State of California
Franchise Tax Board

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LEGAL RULING 2012-01

Subject: Business/Nonbusiness Characterization on Sale of Stock

BACKGROUND

In *Appeal of Occidental Petroleum*, 83-SBE-119, the State Board of Equalization held that the classification of income from intangibles under the functional test of business income must be made on the basis of the relationships between the intangible and the taxpayer's unitary business. Sales of stock in entities that were fully integrated and functioning parts of the taxpayer's existing unitary business gave rise to apportionable income; sales of stock in corporations that were intended to be integrated into the taxpayer's business, but at the time of the sales were not yet integrated, generated nonbusiness income.

This distinction—between the intent and potential for integration, on the one hand, versus actual integration, on the other—has led to confusion as to what the result should be where the two corporations have had a preexisting business relationship beyond that involved in the mere acquisition of stock, yet the purpose for the acquisition of the stock is based on intent to integrate the target into the taxpayer's unitary business operations. If the integration does not occur, and the intent of the taxpayer is frustrated, questions have arisen as to whether a sale of the stock should properly give rise to nonbusiness income even though there are preexisting operational ties unrelated to the acquisition of the stock.

ISSUE

If one corporation purchases stock in a corporation with which it has preexisting operational ties with the intent to integrate the target corporation into its unitary business operations, but the intended integration does not occur, does the later sale of the stock in the target corporation give rise to business or nonbusiness income?

SITUATION 1

Assume Corporations A and B are in the same line of business. The two companies do not engage in any business transactions with each other. Corporation A decides it would like to purchase Corporation B as a means to expand its operations into new territories. Corporation A buys 20 percent of the stock of Corporation B as part of a plan to acquire a majority interest in Corporation B and integrate it into Corporation A's unitary business. One year later Corporation B's shareholders sell a majority stock interest to Corporation C, thereby thwarting Corporation A's effort to gain control of Corporation B. Shortly thereafter, Corporation A sells its stock in Corporation B and has a gain or loss.

SITUATION 2

Assume Corporations D and E are in the same line of business. The two companies do not engage in any business transactions with each other. Corporation D is the leading company in the industry. Corporation E is a smaller company with new technology potentially relevant to Corporation D's business. While Corporation D has no intention of controlling Corporation E, Corporation D purchases a minority stock interest in Corporation E to gain information regarding Corporation E's technology. Following the purchase, Corporation D actually does gain information regarding Corporation E's technology and enters into exclusive agreements with Corporation E to utilize Corporation E's technology. Some time thereafter, Corporation D sells its stock in Corporation E and has a gain or loss.

SITUATION 3

Assume Corporations F and G are in the same line of business and have an ongoing business relationship with each other. As part of this ongoing business relationship, Corporation F has an agreement with Corporation G under which Corporation F is a significant distributor of Corporation G's products. Corporation F buys 20 percent of the stock of Corporation G as part of a plan to acquire a majority interest in Corporation G and integrate it into Corporation F's unitary business. After the purchase of the stock, Corporation F becomes the predominant distributor of Corporation G's products. Some time thereafter, Corporation F determines that it will be unable to obtain control of Corporation G and sells its minority interest in Corporation G for a gain or loss.

LAW AND ANALYSIS

By statute, business income is defined 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." (Rev. & Tax. Code, § 25120, subd. (a).) Nonbusiness income is "all income other than business income." (Rev. & Tax. Code, § 25120, subd. (d).) The governing regulation, in pertinent part, provides as follows:

> *(a) Business and nonbusiness income defined*. 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. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Sections 25120 to 25139 inclusive, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

> Nonbusiness income means all income other than business income.

(Cal. Code Regs., tit. 18, § 25120, sub. (a).) The California Supreme Court in *Hoechst Celanese Corp. v. Franchise Tax Board* (2001) 25 Cal.4th 508, held that Revenue and Taxation Code section 25120, subdivision (a), provides two alternative tests, the "transactional" test and the "functional" test, to determine whether income constitutes business income. Under the transactional test ("'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business"), the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer's trade or business. (25 Cal. 4th at 526.) Thus, the focus is on the activity giving rise to the income. Under the functional test ("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"), however, the focus is on the income-producing property rather than the activity, and the "critical inquiry" is the "nature of the relationship between this property and the taxpayer's 'business operations.'" (*Id.* at 527.) To determine whether property is considered integral to regular business operations, the Court held that "the taxpayer's control and use of the property must contribute materially to the taxpayer's production of business income so that the property becomes interwoven into and inseparable from the taxpayer's business." (*Id.* at 529.)

