ADOPTED 6/29/95 95-SBE-004

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	No. 81A-0883
Fairmont Hotel Company	)	No. 85A-1101
	)	

Appearances:

For Appellant: Franklin C. Latcham
Attorney at Law

For Respondent: Israel Rogers
Supervising Counsel

OPINION ON PETITION FOR REHEARING

On October 31, 1989, we sustained the action of the Franchise Tax Board in denying the claims of Fairmont Hotel Company for refund of franchise tax in the amounts of $9,335, $11,758, $14,194, $147,080, $164,382, $320,103, $516,773, $401,358, and $420,906 for the income years ended on October 31 in each of the years 1973 through 1981, respectively. On November 30, 1989, appellant filed a timely petition for rehearing pursuant to section 26077 (renumbered as section 19334, operative January 1, 1994) of the Revenue and Taxation Code.[1/]

[1/] Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the income years in question.

Appellant and its subsidiaries are engaged in a single unitary business consisting of managing hotels in various cities throughout the United States. Appellant is a California corporation whose commercial domicile is also located in California. Beginning in 1976, appellant purchased certain computer equipment subject to pre-existing triple net leases. Pursuant to the leases, appellant received net rentals in excess of the debt service which, together with investment tax credits and depreciation deductions, yielded a significant after-tax cash flow. Appellant had no role in negotiating or administering the leases. They were merely passive investments. All the computer equipment was located in states where appellant had no other presence. The purpose for buying the leased computers was to generate working capital, and the funds thus generated were actually used to finance the operations of the unitary hotel business during the appeal years.

On its franchise tax returns for the years in question, appellant treated the net losses arising from its leasing activities as nonbusiness losses specifically allocable to its commercial domicile in California. Respondent examined the returns, agreed that the losses were nonbusiness losses, but determined that they should be allocated to the various states in which the computers were physically located. Appellant appealed this determination to this board, where its sole contention is that the losses should be treated as business losses apportionable among all of the states in which the hotel management business was conducted.

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. 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 were "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, Cal. St. Bd. of Equal., Oct. 28, 1980; Appeal of Fairchild Industries,Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; cf. Allied-Signal, Inc. v. Director, Tax. Div., 504 U.S. __, __ [119 L.Ed.2d 533, 552] (1992) (the investment must "serve an operational rather than an investment function.") If either of these two tests is met, the income will constitute business income. (Appeal of DPF Incorporated, supra.) Respondent's determination as to the character of income under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Johns-Manville Sales Corporation, Cal. St. Bd. of Equal., Aug. 17, 1983.) In addition, respondent's regulations provide that "income of the taxpayer is business income unless clearly classifiable as 'nonbusiness income." (Cal. Code Regs., tit. 18, § 25120,

subd. (a).)

We believe the income at issue in this case is clearly classifiable as nonbusiness income. Appellant argues that the income is business income under the functional test because appellant set out with the express purpose of generating working capital, undertook an activity with the express purpose of generating that capital, successfully executed the plan, and used the working capital generated thereby as an integral part of its plan of expanding its hotel management business. This focus on the relationship of the income to appellant's unitary business is misplaced. What matters under the statute is whether the acquisition, management, and disposition of the income-producing "property" (i. e., the computers) constituted integral parts of appellant's unitary business operations.[2/] It is clear that the computers being leased out were entirely unrelated to the hotel management business, except as a source of funds for its operations. If appellant's position were correct, then the income from virtually any investment or activity, no matter how unconnected they are to the operation of the unitary business, would be apportionable business income so long as the income itself was later used in the business. Such a rule could not pass constitutional muster.[3/] As the United States Supreme Court said in Container Corp. v. Franchise Tax Board, 463 U.S. 159, 166 [77 L.Ed.2d 545] (1983), in order for formula apportionment to be a reasonable method of taxation, there must be some sharing or exchange of value "beyond the mere flow of funds arising out of a passive investment or a distinct business operation."[4/] It would be hard to imagine an investment more passive than buying equipment subject to pre-existing triple net leases, as appellant did here. It is apparent that these computers served an investment function, rather than an operational function, in appellant's hotel business. (See Allied Signal, Inc. v. Director, Tax. Div., supra, 504 U.S. at __ [119 L.Ed.2d at 553].)

The facts of this appeal are very different from those in the recent Appeal of Cullinet Software, Inc., et al. (95-SBE-002), decided by this board on May 4, 1995, where we held that the income from idle funds invested in liquid financial instruments constituted business income because those funds were at all times held readily available for use in the unitary business and, therefore, were part of the working capital of that

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[2/] See also Allied-Signal, Inc. v. Director, Tax. Div., supra, 504 U.S. at __ [119 L.Ed.2d at 550], where the Supreme Court said that the relevant constitutional inquiry in the area of state taxation of income from intangible property is "one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state." (Emphasis added.) To the extent that the North Carolina appellate court in National Service Industries, Inc. v. Powers, 391 S.E.2d 509 (N.C. App. 1990), focussed on the relationship between "the return on [the taxpayer's] investment" in safe-harbor leases and the unitary business, rather than on the relationship between the leased property itself and the business, its decision conflicts not only with the Supreme Court's later opinion in Allied-Signal but also with the plain wording of California's statutory definition of (functional test) business income. For that reason, we decline to follow the North Carolina case, and appellant's reliance on that case is, therefore, unavailing.

[3/] The Supreme Court has explicitly indicated that we are not to attach any significance to the fact that appellant commingled the income in question with its general corporate operating funds, because to do so would "subvert" the unitary business limitation on state taxation. (F. W. Woolworth Co. v. Taxation & Rev. Dept., supra, 458 U.S. at 364, fn. 11.)

[4/] In other recent cases, the Court stated emphatically that the due process limitations on a state's power to tax are not satisfied if the income in question merely "adds to the riches of the corporation," (ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 328 [73 L.Ed.2d 787] (1982), quoting Wallace v. Hines, 253 U.S. 66, 70 [64 L.Ed. 782] (1920)), or if the corporate taxpayer simply derives some economic benefit from its ownership of the asset in question. (F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 363-364 [73 L.Ed.2d 819] (1982).)

business. The difference, of course, is that appellant's investment in the computers was illiquid and not readily available for use as part of the working capital of the hotel management business. Under unitary theory, income from the investment of excess working capital constitutes apportionable business income because the capital itself (not just the income therefrom) is available for use in the unitary business, whenever the need arises. (See W. Hellerstein, "State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond," 48 Tax L.R. 739, 793 fn. 317 (1994).) Appellant, for good reason, does not even suggest that the computers were themselves part of the working capital of its unitary business.

For the above reasons, we conclude that respondent properly classified appellant's losses from its computer-leasing activities as nonbusiness income specifically allocable outside of California.

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 19334 of the Revenue and Taxation Code, that the petition of Fairmont Hotel Company for rehearing of its appeals from the actions of the Franchise Tax Board in denying its claims for refund of franchise tax in the amounts of $9,335, $11,758, $14,194, $147,080, $164,382, $320,103, $516,773, $401,358, and $420,906 for the income years ended on October 31 in each of the years 1973 through 1981, respectively, be and the same is hereby denied, and that our order of October 31, 1989, be and the same is hereby affirmed.

Done at Sacramento, California, this 29th day of June, 1995, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs , Chairman

Ernest J. Dronenburg, Jr. , Member

Dean F. Andal , Member

Brad Sherman , Member

Rex Halverson* , Member

*For Kathleen Connell, per Government Code section 7.9.