

BEFORE THE STATE BOARD OF **EQUALIZATION**
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
SUNDSTRAND CORPORATION) No. **84A-376-SW**

For Appellant: Neil D. Traubenberg
Tax Director

For Respondent: Anna Jovanovich
Counsel

O P I N I O N

This appeal is made pursuant to section **25666^{1/}** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Sundstrand Corporation against proposed assessments of additional franchise tax in the amounts of \$22,969 and \$39,629 for the **income** years 1975 and 1976, respectively.

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

Appeal of Sundstrand Corporation

There are two issues presented in this appeal. The first issue is whether the loss resulting from a sale of stock should be characterized as business or nonbusiness; and the second is whether respondent acted properly in refusing to accept appellant's change in its method of accounting.

Appellant is a Delaware corporation with its principal place of business in Illinois. In late 1968, appellant contemplated a merger with Standard **Kollsman** Industries, Inc. (SKI). Negotiations were made with John B. **Huarisa**, chairman of the board and president of SKI, wherein appellant was to transfer to Huarisa 5,686 shares of its stock and appellant was to acquire **Huarisa's** right to purchase 223,190 shares of SKI stock. Huarisa had already paid \$334,785 as a downpayment in connection with his stock-purchase right and the 5,686 **shares** of appellant's stock transferred to him were designed to reimburse him for this cash payment. Under the stock-purchase right acquired from Huarisa, appellant had until February 9, 1969, to make an additional 20-percent installment payment and until April 9, 1969, to make the final payment.

After appellant purchased Huarisa's right to purchase the 223,190 shares of SKI stock, appellant **discovered that Huarisa and other** SKI officers had made material misrepresentations concerning **the financial condition** of SKI. Nevertheless, appellant paid **\$6,390,915** which represented the remaining balance of the purchase price of the 223,190 shares of SKI stock. Appellant contends that the sole reason they consummated the stock purchase was because their counsel mistakenly advised them that there was a legal obligation to complete the transaction.

Lengthy and complex litigation resulted from this transaction. Ultimately, the courts found in favor of appellant but reduced the award to the original payment of \$334,785. The court held that appellant was not required to make the remaining payment under the contract.

Appellant sold its SKI shares, which had at the time, due to a merger, become Sun Chemical Corporation shares, for a loss of **\$6,130,241**. On its tax return for the year ending December 31, 1975, appellant claimed this amount as an ordinary business loss. During the course of an audit, respondent rejected this classification and treated the loss as nonbusiness.

Appeal of Sundstrand Corporation

The first issue to be considered is whether the **\$6,130,241** loss should be characterized as a business loss or a nonbusiness loss. The significance of the ultimate classification is that a business loss is apportioned among the states in which appellant is engaged in business. A nonbusiness loss is specifically allocable to Illinois, which is appellant's commercial domicile.

The Uniform Division of Income for Tax Purposes Act was adopted by California, effective for years beginning after December 31, 1966. (Rev. & Tax. Code, §§ 25120-25139.) Section 25120 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 constitute integral parts of the taxpayer's regular trade or business operations.

* * *

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

The statutory definition of business income provides two alternative tests for determining the character of income. The "transactional test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. The "functional test" provides that income is business income if the acquisition, management, and disposition of the property giving rise to the income 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 New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

As we stated before, capital gains and losses are apportioned by formula if they come within the definition of business income (Rev. & Tax. Code, § 25128), but are allocable entirely to the state of the taxpayer's commercial domicile if they constitute items of nonbusiness income. (Rev. & Tax. Code, § 25125.) Appellant's

Appeal of Sundstrand Corporation

evidence shows that when the stock option was purchased from Ruarisa, appellant intended to merge with SKI. Information then surfaced which indicated that misrepresentations had been made as to the financial condition of SKI. Nevertheless, appellant bought the stock knowing it would never consummate the merger. The evidence available indicates that the only reason the stock was purchased was because appellant mistakenly was advised that it had a legal obligation to complete the sale. No evidence has been presented by appellant to show that the stock, once acquired, was managed in the furtherance of a merger or any other unitary business purpose. Rather, it appears that appellant began almost immediately to try and sell the stock. Clearly, appellant has not met its burden of proving that under the "functional test" the stock constituted an integral part of appellant's unitary **business** operations at the time it was sold. The fact that it, at one time, had the potential of becoming part of appellant's business is not sufficient to satisfy the test. Likewise, there is no evidence that the sale of the stock constituted a "transaction or activity" in the **regular** course of appellant's high-technology business. (See Appeal of Johns-Manville Sales Corp., Cal. St. Rd. of Equal., Aug. 17, 1983; Appeal of Occidental Petroleum Corp., 1 . St. Bd. of Equal., June 21, 1983.)

In sum, because appellant has failed to meet its burden of proof, the action taken by respondent on this issue must be sustained.

The second issue presented in this appeal is whether respondent acted properly in refusing to accept appellant's change in its method of accounting.

Beginning with the income year ending December 31, 1976, appellant changed its method of **accounting** from the percentage-of-completion method to the completed-contract method. Respondent disallowed the change on the ground that appellant failed to **follow** the required procedures which would enable respondent to approve the change. **Appellant** contends that because it treated this item in the same manner it was treated for federal purposes, that its election to use the completed-contract method for California purposes was proper.

Section 24651, subdivision (e), provides, in part, that:

[A] taxpayer who changes the method of accounting on the basis of which it regularly

Appeal of Sundstrand Corporation

computes its income in keeping its books shall, before computing its income under the new method, secure the consent of the Franchise Tax Board.

Respondent's regulations set forth the following procedure **to** be followed in order to secure the consent of the Franchise Tax Board:

[I]n order to secure the Franchise Tax Board's consent to a change of a taxpayer's method of accounting, the taxpayer must file a request with the Franchise Tax Board . . . within **180** days after the beginning of the income year in which it is desired to make the change. The taxpayer shall, to the extent applicable, furnish **(i)** all information **necessary, disclosing** in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be duplicated or omitted as a result of the proposed change and **(ii)** the taxpayer's computation of the adjustments to **'take** into account such duplications or omissions. The Franchise Tax Board may require such other information as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the **Franchise** Tax Board agree to the terms, conditions, and adjustments under which the change will be effected.

(Cal. Admin. Code, tit. 18, reg. 24651, subd. **(e)(3)(A).**)

Appellant merely attached a copy of its federal return to its California corporate franchise tax return and assumed that this action would effectuate the change. We cannot conclude that this satisfies the statutory requirement of securing consent from the Franchise Tax Board. There is no evidence that respondent in any manner agreed to this change. Consequently, the action of respondent must also be sustained as to this second issue.

Appeal of Sundstrand Corporation

O R D E R

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 25667 of the Revenue and Taxation **Code**, that the action of the Franchise Tax Board on the protest of Sundstrand Corporation against proposed assessments of additional franchise tax in the amounts of \$22,969 and \$39,629 for the income years 1975 and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of June , 1986, by the State Board of Equalization, with Board **Members** Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

<u>Richard Nevins</u>	-	-	, Chairman
-* <u>Conway H. Collis</u>			, Member
<u>William M. Bennett</u>			, Member
<u>Ernest J. Dronenburg, Jr.</u>			, Member
<u>Walter Harvey*</u>			, Member

*For Kenneth Cory, per Government Code section 7.9