



88-SBE-020

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BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
R. H. HACY & CO., INC.) No. 86A-0327-MW
)

For Appellant: Kennard N. Hirsch
Vice-President

For Respondent: David Lew
Counsel

O P I N I O N

This appeal is made pursuant to section 25666¹/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of R. H. Macy & Co., Inc., against proposed assessments of additional franchise tax in the amounts of \$71,981, \$48,668, \$147,011, \$264,597, and \$468,820 for the income years ended July 31, 1976, July 31, 1977, July 31, 1978, July 31, 1979, and July 31, 1980, 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 question presented by this appeal is whether interest **earned by appellant from** short-term investments in **marketable securities** was business or nonbusiness income.

'Appellant, a New York corporation doing business in California and other states, was principally engaged in operating a chain of retail department **stores. As a part of a unitary business,** it filed its California franchise tax returns on a combined report basis. During the appeal years, appellant earned substantial amounts of interest income from a variety of short-term securities. Appellant's cash needs for its **department store** business increased greatly at certain times each year, and it **sold sufficient securities to provide the needed cash.** The amount of money invested varied throughout the year depending upon seasonal cash **needs.** The Franchise Tax Board (FTB) has provided the following table showing the highest and lowest monthly amounts invested in short-term securities during the appeal years.

MONTHLY BALANCE OF FUNDS IN SHORT-TERM SECURITIES

<u>Income Year Ended</u>	<u>High</u>	<u>LOW</u>
July 31, 1976	\$ 73,025,563	\$37,642,940
July 31, 1977	74,316,910	4,525,971
July 31, 1978	121,554,465	42,955,714
July 31, 1979	124,883,876	13,383,905
July 31, 1980	205,538,355	39,041,002

(Resp. Br. at 2.)

Appellant reported the interest **earned** from short-term securities as nonbusiness income, allocable entirely to its commercial domicile, New York.

During an audit, the PTB determined **that a number of** -income adjustments **were necessary.** All adjustments have now **been resolved except for the PTB's determination that the** interest income from appellant's investments in short-term **securities** should be classified as business income, **apportion-**able by **formula.2/**

2/ The actual amounts which appellant still contests are:

<u>Income Year Ended</u>	<u>Amount</u>
7/31/76	\$ 49,925
7/31/77	41,541
7/31/78	111,452
7/31/79	165,293
7/31/80	359,308

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The appellant contends that the interest income cannot be classified as business income under either the "functional" or "transactional" test of section 25120. It states that it could have easily **borrowed** money to meet its seasonal cash flow needs, but management's investment philosophy was to keep its own **reserves** available. Appellant's basic argument seems to be that, absent an absolute business necessity, funds invested outside its own business, pending their use in the business, do not produce business income.

Appellant's position, however, is contradicted by the regulations, the cases decided by a number of courts, and the decisions of this board. Regulation 25120, states, in pertinent part:

Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3).)

Example (E) under that subdivision provides:

The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling \$200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3), Ex. (E).)

'The conclusion reached by example E of the regulation is the same as that reached, on similar facts, in decisions of the courts of other states (see e.g., Sperry and Hutchinson Co. v. Department of Revenue, 270 Or.. 329 [527 P.2d 729] (1974); Holfday Inns, Inc. v. Olsen, 692 S.W.2d 850 (Tenn. 1985)) and of **this board** (Appeal of Inco Express, Inc., Cal. St. Bd. of Equal., Mar. 3, 1987.) Where, as here, the taxpayer invests working capital in short-term securities in order to maximize income while awaiting its use, as needed, **in the taxpayer's business**, the securities are considered as arising in the regular course of the taxpayer's business (the transactional test) as well as acquired, managed, and disposed of as integral parts **of** the taxpayer's regular business operations

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'(the functional test). Therefore, the income produced is apportionable business income. There is no basis for a different result based on whether the short-term investments are made because of business necessity or investment philosophy.

The cases cited by appellant in support of its position have been distinguished previously and, as we have said before., would undoubtedly be decided differently under the Uniform Division of Income for Tax Purposes Act (Rev. & Tax. Code, §§ 25120-25139), which they predated.

For the reasons set forth above, the action of the FTB must be sustained.

