BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-1256-DB
MASONITE CORPORATION')

Appearances:

For Appellant: Prentiss Willson, Jr.
Attorney at Law

For Respondent: Paul 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 Masonite Corporation against proposed assessments of additional franchise tax in the amounts of $73,736.00, $35,887.00, $24,216.68, $18,171.91, and $58,145.44 for the income years ended August 31, 1974, August 31, 1976, August 31, 1977, August 31, 1978, and August 31, 1979, respectively.

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

The question presented is whether the income appellant received from the production of oil on its Mississippi timberlands constitutes business income apportionable by formula or nonbusiness income specifically allocable to Mississippi.

Appellant is a Delaware corportion whose principal offices are located in Illinois. During the appeal years, appellant was engaged in a unitary business of manufacturing and selling building materials and other wood-based products. Appellant's principal product is "hardboard," a homoqenous, hard, dense, and grainless wood fibre product having a high tensile and breaking strength and a high resistance to moisture penetration or absorption. Appellant is the world's largest producer of hardboard and has an estimated 35 percent of the total hardboard manufacturing capacity located in the United States.

During the years we are concerned with, appellant conducted sawmill operations in California and Mississippi. It also owned approximately 544,000 acres of timberlands located near its sawmills and plants in Mississippi, California, Pennsylvania, and North Carolina. Acquisition of this acreage began in 1935, when appellant decided that it would be desirable to establish a secure source of raw wood materials sufficient to satisfy at least part of the needs of its manufacturing plants. In 1936 and 1937, appellant purchased Mississippi forestlands upon which oil was later discovered in 1945. Discoveries of oil on these lands continued periodically through 1976, and as of August 31, 1975, appellant owned an interest in 76 wells on its Mississippi property. For the most part, appellant had only a royalty interest in these wells. In seven of them, however, it had a working interest, and one of them it owned totally.

Prom the time of first discovery and development of its oil reserves until the present, appellant has relied on an outside consultant to manage its producing mineral rights. Since appellant has never had any "in-house" expertise in oil and gas matters, the outside consultant has been given enormous latitude in overseeing appellant's oil and gas activities. The consultant is responsible for-disposing of all the oil from the wells, for approving all expenses relating to the wells, for submitting monthly reports to the head of appellant's real estate operations, and for preparing development proposals for appellant's approval. Appellant has always

accepted the consultant's proposals, indicating the substantial reliance it places upon him to carry on its oil operations.

Respondent has determined that the income appellant derived from the oil on its lands in Mississippi constitutes business income apportionable by formula among all the states, including California, in which appellant conducts its unitary business. Appellant, on the other hand, argues that this income is nonbusiness income allocable to Mississippi, because it is unrelated to its unitary hardboard business and is entirely attributable to sources in Mississippi.

Resolution of this issue is governed by the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is contained in sections 25120-25139. Section 25120 defines apportionable business 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.

Nonbusiness income is defined simply as all income other than business income. (Rev. & Tax. Code, § 25120, subd. (b).)

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 arose in the regular course of the taxpayer's trade or business. Under the second, or "functional" test, income from property is considered business income if the acquisition, management, and dispositon of the property 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.)

In support of its position, respondent relies upon regulation 25120, which interprets the terms "business income" and "nonbusiness income."[2/] Respondent contends that Example (C) of subdivision (c)(1) of the regulation most closely parallels appellant's situation and requires a conclusion that the oil income constitutes business income. This portion of the regulation provides as follows:

> (c) Business and Nonbusiness Income; Application of Definitions. The following are rules and examples for determining whether particular income is business or nonbusiness income.. (The examples used throughout these regulations are illustrative only and do not purport to'set forth all pertinent facts.)
>
> (1) Rents from real and tangible personal property: Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includible in the property factor under Regulations 25129 to 25131 inclusive.
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> EXAMPLE (C): The taxpayer operates a multistate chain of men's clothing store:;. The taxpayer purchases a five-story office building for use in connection with its trade or business. Ituses the street floor as one of its retail stores and the second and third

2/ In its brief, respondent has inadvertently quoted the version of' regulation 25120 applicable to years prior, to the ones in issue. (Sea Cal. Admin. Code, tit. 18, reg. 25120 (art. 2).) The relevant version of the regulation appears in the second set of UDITPA regulations contained in article 2.5. (See Cal. Admin. Code, tit. 18, reg. 25720 (art. 2.5).)

