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LEGAL RULING 2003- 3

SUBJECT: Inclusion of Business Income Dividends in the Recipient's Sales Factor

ISSUE

When does income-producing activity exist with respect to a business income dividend so that the dividend is includible in the recipient's sales factor?

FACTS

Situation 1: Corporation A receives a wholly taxable dividend from Corporation B. Assume the stock of B is a business asset in the hands of A, and the dividend is business income, but that A and B are not members of a common combined reporting group. Officers or employees of A are active members of the board of directors of B and participate in the business decisions of B.

Situation 2: Corporation C receives a wholly taxable dividend from Corporation S. The stock of S is a business asset in the hands of C, and the dividend it receives from S is business income. However, C does not have representation on S's board nor does it assist S with its operations in any manner. All sales between S and C are transacted in the same manner as with any other buyer of S's or C's products.

LAW

Revenue and Taxation Code section 25134¹ states that the sales factor of California's apportionment formula is computed using a numerator consisting of sales in California and a denominator consisting of total sales everywhere. Section 25120, subdivision (e), defines "sales" as all gross receipts of the taxpayer except those subject to allocation by sections 25123 through 25127. Sections 25123 through 25127 provide rules for the allocation of various items of nonbusiness income. Section 25120, subdivision (d), defines nonbusiness income as "all income other than business income." Therefore, the term "sales" includes all gross receipts from activities that give rise to business income. Regulation section 25134, subsection (a)(1), which states that "the term 'sales' means all gross receipts derived by the taxpayer from transactions and activity in the regular course of . . . [the taxpayer's] trade or business," is consistent.

¹ All further section references are to the Revenue and Taxation Code, and all references to regulations are to title 18 of the California Code of Regulations, unless otherwise specifically noted.

Section 25120 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." Dividends that are business income fall within the meaning of the term "sales" for purposes of section 25134.

Because the dividends constitute a sale "other than a sale of tangible personal property," they are includible in the sales factor according to the rules set forth in section 25136 and the regulations thereunder. Section 25136 provides that such sales will be sourced for sales factor purposes to the state in which the income-producing activity took place. If the income-producing activity took place in more than one state, the sale is assigned to the state in which the greater cost of performance occurred. Regulation section 25136 further specifies that if income-producing activity occurs in more than one state, the relative amounts of income-producing activity will be measured by ascertaining and comparing the direct cost of such activity in each state.

Regulation section 25134, subsection (a)(2), states that "[i]n some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business." Regulation section 25136, subsection (b), expressly states that "[t]he mere holding of intangible personal property is not, of itself, an income producing activity." Regulation section 25137, subsection (c)(1)(C), provides that "[w]here business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer," such income must be excluded from the numerator and denominator of the taxpayer's sales factor. This regulation section contains the following example: "[W]here business income in the form of dividends received on stock . . . results from the mere holding of the intangible . . . such dividends . . . shall be excluded from the denominator of the sales factor."

DISCUSSION

Based on the language of the Revenue and Taxation Code and its concomitant regulations, business income dividends constitute gross receipts that are generally includible in the sales factor. However, because the "mere holding" of intangible property does not constitute income-producing activity, dividends are includible in the sales factor only when the holder engages in an activity that constitutes more than mere holding. Income-producing activity with respect to a dividend exists when there is participation in the management and/or operations of the dividend payor. However, the exercise of voting rights conferred by ownership of stock, the receipt and review of material normally supplied to a stockholder, and accounting for the receipt of dividend income do not constitute participation in the management and/or operations of the dividend payor and, therefore, do not amount to income-producing activity with respect to a dividend.

HOLDING

Situation 1: Because A participates in the management and operations of B, it engages in income-producing activity with respect to the dividend so that the dividend is includible in A's sales factor.

Situation 2: Because C does not participate in the management and/or operations of S, it does not engage in income-producing activity with respect to the dividend, and the dividend is not includible in C's sales factor.

CONTACT INFORMATION

For further information regarding this ruling, please contact Carl Joseph at the Franchise Tax Board, Legal Department, P.O. Box 1720, Rancho Cordova, CA 95741-1720.