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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY²**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **FARMERS AND MERCHANTS**) Case No. 359062
13 **BANK OF LONG BEACH¹**)

	<u>Years</u>	<u>Proposed Assessment</u>	<u>Claim For Refund</u>
	2000	\$238,928 ³	--
	2001	--	\$140,153 ⁴

18 Representing the Parties:
19 For Appellant: Doug Bramhall, KPMG
20
21 For Franchise Tax Board: Ann H. Hodges, Tax Counsel
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23 ¹ Appellant is headquartered in Long Beach, California.

24 ² This matter was originally scheduled for oral hearing on August 14, 2007, but was removed from the calendar to allow for
25 further briefing.

26 ³ This amount is the amount attributable to respondent's disallowance of the net interest deduction and is the amount at issue
27 in this appeal for 2000. (Appeal Letter, p. 2; Resp. November 20, 2006 Br., fn. 1.) To avoid confusion, briefs will be
28 referenced by the date of the relevant brief and the filing party.

⁴ This amount is the amount attributable to respondent's disallowance of the net interest deduction and is the amount at issue
in this appeal for 2001. (Appeal Letter, P. 2; Resp. November 20, 2006 Br., fn. 2.)

1 QUESTION: Whether appellant is entitled to the enterprise zone net interest deduction under
2 Revenue and Taxation Code (R&TC) section 24384.5.

3 HEARING SUMMARY

4 Background

5 Appellant is a community bank engaged primarily in commercial lending. During the
6 years at issue, appellant held approximately 400 outstanding loans to individuals and entities within
7 various enterprise zones (primarily the Long Beach enterprise zone). (Resp. November 20, 2006 Br.,
8 pp. 1-2.) On its returns for 2000 and 2001, appellant claimed a “net interest deduction” of \$3,768,350
9 and \$3,102,726, respectively, for the interest received on those loans. (*Id.* at pp. 3-4.)

10 Respondent selected appellant’s 2000 and 2001 returns for audit. Due to the large
11 number of loans for which appellant had claimed the net interest deduction, the parties agreed to the
12 following sampling method:

- 13 • the loans were separated into three categories based on the amount of the net interest
14 deduction attributable to the loan for each year: (1) less than \$1,000, (2) between \$1,000 and
15 \$50,000, and (3) over \$50,000;
- 16 • respondent allowed all deductions attributable to loans in the under \$1,000 category;
- 17 • respondent audited every tenth loan in the \$1,000—\$50,000 category and applied the error
18 percentage to all loans in that category; and
- 19 • respondent audited every loan in the over \$50,000 category. (*Ibid.*)

20 As a result of the audit, respondent disallowed \$2,178,689 in deductions for 2000 and \$1,573,232 in
21 deductions for 2001. (*Ibid.*) Respondent’s disallowances arose from its determinations with regard to
22 loans made to four nonprofit organizations (two of which were included as samples from the \$1,000 to
23 \$5,000 category) and a loan made to Allen and Deanna Alevy (“Alevy”) and Amusement Industry, Inc.
24 (“Amusement”).

25 Specifically, respondent disallowed net interest deductions for loans made to the
26 following four nonprofit organizations (Appeal Letter, p. 3.):

- 27 1. The Long Beach Memorial Medical Center (LBMMC), which operates a hospital and
28 provides medical care to the general public for a fee. LBMMC also houses a gift shop and

1 operates an insurance business. LBMCC employs about 7,900 people in the Long Beach
2 enterprise zone (App. September 20, 2007 Br., pp. 5-6.);

- 3 2. The Jewish Federation of Greater Long Beach (Jewish Federation), which operates a fitness
4 center, provides clinics, hosts luncheons, and provides sports and fitness classes within the
5 Long Beach enterprise zone (*Id.* at p. 6.);
- 6 3. The United Cambodian Community Center (UCCC), which provides legal aid, art, music,
7 and dance programs to Cambodian refugees in Long Beach (*Ibid.*);
- 8 4. Bethany Missionary, which conducts church services, runs youth programs and conducts
9 church activities in Long Beach. (*Ibid.*)

10 As discussed in more detail below, the enterprise zone net interest deduction requires that the debtor be
11 engaged in a trade or business in an enterprise zone. Respondent reasoned that, because a “trade or
12 business requires a profit motive; a nonprofit organization cannot be engaged in a trade or business.”
13 Respondent therefore disallowed deductions for loans to the foregoing entities. It appears those four
14 nonprofit organizations are only examples of those that may be involved, due to the sampling method
15 the auditor used. In this regard, respondent states:

16 In its appeal, appellant appears to be disputing the disallowance of the net interest
17 deduction attributable to all loans to non-profits. . . . However, appellant has not argued
18 that the sampling method to which it agreed is incorrect. Therefore, respondent assumes
19 that appellant is in fact arguing that any net interest deduction attributable to loans made
20 to non-profit entities which were disallowed as part of the sample should be allowed and
21 the error rate appropriately revised. (Resp. November 20, 2006 Br., p. 5 at fn. 6.)