> floors for its general corporate headquarters. The remaining two floors are leased to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(1) (art. 2.5).)

Appellant argues, on the other hand, that a much closer analogy can be found in Example (C) of subdivision (c) (5) of the regulation. That part of the regulation states:

> (5) Patent and copyright royalties, Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the propose [sic] for acquiring and holding the patent or copyright is related to or incidental to such trade or business operations.
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> * * *
>
> EXAMPLE (B): The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income.
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> EXAMPLE (C): Same as Example (B), except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(5) (art. 2.5).)

While we would tend to side with appellant in this battle of examples, there is a more compelling reason for ruling in appellant's favor. The record

establishes clearly that the income in question arose from activities completely unrelated to the actual operation of appellant's unitary hardboard business. At best, appellant's oil and gas activities served as a source of funds for the unitary business, and it is settled now that "the mere flow of funds arising out of a passive investment or a distinct business operation" is insufficient to satisfy the constitutional prerequisites for apportionment of the income of a unitary business. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 166 [77 L.Ed.2d 545] (1983).) Although the oil royalty income had its source in timberlands originally purchased for future use in appellant's unitary business, the crucial factor is that this income was generated through operations conducted entirely independently of appellant's unitary hardboard business. The fact that appellant received the income regularly over a long period of years does not alter the nonbusiness nature of the income. There is no reason under the law that "nonbusiness income" must originate from an investment or activity that is short lived and irregular.

Another factor which tends to support our conclusion here is the effect which oil well drilling and development had on the availability of the surface land for timber production. Each well rendered approximately three acres of surrounding land unsuitable for timber production and therefore useless in appellant's hardboard business. Consequently, while this acreage may originally have been properly classified as an asset of the unitary hardboard business includable in the property factor, it ceased to be a unitary asset when it was converted to the production of nonbusiness oil and gas income. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b)(art. 2.5).) Upon that conversion, this land should have been removed from the property factor. Since it apparently was included in the denominator of the factor as computed by appellant for the appeal years, appellant now concedes that appropriate adjustments should be made to its property factor for those years.

For the above reasons, respondent's action in this matter will be modified.

Appeal of Masonite Corporation

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 Masonite Corporation against proposed assessments of additional franchise tax in the amounts of $73,736.00, $36,887.00, $24,216.68, $18,171.91, and $58,145.44 for the income years ended August 31, 1974, August 31, 1976, August 31, 1977, August 31, 1978, and August 31, 1979, respectively, be and the same is hereby modified in accordance with our opinion herein.

Done at Sacramento, California, this 3rd day of March, 1987 by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis., per Government Code section 7.9

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In the **Matter of** the Appeal of	)	
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MASONITE CORPORATION	)	**86A-1256-DB**

For -Appellant: **Prentiss** Willson', Jr.
Attorney at Law

For Respondent: Paul J. **Petrozzi**
Counsel

OPINION AND ORDER DENYING PETITION FOR **REHEARING**

On **March** 3, 1987, we modified the action of the Franchise Tax Board on the protest of Masonite Corporation against pro**po**sed assessments of additional franchise tax in the amounts o**$773,736.00, $35,887.00, $24,216.68, $18,171.91,** and **$58,145.44** for the income **years** ended August 31, 1974, August 31, 1976, August 31, 1977, August 31, 1978, and August 31, 1979, respectively. On April **3,** 1987, respondent Franchise Tax Board filed a'timely petition for rehearing pursuant to section 25667 of the Revenue and Taxation Code.

The basic thrust of respondent's petition is that our original decision added a new requirement for finding that income constitutes business income under the functional test. This allegedly new element comes from our statement that appellant's oil royalty income was nonbusiness income because it *arose from activities corapletely unrelated to the actual operation of appellant's unitary hardboard business.. There is nothing new here. Very similar language appears in our opinion on petition for rehearing in Appeal of Occidental Petroleum Corporation, issued June 21, 1983, where we said, in holding that sales of stock in certain unitary subsidiaries gave rise to business income under the functional test: 'In each case, the stock had been acquired (or created) and managed in furtherance of the actual operation of appellant's unitary business: (Emphasis added.) The concept also appears in the following passage from Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 439 [63 L.Ed.2d 510] (1980):

> [T]he linchpin of apportionability in the field of state income taxation is the unitary business principle. In accord with this principle,-what [Mobil] must show, in order to establish that rts dividend income is not subject to an apportioned tax in Vermont, is-that the income was earned in.the course of actrvitres unrelated to the sale of -petroleum products in that state. (Emphasis added.)

