CHAPTER OF CONTENTS:

4000 NONBUSINESS INCOME

In broad terms, net income, which arises from the conduct of the taxpayer's trade or business operations, is business income. R&TC §25120(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." R&TC § 25120(d) defines nonbusiness income as "all income other than business income."

Nonbusiness income is simply defined as "all income other than business income." Furthermore, CCR § 25120(a) states that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income."

The classification of income as business or nonbusiness is essential to the determination of the California tax base for two reasons:

- Business income is apportioned by formula to the various jurisdictions in which the trade or business activity is conducted. Nonbusiness income is allocated to a specific location under a series of statutory rules; and

- Unitary business income is determined on a combined basis. Nonbusiness income may only be reflected in the measure of tax of the taxpayer incurring the nonbusiness income or loss.

The classification of income by labels such as interest, rents, royalties or capital gains is of no aid in determining whether income is business or nonbusiness. Income of any type or class and from any source is business income if it arises from transactions and activities occurring in the regular course of a trade or business. (R&TC § 25120 (a)) The gain or loss recognized on the sale of property, for example, may be business income or nonbusiness income depending upon its relation to the taxpayer's trade or business. You must look beyond the labels and focus on the relationship of the income to the unitary business activity.

This portion of the manual will describe the tests for determining whether income constitutes business or nonbusiness income. It will then discuss the application of those tests to various types of income and loss and the rules for allocating items of nonbusiness income or loss.

4010 TEST FOR DETERMINING BUSINESS OR NONBUSINESS TREATMENT

The concepts of unity and business versus nonbusiness income came into existence due to the U.S. constitutional limits on the ability of states to tax interstate commerce. In simple terms, there must be some connection or nexus between the state and the taxpayer's economic activity that the state seeks to tax.That is why some income is apportionable (business income) among several states, while other income is allocated to a single location (nonbusiness income). Various states define business income and nonbusiness income either by statute or case law. Many states have adopted the business income definition found in the Uniform Division of Income for Tax Purposes Act (UDITPA), which is found in R&TC § 25120(a).

The US Supreme Court in *Allied-Signal, Inc. v. Director, Div. Of Taxation* 504 U.S. 768 (1992), (112 S.Ct. 2251, 119 L.Ed.2d 533) focused on the characteristics of an asset's use and its relation to the taxpayer's business activities to decide if the related income can be included in the tax base to be apportioned to the non-domiciliary state. The asset, stock of another company in the case of *Allied-Signal*, must have an operational versus investment function to be apportioned. The Court held that gain on the sale of stock was not apportionable because there was no showing that the stock served an operational function, even though the asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions, since such a policy does not convert an otherwise passive investment into an integral operational one. The court also said that the short-term holding of the stock was not analogous to a taxpayer depositing temporary excess working capital in a bank account and receiving interest income. In the case of the bank deposit, the funds, working capital, serve an operational role. Therefore, the interest on the deposit is apportionable business income.

The department, the courts, and the SBE have interpreted R&TC § 25120(a) as providing two alternative tests for determining whether income constitutes business income: the "transactional test" and the "functional test." (Appeal Hoechst Celanese, 25 Cal.4th 508, 106 cal rptr 2d 548, certiorari denied US supreme ct July (2001), 151 L.Ed.2d 537, Jim Beam Brands Company, 34 cal rptr 3d 874 *Appeal of CTS Keene, Inc. and CTS Corporation, DBA CTS Electronics, 93-SBE-005 ,2/10/1993*) Because nonbusiness income is defined as "all income other than business income" (R&TC § 25120(d)), income that does not meet either one of the tests will be characterized as nonbusiness. The SBE has held that a determination of business or nonbusiness character made by FTB under one of these tests is presumed correct, and the taxpayer has the burden of proving error in that determination (*Appeal of Twentieth Century-Fox Film Corp.*, 89-SBE-007, March 2, 1989).

The transactional test stems from the first part of R&TC § 25120(a), that is, "income arising from transactions and activity in the regular course of the taxpayer's trade or business." The functional test stems from the words "and includes income from tangible and intangible property if the acquisition, management, and disposition constitute integral parts of the taxpayer's regular trade or business." The department's position is that the transactional test includes in business income such activity as inventory sales while the functional test includes such activity as sale of property, plant or equipment used in the unitary business.

Taxpayers have argued that the state is not required to tax all of the income that it is authorized to under the U.S. Constitution. States can define apportionable income more narrowly than U.S. constitutional standards (operational role). Some taxpayers interpret R&TC § 25120(a) as providing only one test for business income, that being the transactional test. They argue that the language of the "functional test" is subordinate to the language of the "transactional" test. Under this rationale, income from an extraordinary event such as the liquidation of a subsidiary or pension reversion is nonbusiness income, because the transaction is not a "regular" part of the taxpayer's trade or business. The issue of whether one or two tests exist for business income was resolved in a 2001

California Supreme Court decision, which held that there are two tests. On May 14, 2001, the California Supreme Court held that the California definition of business income contains both a transactional and a functional test in the case of *Hoechst Celanese Corporation v. Franchise Tax Board* [(2001) 25 Cal.4th 508, *cert. denied* (2001) 151 L.Ed. 2d 537].

Hoechst Celanese Corporation (Celanese) was in the business of manufacturing and selling a diversified line of chemicals, fibers and specialty products. Celanese employed a large work force. Since 1947, Celanese had maintained a pension plan for the general benefit of these employees in an effort to retain its current employees as well as to attract other qualified prospects. The pension fund assets were placed in a separate trust with an independent trustee. Celanese retained the power over selection of the trustee and general investment philosophy. The trust held title to the pension assets.

Because of sound investment policies and a robust stock market, by the mid-1980's the trust assets were far in excess of the future pension obligation. Celanese decided to recapture the surplus assets through a process known as a "reversion". Celanese reorganized the pension plan, funded all outstanding employee pension obligations, and reported the remaining balance, $388.8 million, as nonbusiness income in 1985 fully allocable outside of California. FTB issued an NPA treating the income as business income that was in part apportioned to California.

The California Supreme Court noted that the business income definition in R&TC § 25120(a) consists of two clauses that could be interpreted either as two independent tests for business income, or as one test containing a second modifying clause. Due to ambiguity of the law, the Court examined legislative history. The Court concluded that separate transactional and functional tests existed because:

- The UDITPA definition of business income adopted pre-UDITPA California SBE administrative case law language clearly applying a separate, independent functional test for determining business income.
- The Commissioners who drafted UDITPA contemplated the existence of a functional test, because they declared that business income includes income from the sale of property "used" in the trade or business.
- The SBE has thoroughly considered the business income issue, reached a well-reasoned conclusion, and consistently applied this conclusion for 24 years. The Court saw no reason to overturn this long-standing construction of the business income definition. (*Hoechst Celanese Corporation v. FTB* (2001) 25 Cal. 4th 508, citing *Yamaha Corp of America v. State Bd. Of Equalization* (1998) 19 Cal. 4th 1.)
- A separate functional test was consistent with the uniformity principles of UDITPA because, with the exception of Alabama, all states that have considered the issue now have a functional test in either judicial or legislative form.

After determining the existence of two tests, the Court set out the terms of these tests. When applying the transactional test, the Court stated that the controlling factor is the nature of the particular transaction or activity that generates the income. The transaction or activity must be in the regular course of the taxpayer's business and the relevant considerations include frequency and regularity of similar transactions (extraordinary, once-in-a-lifetime occurrences do not meet the transactional test), the former practices or typical practices of the business, and the taxpayer's subsequent use of the funds. (The department would question the significance of the subsequent use of funds. The mere flow of funds, by itself, is insufficient to change the character of income for apportionment purposes. For example, the taxpayer has a gain on the sale of a nonbusiness asset and invests the funds in the unitary business. Just because the funds are used in the unitary business is not enough to change the character of the income from nonbusiness income to business income. See *Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159, 166; see also *Appeal of Fairmont Hotel Company*, 95-SBE-004, June 29, 1995).

The Court applied the above factors to Celanese's pension reversion (the transaction that generated the income), and concluded that the reversion did not generate business income under the transactional test.

The functional test provides that "business income" 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. The Court in Celanese noted that the functional test focuses on the nature of the property, not transactions or activities. The crucial inquiry here is the relationship between the property under consideration and the taxpayer's business operations. This analysis involves interpretation of two key statutory phrases: "acquisition, management, and disposition of the property" and "integral parts of the taxpayer's regular trade or business operations."

In the first part of its analysis, the Court determined that because the phrase "acquisition, management and disposition" contained the word "and" it should be interpreted in the conjunctive. However, the Court also adopted broad, and inclusive definitions of the words "acquisition," "management" and "disposition" that dispelled any restrictive concept of property ownership or disposition. According to the Court, "acquisition" means" to obtain some interest in and control over property"; "management" means " to control or direct the use of that property"; and "disposition" means "to transfer, or have the power to transfer, control of the property in some manner."

In the second phase of its analysis of the functional test, the Court defined "regular", "operations" and "integral" in analyzing the phrase "integral parts of the taxpayer's regular trade or business operations": "Regular," the Court said, means "normal" or "typical." The Court also explained that "operations" means the whole process of planning for and operating a business or a phase of a business activity. The Court's interpretation effectively puts an end to taxpayers' argument that the acquisition, management, and disposition of property must be frequent or regular under the functional test. The Court defined "integral" as materially contributing to the apportioning business.

The Court applied the above analysis to conclude that the pension reversion income was business income as provided by the functional test of R&TC §25120(a). The pension plan and trust enhanced the quality and efficiency of Celanese's labor force and Celanese retained a significant role in administering the trust and plan. As a result, the pension plan assets were interwoven into and inseparable from Celanese's employee retention and recruitment efforts, an essential part of any business operation.

The Celanese decision is important for the following reasons:

- It validates the department's long-standing view that the business income definition does encompass both a transactional and a functional test.
- It validates the department's, as well as the SBE's, interpretation of the scope of the functional test.
- It recognizes that the language in the business income definition originated with pre-UDITPA SBE case law (*Hoechst Celanese Corporation v. FTB* (2001) 25 Cal. 4th 508), and notes with deference that the SBE has thoroughly considered the business income issue, reached a reasonable conclusion, and consistently applied this conclusion for the last 24 years.
- The Court's decision puts to rest several arguments advanced by taxpayers in attempts to limit the scope of the business income definition.
- It specifically repudiates the definition of business income that other states such as North Carolina and Pennsylvania have adopted.

The following discusses various SBE decisions that help define the two specific tests – the transactional test and the functional test.

