87-SBE-005

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BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-629-DB
LOUISIANA-PACIFIC CORPORATION)

For Appellant: John C. Hart
Vice President-Finance

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 Louisiana-Pacific Corporation against a proposed assessment of additional franchise tax in the amount of $525,140.94 for the income year 1976.

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

This appeal involves two issues. The first is whether certain dividend income appellant received should be excluded from the measure of its tax because it was paid by one of appellant's unitary affiliates out of income arising from the unitary business. The second issue is whether the gain appellant realized from the sale of stock in another affiliate constitutes business income or nonbusiness income.

Appellant was created in 1972 as a wholly owned subsidiary of Georgia-Pacific Corporation and was spun off by that corporation in 1973 pursuant to an antitrust settlement with the Federal Trade Commission. Part of the assets which Georgia-Pacific contributed to appellant was its SO-percent stock interest in two corporations: Ketchikan Pulp Company (hereinafter referred to as KPC), and Ketchikan International Sales Corporation (hereinafter referred to as RISC). The other 50 percent of the stock of these two companies was owned by FMC Corporation, a company unrelated to either Georgia-Pacific or appellant. KISC was a domestic international sales corporation which, until 1975, was a sales DISC for KPC. In that year it became a commission DISC for KPC, a function it performed until November 1, 1976.

In 1976, appellant and FMC began discussions regarding appellant's acquisition of FMC's SO-percent interest in KPC. Eventually, an agreement was reached whereby KPC paid a $10 million dividend to its two shareholders in October 1976, and appellant then acquired FMC's stock interest on November 1, 1976. Another agreement was signed on November 1, 1976, granting appellant a put option to sell its stock in KISC to FMC at any time within 15 months after November 1, 1976. Appellant elected to sell its KISC stock in December 1976, and the sale closed on December 27, 1976. Appellant realized a gain on this sale of $5,360,926.53. After auditing appellant's return for its 1976 income year, respondent determined that both the $5 million dividend from KPC and the gain on the sale of the KISC stock constituted apportionable business income taxable in part by California.

With respect to the dividend, appellant contends that this income should be excluded from the measure of its California franchise tax because it was paid out of the earnings and profits of appellant's unitary business. (See Rev. & Tax. Code, § 25106.) Respondent argues, however, that at the time the dividend was paid in October 1976, KPC was not yet a member of

appellant's unitary group, and that section 25106, therefore, does not insulate the dividend from taxation. We agree with respondent.

The parties agree that KPC did not become part of appellant's combined report group until November 1, 1976, when appellant acquired loo-percent ownership of KPC's stock. For federal income tax purposes, KPC's 1976 taxable year was split into two segments: the lo-month period from January 1 through October 31, and the 2-month period from November 1 through December 31. For California franchise tax purposes, a similar split was made. KPC's income for the months of November and December was included in appellant's combined report; its income for the preceding 10 months was not reported to California, however, because KPC did not do business in California during 1976.

Section 25106, upon which both parties rely, states in pertinent part;

> In any case in which the tax of a corporation is or has been determined under this chapter with reference to the income and apportionment factors of another corporation with which it is doing or has done a unitary business, all dividends paid by one to another of such corporations shall, to the extent such dividends are paid out of such income of such unitary business, be eliminated from the income of the recipient. ... (Emphasis added.)

Respondent's position is based on the underscored language and is very straightforward, viz., since KPC paid the dividend prior to becoming a member of appellant's unitary group, the dividend could not possibly have been paid out of the income of the unitary business. As a factual matter, this position is clearly correct. The dividend was actually paid out of earnings accumulated by KPC prior to November 1, 1976, the date on which it became part of appellant's unitary group. Appellant's counterargument first notes that KPC was a calendar year taxpayer and then focuses on the technical definition of a "dividend," which section 24495 states is a distribution out of the corporation's earnings and profits and, generally, out of the most recently accumulated earnings and profits. According to appellant, this means that it is entitled to treat the dividend as having been paid out

of **KPC's** earnings for the last two months of 1976, when KPC was a part of the unitary business.

Appellant admits that there is no decisional authority citable in support of its position. It is not surprising that there is none, since appellant's argument runs counter to the clear language of section 25106. **Its** argument is also contrary to the policy behind section 25106, which is to avoid counting the same income twice in computing the income of a multicorporate unitary business. Here, since the income-of KPC out of which the dividend was paid was never included in appellant's combined report, or in any other California tax return, there is no possibility of double counting or double taxation.

Appellant's alternative argument, which seeks to exclude from income a portion of the dividend based on the proportion of **KPC's** total 1976 income that was earned prior to November 1, 1976, fails for the same reasons as appellant's main argument. It is contrary to the language and intent of section 25106, and there is no authority to support it. Respondent's action on the first issue, therefore, will be sustained..

The second issue we must decide is whether appellant's gain on the sale of its KISC stock to FMC was business income apportionable by formula or nonbusiness income specifically allocable in its entirety to Oregon, where appellant's commercial domicile is'located. 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 income from intangibles 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 arose in the regular course of the taxpayer's trade or business. Under the second, or "functional" test, income from intangibles is considered business income if the acquisition, management, and disposition of the intangibles were "integral parts" of the taxpayer's regular trade or 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.) If either of the two alternative tests set forth in section 25120 is met, the 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 the taxpayer has the burden of proving error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983.) Respondent argues that its determination can be justified under either of the alternative tests.' Since we agree that there is ample evidence to support respondent's conclusion under the functional test, it is unnecessary to give further consideration to the transactional test.

The crucial inquiry is whether the KISC stockholding was integrally related to appellant's unitary business. (See Appeal of Standard Oil Company of California, Cal. St. Bd. of Equal., Mar. 2, 1983; Appeal of Johns-Manville Sales Corporation, supra.) There is little question that it was, although the relationship was, for the most part, an indirect one through KPC. KISC, of course, was KPC's domestic international sales corporation. KPC, like appellant, was engaged in various aspects of the logging and lumber business. During the period, prior to November 1, 1976, that KPC was jointly owned by appellant and FMC, there were substantial interconnections between appellant and KPC. For example, appellant provided management and marketing services to KPC for which it was paid approximately $1.5 million on an annual basis. KPC also purchased from appellant more than $1 million a year in chemicals for use in its pulp manufacturing process. In addition, both appellant and KPC apparently borrowed money from KISC from time to time, since the KISC stock sale agreement required both companies to repay loans to KISC prior to FMC's purchase of the stock.

Under these circumstances, we believe-that respondent was fully justified in concluding that the RISC stock was an integral part of appellant's unitary business at the time appellant decided to sell it. (See Appeal of Occidental Petroleum Corporation, Opn. on Pet. for Reh., Cal St. Bd of Equal., June 21, 1983, fn. 3.)2/ The gain on the sale, therefore, was properly classified as business income within the meaning of section 25120. Accordingly, respondent's action on this issue will also be sustained.

2/ In our view, the actual decision to sell was made sometime prior to November 1, 1976, during the course of the negotiations between appellant and FMC which resulted in the former's acquisition of KPC and the latter's acquisition of KISC. The record leaves no doubt that appellant, by November 1, 1976, was irrevocably committed to 'the sale of its KISC stock. The only question was one of timing: when would it be most advantageous, for federal income tax purposes, to consummate the sale.

Appeal of Louisiana-Pacific Corporation

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Louisiana-Pacific Corporation against a proposed assessment of additional franchise tax in the amount of $525,140.94 for the income year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day Of January , 1987, by the State Board of Equalization, with Board Meobers Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

*For Gray Davis, per Government Code section 7.9