BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 87A-1552-CB:DB
ROBERT M. AND ANN T.)
BASS, ET AL.)

Appearances:

For Appellant: Walter J. Karabian
Attorney at Law

Lawrence O. Graze
Attorney at Law

William Nicholas
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert M. and Ann T. Bass, et al., against proposed assessments of additional personal income tax and penalties in the total amounts of $311,748.25 and $1,100,700.75 for the years 1980 and 1981, respectively.

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

The issue presented by this appeal is whether appellants, who are residents of Texas, are taxable in California on their distributive shares of the income of a Texas limited partnership whose main office was located in California.

During the appeal years, appellants were all of the limited partners in a Texas limited partnership named Idanta Partners (hereinafter referred to as "Idanta"). Idanta was headquartered in La Jolla, California, where it leased office space pursuant to a long-term lease. The office was staffed by four employees--an investment analyst, a bookkeeper, and two secretaries--and also was occupied by Idanta's general partners, all of whom were residents of California. Idanta's books and records were maintained at this office, and Idanta's California partnership returns reflected depreciation deductions for furniture, fixtures, leasehold improvements, and transportation equipment used in connection with this office.

Idanta's activities consisted of the acquisition, holding, monitoring, and disposition of substantial blocks of stocks and other securities. Substantially all of Idanta's income came from dividends, interest, and proceeds from sales of these securities, but minor amounts of income also arose from directors' fees paid to the general partners for service on the boards of directors of several of the corporations in which Idanta had invested. Idanta maintained substantial bank accounts in both Fort Worth, Texas, and San Diego, California, and it also had a multimillion dollar revolving line of credit with the Fort Worth National Bank in Fort Worth. Virtually all of Idanta's securities were pledged with this bank in Texas as security for the credit line.

Purchases and sales of securities by Idanta were usually implemented through a securities trading room maintained by the Bass family interests in Fort Worth. Some transactions, however, were initiated through California offices of member firms of the various stock exchanges, pursuant to instructions issued by the general partners. The Basses' securities trading room handled most of Idanta's transactions because it was necessary for the Basses to be aware of any purchases which, when added to their other holdings, might trigger S.E.C. filing requirements, and because the professionals employed in this facility were expert at handling large block transactions secretly and with minimal impact on the financial markets. In 1980, Idanta bought securities in 8 companies in 41 separate transactions (2 companies accounted for 30 of these purchases), and it sold securities in 6 companies in 57 transactions (1 company accounted for 49 of these sales). In 1981, Idanta purchased 12 stocks in 47 different

transactions (33 of which were attributable to 2 companies), and it sold 4 stocks in 33 transactions (24 of which were attributable to 1 company). (Resp. Br., Ex. J-6 & S-2; App. Hrg. Ex. A-4.) Using a simple average, the average holding period for the securities sold by Idanta during 1980 and 1981 was approximately 5.78 years. (Resp. Br. at 9.)

Respondent has determined that appellants' distributive shares of Idanta's income constitutes California-source income taxable by California. Appellants have appealed the deficiency assessments arising from this determination, contending that there is no legal basis for respondent's conclusion that this income has a California source.

Section 17041, subdivision (a), imposes a tax upon the entire taxable income of **every** nonresident which is derived from sources within this state. Section 17951 defines the gross income of a nonresident to be "only the gross income from sources within this state.' Gross income of a nonresident who is a partner of a partnership includes the partner's distributive share of the taxable income of the partnership to the extent that the partner's distributive share is derived from sources within California. (Cal. Admin. Code, tit. 18, reg. 17951-1, subd. (b).) Income from sources within California includes income from a business, trade, or profession carried on within this state, income from stocks and other intangible personal property having a business or taxable situs in California, and compensation for personal services performed within this state. (Cal. Admin. Code, tit. 18, reg. 17951-2.)

Respondent's position seems to be that Idanta was 'doing business" in California, that these business activities caused all of Idanta's property to have a "business situs" in California, and that the income from this property was, therefore, California-source income taxable to anybody (namely, the limited partners) who received it. (See Rep. Trans. at 11-16.) If we have understood it properly, respondent's argument appears to differ from the position it has **customarily** taken in cases involving the taxation of the operating income or losses of partnerships "doing business" within or without California. The usual contention has been that the source of a partner's distributive share of partnership income or loss is the place where the partnership's property is located and where the partnership's activities are carried on. This was respondent's argument in, for example, the Appeal of H. F. Ahmanson and Co., decided by this board on April 5, 1965, involving oil exploration partnerships operating in Turkey; in the Appeal of Custom Component Switches, Inc., decided on February 3, 1977, involving a partnership which owned and rented out shopping