While Mobil made no such showing, Masonite has in the appeal presently before us. As we said in our original opinion, "the crucial factor is that this income was generated through operations conducted entirely independently of appellant's unitary hardboard business..

The principle at work here is equally applicable to both the transactional and functional tests for business income. Neither test can be satisfied if the income "arose *from* activities completely unrelated to the actual operation of appellant's unitary ... business. or "was generated through operations conducted entirely independently of appellant's unitary ... business: These passages from our original opinion are alternative, synonymous phrasings of the same

requirement: in order to be "business income," the income must arise from transactions, activity, or property having a close relationship with the operation of the taxpayer's unitary trade or business. That there is such a requirement seems self-evident from the language of section 25120, subdivision (a), which defines business income as either income arising from "transactions and activity in the regular course of the taxpayer's trade or business," or as income from property if the acquisition, management, and disposition of the property constitute "integral parts of the taxpayer's regular trade or business operations." In the cases cited by respondent, Appeal of Borden, Inc., decided February 3, 1977, Appeal of Kroehler Mfg. co., decided April 6, 1977, and the Appeal of Thor Power Tool Co., decided April 8, 1980, the items of income we held to be business income all had their source in properties which had the required integral relationship with the taxpayers' unitary business operations when the decisions to dispose of them were made. (See Appeal of Occidental Petroleum Corporation, Op. on Pet. for Reh., June 21, 1983, fn. 3.) Appellant's oil-producing land, on the other hand, although it originally was part of appellant's unitary timberland holdings, had no further relationship with the hardboard business operations once it was dedicated to petroleum-production activities.

Respondent also contends that appellant's oil operations were "incidental" to its unitary hardboard business and thereby gave rise to business income. In support of this argument, respondent analogizes to subdivision (c)(1) of regulation 25120, which states that rental income from property is business income if the property is used in the taxpayer's trade or business "or is incidental thereto," (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(1).) Examples (C) and (E) of this part of the regulation attempt to elucidate this concept by providing, *in* two cases of a taxpayer's less-than-complete business use of an office building, that leasing out 2 floors of a S-story office building is "incidental" to the taxpayer's trade or business and generates business income, whereas leasing out18 floors of a 20-story office building is "not incidental to but is separate from" the taxpayer's trade or business, and generates. nonbusiness income.

The central idea to be inferred from these examples is, we suppose, that leasing out less than half of one's (small) building is too insignificant to qualify as an activity

creating nonbusiness income, while leasing out 90 percent of another (much larger) building is definitely sufficient to constitute a separate, nonbusiness-income-producing activity. This, at least, would be consistent with'the normal definition of "incidental" as a minor or subordinate adjunct of something else. (Webster's Third New Internat. Dict.(1971)p. 1142.) But if this is indeed the basic thought to be derived from these examples, it finds little support in the statutory definitions of business and nonbusiness income. Those definitions do.not imply that either. the absolute amount or the relative size of the income is determinative of its classification. Perhaps one could argue, however, that minor amounts of-income otherwise seeming to be nonbusiness income may nevertheless be classified as business income in cases where it is very difficult or impractical to segregate them accurately from the business income arising from the normal operation of the taxpayer's trade or business. Even if that were a permissible construction of the statute, however, it does not appear to fit the present situation. There is no indication in the record that it is at all difficult to segregate appellant's oil royalty income, and the factors which produced it, from the income and factors of the hardboard business. Under the circumstances, it is clear to us that these royalties can only be classified as nonbusiness income.

For the above reasons, we are of the opinion that none of the grounds set forth in the petition for rehearing 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 March 3, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 15thday of November, 1988, by the State Board of Equalization, with Board Members Mr.Dronenburg, Mr. Carpenter, Hr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

Paul Carpenter, Member

Conway H. Collis, Member

John Davies* **, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

**Abstained