentiation between truly passive investment income and income which is integrally related to the taxpayer's unitary business activities.

(Appeal of Standard Oil Company of California, supra.)

In appellant's 1979 and 1980 annual reports, appellant stated that a slowdown in construction had occurred because of the rise in interest rates for construction loans. In an **attempt to** avoid the interest rate problem, appellant formed American Medical Finance Corporation in February 1979, which was intended to help "finance the medical buildings we design, build, develop and lease." (**App. Br.**, Ex. A at 3.) Presumably, the financing arm of appellant's business would supplement or replace the traditional funding of appellant's construction projects thereby benefiting the unitary organization. Therefore, the acquisition of the capital was very much related to and intertwined with appellant's unitary construction business. Additionally, appellant managed the funds in a manner which benefited the unitary

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operation. The fact that the funds were invested in short-term securities made them easily accessible for distribution as loans if needed. Furthermore, the readily available funds could have given appellant's sales staff leverage over a balking customer by allowing the salesmen to offer less expensive, contingent financing for new projects. The disposition of the proceeds was such that even if the funds were never invested in a construction project, they contributed to the construction business simply by being available for immediate use. Consequently, we find that the purpose of acquiring and holding the intangibles was related to or incidental to such trade or business. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (art. 2.5).)

As we have found that the purpose for acquiring the **intangibles** was related to appellant's trade or business, it follows that the interest income generated from the intangibles was business income. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (art. 2.5).) Accordingly, respondent's action in this matter 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of American Medical Buildings, Inc., against proposed assessments of additional franchise tax in the amounts of **\$18,193.39** and **\$18,096.32** for the income years 1979 and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day Of June , **1986**, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins _____, Chairman
Conway H. Collis _____, Member
William M. Bennett _____, Member
Ernest J. Dronenburg, Jr. _____, Member
Walter Harvey* _____, Member

*For Kenneth Cory, per Government Code section 7.9