95-SBE-002

ADOPTED MAY 4, 1995

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 87A-1561
CULLINET SOFTWARE, INC., et al.	)	

For Appellant: D. Stephen Keating

For Respondent: Cody C. Cinnamon
Counsel

O P I N I O N

This appeal is made pursuant to section 19045[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Cullinet Software, Inc., against proposed assessments of additional franchise tax in the amounts of $22,799, $74,630, and $81,346 for the income years ended April 30, 1981, April 30, 1982 and April 30, 1983, respectively, and on the protest of Mentel, Inc., against a proposed assessment of additional franchise tax in the amount of $13,123 for the income year ended April 30, 1983.

The principal issues involved in this appeal are whether interest income earned on funds

[1/] Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

raised in stock offerings is business or nonbusiness income, and whether the statute of limitations for claiming refunds expired for Mentel, Inc., a wholly owned subsidiary of Cullinet Software, Inc., for the income years ended April 30, 1981, and April 30, 1982. Appellant Cullinet Software, Inc. (Cullinet), also originally objected to its being classified as a unitary business with two of its subsidiaries, Cullinane Investment Corp. and Cullinane Securities Corp. (hereinafter referred to as CIC and CSC, respectively), but has made no real effort to show that respondent's determination in this respect was wrong. Accordingly, we must assume, for purposes of this appeal, that Cullinet was engaged in a single unitary business with CIC and CSC.

Cullinet is a Massachusetts corporation. Appellant Mentel is a California corporation. ("Appellant" will refer to the parent corporation, Cullinet.) Appellants, along with other subsidiaries of Cullinet, are involved in the business of designing, developing, and marketing "off-the-shelf" computer programs.

In September of 1980 and December of 1982, Cullinet made stock offerings which netted $15 million and $29 million, respectively. The purpose of the offerings was to "provide additional capital for the acquisition of companies and products in the systems and applications software markets or in markets complimentary [sic] to the Company's business." (Resp. Br. at 3, citing the 1982 stock offering prospectus.) A short time after the offerings, substantially all the funds were contributed to separate subsidiaries, CIC and CSC, which qualified as Massachusetts Securities Corporations. The offering prospectuses provided that, until the proceeds were utilized for their intended purpose, they would be invested in United States Government obligations, certificates of deposit, short-term commercial paper and other liquid investments. Apparently, this is how the funds were invested for the years in question. The record is silent as to whether any purchases of new businesses or products were investigated or completed during the appeal years, but it does reveal intercompany transactions involving CSC's funds, suggesting that these funds were used as working capital during the appeal period. Although appellants allege that CIC's funds were not used as working capital, there is no proof that that was so.

Cullinet and Mentel filed their franchise tax returns on a separate accounting basis. Respondent audited the returns and determined that appellants and Cullinet's other subsidiaries, including CIC and CSC, were involved in a unitary business, which required the income to be computed on a combined basis. In addition, respondent concluded that the interest income earned by CIC and CSC was business income to be apportioned among all the jurisdictions in which the unitary business was conducted.

During the course of the audit, Cullinet filed "first" amended returns for the appeal years which allegedly reflected the combined activities of it and its other subsidiaries. These amended returns were filed within four years after the filing of appellants' original returns. When respondent was not satisfied with the information provided in support of these amended returns, Cullinet apparently filed "second" amended returns, which clearly included the income and apportionment factors of Mentel. For the income years ended April 30, 1981, and April 30, 1982, these second amended returns were filed

more than four years after the filing of the original returns, although for the year ended April 30, 1983, the returns were filed within four years after the filing of the original returns. Apparently, these amended returns claimed refunds for Mentel, although the basis for the refunds has not been articulated in the record.

The first issue is whether the interest income earned by CIC and CSC from the short-term investment of the stock offering proceeds is business or nonbusiness income. Section 25120, subdivision (a), defines business income as:

> 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. (d).)

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 disposition 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; cf. Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. __, __ [119 L.Ed.2d 533, 552] (1992) (the investment must "serve an operational rather than an investment function.") If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, 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 addition, respondent's regulations provide that "income of the taxpayer is business income unless clearly classifiable as 'nonbusiness income." (Cal. Code Regs., tit. 18, § 25120, subd. (a).)

Appellants contend, especially with respect to CIC, that the proceeds of the stock offerings were not used in their unitary business, but were segregated in separate subsidiaries, which invested those funds "until such time as our management determined a viable business opportunity in which to utilize them." As support for its position that funds so held give rise to nonbusiness income, appellant cites respondent's regulation 25120, subdivision (c)(3), example (F), which provides that the income earned on the proceeds received from the sale of a subsidiary and held in an interest-bearing account "pending a decision by management as to how the funds are to be utilized" generates

nonbusiness income. Appellants say that this is essentially what they did.

