

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
Consolidated Freightways, Inc.) No. 98A-0499
) Case No. 89002460300
)

Representing the Parties:

For Appellant: Charles J. Moll III

For Respondent: Carl Joseph, Tax Counsel

Counsel for Board of Equalization: Selvi Stanislaus, Tax Counsel III

OPINION

This appeal is made pursuant to section 19045¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Consolidated Freightways, Inc., against proposed assessments of additional franchise tax in the amounts of \$644,979, \$392,220, and \$737,302 for the income years ended December 31, 1984, December 31, 1985, and December 31, 1986, respectively.

The issue presented on appeal is whether appellant has satisfied its burden of proving that interest and dividend income earned by appellant from amounts invested in two investment funds is business income. We conclude that appellant has met its burden.

¹ Unless otherwise specified, all future section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Background

Consolidated Freightways, Inc., (hereafter appellant) is a freight transportation company domiciled in California. Prior to the appeal years, freight transportation remained an appellant mainstay, but appellant began to expand its business activities into other areas.² One such endeavor was the manufacture and sale of trucks. Appellant was engaged in this line of business through its subsidiary, Freightliner Corporation (hereafter Freightliner).³ On July 31, 1981, appellant sold Freightliner and its related credit businesses to Daimler-Benz AG for \$280.9 million (hereafter Freightliner Sale). After payment of taxes and reducing a portion of outstanding debts, appellant intended to use the remaining proceeds to acquire a company that would enable appellant to expand its share in the transportation service industry, and which earnings would replace (or exceed) the earnings of the business sold.

Pursuant to its plan to reinvest the balance proceeds from the Freightliner Sale within a year, appellant engaged Boston Consulting Group (hereafter BCG) to assist it in developing and implementing a redeployment plan. As requested, BCG presented proposals identifying viable investment options and listing acquisition candidates within each option. Appellant investigated several potential acquisitions and, in 1982, made an offer for the acquisition of Air Express International (hereafter AEI), a major international air freight forwarder. Appellant chose the international air freight market because of its growth and profit potential, its compatibility with appellant's domestic market and because it enhanced appellant's desire to project itself as a "full service" business.

On January 27, 1983, appellant reached an agreement in principle to acquire AEI for approximately \$63 million. Sometime thereafter negotiations between the parties soured and the agreement was never finalized. Undaunted by its first failed attempt, appellant renewed and enhanced its efforts to locate an appropriate acquisition candidate. Appellant's sincerity and urgent desire to acquire a replacement for Freightliner is well documented. The record shows that in 1984, appellant explored the possibility of acquiring Emery Air Freight Corporation (hereafter Emery). Because the cost of acquiring Emery was estimated to be around \$500 million, appellant continued to explore alternatives in the event that negotiations between the entities failed. Also in 1984, appellant considered taking an equity position in Airborne Freight

² Appellant's transportation activities were organized into two subsidiary operating groups, CF Land Transportation, Inc., which included appellant's entire motor carrier and related activities and CF International and Air, Inc., which was responsible for appellant's international and air freight related activities.

³ The unitary nature of appellant's business is not in dispute.

Corporation (hereafter Airborne) as a prelude to a possible acquisition of an air freight company. Appellant states that although Airborne and Emery were high up on its acquisition list, it continued to investigate other major air freight forwarders such as The Harper Group, Purolator Courier, Schenker, Kuehne & Nagle, and Panalpine.

Appellant's acquisition efforts continued well into 1986 and 1987. Appellant acknowledges that international expansion had been slower than expected, however progress was being made. By the end of 1986, appellant had many candidates in different stages of analysis. However, Emery still continued to be the frontrunner. In 1988, appellant broke off negotiations with Emery due to Emery's financial perils. Finally, in early 1989, appellant's long and arduous search for a replacement candidate came to fruition when it resumed negotiations and consummated the acquisition of Emery. The remaining proceeds from the sale of Freightliner were used to fund this acquisition.

When negotiations with AEI failed in 1983, appellant recognized that the acquisition of a viable candidate would take longer to consummate than originally anticipated, and that an immediate redeployment of the proceeds from the Freightliner Sale was not likely to occur. Moreover, by 1984, in contrast to the previous years, short-term interest rates had declined, making the higher yields associated with securities with longer maturities more attractive. Recognizing that a higher rate of return could be garnered on these funds if they were invested in long-term securities, appellant shifted \$100 million from its \$320 million in cash (held as current assets), into long-term investments. Specifically, in 1984, appellant placed \$50 million each with Rosenberg Capital Management and with Capital Guardian Trust. The goal of each of these two funds was to maximize earnings with low risk (proceeds were shifted into higher yielding financial paper, such as treasury notes, municipal bonds and preferred stock) over a three to five year investment period. In seeking higher returns, appellant continued to adhere to its fundamental strategy of maintaining the proceeds in investments that were liquid, marketable, and easily and immediately available for redeployment when an acquisition candidate was located, with no prepayment penalty. For example, in 1988, when appellant needed to fund capital expenditures, it was able to monetize \$30 million from these long-term security funds almost immediately, and the same ease was manifested when appellant liquidated the remainder of these funds to purchase Emery for \$230 million.

