

Appeal of Beck Industries, Inc.

The issue presented by this appeal is whether interest income realized by appellant from certain certificates of deposit constituted business income apportionable to California by formula, or nonbusiness income specifically allocable to appellant's New York commercial domicile.

Appellant, which has its headquarters and commercial domicile in New York, was incorporated under the laws of Delaware in 1932 and began doing business in California in the same year. During the income years in issue, appellant and its subsidiaries (hereinafter collectively referred to as "the affiliated group") were primarily engaged in the retail sale of shoes, apparel, and furniture, as well as the operation of discount department stores. The affiliated group also manufactured men's and women's shoes and apparel.

For the income years ended January 31, 1972 through January 31, 1975, **those** members of the affiliated group doing business in this state filed separate California franchise tax returns. For the two subsequent income years, however, the affiliated group filed combined reports utilizing California's combined reporting procedures. In 1976, the affiliated group filed amended returns for 1975 and earlier open years using combined reporting procedures. The amended returns were treated as refund claims. To verify the claimed refunds, respondent audited the amended returns; **the combined reports for the 1976 and 1977 income years were also examined. After consideration of the relevant factors, respondent accepted appellant's determination that the affiliated group had been engaged in a single unitary business during the income years in issue, and concluded that its use of California's combined reporting procedures was proper.**

In calculating the amount of its unitary business income subject to apportionment, the affiliated group, on its amended 1975 combined report and on its original 1977 report, excluded interest income earned from certain certificates of deposit ([hereinafter referred to as "the certificates"). On its 1976 report, however, the affiliated group included the interest income derived from the certificates as business income.

Neither the pertinent facts regarding the acquisition of the certificates nor the amounts derived therefrom are disputed. Since 1971, appellant has been operating as a debtor in reorganization under Chapter x of

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the Bankruptcy Act. ^{1/} During the course of the bankruptcy proceedings, appellant has derived substantial **sums** from the sale of the capital **stock** of subsidiaries and from the sale of discontinued business interests. In accordance with **various** orders and directives of the Bankruptcy Court, the funds so derived have been segregated pending a determination by the court regarding the feasibility of reorganizing appellant pursuant to Chapter x. These funds are apparently still under the jurisdiction of the Bankruptcy Court and may be disbursed by order of that body only after a determination is made as to how they are to be utilized. In the interim, the segregated funds have been invested in the certificates. Interest in the amounts of **\$1,048,692**, \$738,488, and \$723,356 was earned from the certificates for the 1975, 1976, and 1977 income **years**, respectively.

Appellant contends that the subject interest income was not earned from any business activity conducted by the affiliated group and, consequently, constitutes nonbusiness income.' Upon its review of the relevant facts, however, respondent concluded that the interest income earned by appellant from the certificates constituted business income and, therefore, was apportionable to California by formula.

The Uniform Division of Income for Tax Purposes Act (UDITPA) was adopted by California, effective for years beginning after December 31, 1966. (Rev. & Tax. Code, §§ 25120-25139.) Section 25120 of the Revenue and Taxation Code defines the terms "business income" and "nonbusiness income" as follows:

(a) "Business income" means 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

1/ Chapter X was in effect at the time appellant's bankruptcy proceedings commenced. Consideration by Congress of numerous reform bills later culminated in the 1978 codification of the bankruptcy laws. (Pub.L.No. 95-598, Nov. 6, 1978, 92 Stat. 2549.) This Act enacted Title 11 of the United States Code, Bankruptcy, into positive law and provided the necessary procedures for transition from the repealed bankruptcy provisions to the new law.

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constitute integral parts of the taxpayer's regular **trade** or business operations.

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(d) "Nonbusiness income" means all income other than business income.

The regulations governing the interpretation of section 25120 provide, in pertinent part, as follows:

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

Nonbusiness income means all income other than business income.

. . . [T]he 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. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade *or* business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business. (Cal. Admin. Code, tit. **18**, reg. 25120, subd. (a) (Art. **2.5**).)

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Interest income is business income where the intangible with respect to which the interest was received arises out of 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 such trade or business operations. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (Art. **2.5**).)

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Section 25120 of the Revenue and Taxation Code provides two alternative tests to determine whether income constitutes business or nonbusiness income. The first is the "transaction" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the gain or loss occurred in the regular course of the taxpayer's trade or business, (Appeal of General Dynamics Corporation, Cal. St. Bd. of Equal., June 3, 1975, opinion on denial of rehearing, Sept. 17, 1975.) Under the second, or "functional" test, all income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; but cf. ASARCO Inc. v. Idaho State Tax Commission, -- U.S. -- [73 L.Ed.2d 787] (1982) (slip opinion at 18).) After careful review of both the relevant authority and of the record on appeal, we are convinced that the subject income did not constitute business income under either of these tests.

The certificates were acquired by appellant in accordance with various orders and directives of the Bankruptcy Court overseeing appellant's bankruptcy proceedings. While respondent is correct in noting that the purpose of a Chapter X bankruptcy proceeding was to enable a corporation to continue its operations through rehabilitation of its affairs under the scrutiny and direction of the Bankruptcy Court, the conclusion that the income derived from the certificates constitutes business income does not necessarily follow. The acquisition of the certificates from the proceeds derived from appellant's sale of stock and other business assets may have been essential in that the sales and the purchase were required by the Bankruptcy Court. However, the acquisition of the certificates did not arise in the regular course of the affiliated group's trade or business, and the acquisition and holding of the certificates did not constitute integral parts of the affiliated group's manufacturing and retail business. Respondent's contention that the purpose for acquiring and holding the certificates was related, or incidental, to that trade or business is erroneous in that it focuses upon the certificates with regard to appellant's corporate existence, rather than the "critical element" used in determining the business or nonbusiness character of income, i.e., the identification of the affiliated group's particular trade or business.

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(Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (Art. 2.5): compare Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (3) (Art. 2.5).) The record of this appeal is clear in this respect: the purpose for acquiring and holding the certificates had no relationship to the affiliated group's manufacturing and retail business.

Additional support for our conclusion that the interest income derived from the certificates was nonbusiness income is found in the following example to respondent's regulations:

Example (F): In January the taxpayer sold all the stock of a subsidiary for \$20,000,000. The funds are placed 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. Admin. Code, tit. 18, reg. 25120, subd. (c)(3) (Art. 2.5).)

Examination of the cited example reveals that it is indistinguishable from the factual situation of this appeal. In the example, the taxpayer's purpose in setting up the account is not related to, or incidental to, its trade or business operations. Likewise, as explained above, appellant's motivation in acquiring the certificates was for a purpose extraneous to its particular trade or business. The only distinction between the quoted example and the factual situation presented by this appeal is that the Bankruptcy Court, rather than appellant's management, will make the ultimate decision as to how the certificates are to be utilized. In the context of this appeal, this is a distinction without a difference; the Bankruptcy Court effectively acts as appellant's management with respect to major considerations, including the future use of the certificates.

In accordance with the views expressed above, we conclude that respondent's action in this matter, must be reversed.