In *Appeal of Occidental Petroleum Corporation*, 83-SBE-119, the State Board of Equalization was faced with determining whether certain gains and losses appellant and its affiliates realized from sales of stock in five different corporations constituted business income apportionable by formula or nonbusiness income specifically allocable to the particular state in which each corporate stockholder maintained its commercial domicile. In reaching its decision, the Board looked to the operational relationship between the entities in question and the taxpayer. The Board held that some of the stock sales gave rise to business income because the entities in question were a part of the taxpayer's unitary business operations. The Board stated:

> With respect to the sales of Cofesa, Waiawa Realty, and Oxytrol stock, we believe that the transactions involving these unitary subsidiaries gave rise to business income under the functional test. In each case, the stock had been acquired (or created) and managed in furtherance of the actual operation of appellant's unitary business. Furthermore, at the times the various decisions to sell were made, the assets and activities represented by the stock were fully integrated and functioning parts of appellant's existing unitary business.

However, with respect to stock in other entities, the Board held that the stock was not part of the unitary business of the taxpayer due to the lack of any integration of the stock into the operations of the taxpayer's unitary business. The Board stated:

> Although appellant's purpose in acquiring KCL and Island Creek stock was to expand its unitary business, 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 fact, at no time did they 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 on these sales were business income under the functional test.

Thus, the decision of the Board rested solely on an analysis of the relationship of the asset in question, the stock and the assets and activities represented by the stock, to the operations of the taxpayer's unitary business. The frustration of the taxpayer's intended purpose for the acquisition of the stock, while true, was not a determining factor. What was determinative was that at the time of the sale, no actual operational relationship existed, but rather only the potential for such a relationship.

Other decisions of the Board are consistent with the Board's analysis in *Occidental Petroleum*. In the *Appeal of Standard Oil Company of California*, 83-SBE-068, decided only a few months before *Occidental Petroleum*, the Board applied a similar analysis to the receipt of certain dividends. In *Standard Oil*, the Board held that dividends received by the taxpayer and its subsidiaries from affiliated joint venture corporations were business income. The taxpayer was an integrated oil company engaged in all aspects of the petroleum business throughout the world. It owned 30 percent of the stock of Aramco, which held and operated major oil producing fields in Saudi Arabia, and 50 percent of the stock of CPI, which held and operated major oil producing fields in Indonesia. The taxpayer's equity interests in Aramco and CPI entitled it to a share of the production from those ventures. For the year at issue, 52 percent of the taxpayer's worldwide supply of crude oil and natural gas came from its Aramco and CPI entitlements. The taxpayer received dividends from Aramco and CPI, which it treated as business income. The SBE upheld this treatment, concluding that the dividends met the functional test of business income. The Board held that the purpose for creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to ensure an available supply of crude oil and natural gas and that this was an essential element in the taxpayer's worldwide petroleum operations. The dividends were therefore found to be business income.

In the *Occidental Petroleum* decision, the Board cited its *Standard Oil* decision and described its holding there by stating:

> We went on to hold that the classification of all types of income from intangibles, under the functional test, must be made on the basis of the relationship between the intangibles and the taxpayer's unitary business operations. Thus, if the income-producing 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.

This is wholly consistent with the reasoning of the Board in *Occidental Petroleum,* a fact the Board recognized when it stated in *Occidental Petroleum* that "it is apparent that the present situation is merely one step removed from that in the A*ppeal of Standard Oil*

Company of California"; the "one-step" referred to by the Board being that *Occidental Petroleum* involved the sale of the stock, *Standard Oil* the dividend income from the stock.