Transactional Test

The relevant inquiry under the transactional test is whether the transaction or activity that gave rise to the income occurred in the regular course of the taxpayer's trade or business. If so, it is business income. For example, income from sales of inventory arises from transactions occurring in the regular course of a taxpayer's trade or business, and is therefore business income. Likewise, fee income received by a consulting firm for the performance of consulting services would be business income under the transactional test. The application of the transactional test to a less obvious situation can be found in the following SBE decision:

In the *Appeal of General Dynamics Corporation*, 75-SBE-063, June 3, 1975, Opinion on Rehearing Sept. 17, 1975, the taxpayer was in the business of buying and reselling aircraft. In 1959, the taxpayer purchased seven aircraft from two airlines for a price that was contingent upon the amount of proceeds received from the resale of the aircraft. The taxpayer resold the aircraft in 1960 and received installment obligations for part of the sales price. The buyer subsequently defaulted on the installment obligations, and entered into various refinancing arrangements with the taxpayer. In connection with the refinancing, the taxpayer received 1 million shares of the buyer's stock in 1963. The agreement provided that the shares could only be sold with the approval of the buyer's management, and only in conjunction with a bona-fide public offering. When a public offering was proposed in 1967, the buyer permitted the taxpayer to sell its shares for a net gain. Pursuant to the terms of the contract with the airlines, the gain from the sale of the stock was treated as proceeds from the sale of the aircraft and the final purchase price paid to the airlines for the aircraft was adjusted to reflect that gain.

The taxpayer treated the gain from the sale of stock as nonbusiness income, claiming that when it received the stock the transaction was transformed into an investment. The SBE disagreed, pointing out that the acquisition, retention, and disposition of the stock were inextricably entwined with the transactions involving the purchase and sale of the seven aircraft. Because there was no question that the purchase and sale of the aircraft arose in the ordinary course of the taxpayer's business, the entire amount of income from the transactions, including the gain from the sale of stock, must be considered business income.

Functional Test

Because the transactional test requires that the income be derived from transactions occurring in the regular course of the taxpayer's trade or business, it may not extend business treatment to income that is integrally related to the trade or business, but that arises from occasional or extraordinary transactions. Under the functional test however, all income from property is considered business income if the acquisition, management, and disposition of the property was an integral part of the taxpayer's regular business operations. For example, assume that a manufacturer sells equipment that was used in its production process. Because the manufacturer does not regularly sell its equipment, the transaction did not occur in the regular trade or business activity. The transactional test is therefore not met. Because the equipment was used as an integral part of the unitary business activity however, the functional test is met. The income from the sale of the equipment is business income.

In the *Appeal of Borden*, Inc., 77-SBE-007, February 3, 1977, the taxpayer sold all of the tangible and intangible assets of its western district operations. The sale resulted in a $12.8 million loss that was attributable to the western district's goodwill. The taxpayer treated the loss as nonbusiness, allocable entirely to California. Its first argument was that the test for determining business income required that the transactions occur in the regular course of the trade or business. The SBE dismissed this argument by confirming that there are two alternative tests for determining business income, and that the functional test may be applied even if the transactional test is not met.

The taxpayer then argued that the loss did not meet the functional test. Furthermore, it claimed that because no depreciation or other goodwill-related deductions had been charged against business income, the loss from the sale of goodwill should also not be considered to be business income. The SBE found that goodwill was undeniably an important asset of the business and contributed materially to the production of business income. Because the goodwill was acquired and maintained in furtherance of the unitary business activity, the loss on the sale should be treated as business income regardless of whether deductions relating to the goodwill had been claimed.

The long-standing view of the FTB and the SBE is that the transactional test and the functional test are two alternative tests, the satisfaction of either one of which will result in a determination of business income (*Appeal of DPF Inc*., 80-SBE-113, October 28, 1980; *Appeal of Borden, Inc*., 70-SBE-007, February 3, 1977). The California courts had not squarely addressed this point until the decision in *Times-Mirror Co. v. Franchise Tax Board* (1980) 102 Cal.App.3d 872, where the court clearly found the sale of stock of a unitary subsidiary to be business income under a functional test. A transactional test would not have resulted in the same conclusion because the sale of a subsidiary was not a transaction in the regular trade or business of the taxpayer.

Identifying Nonbusiness Income

Specific techniques for identifying nonbusiness issues will vary for the various types of income. In general, you can often spot potential nonbusiness items during the normal audit procedures simply by being alert to activities or income items that seem unusual or unrelated to the taxpayer's trade or business. Some of the best sources for identifying such income or activities are the annual reports, SEC Form 10K's, corporate minutes, "other income" detail to the Form 1120, and Schedule D of the Form 1120.

A nonbusiness determination is based upon the facts of each particular taxpayer. When examining a nonbusiness issue, you should develop as many facts as possible to portray a complete picture of the relationship between the nonbusiness activity and the unitary trade or business. Ask questions to discover why the property or activity was acquired, how it related to the unitary business, and whether that relationship changed over the years.

4012 EARMARKING

As MATM 4010 points out, under the functional test, income from property is considered business income if the acquisition, management, and disposition of the property is an integral part of the taxpayer's regular business operations. In many instances where large amounts of liquid assets are involved it can be difficult for the auditor to determine whether the income derived from such funds qualifies as business income under the functional test or, alternatively, whether the income qualifies as nonbusiness income. As mentioned in MATM 4025, in *Appeal of Cullinet Software, Inc*., 95-SBE-002, May 4, 1995, the SBE held that funds set aside, "earmarked," for a nonbusiness purpose ordinarily generate nonbusiness income. It follows, then, that funds could also be "earmarked" for business purposes. (See CCR §25120(c)(3) Example (C), CCR §25120(c)(4) Example (B).)

From the taxpayer's point of view, the practical purpose of earmarking is to ensure that a source of funds will exist that can be used to pursue a specific endeavor. This endeavor can be either for a business or nonbusiness purpose. Accordingly, earmarking can be seen as a method by which specific funds are identified as those that are intended to be available to further either a future business purpose or a future nonbusiness purpose. The funds are "earmarked" so that they will not be used for other purposes.

A case in point is *Appeal of Consolidated Freightways, Inc*., 2000-SBE-001, September 14, 2000. In that case, the taxpayer sold a unitary subsidiary, invested the proceeds, and eventually classified the assets as long-term investments on its audited financial statements. The taxpayer claimed that it intended to use the funds to acquire another company in the same line of business in order to expand its share in the transportation service industry. Pursuant to its plans to reinvest the sales proceeds, the taxpayer employed a consulting firm to assist it in developing and implementing a redeployment plan. The taxpayer demonstrated that it did investigate several acquisition possibilities and began negotiations with several entities over the years. However, eight years passed before the taxpayer actually used the funds to make an acquisition. FTB took the position that the interest and dividend income earned from investing the funds were nonbusiness because the taxpayer held the funds for an extended period of time without earmarking them for a specific acquisition target.

The SBE found conclusively that the facts established that the taxpayer continuously looked for a complementary business and did ultimately acquire another company in the transportation service industry. The SBE found in favor of the taxpayer, stating that the facts supported a business income finding under the functional test.

The opinion outlines a two-pronged test for business income under the functional test: a working capital test and an earmarked for business purpose test. *Consolidated Freightways* did not meet the working capital test, but did satisfy the earmarked for a business purpose test. The taxpayer failed to meet the working capital test because the funds were well in excess of working capital needs. This was evidenced, among other things, by the taxpayer's transfer of these funds from short-term working capital accounts into longer-term investments, at which point, the funds were reported as "Other Assets" rather than "Current Assets." However, the taxpayer met the functional test because it showed that the long-term purpose for holding the funds was for a specific future expenditure or project, also known as "earmarking". In the SBE's opinion, it is not necessary to have a specific company targeted for acquisition for business income treatment, as long as the funds are readily available for the acquisition, the acquisition is in a specific line of business, and the taxpayer acts consistently with that purpose. Because the taxpayer was engaged in an active, ongoing effort to acquire a complementary business, the SBE found that to be strong evidence that the funds were earmarked for an acquisition target in the transportation industry.

The SBE's decision in *Consolidated Freightways* is consistent with the analysis utilized in FTB Legal Ruling 98-5. This case and FTB Legal Ruling 98-5 both emphasize that the relevant issue is not whether funds, in excess of ordinary business needs, are merely available for use, but whether these funds meet the transactional or functional tests of business income contained in R&TC §25120.

During audit fieldwork, you should gather facts to determine whether certain funds have been earmarked. This is a "facts and circumstances" test, and the facts and circumstances of each case will control the result. However, overall guidance is warranted.

The examination should first focus upon whether the taxpayer has expressed an intent to pursue some future business or nonbusiness objective. Next, you should determine whether the taxpayer specifically identified a source of funds that were to be used to achieve the future objective. Finally, depending upon the amount of time that has lapsed between the date when the taxpayer developed the objective and earmarked the necessary funds, you should determine whether there is evidence that shows that the taxpayer took affirmative steps to pursue its stated objective. If such steps cannot be identified, then the taxpayer has not acted consistently with the stated purpose and earmarking has not been established.

Following, are examples of the types of evidence that may indicate that the taxpayer has earmarked funds for a specific objective. Because, as mentioned above, the facts and circumstances surrounding each case will control, these examples should not be considered all inclusive. Other types of evidence, as noted in MATM 4025, may exist, and these examples are only being provided as guidelines.

- Intent to pursue future business or nonbusiness objective: When reviewing the minutes of the board of directors meetings and internal correspondence, you should take note of discussions involving specific future projects. These will serve as evidence of the taxpayer's intent to pursue the stated objective.
- Specific identification of funds: You should identify whether separate accounts used to achieve the future objective qualifies as earmarking. In addition to this, the taxpayer may reserve a specific portion from an existing pool of funds to be used to achieve the objective. For instance, assume that the taxpayer has a $10 million certificate of deposit: If an internal memorandum states that $5 million from this CD will be used toward a project, then the funds can be considered as being earmarked even though they have not been placed in a separate account.
- Affirmative steps to achieve objective: This will depend upon the type of future endeavor the taxpayer has identified. For example, if the taxpayer has indicated that it wants to construct a new facility, assess whether the taxpayer has begun to identify sites for its new facility. If the taxpayer has indicated that it wants to develop a new product or service, assess whether the taxpayer has commenced the appropriate steps to achieve this objective.

To reiterate, these are merely examples that are intended to be illustrative rather than exhaustive. The types of evidence that you need to gather will depend on the specific identified project. For additional guidance and a more detailed list of potential audit steps, please refer to FTB Legal Ruling 98-5 and MATM 4025.

4013 TAX-MOTIVATED INVESTMENT VEHICLES

A tax-motivated investment involves the acquisition of property or property rights that generate tax benefits for the taxpayer. The tax benefits, rather than the use of the property, are the primary reason for the investment. Hence, the underlying property or property rights are not used or expected to be used in the unitary business, or in any other trade or business of the taxpayer. The leased computers in *Appeal of Fairmont Hotel Co.*, 95-SBE-004, June 29, 1995, are an example of a tax-motivated investment. As demonstrated in *Fairmont*, taxpayers will often seek business treatment of these losses. If you encounter this issue, you may be required to make a determination as to the proper business/nonbusiness income treatment of losses generated by these tax-motivated investments.

