91-SBE-002

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84A-1161-SS
VSI CORPORATION, TAXPAYER, AND	)	
VSI CORPORATION, ASSUMER	)	
AND/OR TRANSFEREE	)	

Appearances:

For Appellant: James Kleier
Attorney at Law

For Respondent: Donald C. McKenzie
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[2] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of VSI Corporation, Taxpayer, and VSI Corporation, Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of $18,163, $24,992, $14,530, and $1,025,436 for the income years ended June 30, 1976, 1977, 1978, and 1979, respectively.

[2] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Subsequent to the filing of this appeal, appellant decided to withdraw its appeal with regard to the 1976, 1977, and 1978 income years. Only the 1979 income year remains in controversy. The issues in this appeal are (1) whether losses from the sale of stock in two wholly owned subsidiaries were business income or nonbusiness income, and (2) even if the losses were nonbusiness, whether they should be offset against the California income of the entire unitary group rather than against only the income of the corporation generating the nonbusiness loss.

In 1978, the year before the appeal year, appellant purchased Liquidonics Industries, Inc. (LII), a producer of hydrolic and communications equipment. LII in turn was sole owner of H.O. Boehme, Inc. (Boehme), and Liquidonics Finance Corporation N.V. (LFC). Appellant purchased LII primarily in order to acquire Greer Hydrolics (Greer), another of LII's subsidiaries. Appellant was required to purchase the entire LII group as part of the deal. In 1979, the year after acquisition by appellant, LII sold all of its stock in Boehme and LFC, generating the losses at issue in this appeal.

Neither LFC nor Boehme was in active operation at the time of the stock sale. By 1975, Boehme had ceased conducting business or employing employees, and in that year, LII leased much of Boehme's facilities and equipment to third parties, followed by sale or sublease of all remaining Boehme assets in 1976 and 1977. According to appellant, Boehme's existence was maintained until its sale in 1979 for one reason: to facilitate compliance with a repayment schedule pursuant to a 1974 settlement with the federal government over contracts for which Boehme had been overpaid. In 1979, after taking over Boehme's small remaining obligation to the federal government, LII created a $7,000 account receivable fund for Boehme and placed a $2,000 sale price on its stock to entice a buyer. LII sold Boehme and structured the transaction to secure a stock loss write-off of $11,521,950.

LII had formed LFC as a Netherlands Antilles Corporation in 1969 for the purpose of effectuating Eurodollar financing for acquisition of Universal Match Corporation (UMC). Full acquisition was never accomplished, and UMC was never included in LII's combined reports. The UMC stock was sold at a loss in the same year it was acquired, resulting in a deficit on LFC's balance sheet. On audit, the FTB excluded LFC from LII's combined reports for income years ended June 30, 1971, through June 30, 1976, apparently due to LFC's conceded dormancy. LII did not even attempt to include LFC in its combined reports for 1977 and 1978. In 1979, LFC's stock was sold to an attorney with a client who needed a Netherlands Antilles Corporation.

On its combined report for 1979, appellant characterized the losses occasioned by the sales of Boehme and LFC as "nonbusiness losses," but sought to deduct them from the California income of its entire unitary business. Although the Franchise Tax Board (FTB) concedes that appellant and LII were engaged in a unitary business, it determined that, as of the appeal year, the subsidiaries sold were not part of the unitary enterprise and the sale losses were therefore nonbusiness losses. As such, they were deductible only from the California income of LII. Specifically, the FTB found that (1) Boehme's unitary relationship with LII had ceased in 1973, long before purchase of LII

by appellant or sale of the stock, and that (2) LFC had never been engaged in a unitary business with LII because it was formed to acquire a nonbusiness asset and had lain dormant for eight years before purchase by appellant and sale of the stock. We uphold respondent's conclusion that the sale losses were nonbusiness losses.

There are two separate tests for classifying business income. Income from property is business income if the transaction or activity which gave rise to it occurred in the regular course of the taxpayer's trade or business (the "transactional test"), or if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's regular trade or business operations (the "functional test"). (Rev. & Tax Code, § 25120, subd. (a).) Under the functional test (which the parties appear to agree is applicable here), the treatment of income-producing intangibles, such as stock, is dependent upon the relationship between the intangibles and the taxpayer's unitary business operations. (Appeal of Occidental Petroleum Corporation, Opn. on Pet. for Reh., Cal. St. Bd. of Equal., June 21, 1983.) Thus, if the intangible is integrally related to the unitary business activities, the income is business income subject to formula apportionment. If the intangible is unrelated to those activities, however, the income is nonbusiness income subject to specific allocation.

Although appellant's purpose in acquiring the LII subsidiaries at issue here may have been to expand its unitary business (an allegation that has not been proven), as was the case with the Tenneco and Island Creek stock in Occidental Petroleum, supra, "neither the stockholdings nor the assets and activities they represented constituted integral parts of appellant's existing unitary operations at the times appellant decided to sell them." In the case of LFC, "at no time did [it] possess more than the potential for actual integration into appellant's ongoing business, and we believe that mere potential is insufficient to support a finding that the gains [or losses] on these sales were business income [or losses] under the functional test." (Appeal of Occidental Petroleum Corporation, supra.)

Appellant's claim that Boehme continued operations during the appeal years, even if true, would not establish that the subsidiaries were integrally related to appellant's unitary operation. Maintenance of a corporate shell for the primary purposes of avoiding liability and obtaining tax benefits, while it may provide certain advantages, does not provide any sort of integral relationship with the unitary business activities necessary to meet the functional test for business income.

Having found that the subsidiaries sold were not integrally related to appellant's unitary business, we are compelled to agree with the characterization by respondent (and, originally, by appellant) that the losses were nonbusiness losses. We must also reject appellant's contention that the losses, even if nonbusiness, should be deducted from the California-apportioned income of VSI's entire unitary group. We considered this question in the Appeal of Signal Companies, Inc. (85A-203), decided by this board on November 19, 1986, and concluded that nonbusiness income or loss of a unitary affiliate is properly added to or subtracted from the apportioned business income of the particular corporation generating the nonbusiness item and not that of the unitary group as a whole. "Thus, each taxpayer pays tax on its fair share of the business income, which is generated by the unitary business as a whole, and on its own nonbusiness income, which is not connected with the

unitary business, but arises out of the activities of the individual corporate entity." (Appeal of Signal Companies, Inc., supra.) Appellant's assertion that LII has little California income to offset the losses generated by the stock sales does not prove an unfair distortion of appellant's income. Neither does it meet appellant's burden of proving under section 25137, subdivision (d), that respondent's formula does not fairly represent the extent of the taxpayer's business activity in the state. Finally, we have repeatedly declined to entertain constitutional challenges in cases involving deficiency assessments. (See Appeal of Aimor Corporation, Cal. St. Bd. of Equal., Oct. 26, 1983.)

For the reasons set forth above, we conclude that the respondent's action in this matter must be sustained.

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 VSI Corporation, Taxpayer, and VSI Corporation, Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of $18,163, $24,992, $14,530, and $1,025,436 for the income years ended June 30, 1976, 1977, 1978, and 1979, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of May, 1991, by the State Board of Equalization, the Board Members Mr. Sherman, Mr. Bennett, and Mr. Dronenburg present.

Brad Sherman , Chairman

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

_____, Member

_____, Member

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