BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-421-KP
ARMOUR OIL COMPANY)

Appearances:

For Appellant: Vaughn S. Morris
Certified Public Accountant

For Respondent: Anna Jovanovich
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Armour Oil Company against proposed assessments of additional franchise tax in the amounts of $4,608, $1,928, and $2,449 for the income years ended May 31, 1977, December 31, 1977, and December 31, 1978, 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.

Appeal of Armour Oil Company

The issue presented by this appeal is whether interest income received on certain promissory notes should be classified as business income to appellant.

Appellant and its subsidiaries are engaged in the distribution and sale of petroleum products. Its headquarters and commercial domicile are in San Diego, California. Appellant's stock is wholly owned by Ogden Armour and his wife. Prior to the appeal years, the Armour's adult children owned separate closely held corporations that operated retail gasoline stations in Hawaii. Although appellant operated the Hawaiian stations, they were not part of appellant's unitary business due to the lack of unity of ownership.

In June 1976, Powerine Oil Company, an unrelated corporation that has business connections with appellant,.purchased the Hawaiian gasoline stations from the Armour children for cash and a series of promissory notes. The notes were placed in separate trusts for each of the children. In September 1976, appellant purchased the notes from the children's trusts. Sometime after appellant purchased the notes, the relationship between the Armours and their children began to deteriorate. On May 12, 1978, one of the children filed suit against her parents alleging that they improperly negotiated the sale of the gasoline stations to Powerine's advantage in an attempt to better appellant's relationship with Powerine.

During the appeal years, appellant reported the interest payments it received from the notes as business income subject to formula apportionment among all of the states in which its unitary business operated. During 1979, respondent audited appellant's tax returns for the years in question and determined that all of the interest received was nonbusiness income specifically allocable to appellant's commercial domicile in California. The appropriate assessments were issued, appellant's subsequent protest was denied, and this appeal followed.

The issue on appeal is governed by 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.
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> **(d)** "Nonbusiness income" means all income other than business income.

Section 25120 provides two alternative tests to determine whether the interest from intangibles 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 arose in the regular course of the taxpayer's trade or business. Under the second, or "functional" test, all interest income from the intangibles is considered business income if the acquisition, management, and disposition of the intangibles were "integral parts" of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordin'ary transaction. (Appeal of DPF 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 interest income will constitute business income. (Appeal of DPF Incorporated, supra; Appeal of Fairchild Industries, Inc., supra.) Respondent's determination as to the character of income to a business under either test is presumed correct, and it is the burden of the taxpayer to prove error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal,, Aug. 17, 1983.) An unsupported statement by a taxpayer that the transaction or activity which gave rise to the interest arose in the regular course of the taxpayer's trade or business or that it acquired, managed, and disposed of an intangible in a manner that made it an integral part of its unitary operation is insufficient to satisfy its burden of proof. (Appeal of Johns-Manville Sales Corporation, supra.)

Appellant contends that the notes were purchased from the children's trusts to protect its business relationship with Powerine from any complications resulting from the family squabbling between the Armours and their children. Appellant contends that since good business relations between appellant and Powerine were deemed necessary for future supplies and sales, the purchase of

the notes constituted an "integral part" of its business even though the purchase was an extraordinary event. In support of its position, appellant cites respondent's regulations which state that "[i]nterest income is business income where the intangible with respect to which the interest was received ... is related to or incidental to such trade or business operations." (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (art. 2.5).)

We find appellant's contention unpersuasive as its argument does not correspond with the facts presented in the record. The only indication that the alleged family squabble existed is the lawsuit filed by the Armour's daughter almost two years after the sale of the gas stations. The sale of the notes to appellant, however, occurred just three months after the sale of the gas stations. If the family fight was so intense three months after the sale of the gas stations that it "forced" appellant to purchase the notes, we find it extremely unlikely that the Armour's daughter would have waited two years to file her lawsuit. Indeed, the complaint filed in the lawsuit states that the daughter did not even become aware of her parents' allegedly improper actions until after April 20, 1978. There is, thus, no evidence of serious family discord prior to 1978.

Even if we were to assume that the family dispute existed prior to the sale of the notes in 1976, we find appellant's argument fails because it has attempted to frame the argument in terms of a legal question without first establishing the factual basis for the legal inquiry. There is no evidence provided that shows the value of appellant's business relationship with Powerine to appellant's business operation. Nor is there evidence to show that the family squabble was actually damaging the allegedly important business relationship. Appellant's unsupported argument would force, us to speculate as to the relationship between the notes and appellant's business operations. The mere statement that appellant bought the notes of a corporation with which it claimed to have an important business relationship is insufficient to satisfy appellant's burden of proving that the purchase of the notes occurred in the regular course of appellant's trade or business or that appellant acquired, managed, and disposed of the intangibles in a manner that made the notes an integral part of its unitary operation. (Appeal of Johns-Manville Sales Corporation, supra.)

Consequently, we find that appellant has failed to prove that the purchase and holding of the notes occurred in the regular course of its trade or business or that the notes were an integral part of appellant's unitary business operations. (Appeal of Johns-Manville Sales Corporation, supra.) As appellant has failed to satisfy its burden of proving that the notes were related to its trade or business under either test, it follows that the interest generated from the notes was nonbusiness income rather than business income. (See Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (art. 2.5).) Accordingly, respondent's action in this matter must be sustained.

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 Armour Oil Company against proposed assessments of additional franchise tax in the amounts of $4,608, $1,928, and $2,449 for the income years ended May 31, 1977, December 31, 1977, and December 31, 1978, 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