In *Fairmont*, a taxpayer that was in the business of managing hotels purchased computer equipment subject to pre-existing triple net leases. Pursuant to the leases, the taxpayer received net rentals in excess of the debt service that, together with investment tax credits and depreciation deductions yielded a significant after-tax cash flow. These were passive investments and the taxpayer had no role in negotiating or administering the leases. The purpose for buying the leased computers was to generate working capital, and the funds generated were actually used to finance the operations of the unitary hotel business during the appeal years. The Board held that the computers served an investment function and not an operational function. According to the Board, if it followed the taxpayer's rationale, then income from virtually any investment would be classified as business income if the proceeds from the investment were put to use in the apportioning business. As the Board explained, that theory had essentially been rejected in *Container Corp. of America v. Franchise*

Tax Board (1983) 463 U.S. 159 103 S. Ct. 2933, 77 L. Ed. 2d 545, because "a mere flow of funds arising out of a passive investment or a distinct business operation" is not sufficient to constitute a unitary business activity. The Board held that this principle was further supported by *Allied-Signal, Inc. v. Director, Division of Taxation (New Jersey)* (1992) 504 U.S. 768, 112 S. Ct. 2251, 119 L. Ed. 2d 533, in which the U.S. Supreme Court held that an asset must serve an operational function, as opposed to an investment function, in order to be considered part of the unitary business.

The *Fairmont* decision will generally control when a taxpayer seeks business income treatment for a tax-motivated investment vehicle. However, taxpayers may argue that business income treatment is appropriate in circumstances that appear to fall outside of the parameters of the Fairmont holding. Taxpayers may attempt to demonstrate that the tax-motivated investment generated short-term cash flow for the apportioning trade or business. In that case, you should consider all items that affect short-term cash flow, taking into account cash outflow related to the investment, debt acquisition, and debt service. A cash flow analysis is not likely to show that a taxpayer's "working capital" was significantly enhanced by a tax motivated transaction, as that transaction is more likely to consume liquidity and cash position than create it.

To illustrate, taking on debt to acquire an asset in a tax motivated transaction may create some cash flow from tax savings. However, the debt is usually much greater than the tax savings generated in the year of acquisition. For example, assume a taxpayer borrows $1,000 to acquire an asset in a tax-motivated transaction that generates a $200 tax deduction. Assume that the combined state and federal tax savings attributable to the deduction is approximately $100. If the taxpayer needed $100 in cash flow, it need have borrowed only $100, not $1,000. Thus, the primary function of the debt is to acquire an asset, not to generate cash flow. In addition, borrowing $1,000 will significantly adversely affect a taxpayer's borrowing capacity, when compared to a $100 loan. Thus, the acquisition of such debt may actually weaken the taxpayer's net capacity to obtain needed cash flow. On the other hand, if the taxpayer spends $1,000 in cash to acquire the asset without incurring debt, it obviously had more than $100 in cash liquidity in the first place.

Thus, tax savings cash flow from such an investment is much closer by analogy to income received from a nonbusiness investment that is later applied to business use. Mere flow of funds from a nonbusiness asset into an apportioning trade or business does not convert the asset into a business asset (*Container Corp. of America* v. Franchise Tax Board (1983) 463 U.S. 159; *Fairmont*, supra.)

Taxpayers also may assert that both the cash flow from the tax-motivated investment and the underlying principal of the investment was intended for future business use. In that case, you should develop information to determine that both the cash flow from the tax motivated investment and recovery of the value of the principal amount of the investment were used in furtherance of the apportioning trade or business for the income to be business income. To constitute a business asset, the asset must constitute an integral part of the taxpayer's apportioning trade or business (R&TC § 25120(a), *Hoechst Celanese v. Franchise Tax Board* (2001) 25 Cal. 4th 508) and must serve an operational function rather than an investment function (*Allied-Signal v. Director, Div. of Taxation* (1992) 504 U.S. 768.

4014 OUT-OF-STATE CASES

Some taxpayers have unsuccessfully cited one or more of the following out of state appellate court decisions in attempting to secure business income treatment of tax benefit generating investments:

- *National Service Industries, Inc. v. North Carolina*, (1990) 98 N.C. App. 504. Taxpayer entered into "safe harbor leases" (as defined in Internal Revenue Code § 168(f)(8)) and treated the attendant losses as business income. The North Carolina Court of Appeals agreed with taxpayer, placing significance on the fact that the investment generated cash flow for business operations, and giving weight to the fact that the investments represented a large portion of the taxpayer's net worth.
- *Eastman Kodak v. South Carolina*, (1992) 308 S.C. 415. Taxpayer entered into "safe harbor lease" and treated the attendant losses as business income. The losses resulted in tax savings. The South Carolina Supreme Court ruled in taxpayer's favor, holding that the magnitude and frequency of the various lease transactions indicated that they were related to the apportioning business, and giving weight to the fact that the funds used to acquire the leases came from the corporate treasury and that no separate staff supervised the investments.
- *Kewanee Industries, Inc. v. New Mexico*, (1993) 114 N.M. 784. Taxpayer leased equipment to an affiliated party. Due to the depreciation expense deduction, the transaction generated net losses that resulted in tax savings. Ultimately, the New Mexico Supreme Court found the leases to be part of the unitary business because they generated substantial capital for the unitary business enterprise. Furthermore, the court found it significant that the leases were ongoing and recurring transactions.
- *American Home Products Corp. v. Limbach*, 49 Ohio St. 3d 158 [551 N.E.2d 201]. The taxpayer in that case devised a formula that calculated the amount of the investment funds in excess of funds actually spent for operations, and treated that excess as "non-unitary" income. The Ohio case does not have precedential value for California. Furthermore, auditors should not use the rationale from the *American Home Products* (AHP) case to support a determination. The Ohio court relied on the U.S. Supreme Court decision in *ASARCO v. Idaho* (1982) 458 U.S. 307, to hold that AHP's corporate independence from the payers of the investment income broke nexus with Ohio for the investment income. Nexus was reestablished for funds that AHP used to foster its interstate business, but AHP proved a lack of need for the excess funds. The department's position is that *ASARCO* is materially distinguishable because the investment held by ASARCO was a 51.5 percent interest in a nonunitary subsidiary rather than a liquid investment. Also, the constitutional constraints on a state's right to tax income as outlined in ASARCO have been clarified to some extent by the U.S. Supreme Court in *Allied Signal v. Director* (1992 U.S. [112 S.Ct. 251]). In *Allied Signal*, the Court held that income can be included in the apportionment base if the capital transaction served an operational rather than investment function. Finally, the formula used in the AHP decision does not realistically represent business needs. For example, the AHP formula does not take into account inventory or accounts receivable turnover, contingencies such as a downturn in the economy, plant expansion or future R&D, or the fact that lenders look at working capital as the ability of the borrower to make timely loan repayments.

- *Lenox, Inc. v. Tolson* (2001) 353 N.C. 659; *Texaco-Cities Service Pipeline Co. v. McGaw* (1998) 182 Ill.2d 262 [695 N.E.2d 481]; *Laurel Pipe Line Co. v. Commonwealth* (1994) 537 Pa. 205 [642 A.2d 472]; *Welded Tube Co. v. Commonwealth* (Pa. Commw. Ct. 1986) 101 Pa.Commw. 32 [515 A.2d 988]; *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue* (1975) 88 N.M. 521 [543 P.2d 489].) In recent years, some taxpayers have argued, and some states have agreed, that any sale of assets that represents a cessation of the taxpayer's trade or business, in whole or in part, should not be subject to the functional test. Proponents of this "cessation-of-business" concept advocate that, instead, a "totality of the circumstances" test be applied to characterize the gains from any such sales. However, when one examines the roots and development of the "cessation-of-business" concept, and its "totality of the circumstances" test, it becomes clear that they are really based on the transactional test, not the functional test. As a result, they are an improper replacement for the functional test in states that recognize the validity of that test, which include California. Moreover, in *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal.4th 508, cert. den. November 26, 2001, the California Supreme Court relied heavily on Holly Sugar Corp. v. Johnson (1941) 18 Cal.2d 218 (a pre-UDITPA case in which the California Supreme Court held that the sale of a unitary subsidiary generated business income), to explain that any gain on the sale of a business asset constitutes business income. As a result, the "cessation-of-business" concept and the *Lenox* case have no validity in California.

The cases discussed above are not controlling for California purposes, for three reasons.

- First, they are out-of-state cases, and thus are not binding authority.
- Second, two of the cases (*National Service Industries* and *Eastman Kodak*) deal with safe harbor leases. Safe harbor leases are investment vehicles that are not recognized under California law, and most safe harbor lease transactions permitted essentially a "sale" of tax benefits, without significant risk or economic reality.
- Finally, the cases are conceptually flawed, because they are based in part on the magnitude and/or the frequency of the transactions in question.

These considerations are not the proper focus of inquiry under the transactional or functional tests of UDITPA, nor would an analysis based on them pass constitutional muster under *Allied Signal*. (*Allied-Signal Inc. v. New Jersey* (1992) 119 L.Ed.2d 533, 550.) The fact that acquisitions occur with some frequency or are large in size does not by itself establish that the assets are acquired in the regular course of the taxpayer's apportioning trade or business, or are integral parts of the taxpayer's apportioning trade or business within the meaning of R&TC § 25120(a).

4015 CONVERSION FROM BUSINESS TO NONBUSINESS INCOME

Items of income may, over time or because of changed circumstances, change their character between business and nonbusiness. The types of income that are most likely to change character are rental income and gains and losses from sales of assets. CCR § 25120(c)(1) indicates that rental income from real and tangible personal property is business income when the property is includable in the property factor. CCR § 25120(c)(2) provides that gain or loss from sales of real or tangible or intangible personal property will be nonbusiness if the property was used for the production of nonbusiness income or otherwise was removed from the property factor before its sale. The reference to the property factor in both of these rules has been interpreted by the SBE to imply that the rules for exclusion of property from the property factor can serve as a guide for determining when income related to that property is nonbusiness.

CCR § 25129(b) provides that property is includable in the property factor if it is actually used or is available for or capable of being used during the taxable year in the regular course of the trade or business. Once property is used in the trade or business, it remains in the property factor until its permanent withdrawal is established by an identifiable event. Property that is temporarily idle is still available for use, as is property that is being held for sale. If idle property held for sale has not been sold after an extended period of time (the regulations suggest five years), then it will be removed from the property factor. (See MATM 7140 for further discussion of these concepts.)

CCR § 25120(c)(1) contains the following examples of when property converts from business to nonbusiness use:

Example

The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business income.