22 Respondent states that the loans to Bethany Missionary and UCCC were samples taken from the \$1,000
23 to \$50,000 category and were the only loans to nonprofits that were included in the sample. (Resp.
24 September 21, 2007 Br., p. 6.) Respondent states that, although it has a list of loans made in the \$1,000
25 to \$50,000 category, it is unable to determine which of the recipients of these loans were nonprofits.⁵
26 The loans to LBMCC and the Jewish Federation were over \$50,000; they were audited separately, were
27 not part of any sample and were disallowed in their entirety. (*Ibid.*) Appellant asserts that, if the Board

28 ⁵ Staff requests that, at the hearing, the parties clarify what effect a Board decision with regard to Bethany Missionary and UCCC will have on the amounts at issue and whether they agree on the calculations necessary to determine the amount of tax if the Board reverses respondent’s determination with respect to either or both of these loans.

1 permits net interest deduction related to nonprofit entity loans, the error rate for 2000 and 2001 will be
2 adjusted for the \$1,000 to \$50,000 category; from 42.2539 percent to 23.2560 percent in 2000 and from
3 41.4243 percent to 39.1462 percent in 2001. (App. September 20, 2007 Br., p. 7.) Appellant further
4 explains that, since respondent looked at each loan over \$50,000, the allowance of an interest deduction
5 for the loans to LBMMC and the Jewish Federation would not affect the error rate.⁶ (*Ibid.*)

6 As noted previously, respondent also disallowed the net interest deduction for a loan
7 made to Alevy and Amusement. (Resp. November 20, 2006 Br., p. 5.) Amusement is a California
8 corporation of which Alevy owns 20 percent. Amusement owns and rents commercial and residential
9 real estate, including at least 140 separate parcels in Southern California, most of which are outside of
10 the Long Beach enterprise zone. (*Id.* at p. 6.) Alevy and Amusement used the proceeds of appellant's
11 loan to purchase a note from Tokai Bank, which was secured by a first trust deed on the Sylmar Square
12 Shopping Center. (*Id.* at p. 7.) The shopping center is located outside the Long Beach enterprise zone.
13 Respondent determined that Alevy/Amusement were not engaged in a trade or business solely within the
14 Long Beach enterprise zone, as required by R&TC section 24384.5, and therefore denied the net interest
15 deduction for the Alevy/Amusement loan. (*Id.* at p. 8.)

16 Respondent proposed assessments based on its partial disallowance of the net interest
17 deductions. In addition, while the audit was pending, appellant filed claims for refund in which it
18 claimed enterprise zone hiring credits. (*Id.* at p. 1, fn. 1.) Respondent allowed all of the claimed hiring
19 credits and used them to partially offset the proposed assessments, which resulted in the dual
20 assessment/refund nature of this appeal. (*Id.*, at p. 1, fn. 2.)

21 Applicable Law

22 The Board has described the purpose of the enterprise zone program as follows:

23 The Legislature enacted the Enterprise Zone Act (EZA) to stimulate business and
24 industrial growth in economically depressed areas of the state by relaxing regulatory

25 ⁶ Respondent requests that, if the Board allows an interest deduction for these loans, that respondent have the opportunity for
26 its audit staff to verify the revised sample error percentage. (Resp. November 5, 2007 Br., p. 5.) Staff requests that
27 respondent attempt to prepare this information prior to the meeting so that, at the meeting, respondent can explain the effect
28 of the disallowance of these on the error percentage and the amounts at issue. Both parties should be prepared to discuss the
error percentage calculations so that, regardless of how this Board rules with respect to each loan, the Board's ruling can
resolve this matter without further hearings or delay. If the parties disagree with regard to the calculation of the error
percentage, the parties should be prepared to explain their areas of disagreement at the hearing.

1 controls that impede private investment. . . . The EZA thus contains regulatory, tax, and
2 other incentives to attract investment into those areas. (*Appeal of Deluxe Corporation*,
2006-SBE-003, Dec. 12, 2006 [citation omitted].)

