

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CTS KEENE, INC., 0500289, TAXPAYER,) No. 90A-0621-DB
AND CTS CORPORATION, DBA CTS)
ELECTRONICS, 0288781, ASSUMER AND/OR)
TRANSFEE)

Appearances:

For Appellant: Robert W. Scott
Tax Manager

For Respondent: John A. Stillwell, Jr.
Counsel

OPINION

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 CTS Keene, Inc., 0500289, Taxpayer, and CTS Corporation, DBA CTS Electronics, 0288781, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of \$91,339 for the income year 1982.

^{1/} Unless otherwise specified, all section references are to the Revenue and Taxation Code as in effect for the year in issue.

After a concession by respondent Franchise Tax Board, the sole question presented by this appeal is whether the gain appellant's parent company realized from the sale of stock in a British corporation should be treated as business income or as nonbusiness income.

Appellant was incorporated in California and began doing business in this state in 1965. It was a member of a unitary group (hereinafter referred to as the CTS group) engaged in the manufacture and sale of electronic components and subsystems for home entertainment, automotive, data processing, and industrial uses. In 1965, appellant's parent company, CTS Corporation (hereinafter referred to as CTS), entered into a licensing agreement with AB Electronic Components, Ltd. (hereinafter referred to as AB), an unrelated corporation engaged in business in Great Britain, to manufacture some of the CTS group's products in Great Britain and to market them in Great Britain and Europe. At approximately the same time, CTS also formed a German subsidiary to manufacture and sell the CTS group's products in Europe. The activities of the German subsidiary were in competition with AB's activities in Europe and thus caused friction between CTS and AB.

To resolve this conflict, CTS sold its German subsidiary to AB in 1970, in exchange for 10 percent of AB's common stock. At the same time, AB and CTS modified their existing licensing agreements and executed new licensing and sales representation agreements which granted to AB "full manufacturing and selling rights for Europe to their [the CTS group's] patents, trade-marks and know-how in the fields in which we [AB] operate." (AB Annual Report for the year ended July 2, 1971.) In a letter to respondent, CTS stated that the stock purchase and the modification of the licensing agreements were "related to some extent" and that it "used these agreements to expand its influence in Europe." (Resp. Br., Ex. A.) CTS also stated, in another letter to respondent, that the purpose of the stock purchase was to "provide it with the opportunity to expand its marketing and manufacturing operations in Europe." (Resp. Br., Ex. D.)

In 1979, CTS contracted to purchase from AB an additional 450,000 newly issued common shares of AB, increasing its ownership interest in AB to 20.5 percent of AB's outstanding common stock. The subscription agreement entered into by CTS and AB concerning these shares recited that CTS and AB "mutually desire to extend their present co-operation and to progress further the successful relationship that has, for many years, existed between them," and the agreement was expressly conditioned upon the execution of a new licensing agreement between AB and CTS covering a new product developed by the CTS group and upon the extension, from 1985 to 1990, of the expiration dates of two other licensing agreements which CTS and AB had first executed in 1965.

In 1982, CTS sold all of its AB stock for a gain. On its California combined report for that income year, appellant reported the gain as nonbusiness income and allocated the income entirely to CTS's commercial domicile outside of California. Respondent examined appellant's records and determined that the income was business income to be apportioned among all of the states, including California, where the CTS group did business. Appellant protested, respondent disallowed the protest, and this appeal followed.

Section 25120, subdivision (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.

Nonbusiness income is defined simply as all income other than business income. (Rev. & Tax Code, § 25120, subd. (d).) Section 25120 provides two alternative tests to determine whether income constitutes business income, and, if either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, Cal. St. Bd. of Equal., Oct. 28, 1980.) The first is the "transactional" test. Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the regular course of the taxpayer's trade or business. Under the second or "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property are "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of DPF Incorporated, supra; Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980.) In order for income from the sale of intangible property by a nondomiciliary corporation to be constitutionally apportionable, "[w]hat is required . . . is that the capital transaction serve an operational rather than an investment function." (Allied-Signal v. Director, Div. of Taxation, 504 U.S. --, -- [119 L.Ed.2d 533, 552] (1992).)