Example

The taxpayer operates a multistate chain of grocery stores. It owned an office building that it occupied as its corporate headquarters. Because of inadequate space, the taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The old building was rented to an investment company under a five-year lease. Upon expiration of the lease, the taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

The following cases also help to illustrate the criteria that is relevant for determining whether business property has been converted to nonbusiness use:

In the *Appeal of Ethyl Corporation*, 75-SBE-014, March 18, 1975, the taxpayer sold a plant that had been idle and partially dismantled for a period of time. The SBE first addressed the issue of whether the plant was properly includable in the property factor prior to its sale. Although it would only have been economically feasible to resume operations at the plant under certain unusual conditions, the fact remained that the plant was available for limited use in the unitary business, and was capable of such use. Therefore, the SBE held that it was includable in the property factor.

In addressing the issue of whether the gain from the sale of the plant was business or nonbusiness income, the SBE referred to its analysis of the property factor issue and concluded that since the plant had not been permanently withdrawn from unitary use, the gain was unitary business income.

Although this was a pre-UDITPA case, the same conclusions would be applicable under current law.

In the *Appeal of Thor Power Tool Company*, 80-SBE-032 April 8, 1980, the taxpayer closed one of its manufacturing plants and then held the property for sale. Since the building was deteriorated, the taxpayer demolished it to facilitate the sale of the land. The land was sold in the following year at a gain. The taxpayer argued that the gain should be treated as business income, but the FTB determined that the property had been converted to nonbusiness use when the plant was demolished.

The SBE agreed with the taxpayer, stating that the land and building had been consistently used in the taxpayer's trade or business from the time of acquisition, and although the building had been demolished, the land could still have been put to use in the unitary business. The SBE pointed out that it did not consider the examples in the regulations of identifiable events sufficient to cause property to be permanently withdrawn from the property factor to be all-inclusive. Nevertheless, it did not conclude that an identifiable event of the type contemplated by the regulations had occurred with respect to the land prior to its sale.

The *Appeal of Nicholas Turkey Breeding Farms, Inc*., 87-SBE-038, May 7, 1987, involved whether income received from the rental and sale of former turkey farms was nonbusiness. The taxpayer was engaged in the turkey breeding business in California and South Carolina that involved the sale of eggs and the "growing out" of surplus stock for meat. Its four South Carolina farms had been operated as part of the business until operations were terminated due to ineradicable diseases that were affecting the production. The taxpayer moved the salvageable portions of those operations to California and leased the four farms to third parties, who used them to raise turkeys for meat. Each lease gave the lessee an option to purchase the property, and each option was eventually exercised. The taxpayer treated the rental income and the gains from the sale of the farms as nonbusiness on the theory that the leases had converted the farms into nonbusiness assets.

The SBE agreed with this treatment, holding that the farms began producing nonbusiness income when they were leased out to other parties, and that they should have been withdrawn from the property factor at that time. The disease had made the farms unusable for producing eggs, the taxpayer's principal product. Although meat production was still possible, the SBE stated that the property must be usable by the *taxpayer* in its own trade or business. When the farms were leased to third parties, they were no longer available for use in the taxpayer's turkey breeding business, and their permanent withdrawal from the business was established.

In *Appeal of Masonite Corporation*, 87-SBE-018, March 3, 1987; Opinion and Order Denying Petition for Rehearing, 11/15/88, the issue was whether income received by the taxpayer from production of oil on its timberlands constituted business income. The taxpayer was engaged in the unitary business of manufacturing and selling building materials, primarily hardboard. It owned large tracts of timberland for the purpose of having a secure source of raw wood materials for its business. Oil was discovered on some of those timberlands, and the taxpayer derived royalty income from its producing mineral rights. The taxpayer treated the royalty income as nonbusiness, arguing that it was unrelated to its unitary hardboard business.

The SBE agreed with the nonbusiness treatment, pointing out that although the oil royalty income had its source in timberlands originally purchased for future use in the unitary business, the crucial factor was that the income was generated through operations conducted entirely independently of the unitary business. Another factor supporting the SBE's conclusion was the fact that each oil well rendered approximately three acres of surrounding land unsuitable for timber production. Those portions of land ceased to be unitary assets when they were converted to the nonbusiness production of oil, and should have been removed from the property factor at that time.

The SBE also rejected the FTB's argument that the royalties were incidental to the unitary business and should therefore be treated as business income. Since the income was classifiable as nonbusiness income under the statutory tests, and since there was no problem with segregating the oil royalties and factors from the income and factors of the unitary business, the SBE concluded that the royalties could only be classified as nonbusiness income.

The *Appeal of Trus-Joist Corporation*, 84-SBE-116, August 1, 1984 also deals with the issue of business property, which had been converted, to nonbusiness use. In that case, the nonbusiness use consisted of a series of sub-leases.

Appellant entered into a 15-year lease of real property in Cucamonga, California. The lease provided an option to purchase, exercisable only during specified intervals. The property was used in appellant's business for a short time at the beginning of the lease term, but it was later sublet to an unrelated company. The sublease apparently contained an option to purchase the property from appellant. Thereafter, the property was sublet at various times to unrelated tenants. Except for one short-term month-to-month tenancy, all of the subleases contained similar options to purchase. The original lessor acted as real estate broker, attempting to sell the property from the time appellant vacated.

During all the appeal years, appellant included the rental income from the property as apportionable business income on its franchise tax returns. It also reported the gain on the sale of the property as business income on its 1976 return.

The Franchise Tax Board determined that the Cucamonga property had been permanently withdrawn from the property factor at least as early as 1974. Therefore, it treated income and the gain on the sale as nonbusiness and eliminated the property from the calculation of the property factor for the appeal years.

Because the property began producing nonbusiness income and should have been withdrawn from the property factor before 1974, both the rental income produced during the appeal years and the gain on the sale were correctly characterized by the taxpayer as nonbusiness income, allocable entirely to California.

The SBE concluded that the taxpayer's Cucamonga property began producing nonbusiness income, and should have been withdrawn from the property factor, before 1974. Although the property was used in appellant's unitary business for a short time, beginning in 1968 it was fairly continuously leased to unrelated parties and was, at all times, held for sale.

4020 DIVIDEND INCOME

The classification of dividend income as business or nonbusiness is discussed in CCR § 25120(c)(4). Applying the transactional and functional tests (MATM 4010) to dividend income, dividends will be business income when:

- The stock was acquired in the regular course of the taxpayer's trade or business operations, or
- The purpose for acquiring and holding the stock is integrally related to the trade or business operations (see *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal. 4th 508, cert. den. November 26, 2001; *Allied-Signal, Inc*. (1992) 504 U.S. 768).

R&TC § 25126 provides that nonbusiness dividend income is allocated to the state of the taxpayer's commercial domicile (see MATM 1500 for the definition of commercial domicile).

Under these guidelines, dividends will clearly be considered business income when a stockbroker holds the stock from which those dividends are derived in the ordinary course of business. Dividends may also be business income if they are derived from stock held as current assets or excess working capital (for an analysis of this point in the context of interest, see MATM 4025). Additionally, dividends have been considered to be business income when the stock is held for a purpose that furthers the unitary business operations, such as when stock of a supplier is held to ensure a steady source of raw materials (*Appeal of Standard Oil Company of California*, 83-SBE-068, March 2, 1983). Another example is where stock is held to further a technical service agreement that plays an operational function in the taxpayer's trade or business. Nonbusiness treatment of dividends is generally warranted only when the stock is held as an investment unrelated to the unitary trade or business activities. CCR § 25120(c)(4) contains several examples illustrating when dividends may be considered business or nonbusiness income.

The following decisions illustrate the analysis used to determine whether dividends are business or nonbusiness income. Because this issue is very similar to the issue of whether gain or loss from the sale of stock is business income, the cases discussed in MATM 4030 may also be applicable.

In *Appeal of Standard Oil Company of California*, 83-SBE-068, March 2, 1983, the SBE 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. The purpose for creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to insure an available supply of crude oil and natural gas. This was an essential element in the taxpayer's worldwide petroleum operations. The dividends were therefore found to be business income.

In *Appeal of Twentieth Century-Fox Film Corporation*, 89-SBE-007, March 2, 1989, the SBE interpreted and applied FTB's current CCR §25120(c)(4) and concluded that dividends received by the taxpayer were nonbusiness income. The taxpayer, a major producer and distributor of motion pictures and television programs, acquired a regional soft drink bottler. The taxpayer had originally filed a combined report which included the soft drink bottler, and which reflected the elimination of a dividend received from the soft drink bottler pursuant to R&TC § 25106. As a result of a determination by the SBE that the soft drink bottler was not unitary with the taxpayer, the corporations were decombined, and the dividend was no longer eliminated. The taxpayer's alternative argument was that the dividend should be treated as business income based upon its interpretation of the functional test. The taxpayer advocated the position that the functional test was met so long as it became involved in the activities of the dividend-paying subsidiaries in ways that went significantly beyond what an ordinary investor would do.

The SBE rejected the taxpayer's interpretation of the functional test as far too broad. The SBE went on to state that the proper test was whether there is an integral relationship between the stockholding and the taxpayer's trade or business. In this case, the SBE found no evidence that the soft drink bottler was acquired and managed as anything more than an investment, and specifically noted that the mere flow of funds between the entities was not sufficient to make the stock integrally related to the taxpayer's trade or business. The dividends were determined to be nonbusiness.

In *F.W. Woolworth Co. v. New Mexico* (1982) 458 U.S. 354, the U.S. Supreme Court stated that the mere potential to operate a company as part of a unitary business will not necessarily result in the business characterization of the dividends if the company is in fact operated as an unrelated business enterprise. In *Allied Signal v. Director, Division of Taxation* (1992) U.S. [112 S. Ct. 2251], however, the U.S. Supreme Court clarified that the payee and payor of a dividend need not be engaged in the same unitary business as a prerequisite to apportionment of the dividend income in all cases, so long as the holding of the stock served an operational rather than an investment function. Restating its previous position, the Court stated that in order to exclude certain income from the apportionment formula, the taxpayer must prove that the income was earned in the course of activities unrelated to those carried out in the taxing state (*Exxon Corp. v. Wisconsin Dept. of Revenue* (1980) 447 U.S. 207; *Mobil Oil Corp. v. Commissioner of Taxes* (1980) 445 U.S. 425).

Identifying Nonbusiness Dividend Issues

When analyzing the Federal 1120 Schedule C to determine the appropriate California dividend deductions (see MATM 6030 - MATM 6036), you should consider the nature or character of the dividends and the purpose of the stockholdings in order to determine whether a possible nonbusiness issue exists.

In those situations where business income characterization is based on the business purpose of the stockholding, the business purpose will need to be established. All facts supporting the business relationship between the payee and payor must be developed at audit. Many of the techniques discussed in MATM 3500 - MATM 3595 with respect to developing facts related to unitary relationships may be applicable for developing this issue as well.

4025 INTEREST INCOME

The classification of interest income as business or nonbusiness is discussed in CCR §25120(c)(3). The regulation states that interest income will be business income where the intangible, which generated the interest, was received or was created in the regular course of the taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangible is related to or incidental to the trade or business operations.