Appellant reported interest and dividend income earned on these long-term investments as business income. Upon audit, respondent determined that these accounts produced nonbusiness income.

Applicable Law

Revenue and Taxation Code section 25120, subdivision (a), defines nonbusiness income to include all income which is not business income. That same code section 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.”

Based on the terms of the statute, there are two separate tests for determining business income, the transactional test and the functional test. Under the transactional test, the relevant inquiry is whether the transactions or activities which give rise to the income occurred in the regular course of the taxpayer’s trade or business. Under the functional test, income is business income if the acquisition, management, and disposition of the income-producing property constitute integral parts of the taxpayer’s regular trade or business operations. (Appeal of DPF Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980.) If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, *supra*.) Respondent’s determination of the character of the income under these tests is presumed correct, with the taxpayer bearing the burden of proving otherwise. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983; Appeal of Joy World Corporation, Cal. St. Bd. of Equal., June 29, 1982.)⁴

As explained below, we find that appellant has met the functional test for business income. The Board has previously applied the functional test to liquid asset accounts in order to determine whether income was business or nonbusiness. (Appeal of American Medical Buildings, Inc., Cal. St. Bd. Equal., June 10, 1986; Appeal of Inco Express, Inc., 87-SBE-016, Mar. 3, 1987; Appeal of Cullinet Software, Inc., et al., 95-SBE-002, May 4, 1995.) Through

⁴ Under California law, a presumption stands as proof of the presumed fact unless and until evidence is introduced to support a finding of its nonexistence, in which case the effect of the presumption disappears and the case is determined without regard to the presumption. (Evid. Code, § 604; Appeal of Sierra Production Service, Inc., 90-SBE-010, Sept. 12, 1990.) In the Appeal of Cullinet Software, Inc., et al., (95-SBE-002), May 4, 1995 the Board indicated that the taxpayer failed to meet the burden of proof necessary to overcome the regulatory presumption in favor of business income. (See Cal. Code Regs., tit. 18, § 25120, subd. (a) [“Income of the taxpayer is business income unless clearly classifiable as nonbusiness income.”].)

these cases, the Board has effectively developed a two-prong approach for applying the functional test to liquid asset accounts.

Applicable Tests and Analysis

A. The Working Capital Test

The first prong analyzes whether the pool of funds in issue is part of the “working capital” of the taxpayer. If so, the subject funds may give rise to business income. As explained in the Appeal of American Medical Buildings, Inc., *supra*, the term “working capital” is not a term of art but generally refers to a pool of liquid funds which is part of appellant’s total assets and held to meet the reasonable needs of the business.

In the Appeal of American Medical Buildings, Inc. the taxpayer, a corporation, which was incorporated to construct medical buildings, faced a slowdown in construction because of rising interest rates for construction loans. The taxpayer formed a subsidiary, which was intended to help finance the medical buildings. The taxpayer contributed \$8 million of the proceeds of a corporate bond sale to this newly formed subsidiary. These funds were then invested in short term liquid accounts pending their use as capital for the construction of buildings. Because interest rates had risen, the taxpayer, in an effort to keep its building operations going, used these funds to make loans to customers at below market rates, as an incentive to get them to buy buildings. The Board found that these funds generated business income. Although the term “working capital” was not used, the Board’s holding in this case supports the conclusion that, when funds are being held for the reasonable needs of the business, the subject funds may be classified as business income.

Similarly, in the Appeal of Inco Express, Inc., *supra*, the taxpayer invested its retained earnings in short term securities in order to ensure that funds would be available without the necessity of borrowing additional funds at high interest rates. The invested funds were ultimately intended for use in the purchase of land to expand the taxpayer’s facilities. The Board stated that, “the relevant inquiry under the statute and regulations is not what asset was purchased with the income, but whether the intangible which created the income is related to the taxpayer’s unitary business.” (*Id.*; see also Appeal of Fairmont Hotel Company, 95-SBE-004, June 29, 1995.) In ruling that the income from such short-term investments was apportionable business income, the Board found that such short-term investment strategies were part of prudent corporate money management and, therefore, held that the income from those investments arose from the taxpayer’s regular course of business. This case makes clear that business income is

generated if the funds are intended to be used by the appellant in the short-term, and are necessary for appellant's business operation.

In the Appeal of Cullinet Software, Inc., et al., *supra*, the Board considered a case in which the taxpayer issued stock in order to generate additional capital for the acquisition of companies and products similar or complimentary to the taxpayer's existing business. Until the funds were used for that purpose, the taxpayer invested the funds in short-term investments; the taxpayer provided no evidence that it segregated the funds from its normal working capital. On those facts, the Board found that "idle funds invested in liquid financial instruments are part of a unitary business' working capital pool, and thus generate business income."

