



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
MARK CONTROLS CORPORATION) No. 84A-528-KP

Appearances:

For Appellant: Helen E. Witt
Attorney at Law

For Respondent: Paul J. Petrozzi
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 Mark Controls Corporation against proposed assessments of additional franchise tax in the amounts of \$5,730, \$89,036, \$20,595, and \$99,792 for the income years 1974, 1975, 1976, and 1977, 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 the gains appellant realized ~~from~~ the sale of stock of two corporations constituted "**business income**" for the years at issue.

Appellant is a **Delaware** corporation with its commercial domicile in Illinois. Appellant is engaged directly and indirectly, through ~~its~~ wholly owned domestic and foreign subsidiaries, in the manufacture, sale and installation of flow control products, **environ-**mental control products, and lavatory fixtures. These activities **are** conducted in part ~~in~~ California.

In 1971, appellant **purchased** 49.5 percent of the stock of Weir Pacific Valves, **Ltd.** (Weir), a Scottish manufacturer of ball and butterfly valves. Appellant also held an **option to purchase** ~~the~~ remainder of ~~the~~ outstanding shares of Weir which were owned by subsidiaries of The Weir Group, **Ltd.**, a United Kingdom corporation.* The acknowledged intention of appellant's purchase was to provide it with t-X-2 opportunity to expand its marketing and manufacturing **operations** to the United Kingdom. Appellant and Weir **executed a** licensing agreement which allowed Weir to manufacture some of appellant's Products. There were **approximately** \$200,000 in annual intercompany sales **between** Weir and appellant during the appeal years. Appellant placed one of its own directors on the board of directors of Weir. That director also became an officer of Weir. Sometime after acquiring the stock, it became apparent to appellant that Weir was mismanaged. In 1974, **appellant** provided two executives to Weir in an attempt to improve Weir's performance. **The** efforts to improve the operation and profitability of Weir failed, **As a** result of its inability to control Weir's **costs and** management, **appel-**
lant sold Weir's stock in 1976, realizing a gain of \$11,709.

Prior to December 31, 1975, appellant began to purchase stock in **Walton-Weir P.S.A. (Walton)**, a Spanish **corporation** engaged in the manufacture of standard control valves. By the end of 1975, **appellant** owned 20 percent of Walton's outstanding shares. One of the reasons for the purchase of the stock was that Walton's bylaws required it to pay annual dividends equal to 50 percent of its audited earnings. The Walton stock was purchased under the **belief** that the majority owners of Walton would not sell a controlling interest in that **corporation** to appellant. Appellant executed a similar licensing **agreement** with **Walton as** it did with

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Weir. There were no intercompany sales between Walthon and appellant. Appellant did place one of its board members on the board of **directors** of Walthon, but **that** director resigned from **Walthon's** board one year prior to appellant's divestment of Walthon's stock. **That** resignation came as a result of Walthon's hostility towards appellant's attempts to gain more complete information about Walthon's activities. This lack of information raised concerns about the propriety of Walthon's business dealings. These events led to appellant's sale of the stock in 1977, through which appellant realized a gain of **\$2,185,237.**

Appellant and its wholly owned subsidiaries have always filed their California franchise tax returns on a **combined** basis. 'During the appeal years appellant **did not include in its combined report the apportionment** factors and income of Weir and **Walthon.** Further, appellant did not include as business income the gain it realized on **the** sale of the corporations' stock. Appellant's stated reason for this exclusion was its conclusion **that the two corporations were not unitary or** functionally integrated with appellant.

Respondent reviewed the franchise tax returns for the years at issue and determined that appellant was more than a passive investor in the two foreign affiliates. Respondent determined that the two affiliates were so integrated into appellant's operations that the sale of stock resulted in business income apportionable by formula in the **California** combined report. During the same audit, respondent made several other adjustments for the income years 1974 and 1975, as well as 1976 and 1977, based on previous federal determinations and several improper depreciation deductions. Appellant has acquiesced **in** those adjustments. **As** a result of the parties' stipulations, the remaining issue to be decided is whether the capital gains realized from the sale of the stock of Weir and Walthon constitute business income 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

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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.

Capital gains and losses are apportioned by formula if they come within the definition of business income. (Rev. & Tax. Code, § 25128.) They are allocable to the state of the taxpayer's commercial domicile, however, 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 **pro-** 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. 2.51.) Generally, the 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**).)

Section 25120 provides **two** alternative tests to determine whether income constitutes business income. The first is the "transactional" test. **Under** this test, the relevant inquiry is whether **the** transaction or activity which gave rise to the **income** occurred in the regular course of the taxpayer's trade **or** business. "Insofar as sales of property are concerned, the transactional test seems designed primarily to embrace sales of things like inventory items." (Appeal of Occidental Petroleum Corporations, Opinion on Petition for Rehearing, Cal. St. Bd. of Equal., June 21, 1983.) Under the second, or "functional" test, the 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 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.

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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 DFF Incorporated, supra; Appeal of Fairchild Industries, Inc., supra.) As the **Franchise Tax Board** has not argued **that** the transactional test applies to this situation, we need only consider whether the functional **test compels** respondent's conclusion.

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, Cal. St. Ed. of Equal., Mar. 2, 1983.)

For income to be characterized as nonbusiness, it must be found that "neither the stockholdings nor the assets and activities they represented constituted integral parts of appellant's existing unitary operations at the times appellant decided to sell them." (Appeal of Occidental Petroleum Corporation, supra.)