R&TC § 25126 provides that nonbusiness interest income is allocated to the state of the taxpayer's commercial domicile (see MATM 1500 for the definition of commercial domicile).

One of the keys to determining the proper classification of interest income is understanding that the controlling factor is the purpose for which the interest-bearing fund is established or the use to which the fund or account is put. If the fund is established for an identifiable business purpose, the source of the funds deposited into the interest-bearing account is irrelevant, as is the use to which the interest income is ultimately put.

Notes and accounts receivables from customers arise out of the regular trade or business operations, therefore interest income generated by those notes and receivables are business income. Many taxpayers will deposit funds into special accounts to cover items such as workers' compensation claims, self-insurance or machinery replacement. As long as the purpose for these funds is related to the trade or business activity, any interest or dividend income generated will be business income. Likewise, interest income earned from items such as federal tax refunds and court judgments arising from the business operations will be business income.

CCR § 25120(c)(3) contains examples of the application of these concepts. The following decisions also illustrate how the SBE has distinguished between business and nonbusiness interest income.

In the *Appeal of Cullinet Software, Inc*., 95-SBE-002., May 4, 1995, the taxpayer was in the business of designing, developing, and marketing computer programs. The taxpayer made stock offerings that 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 complementary [sic] to the Company's business." A short time after the offerings, substantially all the funds were contributed to separate subsidiaries. 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. Intercompany transactions involving one of the subsidiary's funds suggest that the funds were used as working capital during the appeal period.

The taxpayer argued that the income from the funds must be classified as nonbusiness income because until the subsidiaries decided how to invest the funds, there was not a certainty that the funds would be used in the unitary business. The SBE disagreed, stating that "idle funds invested in liquid financial instruments are part of a unitary business's working capital pool, and thus generate business income, 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." In this case, there was no such segregation or earmarking, and it was clear that the proceeds from the stock offerings were, in fact, at all times held readily available for any use in the unitary business which might have arisen during the appeal years. The income earned on those investments, therefore, constituted business income.

When read on its facts, *Cullinet* is properly considered a burden of proof case. The Board specifically found that the taxpayer had earmarked the funds at issue to acquire companies and products similar or complementary to the taxpayer's unitary business. The Board found no evidence that the taxpayer acquired any companies or products with those funds, or that the taxpayer even investigated any such new purchases. Instead, the Board pointed out that (1) "intercompany transactions "suggested the funds contributed to one subsidiary were used as working capital, and (2) "no proof" was presented that the funds contributed to the other subsidiary were *not* used as working capital (in fact, the Board noted that "it is admitted that [the funds] were available for use in appellant's regular business operations, if and when needed"). The Board further stated that it had "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."

As explained in Legal Ruling 98-5, some have interpreted the language used by the Board in *Cullinet* as creating an "available for use" test of business income. Any implication in *Cullinet* that a liquid asset produces business income merely because it has the potential to be used in the trade or business, however, is not consistent with the language of the statute or CCR § 25120(c)(3) and (4), which for business treatment require that (a) the intangible with respect to which the interest or dividend was receive must have arisen out of or have been created in the regular course of the taxpayer's trade or business operations, or (b) must have had a purpose for acquiring and holding the intangible that is related to or incidental to the trade or business operations. Contrasting CCR §25120, subdivisions (c)(3) Example (A) (interest income from accounts receivable), Example (C) (interest from special accounts for insurance or machinery replacement, and (c)(4) Example (F) (portfolio of stock and interest-bearing securities unrelated to the unitary business) clearly demonstrates that the regulation contemplates the generation of business or nonbusiness income from liquid investments. Moreover, the broad proposition of an "available for business use" test in and of itself raises concerns under the "potentiality doctrine" of *F.W. Woolworth v. Taxation & Revenue Department* (1982) 458 U.S. 354, 362. Thus, there is no support in the statute, regulations, or case law for the proposition that funds, in merely being available for business use, should always be characterized as business income: Given the fungibility of money, funds available for business use are likewise available for nonbusiness use. Rather, the facts of a particular case ultimately control resolution of the question of how income should be properly characterized under either the functional or transactional tests for business income. Accordingly, auditors should analyze whether the funds are needed for the taxpayer's current business cycle needs or have been identified for future business needs. To the extent that funds can be identified as in excess of any business need or contingency, the functional and transactional tests of business income have not been satisfied. Thus, the income from such funds clearly is not business income.

Although the fact that a taxpayer holds funds in liquid investments available for use in the unitary business is an indication supporting business income treatment, the mere fact that the funds are available for use, in and of itself, is not a valid separate indication of business income supported by statute or regulation.

See Legal Ruling 98-5 for detailed discussion of this topic.

CCR §25120(a) provides, in part, that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Under California law, a presumption stands as proof of the presumed fact only until such time as sufficient contrary evidence is introduced to rebut the presumption, at which time the presumption "disappears." In other words, the regulatory presumption does not end the inquiry, but serves to determine which party has the burden of proof to introduce evidence in support of its position. Once this has been done, the burden of proof shifts again. Once all evidence has been gathered, the State Board of Equalization or the courts must weigh the totality of the evidence and come to a conclusion. See Evid. Code § 604, subd. (a), or *Appeal of Sierra Production Services*, 90-SBE-010, Sept. 12, 1990, for additional discussion of the presumption.

In the *Appeal of Beck Industries*, Inc., 82-SBE-257, November 17, 1982, the issue was whether interest income from certificates of deposit (CDs) was properly treated by the taxpayer as nonbusiness income. The taxpayer was primarily engaged in the manufacture and retail sale of shoes, apparel and furniture, and the operation of discount department stores. Pursuant to bankruptcy proceedings, the taxpayer had received substantial sums of cash from the sale of subsidiary stock and from the sale of discontinued business interests. The Bankruptcy Court had directed that the funds be segregated pending a determination by the court regarding the feasibility of reorganizing the taxpayer. The segregated funds were invested in CDs, the interest income from which was treated as nonbusiness by the taxpayer.

The FTB auditor reclassified the interest as business income. This position was based on the fact that the funds were segregated and invested at the direction of the Bankruptcy Court, and the purpose of the bankruptcy proceedings was to enable the corporation to continue its operations through rehabilitation of its affairs under the scrutiny and direction of the court. The SBE agreed with this basic premise, but noted that the conclusion of business income did not necessarily follow.

The SBE ruled that the FTB's position was erroneous in that it focused upon the relationship of the CDs with the taxpayer's corporate existence. The proper criteria for determining the business or nonbusiness character of the income was held to be the relationship between the CDs and the taxpayer's particular trade or business activity. Because the purpose for acquiring and holding the CDs had no relationship to the manufacturing and retail business, the interest was held to be nonbusiness income.

The *Appeal of American Medical Buildings*, *Inc*., 86-SBE-105, June 10, 1986 involved the classification of interest income from investments in marketable securities by a taxpayer engaged in the design, construction, and development of medical buildings. The taxpayer had raised $3.3 million through sale of its common stock: $2.2 million of these proceeds were invested in short-term investments pending a decision as to how the funds should be used. The following year, the taxpayer made a $10 million public bond offering, the stated purpose of which was to fund a wholly owned finance subsidiary to make loans to construct the medical buildings developed by the taxpayer. Over $8 million of these proceeds were distributed to the subsidiary. During the taxable years at issue, both the parent and subsidiary had invested their proceeds in marketable securities.

The taxpayer treated the interest income from its investments in marketable securities as nonbusiness on the grounds that the sale of the stock and the issuance of the bonds were unrelated to the development of medical buildings. The SBE rejected this argument, stating that the relevant inquiry was whether the transactional or functional tests had been met. The finance subsidiary had been formed to benefit the unitary business during a time of rising interest rates by supplementing or replacing the traditional funding of the construction projects. The SBE found that the acquisition of the capital was very much related to the unitary construction business. Additionally, the funds were managed in a way that benefited the unitary business because they were invested in short-term securities, which made them easily accessible for distribution as loans if needed. The readily available funds could also have given the sales staff leverage over a balking customer by allowing them to offer less expensive financing for new projects. Because the purpose for acquiring and holding the intangibles was related to the trade or business, the SBE concluded that the interest was business income.

In the *Appeal of Inco Express, Inc*., 87-SBE-016, March 3, 1987, the taxpayer had been retaining its earnings so that it would not need to borrow money at high interest rates, and also because it intended to eventually purchase land for expansion of the business. The cash was invested in short-term certificates of deposit when it was not being used in the business. During the taxable year at issue, the taxpayer purchased land using the cash that it had accumulated, and the land was treated as nonbusiness because it was not yet ready to be used in the unitary trade or business. The taxpayer also treated the interest income earned from its short-term investments as nonbusiness on the grounds that it had been earmarked for the purchase of a nonbusiness asset, and was in fact used for that reason.

The SBE rejected the taxpayer's argument, stating that the relevant inquiry was not what was purchased with the income, but whether the intangible that created the income was related to the taxpayer's unitary business. Short-term investments made to maximize the income of what would otherwise be idle funds are prudent and customary corporate money management. The SBE found that this taxpayer's investments arose in the regular course of its business, and were acquired, managed, and disposed of as integral parts of the regular business operations. Therefore, the interest generated from those investments was ruled to be business income.

In the *Appeal of R.H. Macy & Co., Inc*., 88-SBE-020, July 26, 1988, the taxpayer earned substantial amounts of interest income from a variety of short-term securities. The amount of money invested varied throughout the year depending upon the seasonal cash needs of the taxpayer's department store business. When cash needs increased, the taxpayer would sell sufficient securities to provide the needed cash. The taxpayer treated the interest from those investments as nonbusiness on the basis that the cash reserves were due to management's investment philosophy rather than due to the needs of the business because it easily could have borrowed the money to meet seasonal cash flow needs. The SBE interpreted this argument to imply that, absent an absolute business necessity, funds invested outside the taxpayer's business pending their use in the business do not produce business income. The SBE rejected this argument, stating that both the transactional and functional tests had been met, and there is no basis for a different result based on whether the investments are made because of business necessity or investment philosophy. The interest was found to be business income.

In the *Appeal of Armour Oil Company*, 86-SBE-106, June 10, 1986, the taxpayer earned interest income on promissory notes. The notes were obtained through the sale of nonunitary subsidiaries, which were owned separately by the Armour children. An unrelated third party that had business connections with Armour purchased the closely held, nonunitary corporations for cash and a series of promissory notes. The notes were placed in trusts for the Armour children. Subsequently, the notes were purchased from the trusts by the taxpayer. During the appeal years, the taxpayer reported the interest income from the trusts as business income subject to apportionment. Upon audit, the Franchise Board determined that the income was nonbusiness allocable to California, the taxpayer's commercial domicile.