In essence, appellants appear to argue that, even though these funds were invested in highly liquid financial instruments which were part of the pool of capital which Cullinet kept available at all times for immediate use in the business, the income from these funds must be classified as nonbusiness income because CIC and CSC decided how to invest the funds, and because it was not a certainty that appellants would decide to use the funds in the unitary business. Respondent, on the other hand, contends that investing in liquid assets and holding them ready for use in the unitary business gives rise to business income, especially where, as in this case, the funds are earmarked for the acquisition of companies and products similar or complementary to the taxpayer's unitary business. It appears that respondent's view is that such assets do not generate nonbusiness income unless the taxpayer's management somehow segregated them in a way which clearly establishes that they were not being held for use in the unitary business. We think respondent is correct.

Appellant's position conflicts with respondent's regulations and is not supported by the relevant decisions. In substance, appellants' argument is that these funds generate nonbusiness income unless there was a specific intent to use the funds in appellants' regular business. If that is so, it would amount almost to a presumption in favor of nonbusiness income, at least in cases where there is some doubt regarding the nature of the asset's relationship to the unitary business. That, however, would be completely contrary to respondent's regulations, which clearly establish a presumption in favor of business income. (Cal. Code Regs., tit. 18, reg. 25120, subd. (a).)

The United States Supreme Court's opinion in Allied-Signal clearly indicates that income from stock investments constituting interim uses of idle funds accumulated for the future operation of a nondomiciliary taxpayer's business is constitutionally apportionable. (Allied-Signal v. Director, Division of Taxation, supra, 504 U.S. at __ [119 L.Ed.2d at 552].) The court also reiterated the heavy burden of proof that must be borne by a taxpayer challenging a state tax, namely, that of showing by "clear and cogent evidence" that the state is seeking to tax extraterritorial values. (Allied-Signal v. Director, Division of Taxation, supra, 504 U.S. at __ [119 L.Ed.2d at 549].) In the context of state taxation of income from short-term investments of idle funds, we have great difficulty perceiving how a taxpayer could satisfy this burden of proof when it admits, as appellant does here, that a major reason for having the funds was to meet the future capital needs of its business.

Finally, we believe that appellant's reliance on example (F) of regulation 25120, subdivision (c)(3), is misplaced. The example provides that the taxpayer sells a subsidiary for $20,000,000 and places the proceeds in an interest-bearing account pending a decision by management on use of the funds. In our opinion, the example describes a situation in which the funds have clearly been set aside in an account distinct from the taxpayer's normal pool of working capital. It seems to us that one may assume, from the statement that management has not yet decided how to use the money, that the funds have not yet been made available as part of the working capital of the business. In appellant's case, there is no proof that the funds were set aside from appellants' working capital, and it is admitted that they were available for use in appellant's regular business operations, if and when needed.

We conclude that idle funds invested in liquid financial instruments are part of a unitary business's working capital pool, and thus generate business income (Appeal of R. H. Macy & Co., Inc., 88-SBE-020, July 26, 1988), unless management segregates or earmarks the funds in such a way as to clearly establish that they were not being held readily available for use in the taxpayer's regular trade or business operations. (Cf. Appeal of Inco Express, Inc., 87-SBE-016, March 3, 1987.) In the present appeal, it is clear not only that there was no such segregation or earmarking but also that the proceeds from appellant's stock offerings were, in fact, at all times held readily available for any use in its unitary business which might have arisen during the appeal years. The income earned on these investments, therefore, constituted business income.

The second issue is whether Mentel timely filed refund claims for the income years ended April 30, 1981, and April 30, 1982. The general rule is that a refund claim must be filed within four years after the filing of the original return, or one year after the date of the overpayment. (Rev. & Tax. Code,
§ 19306.) Appellants have failed to show that Mentel's apportioned part of the unitary business's income was previously reported by appellant prior to the "second" amended return. Therefore, based on the evidence presented to this board, appellants have not demonstrated that respondent misapplied the general rule to Mentel.

Due to concessions by the parties, the proposed assessments at issue herein must be modified. In general, appellants' income and liabilities are as shown on Exhibits II, III, and IV of respondent's brief, subject to any further modification that may be necessary because of appellants' concession regarding $69,426 of business interest income for the income year ended April 30, 1983.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Cullinet Software, Inc., against proposed assessments of additional franchise tax in the amounts of $22,799, $74,630 and $81,346 for the income years ended April 30, 1981, April 30, 1982 and April 30, 1983, respectively, and on the protest of Mentel, Inc., against a proposed assessment of additional franchise tax in the amount of $13,123 for the income year ended April 30, 1983, be and the same is hereby modified in accordance with our opinion herein. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 4th day of May, 1995, by the State Board of

Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

Brad J. Sherman, Member

Rex Halverson*, Member

*For Kathleen Connell, per Government Code section 7.9.