We begin with an analysis of the relationship between Weir and appellant. Superficially, Weir, a corporation engaged in a business similar to appellant's, would appear to be integrated with appellant's existing unitary operation. Appellant purchased a large minority block of shares in Weir through which appellant intended to expand its business in the **United Kingdom**. With this

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intent in mind, appellant had an option to purchase the remainder of the shares, which, if exercised, would have made Weir appellant's wholly owned subsidiary. Yet, even with appellant's admission that its purchase of the stock was not intended as an investment, its actions and intent did not result in the stockholdings nor the underlying assets or activities of Weir becoming an integral part of appellant's business.

All of appellant's actions were, at most, preparatory to integrating Weir into appellant's unitary business,. Upon becoming a substantial **shareholder**, appellant placed one of its **employees** on the board of directors- of **Weir**. That same **employee** became an **officer** in Weir. There is no evidence, **however**, that appellant's **employee** had any say or influence over Weir's **corporate** policy or day-to-day operations; in **fact, the opposite** appears to be true. This is evident by appellant's "loan" of two key employees to the corporation in an attempt to make Weir more efficient and profitable, and to smooth the way for Weir's eventual **integration** into appellant's business. **Appellant's** employees, however, were unable to stop the "hemorrhaging" at Weir or change Weir's management style in preparation for the final. **takeover**. Eventually, because of the animosity between the corporations, appellant felt it was-better to "cut and run" rather than pour more money into a situation that was so resistant to change.

The failure to integrate Weir into appellant's unitary business operation was also evident with regard to the **intercompany** sales. Nothing in those transactions describe any special economic advantage gained by appellant by **choosing** Weir as either a supplier or buyer of goods. There were no known guaranteed purchases or sales between the corporations, nor was either company given any special price break on its purchases- Furthermore, there is nothing in the record to indicate that the sales were part of a **guaranteed** supply of raw materials or finished products to either company.

Consequently, despite appellant's **plan** to the contrary, appellant was left with stock in a company resistant to change that made products of no special value to appellant. As a result of stalemate in the companies' relationship, we find that at no time did Weir possess more than the **potential** for actual integration into appellant's ongoing unitary business operations, and "mere potential is insufficient to support a finding that the gains on these [stock] sales were business income

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under the functional test." (Appeal of Occidental Petroleum Corporation, supra.) Therefore, the sale of Weir's stock resulted in capital gains which appellant properly characterized as nonbusiness income,

Similarly, we do not find any integration between the appellant and Walthon so as to find that the sale of the Walthon stock resulted in business income. Appellant purchased the stock of a **corporation** with bylaws requiring it to pay healthy dividends. Furthermore, it would seem to be sound investment policy to purchase stock of a company in an industry in which the shareholder has extensive familiarity. **Also**, appellant bought the stock believing that it could not gain control of more than 20 percent of the **corporation**. At no time during appellant's ownership of the stock did it attempt to control the day-to-day **operations** of **Walthon**. At no time did appellant attempt to integrate **Walthon's** activities into appellant's unitary business;

Respondent's emphasis on appellant's access to **Walthon's** operational reports is misguided. As appellant was a substantial shareholder, by right it had access to Walthon's operating records and any substantial investor would be avidly interested in operating reports. Furthermore, as a large shareholder, appellant would naturally want to control at least one director to insure that it would have all available inside knowledge on the workings of the company. It was Walthon's secrecy in its operations and the hostility of the management and the majority **shareholders** that led to the resignation of appellant's director and the **ultimate** sale of the stock.

Finally, the licensing contract, and the appurtenant agreements allowing the use of common **trademarks** and names, were contracts negotiated at **arm's-length**. They continued five years beyond the sale of stock. While the revenue generated by the agreements was most likely business income to **appellant**, that fact does not compel a conclusion that the investment in **Walthon** stock was transformed into business income. Appellant's purchase of the stock and its licensing agreement with Walthon were entered into for different reasons. The two **sources** of revenue were distinctly separate in their **importance** to appellant. While we agree that due to the existence of the licensing agreement, the ownership of stock may have had the potential for actual integration into appellant's ongoing business, as quoted above, "mere potential is insufficient to support a finding that the gains on these sales were business income under the

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functional test". (Appeal: of Occidental Petroleum Corporations., supra.)

Consequently, respondent's classification of the capital gains from the sales of the stock of Weir and Walthon as business income is incorrect as neither the stockholdings nor the assets or activities of **either corporation** constituted integral parts of appellant's existing unitary operations at the times appellant decided to sell the stock. For the above-stated reasons, respondent's action must be reversed with respect to these capital gains.

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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 Mark Controls Corporation against proposed assessments of additional franchise tax in the amounts of \$5,730, \$99,036, **\$20,595**, and \$99,792 for the income years 1974, 1975, 1976, and 1977, respectively, be and the same is hereby modified to reflect our conclusion that the capital gains from appellant's sale of stock constitute nonbusiness income, In all other respects, **the action of the Franchise Tax Board will be sustained.**

Done at Sacramento, California, this 3rd' day Of December , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9

In the Matter of the Appeal of)
) No. 84A-528-KP
MARK CONTROLS CORPORATION)

Upon consideration of the petition filed January 2, 1987, by the Franchise Tax Board for rehearing of the appeal of Mark Controls Corporation, ~~we~~ are of the opinion that none of the grounds set forth in the petition **constitute cause** for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of December 3, 1986, be and the same is hereby affirmed.

<u>Conway H. Collis</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Paul Carpenter</u>	, Member
<u>Anne Baker*</u>	, Member
	, Member

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