Armour argued that the notes were purchased for a business purpose and were an integral part of the business. The SBE found Amour's contention unpersuasive as its argument did not correspond with the facts presented in the record. Armour's argument failed because it attempted to frame the argument in terms of a legal question without first establishing the factual basis for the legal inquiry. There was no evidence provided that showed the value of the taxpayer's business relationship with the third party to the taxpayer's business operation.

The SBE found that Amour failed to prove that the purchase and holding of the notes

occurred in the regular course of its trade or business or that the notes were an integral part of its unitary business operations. As Amour failed to satisfy its burden of proving that the notes were related to its trade or business under either test, it follows that the interest generated from the notes was nonbusiness income rather than business income.

Working Capital Analysis

Investment of temporarily idle cash in marketable securities or other liquid investments will result in business interest income when the purpose of the investments is to maximize income pending the use of the cash in the unitary business (see *Appeals of American Medical Buildings, Inco Express, and R.H. Macy & Co.*, above). Occasionally, taxpayers will claim nonbusiness treatment for interest or dividend income arising from investments of surplus cash that arguably exceed their expected business cash requirements. As stated in CCR §25120(a), income is business income unless clearly classifiable as nonbusiness income. Therefore, taxpayers should be asked to substantiate the nonbusiness portion of their investments. An analysis of the working capital requirements of the business will usually need to be performed to evaluate how much of the interest-producing intangibles are reasonably necessary to meet business needs in the near future.

The "Bardahl" formula originally developed in *Bardahl Mfg. Corp*. (24 TCM 1030) is one method for computing working capital requirements that also takes into account any anticipated extraordinary operating expenses. A set of standard audit schedules that perform this calculation is available on PASS. When applying this formula, you need to be careful not to overlook business reasons for accumulating cash in excess of the normal working capital needs for the operating cycle. For example, a computer manufacturer may accumulate earnings over several years to have the cash necessary when the time comes to launch a new generation of computers. Taxpayers may also accumulate funds to pay anticipated court awards, for business expansion, and for various other reasons.

Once the scoping process is completed and a commitment has been made to audit the issue, you can explore numerous areas to develop the facts of a particular case.

HOW DID TAXPAYER FILE

The fact gathering process should include an explanation from the taxpayer regarding why the return was filed in the manner reported. In some cases, this explanation could provide significant insight into the taxpayer's reasoning for treating the income in the manner reported and might dictate a different approach to the fact gathering process than originally planned. For example, an admission by the taxpayer that the funds are for business needs but were reported as nonbusiness because State X required that they be reported in this manner could eliminate a substantial amount of audit work, simply because such an admission per se is strong evidence of the correct characterization of the funds under examination.

REASONABLE NEEDS OF THE BUSINESS: EARMARKING OF FUNDS

To classify income as business income, the capital requirements of funds invested in liquid assets should be for the reasonable needs of the business, taking into account both current and future business needs.

In addition, a taxpayer's substantiated specific earmarking of funds for a specific purpose, in most cases, will be controlling in determining business or nonbusiness income. An absence of earmarking of funds, however, is not the sole criteria for determination.

Suggested audit approaches:

- Ask the taxpayer to substantiate earmarking of funds; however, factual gathering should not be limited solely to this item.
- Obtain cash forecast projections from the treasury department.
- Interview appropriate people handling cash forecasts.
- Conduct a financial statement analysis using the Bardahl formula.
- Review cash needs for dividend purposes. Historical payment of dividends might be used to determine potential for current dividend needs.

- Review corporate minutes, including the Board of Director's minutes, committee minutes, and any other director committee minutes dealing with finance and budgeting.
- Review long- and short-term business plans.
- Analyze capital structure to determine how the business is funding its operations.
- Review annual reports and SEC 10-Ks, including footnotes and management discussion of operations, which may disclose restricted retained earnings and contingent liabilities.
- Review loan documents that may provide restrictions or covenants, such as a requirement that the working capital ratio never go below two to one.
- Review all SEC filings.
- Review prospectuses for any public offering or debt.
- Review news articles that may identify leads on future expansion, research and development costs, marketing cost, liabilities, etc.

Once you have gathered and evaluated this information, the Bardahl schedules may be used to determine whether excess working capital exists. The result of the Bardahl formula should not be thought of as the "correct" answer, however. The Bardahl formula may not work for all industries or taxpayers. Either you or the taxpayer may use more sophisticated financial analysis to prove excess working capital. The key issue is one of substantiation. For example, assume the taxpayer alleges that it properly classified income as nonbusiness income because the fund generating the income was excess working capital not needed in the unitary business. You compute the Bardahl formula and determine that the taxpayer does not have excess working capital. You can provide the Bardahl computation to the taxpayer and request the taxpayer to provide some other evidence of the amount, if any, of excess working capital. You must evaluate any information provided by the taxpayer in making the final audit recommendation.

4030 GAIN OR LOSS FROM SALE OF STOCK

The issue of whether gain or loss from the sale of stock is business or nonbusiness income is identical to the issue of whether dividends from such stock are business or nonbusiness income. For both dividend and stock gain income, the determination of business or nonbusiness treatment will be based upon whether the stock was acquired in the regular course of the taxpayer's trade or business operations (the transactional test), or whether the purpose for acquiring and holding the stock is integrally related to the trade or business operations (the functional test). The analysis under MATM 4020 will be applicable to this issue.

Pursuant to R&TC § 25125, nonbusiness capital gains and losses from sales of stock and other intangible property are allocated to the state in which the taxpayer is commercially domiciled. (See MATM 1500 for the definition of commercial domicile).

The *Appeal of General Dynamics Corporation,* 750-SBE-63, June 3, 1975, summarized in MATM 4010, provides an example of when gain from the sale of stock was held to be business income under the transactional test. The following cases illustrate application of the functional test to gain or loss from stock sales.

In *Times-Mirror Co. v. Franchise Tax Board*, (1980) 102 Cal.App.3d 872, the taxpayer sold the stock of a unitary subsidiary, and treated the gain on the sale of the stock as business income. The FTB determined that the gain was nonbusiness based upon pre-UDITPA standards and the regulations (now repealed) under R&TC § 25120. The Court rejected this argument, concluding that under the tests imposed by the statute, and the stipulations by FTB which conceded that "the facts precisely met the statutory definition of business income in section 25120, subdivision (a)," gain from the sale of stock of a unitary subsidiary was business income as a matter of law.

In *Appeal of Occidental Petroleum Corporation*, 83-SBE-119, June 21, 1983, the taxpayer sold stock in five different corporations, each of which was in some way related to the taxpayer's effort to expand and consolidate its basic unitary business involving natural resources and energy sources. The taxpayer acquired 20 percent of the stock of KCL in an unsuccessful effort to acquire the company and combine KCL's petroleum operations into its own. A relatively small amount of stock in Island Creek Coal Co. was acquired for the purpose of impressing Island Creek's management with the sincerity of the taxpayer's interest in acquiring the company. The stock was sold in order to complete a merger of Island Creek and the taxpayer as a tax-free reorganization. Cofesa, Waiawa Realty Co., and Oxytrol were all unitary subsidiaries, the stocks of which were sold for various reasons. The taxpayer treated the gains and losses from each of these stock sales as business income. The SBE confirmed that 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 unitary business operations. With respect to the sales of Cofesa, Waiawa, and Oxytrol stock, the SBE found that the stock had been acquired and managed in furtherance of the unitary business. Furthermore, at the time that the decisions to sell the stock were made, the assets and activities represented by the stock were fully integrated and functioning parts of the existing unitary business. The gain from the sale of the Cofesa, Waiawa and Oxytrol stock was business income. Although the taxpayer had intended to integrate KCL and Island Creek into its business operations, no such integration had taken place by the dates of the stock sales. The SBE held that mere potential to become an integral part of the unitary business was insufficient to support a finding that the gains and losses from the stock sales were business income, therefore those gains were nonbusiness. It is also noteworthy that the SBE commented upon the dictum in *Times-Mirror*, stating in a footnote that they did not agree that any particular significance should be attached to the taxpayer's eventual use of the proceeds from the stock sales. The SBE explained that the moment of judgment will generally be when the decision to sell is made. If the stock is an integral part of the taxpayer's unitary business at that moment, the gain or loss will be business income.

The *Appeal of Sundstrand Corporation*, 86-SBE-122, June 10, 1986, also involved a situation where the intended integration of an acquired subsidiary into the unitary business never materialized. Neither the functional nor the transactional tests were determined to have been met, and the subsequent sale of stock was held to be nonbusiness.

In 2001, the California Supreme Court in *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal. 4th 508 supported the department's view that liquidation gains can constitute business income under the functional test. Although Hoechst Celanese itself did not involve the liquidation of a subsidiary, the court interpreted the functional test by quoting and relying on a case that did involve such a liquidation. The term " integral" used in Hoechst Celanese came from the decision of *Holly Sugar Corp. V. Johnson* (1941) 18 Cal.2d 218. The court in Holly Sugar held that losses suffered by a taxpayer from the forced liquidation of stock were apportionable because "the stockholding was an integral part of the taxpayer's unitary sugar business". Accordingly, there should not be an analytical distinction between a liquidation sale of a single asset and a liquidation sale of a collection of assets such as a division or subsidiary stock. A corporation that decides to liquidate a portion of its business, such as a corporate division, by sale for cash or other value has made the same determination that such portion of the business is no longer "essential" to its operations. Thus, *Celanese* supports the proposition that liquidation gain or loss should be treated no differently than any gain or loss of any business asset under the functional test. See MATM 4035 for a discussion of additional cases in the context of the cessation of a business.

Material sales of stock may often be identified by a review of the federal Schedule D (capital gains schedule). When analyzing the treatment of stock sales, the auditor should be sure to consider whether federal/state basis differences have been properly taken into account in the computation of the gain or loss (MATM 6095).

4035 Gain or Loss from Sale of Assets Other Than Stock

CCR § 25120(c)(2) provides that gain or loss from sales of property constitute business income if the property was used in the unitary trade or business while owned by the taxpayer. Gain or loss will be nonbusiness if the property was used for the production of nonbusiness income or was otherwise removed from the property factor before its disposition. Unless an identifiable event has taken place to establish the permanent withdrawal of property from the unitary business however, the fact that it is temporarily idle or held for sale will not be sufficient to cause the gain to be nonbusiness (see MATM 4015). The regulation includes some examples of when gains or losses on sales of assets are treated as business or nonbusiness income. The *Appeal of W.J. Voit Rubber*, 64-SBE-048, May 12, 1964, is a widely cited decision that also addresses this issue.

Pursuant to R&TC § 25125, nonbusiness capital gains and losses are allocated as follows:

- Gains and losses from sales of real property are allocable to the state in which the property is located.
- Gains and losses from sales of tangible personal property are allocated (1) to the state in which the property had a situs, or if the taxpayer is not taxable in that state, (2) the taxpayer's commercial domicile. (See MATM 1500 for the definition of commercial domicile.)
- Gains and losses from sales of intangible property (other than partnership interests see MATM 4040) are allocated to the state of the taxpayer's commercial domicile.

