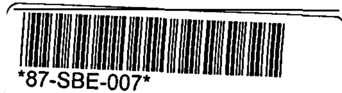

87-SBE-007

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85R-179-MW
PEEL CONSTRUCTION, INC.)

Appearances:

For Appellant: Dale J. Stephens
Certified Public Accountant

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Peel Construction, Inc., for refund of franchise tax in the amounts of $9,216 and $9,813 for the income years 1978 and 1979.

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.

The question presented by this appeal is whether the Franchise Tax Board (FTB) properly disallowed the deduction of losses incurred in lettuce-growing activities in Arizona from appellant's income from its California construction business.

Appellant is a California corporation engaged in the construction business in California. On November 24, 1978, appellant entered into a written agreement with J. A. Wood Company to "go into a joint venture on lettuce ...." (Resp. Br., Ex. A; App. Br., Ex. A.) The agreement stated that appellant was to pay $100,000, but no other terms of the agreement were stated, except that it was not intended to be a general or limited partnership. Appellant reported losses on this venture of $100,000 and $105,000 for the 1978 and 1979 income years, respectively, deducting them from its California income in each of those years.

The FTB disallowed the deduction of these losses, having determined that they were nonbusiness losses wholly attributable to sources outside this state. Appellant's tax liability was recomputed and deficiency assessments were issued which became final because appellant did not file a protest. Subsequently, appellant paid the deficiencies and filed claims for refund, which were denied.

Appellant contends that it was engaged in a unitary business, with its primary business being construction contracting and its secondary business being farming. It argues that the losses from its lettuce-growing activities in Arizona are apportionable business losses.

Since its adoption in 1966, the Uniform Division of Income for Tax Purposes Act (UDITPA) (Rev. & Tax. Code, §§ 25120-25139) has provided a comprehensive statutory scheme of apportionment and allocation rules to measure California's share of the income earned by a taxpayer engaged in a multistate or multinational unitary business. UDITPA distinguishes between "business income," which must be apportioned by formula, and "nonbusiness income," which is specifically allocated by situs or commercial domicile. Business income is defined as:

> [I]ncome 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.

(Rev. & Tax. Code, § 25120, subd. (a).)

Nonbusiness income, on the other hand, is defined as "all income other than business income." (Rev. & Tax. Code, § 25120, subd. (d).)

Before it becomes necessary to consider whether the gains in question constitute business or nonbusiness income, however, we must be able to conclude that appellant's activities constitute a single unitary business under either the three-unities test (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942)) or the contribution or dependency test (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947)). For our purposes, unless a unitary business exists, there can be no "business income"; the loss in question would merely be specifically allocated by situs. (Appeal of Holloway Investment Company, Cal. St. Bd. of Equal., Aug. 17, 1983.)

Appellant has asserted that a unitary business existed, but has presented no evidence to substantiate its assertion. We can find nothing in the record which would tend to show that there was any integration between the lettuce-growing activities in Arizona and the construction contracting in California. The lettuce-growing joint venture appears to be simply an investment, unrelated to appellant's construction contracting business. We must conclude that appellant was not conducting a unitary business and that none of its income or loss can be apportionable business income.

Our remaining inquiry is whether the source of the 'losses was California or Arizona. The net income by which the franchise tax is measured is restricted to net income from California sources. (Rev. & Tax. Code, § 25101.) Income from California sources includes income from tangible or intangible property located or having a situs in this state and any income from activities carried on in this state. (Rev. & Tax. Code, § 23040.) Conversely, any losses from California sources are deductible (Appeal of H. F. Ahmanson & Company, Cal. St. Bd. of Equal., Apr. 5, 1965), while losses attributable

to out-of-state sources are not deductible. (Appeal of Angelus Hudson, Inc., Cal. St. Bd. of Equal., Dec. 13, 1983; Appeal of Custom Component Switches, Inc., Cal. St. Pd. of Equal., Feb. 3, 1977.)

In the present appeal, respondent determined that appellant was engaged in a joint venture. Appellant has asserted that this joint venture was not a partnership, but rather a contract with a subcontractor to grow lettuce for appellant on a fixed-fee basis. While the matter is open to some doubt because of the ambiguous language of the letter agreement presented as evidence, respondent's determination that appellant entered into a joint venture is presumptively correct, and appellant has not provided any substantiation for its contention to the contrary.

We must conclude that appellant was engaged in a joint venture, which is treated, for tax purposes, as a partnership. (Rev. & Tax. Code, § 17008.) Where a taxpayer realizes income from a partnership, the source of the taxpayer's share of the partnership income is where the property of the partnership is located and where the partnership activity is carried on. (Appeal of H. F. Ahmanson & Company, supra.) The principal activity of the joint venture was growing lettuce in Arizona. Since the activity of the partnership was conducted outside of California, the source of appellant's loss from the partnership must likewise be outside of California. Therefore, the losses are not deductible from appellant's California-source income and the action of the Franchise Tax Board must be sustained.

Appeal of Peel Construction, 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 Peel Construction, Inc., for refund of franchise tax in the amounts of $9,216 and $9,813 for the income years 1978 and 1979, 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 Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, Mr. Carpenter an% 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 7.53

87-SBE-007-A

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) 85R-179 MW
Peel Construction, Inc.)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed January 29, 1987, by Peel Construction, Inc., for rehearing of its appeal from the action of the Franchise Tax Board, 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 January 6, 1987, be and the same is hereby affirmed.

Done at Sacramento California this 7th day of April 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

Anne Baker*, Member

_______________, Member

*For Gray Davis, per Government Code section 7.9