centers and factories; in the Appeal of W. R. Thomason, Inc., decided March 3, 1987 (87-SBE-025), involving oil and gas exploration partnerships; and in the three Talisman Fund cases--Appeal of Lore Pick, decided June 25, 1985, Appeal of George D. Bittner, decided October 9, 1985, and Appeal of Estate of Marion Markus, decided May 6, 1986--involving a partnership engaged in trading commodities futures. With the addition of the 'business situs" concept to the equation,. respondent's current position bears some resemblance to the analysis contained in respondent's Legal Ruling No. 125, issued on December 5, 1958, which held, in reliance on the predecessor of regulation 17952, subdivision (c), that the nonresident members of a family investment partnership were taxable in California *on* their distributive shares of the partnership's income, because the intangibles (corporate stock) owned by the partnership had acquired a business situs in California due to the fact that (1) the partnership had actively engaged in a continuous course of business in California and (2) the intangibles were the partnership's chief asset and were controlled by the resident partner from California. Insofar as we can determine, this ruling has *not* been cited *in* any'reported case in the 30 years since it was issued.

Taking the case as respondent has framed it, the dispositive issue is whether Idanta was conducting a business in California or whether, as appellants contend, it was simply investing the partners' capital primarily for long-term capital appreciation. If the latter is true, then respondent concedes that the income from the intangibles cannot be taxed by California, because the situs of the intangibles would be at the appellants' domicile in Texas. (Rep. Trans. at 11.)

In resolving this issue, guidance may be taken from federal cases dealing with the question of whether a nonresident alien individual was engaged in a trade or business in the United States so as to be taxable on capital gains, in situations where a resident agent had been empowered to manage the investments of'the nonresident alien. The rule of these cases is succinctly set forth inrespondent's Legal Ruling No. 179, issued on December 5, 1958, asfollows:

> If the activities of the fund are extensiv'e and the securities are bought and sold with reasonable frequency in order to profit on the short term basis then the nonresident, through his agent, is deemed to be engaged in a trade or-business. Fernand C. A. Adda, 10 T.C. 273, aff'd. 171 Fed.2d 457, cert. den. 336 U.S. 952. If, on the other hand, the fund is managed as an investment account

> in which the securities are held for capital appreciation and income, the nonresident will not be deemed to be engaged in a trade or business. Chang Hsiao Liang, 23 T.C. 1040.

On the facts before. us, we *believe it is clear that Idanta's securities were not bought and sold in order to profit from short-term swings in market prices but rather were held for long-term capital appreciation and income. A principal factor leading to this conclusion is the average holding period of about 5.78 years for the stocks Idanta sold during the appeal years. This is nearly identical to the 5.8-year average holding period for the securities sold by the taxpayer in the Liangs e , where the tax court held that the taxpayer was not engaged in a trade **or** business. (Chang Hsiao Liang v. Commissioner, 23 T.C. 1040, 1044 (1955).) The court observed that: "The absence of frequent short-term turnover in petitioner's portfolio negatives the conclusion that these securities were sold as part of a trading operation rather than as investment activity." (Id.) The lack of such turnover in the present case also distinguishes this situation from the Talisman Fund appeals, cited previously, where a partnership engaged in trading commodities futures from a California location was said to be doing business in this state, (See e.g., Appeal of Lore Pick, supra.)

Respondent objects to characterizing Idanta as merely an investment partnership, for, in its view, Idanta possessed many of the trappings of a business operation (leased office space, a number of full-time employees, and significant amounts of furniture, fixtures, transportation equipment, and business expenses), and also enhanced the value of its investments by placing one of its general partners on the board of directors of some of the companies in which it had substantial investments. While it is obvious that Idanta is not the sort of investment partnership that could be created and maintained by the average investor, it is equally obvious that the Basses are not typical investors. We believe that the "business" characterictics of Idanta which respondent has identified are indicative simply of the scale of the Basses' investment activities. The market value of Idanta's investment portfolio was measured in the tens of millions of dollars. Of necessity, prudent investing on this scale requires the use of substantial human and other resources. It also often permits the placement of one or more representatives on the board of directors of a corporation in which a significant investment has been made. But none of this, in our view, changes the essentially 'investment' nature of the activity, even though that activity is sophisticated, costly; and not as passive as the investment

activities of the average individual corporate shareholder. Idanta's operations simply do not fit the mold of any of the partnerships held to have been "doing business" in the cases respondent has cited in its brief.

For the above reasons, we hold that the income from Idanta's investment securities is not California-source income taxable by this state. However, we also hold that the director's fees received by Idanta are California-source income to the extent they are attributable to personal services rendered in California by Idanta's general partners. (Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) Although it is apparent that some such services were performed in California, the record lacks the necessary factual detail to permit us to make a specific finding at this time. If the parties are unable to resolve this matter satisfactorily between themselves, we will resolve it in a subsequent proceeding.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert M. and Ann T. Bass, et al., against proposed assessments of additional personal income tax and penalties in the total amounts of $311,748.25 and $1,100,700.75 for the years 1980 and 1981, respectively, be and the same is hereby modified in accordance with our opinion herein.

Done at Sacramento, California, this 25th day of January, 1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

John Davies*, **, Member

, Member

*For Gray Davis, per Government Code section 7.9

**Dissented.