Material sales or other dispositions of assets may be identified by a review of the federal Schedule D (capital gains schedule). You should ensure that any gains or losses from the disposition of property are given business or nonbusiness treatment consistent with the treatment of any income (such as rents or royalties) generated by the property prior to its disposition. When business/nonbusiness determinations are an issue, the gains or losses involved are generally material. You should therefore be careful to examine all aspects of the transaction, including a verification that the gain or loss is computed correctly and that federal/state basis differences have been considered (MATM 6040).

4040 PARTNERSHIP INTERESTS

Classification of Distributive Share of Partnership Income as Nonbusiness

As discussed in MATM 5300, CCR § 25137-1 provides that the determination of whether partnership income is business or nonbusiness is initially made at the partnership level. No distinction is made between general and limited partnerships. If an item of income is nonbusiness to the partnership, then the corporate partner's distributive share of that income is also treated as nonbusiness, but is treated as if earned directly by the corporate partner. CCR § 25137-1(b) states, "The taxpayer's distributive share of such nonbusiness income shall be reported in the same manner as other nonbusiness income derived from other activities of the taxpayer." Each item of partnership nonbusiness income is therefore allocated in accordance with the rules set forth in R&TC § 25123 - R&TC §25127. Thus, nonbusiness items such as interest or dividends are allocated to the commercial domicile of the corporate partner rather than the commercial domicile of the partnership.

Gain or Loss from Sale of Partnership Interest

R&TC § 25125(d) provides that nonbusiness gain or loss from the sale of a partnership interest shall be allocated to California in the ratio that the original cost of tangible partnership property in this state bears to the original cost of tangible partnership property everywhere. The tangible partnership property is determined as of the time of the sale of the partnership interest. An exception to this rule will apply when more than 50 percent of the value of the partnership's assets consists of intangibles. In such cases, nonbusiness gain or loss from the sale of the partnership interest shall be allocated to California in accordance with the partnership's sales factor for its first full tax period immediately preceding the tax period during which the partnership interest was sold.

The current rules for allocation of gain or loss from sales of partnership interests are effective for taxable years beginning on or after January 1, 1989. For years prior to the addition of this statutory rule, the SBE has held that the sale of a partnership interest is a sale of intangible property allocable to the commercial domicile of the taxpayer (*Appeal of Holiday Inn, Inc.*, 89-SBE-074, April 9, 1986).

The determination of whether gain or loss from the sale of a partnership interest is business or nonbusiness is subject to the transactional and functional tests as illustrated by the following SBE decision:

In *Appeal of Centennial Equities Corporation*, 84-SBE-086, June 27, 1984, the taxpayer and its unitary subsidiaries were engaged in the business of real estate development, and owned interests in 39 partnerships which were also involved in real estate development and which were part of the taxpayer's unitary business. During the appeal year, the taxpayer sold partnership interests and reported the gain as nonbusiness income allocable to its New York domicile (under pre-1989 law).

The taxpayer argued that the nonbusiness treatment was appropriate because it did not continuously acquire and dispose of partnership interests in the regular course of its business.

The SBE applied the functional test, pointing out that income realized from assets which are an integral part of the unitary business are business income even though the income may arise from an extraordinary disposition of the property. The SBE further noted that gain realized from the disposition of an asset, which "contributed materially to the production of business income" constitutes business income. Based upon this analysis, the SBE concluded that the gains from the sale of the partnership interests were business income.

4045 RENTS AND ROYALTIES FROM REAL AND TANGIBLE PERSONAL PROPERTY

CCR § 25120(c)(1) provides that rental income from real and tangible personal property is business income if the property is used in the taxpayer's trade or business or is incidental to the business and therefore includable in the property factor. In *Appeal of Masonite Corporation* however, the SBE held that if rent and royalty income is properly classifiable as nonbusiness under either the functional or transactional test, and if the income and expenses attributable to the income can be segregated, then the fact that the income arose from an incidental activity will not transform it to business income (a summary of this decision is at MATM 4015).

Clearly, if a taxpayer is engaged in a rental business, such as car rentals, then the rents will be business income under the transactional test. An example of rents considered to be business income under the functional test would occur if a taxpayer rents temporarily idle equipment out on a short-term basis. On the other hand, if a taxpayer purchases a rental property such as a shopping mall or an office building as an investment, and neither the property nor the rental activity is related to the taxpayer's trade or business operations, then the rental income will be nonbusiness.

R&TC § 25124 provides for the allocation of rents and royalties from real and tangible personal property as follows:

- Net rents and royalties from real property are allocated to the state in which the property is located.
- Net rents and royalties from tangible personal property are allocated to the state in which the property is utilized. If the taxpayer is not taxable in that state (MATM 1100), then the rents and royalties are allocated to the state of the taxpayer's commercial domicile (MATM 1500).
- If the property from which the rents and royalties were generated was used in more than one state, the portion allocable to California shall be determined based upon the ratio that the number of days that the property was physically located in this state bears to the total number of days the property was rented everywhere during the taxable year. If the taxpayer does not know this information, then the income will be allocable to the state in which the rental or royalty payor obtained possession.

The determination of business or nonbusiness classification is not always so clear-cut. CCR § 25120(c)(1) contains an example wherein a taxpayer owns a 20-story building and uses the first two floors in its trade or business. The remaining 18 floors are leased to others. The example states that the rental of the 18 floors is not incidental, but rather is separate from the operation of the taxpayer's trade or business. Therefore, the rental income is nonbusiness. The Regulations contain a different example wherein the taxpayer uses three floors of a five story building in its trade or business, and leases the remaining two floors. That example states that the rental of the two floors is incidental to the trade or business, and that the rents are business income. In light of the *Masonite Corporation* decision, you should not attempt to apply these examples as bright-line tests, but should consider the unique facts and circumstances of each case. For example, if the two leased floors in the above example would not be considered to be "available for or capable of being used" in the taxpayer's trade or business for purposes of being included in the property factor, and if the transactional and functions tests are clearly not met, then a situation that appears similar to the Regulation example on the surface might actually warrant nonbusiness treatment.

Another example in CCR § 25120(c)(1) indicates that if property that has been used in the trade or business is temporarily rented out while it is held for sale, the rents will be business income. This issue is discussed in MATM 4015.

Annual reports might mention material leases or royalty arrangements that may alert you to a potential nonbusiness issue. If your review of lines 6 (Gross Rents), 7 (Gross Royalties), and 10 (Other Income) of the Federal 1120 reveals amounts that appear especially high or otherwise unusual for the taxpayer's trade or business, then you should inquiry further into the source of the income to identify whether a nonbusiness issue exists.

Taxpayers with rental income will generally have expenses associated with that income. For example, a taxpayer renting out an office building will normally incur expenses such as depreciation and maintenance with respect to that office building. If the rental income is treated as nonbusiness, then you should ensure that the expenses related to the income are also treated as nonbusiness and allocated along with the rental income.

(FTB notice 2000-9)

If rent or royalty income is treated as nonbusiness, you should verify that the property generating that income has not been included in the property factor.

4050 ROYALTIES FROM INTANGIBLE PROPERTY

CCR § 25120(c)(5) explains that patent and copyright royalties are business income where the patent or copyright arises out of or was created in the regular course of the taxpayer's trade or business, or where the purpose for acquiring and holding the patent or copyright is related to or incidental to the trade or business operations.

R&TC § 25127 provides that nonbusiness patent and copyright royalties will generally be allocated to the state in which the patent or copyright is used. If the taxpayer is not taxable in the state in which the patent or copyright is used, the royalties will be allocated to the state of the taxpayer's commercial domicile. See MATM 1500 for a definition of commercial domicile.

The statute further explains that patents will be considered to be used in a state if they are employed in production, fabrication, manufacturing, or other processing in the state; or if the patented product is produced in the state. Copyrights are used in a state if the printing or other publication originates in the state. If patents or copyrights are used in more than one state, then the royalties should be allocated among those states. In cases where the basis of the receipts from patents or copyrights do not permit a reasonable allocation among the states in which the intangible is used, or if the taxpayer's accounting procedures do not identify the states of use, then the royalties should be allocated to the taxpayer's commercial domicile.

The following examples are contained in the Regulation:

Example (A)

The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Long-established SBE decisions have held that royalties received on patents developed in the regular course of the taxpayer's trade or business are business income even if the taxpayer is not in the business of licensing patents, and even if the taxpayer never actually manufactured the patented product itself: *Appeal of International Business Machines Corporation*, 54-SBE-013, October 7, 1954; *Appeal of Velsicol Chemical Corporation*, 65-SBE-040, October 5, 1965.

Example (B)

The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including copyrights. The taxpayer thereafter uses these acquired copyrights in its business. The royalties received on these copyrights are business income.

Example (C)

Same as Example (B), except that the acquired company also held the patent on a type of phonograph needle. The taxpayer does not manufacture or sell phonographs or phonograph equipment. Any royalties received on the patent would be nonbusiness income.

4052 TRADE OR BUSINESS OF INVESTING

This section has been temporarily removed as it is being updated.

4053 WORKING INTERESTS IN OIL AND GAS OPERATIONS

CCR § 25120(a) provides that ". . . the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business." If a taxpayer's involvement in working interests is sufficient to constitute a trade or business, then the analysis should be whether that trade or business is unitary with the taxpayer's other trade(s) or business(es). Otherwise, a nonbusiness analysis will apply. The following steps may be taken in conducting the analysis:

1. Identify the existence of the taxpayer's principal trade or business.
2. Identify other activities outside of the main trade or business that are subject to question (i.e., the holding of working interests).
3. Apply the functional and transactional tests (MATM 4010) to the items of income or loss identified in step #2 to determine whether the items arose from transactions and activities occurring in the taxpayer's main trade or business.
4. If the income or loss from the working interests does not satisfy the transactional or functional tests in step 3, then determine whether the activity is conducted in a trade or business-like manner sufficient to constitute a "trade or business." Passive holding of income producing assets is unlikely to constitute a trade or business.
5. If the activity does not meet the standard for a trade or business-like activity, then the income or loss should be allocated under the nonbusiness rules.
6. However, if the activity is conducted in a trade or business-like manner, analyze whether it is either (a) a separate trade or business, or (b) unitary with the main trade or business. If the basis for combination is strong central management and centralized departments, see MATM 3075 dealing with those topics.
7. If the working interest activity is determined to be unitary in step #6, combine. If not unitary, separately apportion the income or loss.

The determination whether income or loss from a working interest is nonbusiness or non-unitary must be based upon the facts and circumstances of each particular case. Therefore, you should be careful not to jump to conclusions regarding the characterization of the income or loss based upon labels or upon perceptions about how investments in working interests are generally managed. Instead, you need to develop the facts concerning the relationship between the working interest and the taxpayer's other trade(s) or business(es). For example, if the taxpayer claims that the primary purpose of the working interests in oil and gas drilling operations is to serve as a hedge against fuel shortages, the taxpayer should be asked to provide documentation to establish that such a plan would actually be feasible. If the taxpayer claims that strong central management exists, documentation to support this contention needs to be examined.