This appeal involves application of the functional test for determining business income. On the facts presented, we agree with respondent that CTS's stockholding in AB was integrally related to the CTS group's unitary business and was an asset that served an operational function in that business rather than merely an investment function. The evidence establishes a clear connection between CTS's two purchases of stock from AB and the licensing agreements between the two companies, agreements which expanded AB's manufacturing and marketing of CTS's products in Europe and which generated royalties to CTS that undoubtedly constituted business income. CTS's real goal was not to achieve a return on the stock itself, but rather was to support AB's efforts, under the licensing agreements, to help create a broader worldwide market for the various products developed by the CTS unitary group. CTS accomplished that goal by supplying capital to AB (transferring assets and cash to AB in exchange for newly issued AB stock), thereby putting AB in a stronger position to enhance the sale of CTS's products in Europe.

The absence of a typical return-on-investment objective is further confirmed by the absence of any evidence that CTS's acquisition or holding of AB's stock was ever motivated by anticipated dividend income or by possible appreciation in the price of AB's stock. It is clear, therefore, that CTS's stockholding in AB was functionally and integrally related to the actual operation of the CTS group's worldwide unitary business, and was not merely a passive investment such as might have arisen, for example, from open market purchases of AB stock by CTS based on an analysis of the stock's

long-term investment potential.

The principal case upon which appellant relies is our opinion in the Appeal of Mark Controls Corporation, decided by this board on December 3, 1986. In Mark Controls, we held that the taxpayer realized nonbusiness income from the sale of stock in two different companies, each of which was engaged in the same general business as the taxpayer, and each of which was a foreign licensee of the taxpayer. Despite superficial similarities between that appeal and this one, we believe the situations considered in Mark Controls are quite distinguishable from the one we have here.

With respect to Mark Controls' purchases of stock in the Spanish company Walthon-Weir P.S.A., it was clear that one of the primary reasons for the purchases was that Walthon's bylaws required it to pay annual dividends equal to 50 percent of its audited earnings. This was an explicit passive investment motive that certainly is not present in the appeal now before us.

In the case of the Scottish company referred to as Weir, Mark Controls had acquired 49.5 percent of Weir's stock, and also held an option to purchase the remainder of the outstanding shares. Although Weir's stock was acquired in order to give Mark Controls the opportunity to expand its marketing and manufacturing operations in the United Kingdom, it intended to accomplish this result by acquiring complete ownership and control of Weir and integrating its operations into Mark Controls' existing unitary operations. Mark Controls never gained control of Weir, however, completely frustrating its only reason for having acquired the stock in the first place. We held that the gain on the sale of the Weir stock was nonbusiness income since neither the underlying assets nor the activities of Weir ever became an integral part of Mark Controls' business. Our rationale was that all of Mark Controls' actions with respect to Weir were preparatory to integrating Weir into its operations, and we stated that the mere potential to integrate Weir into the operations of Mark Controls was insufficient to find that the gain on the sale of the stock was business income, citing our opinion on petition for rehearing in the Appeal of Occidental Petroleum Corporation, issued by this board on June 21, 1983.

In the present appeal, on the other hand, there was nothing "preparatory" about CTS's actions; CTS's apparent business goal was fully accomplished by becoming a minority shareholder in AB, for in doing so it supplied new capital to AB and thereby assisted AB's efforts to become a more effective promoter of CTS's products in Europe. Thus, the AB stock was a fully integrated asset of the CTS group's unitary business, and, while appellant would have us believe that the AB stockholding had become a mere investment by the time it was sold, there is no evidence that CTS's reason for owning it ever changed.^{2/} Finally, it simply is not necessary that CTS have acquired control of AB before income

^{2/} The record does contain a one-page report by a CTS employee, prepared shortly before CTS sold its AB stock. However, it consists almost entirely of two tables summarizing the impact on cash flow and earnings of a sale at various assumed prices, as compared to the cost of exercising an apparent right owned by CTS to purchase additional stock from AB. This sort of comparison hardly amounts to proof that CTS regarded its AB stock as a mere investment. There is no analysis of CTS's historical return on its investment in AB's stock and no attempt to predict what the future return might be.

from the stock could be considered business income. The U.S. Supreme Court has clearly held that gain from the sale of stock can constitutionally be apportioned even if the previously affiliated companies were not part of the same unitary business, as long as the stockholding served an operational function rather than an investment function. (Allied-Signal v. Director, Div. of Taxation, supra.) That is definitely what occurred here. Accordingly, respondent properly classified the gain as apportionable business income.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of CTS Keene, Inc., 0500289, Taxpayer, and CTS Corporation, DBA CTS Electronics, 0288781, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of \$91,339 for the income year 1982, be and the same is hereby modified in accordance with the Franchise Tax Board's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 10th day of February, 1993, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Windie Scott* _____, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9