These cases all indicate that, if a pool of liquid funds is part of the total assets of appellant's business and held to meet the reasonable needs of the business, the funds generate business income. In the instant case, on January 20, 1984 the Board of Directors moved to shift \$100 million from its short-term working capital accounts and transfer these funds to longer-term investments. At the time appellant-Board so moved, appellant was flush with cash and projected having in excess of \$500 million for its daily business needs. After the move, these funds were listed on appellant's annual reports under "Other Assets" rather than "Current Assets." Clearly, there was no short-term business need for the funds that were subsequently invested in longer-term securities. Because the funds were well in excess of working capital needs and were removed from working capital, we conclude that appellant cannot qualify under the working capital element of the functional test. However, our inquiry does not end here. Appellant may still meet the functional test for business income if it can show that the long-term purpose for holding the accounts is to fund a specific expenditure or project, a practice known as "earmarking."

B. Funds Earmarked for a Specific Business Purpose

If the funds are not characterized as working capital, then the next prong analyzes whether the liquid funds have been earmarked for a specific future business need. If the funds are earmarked for a unitary business use, business income may be generated. Support for this test is found in the current regulation pertaining to section 25120. This regulation provides the following illustration:

"Example (F): In January the taxpayer sold all the stock of a subsidiary for \$20,000,000. The funds are place in an interest-

bearing account pending a decision by management as to how the funds are to be utilized. The interest income is nonbusiness income.”

(Cal. Code Regs., tit. 18, § 25120, subd. (c)(3), Example (F) (emphasis added).)

As the underscored portion indicates, management in this illustration had not yet decided how to use the money. In the Appeal of Cullinet, *supra*, the Board considered this same illustration and held that “investing in liquid assets and holding them ready for use in the unitary business gives rise to business income, especially where, as here, the funds are earmarked for the acquisition of companies and products similar or complementary to the taxpayer’s unitary business.”

In the instant case, although appellant underestimated the amount of time it ultimately would take to redeploy the proceeds, appellant never abandoned its efforts to make the acquisition. On the contrary, between the time of the Freightliner sale in 1981 and the ultimate acquisition of Emery in 1988, appellant engaged in continuous negotiations with one potential acquisition candidate after another. At any particular time during those intervening years, appellant typically was on the verge of acquiring one target or another (which planned acquisition would then fall through due to unforeseen circumstances). Respondent concedes that appellant was looking for an acquisition target; however, respondent believes that nothing appellant did can be construed as anything beyond exploration. Respondent also believes that when the funds were moved to long-term securities appellant may have abandoned its business objective to use the proceeds to fund the intended acquisition and/or that appellant may have earmarked these funds for another nonbusiness use. We disagree with respondent on both counts. The appeal record is clear. Appellant never wavered in its commitment to purchase a Freightliner substitute and, like in Cullinet, the proceeds were earmarked for the acquisition of companies similar or complementary to the taxpayer’s unitary business and were at all times held readily available for use in the business. Based on these facts we hold that the funds were earmarked for the acquisition of a specific business purchase during the years in issue.

Our conclusion is further strengthened by appellant’s stated purpose for acquiring the liquid investments, which is to have immediate cash available to finance the acquisition. (But see Appeal of Fairmont Hotel Company, *supra* [holding that the income in question was nonbusiness income because the taxpayer’s investment in computers was illiquid and not readily available for use in the hotel management business].) Respondent argues that liquidity (or even availability) is no test at all. Rather, respondent correctly asserts that appellant must show that the acquisition, management and disposition of the funds constitute an integral part of appellant’s

trade or business (Allied-Signal, Inc. v. Director, Div. Of Taxation (1992) 504 U.S. 768), and that funds held for an investment function may still be ‘available’ in the sense that they can be liquidated, but this fact, by itself, will not meet the constitutional requirement that the funds be connected operationally with the taxpayer’s business. We agree that availability and liquidity has never been held to be the primary determining factors for the Board’s determination regarding business income. However, the fact that proceeds were managed to make them readily accessible, liquid, and available for immediate use with no prepayment penalty, while appellant was engaged in an active, ongoing effort to acquire a compatible business, is strong evidence that these funds were earmarked for an acquisition target in the transportation industry.

For the above reasons, we reverse respondent’s determination and hold that appellant has met its burden of showing that business income was generated by these two investments.

ORDER

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of against proposed assessments of additional franchise tax in the amounts of \$644,979, \$392,220 and \$737,302 for the income years ended December 31, 1984, 1985, and 1986, respectively, be and the same are hereby reversed.

Done at Sacramento, California, this 14th day of September, 2000, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Parrish, Mr. Chiang, Ms. Mandel* present, Ms. Mandel* not participating.

Dean Andal, Chairman

Claude Parrish, Member

John Chiang, Member

_____, Member

_____, Member

*For Kathleen Connell per Government Code section 7.9.