Although items of income or loss (i.e., capital gains or losses, royalties, etc.) from working interests in oil and gas drilling operations are ultimately sourced under the rules found in R&TC §§ 25124 - 25127, there are some unique features of working interests that should be considered.

4055 INCOME NOT SPECIFICALLY ADDRESSED IN THE STATUTE

R&TC §25123 provides for the allocation of nonbusiness income. That section lists various types of income (rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent or copyright royalties) and states that such items, to the extent that they are nonbusiness, shall be allocated as provided in R&TC §25224 - R&TC §25127. Certain types of income are not listed in that section. The position can be taken that such income should be allocated to California if it arises from tangible or intangible property located or having a situs in this State, or from activities carried on in this State (R&TC §23040).

4060 EXPENSES ATTRIBUTABLE TO NONBUSINESS INCOME

To the extent that expenses have been incurred for the production of nonbusiness income, those expenses will not be allowed as a deduction from business income. For example, assume a taxpayer invests in an apartment building from which it derives nonbusiness rental income. The depreciation, maintenance, management fees, and any other expenses attributable to that property will not be allowed as a deduction from the taxpayer's business income. Instead, the expenses will be netted with the gross rents received from the property, and the net income or loss from the activity will be treated as nonbusiness.

In some cases, an expense may be applicable to more than one nonbusiness activity, or to both, a business and a nonbusiness activity. In such cases, CCR § 25120(d) provides that the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner that fairly distributes the deduction. The allocation method may vary depending upon the type of expense. For example, a ratio of time spent on the various activities may be an appropriate method for allocating employee compensation expenses. Square footage of floor space may be a better basis to use for the allocation of building expenses. In general, any method of proration which is reasonable under the circumstances and which bears a rational relationship to how the expenses are incurred will be allowable so long as the same method is used consistently from year to year.

4065 INTEREST OFFSET AND BUSINESS OR NONBUSINESS CHARACTER OF INTEREST EXPENSE

The interest offset is contained in R&TC § 24344(b). Its purpose is to match income and expense to nonbusiness interest and dividends and interest expense. In general, R&TC § 24344(b) is an expense ordering rule that requires that interest expense be applied as a deduction (i.e., offset) first dollar-for-dollar against business interest income, and then, if interest expense exceeds business interest income, interest expense is applied dollar-for-dollar against nonbusiness interest and dividends. If interest expense exceeds business interest income and nonbusiness interest and dividends, interest expense is generally allowed as a deduction under R&TC § 24344. That section provides no further guidance as to business or nonbusiness treatment of such excess interest expense. However, CCR § 25120(d) provides general rules for assignment of expense, including interest income, against business or nonbusiness income. Thus, to the extent that the provisions of R&TC § 24344 do not provide a rule for assignment of interest expense, CCR § 25120(d) will apply, except as provided below.

The U.S. Supreme Court in *Hunt-Wesson, Inc. v. FTB*, 120 S. Ct. 1022 (2000), found that the interest offset was unconstitutional as applied. The basis of the court's finding was that the methodology of the interest offset resulted in the taxation of extra-territorial values.

The Franchise Tax Board issued FTB Notice 2000-9 to explain the department's policy concerning the application of the Supreme Court's decision in *Hunt-Wesson*. The Franchise Tax Board determined that:

1. The U.S. Supreme Court did not consider the first clause of the interest offset. The first clause provides for the netting of interest expense and business interest income. The Franchise Tax Board will continue to apply that portion of R&TC § 24344(b) to all taxpayers.
2. The Court did not address the application of R&TC § 24344(b) to California domiciled entities, The Franchise Tax Board will continue to apply R&TC § 24344(b) to such entities.
3. The US Supreme Court held that R&TC § 24344(b) was unconstitutional to the extent that it would assign interest expense to nonbusiness interest and dividends allocable to another state. Accordingly, such interest expense is to be treated as business interest expense.

The notice goes on to explain that CCR § 25120(d) will be used to assign any remaining interest expense to nonbusiness income. An exception is made for income from such assets that have the potential to give rise to dividend and interest income. In other words, CCR § 25120(d) cannot be used to assign interest expense to the value of capital gain from debt or equity securities.

The following examples explain the application of FTB Notice 2000-9:

1. X Corporation operates retail department stores. X Corporation also provides credit for their customers through the use of the stores credit card system. X Corporation has business interest income of $100 million from the credit card operations and total interest expense of $80 million. The first step for all taxpayers regardless of domicile is to net business interest income and interest expense. In this example business interest income exceeds interest expense resulting in no nonbusiness interest expense.
2. Y Corporation is a manufacturer commercially domiciled in California. Y Corporation has $50 million interest expense, $10 million business interest income and $45 million of nonbusiness dividends and interest income. The first step is to net the interest expense of $50 million with business interest income of $10 million resulting in excess interest expense of $40 million. The second step is to match the excess interest expense of $40 million with nonbusiness interest and dividend income of $45 million. Since the nonbusiness interest and dividend income exceeds the remaining interest, all of the $40 million interest expense, not directly assigned to business interest income, is classified as a nonbusiness expense.
3. Same facts as 2 except Y Corporation is domiciled outside California. All of the interest expense would be classified as business interest expense.
4. The following two examples are based on an example in FTB Notice 2000-9:

    a. Assume that a taxpayer's total interest expense was $400 including $200 that can be directly traced to holding nonbusiness stock and $50 that can be directly traced to a mortgage to acquire nonbusiness real property located in California. The taxpayer had business interest income of $100 and nonbusiness dividends of $100. If the taxpayer is domiciled in California, the first step is to net interest expense of $400 and business interest income of $100 resulting in excess interest expense of $300. Thus, the first $100 of interest expense is treated as business interest expense. The second step is to net the $300 excess interest expense with $100 nonbusiness dividend income for remaining interest expense of $200. The California domiciled entity treats the $100 interest expense in step 2 as a nonbusiness expense. Step 3 is to use CCR §25120(d) to assign interest expense to directly traceable business or nonbusiness income. In this example the taxpayer has $50 directly traceable to nonbusiness real property rental located in California, which is treated as a nonbusiness expense allocable to California. However, FTB Notice 2000-9 provides that you cannot use CCR § 25120(d) to assign interest expense to assets that have the potential to generate nonbusiness interest and dividend income. Thus, you cannot assign interest expense to holding the nonbusiness stock even though $200 can be directly traced to that activity. The California domiciled entity would have business interest expense of $100 and nonbusiness interest expense of $150 ($100 from step 2 and $50 from step 3). The remaining interest expense of

$150 would be treated as business or nonbusiness expense under the general provisions of CCR § 25120(d), as described above.

b. Assume the same facts as example 4, except that the taxpayer is domiciled in another state. Step one (assignment to business interest income) would be the same as example 4. However, in step 2, interest expense in an amount equal to nonbusiness interest and dividends ($100) is treated as a business expense. As in example 4, directly traceable interest expense would be assigned to the California nonbusiness real property, but would not be assigned to the holding of nonbusiness stock. Thus, the non-California domiciled entity with these facts would have business interest expense of $200 and would have California nonbusiness interest expense of $50 from step 3. The remaining interest expense of $150 would be subject to the general provisions of CCR § 25120(d).

On August 10, 2001 the California Legislative Counsel offered an opinion concerning the question of whether, in light of the US Supreme Court decision in Hunt-Wesson v. FTB, the Franchise Tax Board may continue to enforce any portion of R&TC § 24344(b). It was the opinion of the Legislative Counsel that the Franchise Tax Board may not continue to enforce any portion of R&TC § 24344(b). The role of the Legislative Counsel is to provide legal advice to the Legislature. The opinion of the Legislative Counsel is not controlling concerning the department's administration of the tax law. Staff will continue to follow FTB Notice 2000-9 unless otherwise provided by the members of Franchise Tax Board or R&TC § 24344 is amended by legislation.

4070 CONTRIBUTIONS ADJUSTMENT

The purpose for the contributions adjustment is to allocate the charitable contribution deduction between business and nonbusiness income and to properly reflect the 10 percent (5 percent for taxable years beginning before 1/1/96) income limitation after apportionment and allocation. At one time, the Schedule R-6 also allocated a portion of the contributions deduction to deductible dividends, but that allocation is no longer a part of the contributions adjustment computation. If you are proposing to disallow contributions allocable to deductible dividends, you will need to make that adjustment first. The disallowed contributions will then reduce the amount of remaining contributions that you will input on line 1 of the Schedule R-6.

Pursuant to R&TC § 24358, the deduction for charitable contributions is limited to 10 percent (5 percent for taxable years beginning before 1/1/96) of the taxpayer's net income (computed before special deductions including built-in gains, dividend deductions and NOL deductions). For taxable years beginning before 1/1/96, since the limitation is 10 percent for federal purposes, a state adjustment is usually made to adjust the federal contributions deduction to the 5 percent state limitation. Taxpayers will normally compute this limitation based upon net income before apportionment and allocation. If the taxpayer has nonbusiness activity allocated outside of California however, the income from that activity is not included in the California measure of tax. Since the nonbusiness income was included in the base for the 10 percent limitation, the department requires that a portion of the contributions deduction be allocated to that income.

Example

Corp Y paid contributions of $100 during the taxable year. Corp Y had business income of $800 (without regard to the contributions deduction) and nonbusiness income allocated outside of California of $200, for total net income (before apportionment and allocation) of $1000. Corp Y's apportionment percentage was 60 percent. The contributions deduction reported after state adjustments would be limited to $100 ($1,000 X 10 percent). After running through Schedule R, the contributions effectively allowed against California income would be $60 ($100 X 60 percent apportionment percentage).

Since $200 of nonbusiness income is not taxable to California, the portion of the contribution deduction attributable to that income is not deductible against California income. The Schedule R-6 (contribution deduction worksheet) limits the contributions deduction to 10 percent of the income that is subject to California tax. The allowable deduction is limited to $48 (800 X 60 percent apportionment percentage X 10 percent). Since income before the contributions adjustment should reflect a $60 deduction, a $12 contributions adjustment is necessary.

The contributions adjustment is only necessary if the taxpayer has nonbusiness income. Sometimes, however, taxpayers will use the Schedule R-6 contributions adjustment computation to compute the overall difference in the federal/state limitations. Other taxpayers may not add back the dividend deduction before calculating the 10 percent limitation for purposes of the state adjustment. In these types of situations, an amount may be characterized as a contributions adjustment even though there is no nonbusiness income. If material, you will need to analyze what has ultimately been deducted on the California return (federal deduction ± state adjustment ± contributions adjustment) in order to determine whether contributions have been reported correctly. See MATM 6050 for further discussion.

Rev. 8/19