Since *Occidental Petroleum*, the Board has, on occasion, examined the intent of the stockholder in its analysis of business/nonbusiness income. However, the fact that a taxpayer was unable to realize its intent has not been held to be the determinative factor in any of the cases. Instead, consistent with its analysis in *Occidental Petroleum* and *Standard Oil*, the holdings of the cases rely on the actual, rather than intended, relationship between the property and the unitary business.

For example, in *Appeal of Mark Controls Corporation*, 86-SBE-204, while the Board explained the taxpayer intended to expand its business in the United Kingdom, its purchase of a large minority stock interest in Weir, with an option to acquire the remainder, together with its subsequent actions, did not result in either the stockholdings or the underlying assets or activities of Weir becoming an integral part of appellant's business. In the Board's view, all of appellant's actions were merely preparatory to integrating Weir into its unitary business and there was no business relationship or operational involvement other than that attempt to acquire sufficient stock to integrate Weir into its unitary business.

In *Appeal of CTS Keene*, 93-SBE-005, the Board held that gain realized on the sale of stock held by appellant's parent in AB Electronics was properly characterized as apportionable business income. The evidence established that CTS's goal was operational in character rather than the typical return-on-investment objective held by an ordinary passive investor of anticipated dividend income or possible appreciation in the price of the stock. In so holding, the Board distinguished *Appeal of Mark Controls* on the grounds that the purchases of stock were motivated by explicit passive investment motives not present in this case, and that there was nothing preparatory about CTS's actions here: The AB Electronics stock became a fully integrated asset of the unitary group's business once CTS acquired its minority interest because the result was that it supplied new capital to AB Electronics and thereby assisted AB Electronic's efforts to become a more effective promoter of CTS's products in Europe.

The common thread running through *Appeal of Occidental Petroleum*, *Appeal of Mark Controls*, and *Appeal of CTS Keene* is the Board's careful analysis of the underlying facts surrounding the relationship between the acquiring or parent corporation and the stock that was the subject of the inquiry in determining whether gain or loss on the disposition should be characterized as giving rise to business income under the functional test of business income set out in Revenue and Taxation Code section 25120, subdivision (a). In those circumstances in which the Board found the gain or loss on disposition to be business income, the taxpayer and the entity represented by the stock at issue had an actual operational business relationship of some significance.

In contrast, the Board has consistently not focused on the taxpayer's frustrated intention to acquire majority ownership in its intended target as determinative of whether the sale gives rise to business income. While the fact that the taxpayers in each of these cases had such an intention is acknowledged, that fact by itself is not controlling. While the taxpayer's intent, along with other factors, may support a determination that an operational relationship did or did not exist, it is the actual operational ties and the significance of such ties that are most important.

HOLDING—SITUATION 1

Corporation A had no preexisting or ongoing business relationship or operational involvement with Corporation B such that any gain or loss on disposition of Corporation B stock should be characterized as generating business income. Instead, Corporation A purchased 20 percent of the stock of Corporation B merely as part of its plan to acquire a majority interest in Corporation B and integrate it into Corporation A's unitary business. Since that integration was frustrated by Corporation B's shareholders' sale of a majority interest in its stock to Corporation C, Corporation A's gain or loss on its stock in Corporation B is thus properly characterized as generating nonbusiness income.

HOLDING—SITUATION 2

Corporation D's intention for purchasing the stock of Corporation E was to gain information regarding Corporation E's technology, an operational factor. Following the purchase, Corporation D actually did gain information regarding Corporation E's technology, thereby integrating Corporation E's stock into its unitary business by virtue of the ongoing business relationship. Corporation D's gain or loss on its stock in Corporation E is thus properly characterized as generating business income.

HOLDING—SITUATION 3

Corporations F and G are in the same line of business and have a significant ongoing business relationship with each other. The business relationship between Corporation F and Corporation G for purposes of applying the functional test of business income continued despite Corporation F's unsuccessful attempt to acquire a majority interest in Corporation G and integrate it into Corporation F's unitary business. Corporation F's gain or loss on its stock in Corporation G is thus properly characterized as generating business income.

The principal author of this ruling is Frederick W. Campbell-Craven of the Franchise Tax Board, Legal Division. For further information regarding this ruling, contact Mr. Campbell-Craven at the Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720.