3 Similarly, published legislative history states that enterprise zones were created:

4 . . . in an attempt to stimulate business development and employment growth within
5 economically distressed areas. Tax benefits, regulatory relief, reduced utility rates, and
6 other business-friendly benefits are offered by state and local governments to increase
investment and attract businesses in these areas. (Assem. Com. on Rev. & Tax., Analysis
of SB 2023 (1995-1996 Reg. Sess.) as amended June 27, 1996, p. 5.)

7 Among the tax incentives designed to attract investment to enterprise zones is the net
8 interest deduction. R&TC section 24384.5, subdivision (a), allows a deduction for “the amount of net
9 interest received by the taxpayer in payment of indebtedness of a person or entity engaged in a trade or
10 business located in an enterprise zone.” R&TC section 24384.5 provides that the deduction is allowed
11 only if all of the following requirements are met at the time the indebtedness is incurred:

- 12 (1) The trade or business is located solely within an enterprise zone;
- 13 (2) The indebtedness is incurred solely in connection with activity within the enterprise zone;
- 14 and
- 15 (3) The taxpayer has no equity or other ownership interest in the debtor.

16 As mentioned above, respondent denied the net interest deduction for loans to nonprofit
17 organizations on the basis that nonprofit organizations cannot be engaged in a “trade or business” in an
18 enterprise zone. R&TC section 24384.5 does not contain a definition of the phrase “trade or business,”
19 as used therein. Although the phrase “trade or business” appears to be ubiquitous in the federal and state
20 tax codes, there is no statutory definition of general application.

21 In *Commissioner v. Groetzinger* (1986) 480 U.S. 23, the U.S. Supreme Court reviewed
22 the evolution of the phrase “trade or business” in case law and summarized the definition:

23 We accept the fact that to be engaged in a trade or business, the taxpayer must be
24 involved in the activity with continuity and regularity and that the taxpayer's primary
25 purpose for engaging in the activity must be for income or profit. A sporadic activity, a
hobby, or an amusement diversion does not qualify. (*Id.*, at p. 35.) [Emphasis added.]

26 The Court then cautioned that “trade or business” is not susceptible to a bright-line definition, but rather
27 requires an examination of the facts and circumstances of each case. (*Id.*, at p. 36.) The Court
28 recognized that this would not be a satisfactory solution for many people, however:

1 . . . the difficulty rests in the Code’s wide utilization in various contexts of the term ‘trade
2 or business,’ in the absence of an all-purpose definition by statute or regulation, and in
3 our concern that an attempt judicially to formulate and impose a test for all situations
would be counterproductive, unhelpful, and even somewhat precarious for the overall
integrity of the Code. (*Id.*)

4 The Internal Revenue Code (“IRC”) uses the phrase “trade or business” in numerous
5 contexts, including one that deals specifically with nonprofit organizations. The Unrelated Business
6 Income Tax (“UBIT”) is imposed on the “unrelated business taxable income” of a tax-exempt
7 organization. (Int.Rev. Code, § 511(a).) “Unrelated business taxable income” is, in general, the net
8 income that a tax-exempt organization derives from an “unrelated trade or business.” (Int.Rev. Code,
9 § 512(a)(1).) An “unrelated trade or business” is:

10 . . . any trade or business the conduct of which is not substantially related . . . to the
11 exercise or performance by such organization of its charitable, educational, or other
12 purpose or function constituting the basis for its [tax] exemption (Int.Rev. Code,
§ 513(a).)

13 As with other contexts, the UBIT’s use of the phrase “trade or business” requires that an activity be
14 motivated by profit. (*Portland Golf Club v. Commissioner* (1990) 497 U.S. 154, 164-166; *West Virginia*
15 *State Med. Ass’n v. Commissioner* (4th Cir. 1989) 882 F.2d 123, 124-125.) California law governing
16 nonprofit entities, including public benefit corporations, mutual benefit corporations, and religious
17 corporations, expressly affirms the right of those entities to “carry on a business at a profit” and use that
18 profit for any lawful activity. (Cal. Corp. Code, §§ 5140, subd. (1), 7140, subd. (1), & 9140, subd. (1).)

19 Contentions Regarding the Loans to Nonprofits

20 Appellant’s Contentions Regarding the Loans to Nonprofits

21 Appellant contends that respondent’s disallowance of the net interest deduction for the
22 loans to nonprofits at issue here is in error because a nonprofit organization can engage in a trade or
23 business. For example, the LBMMC operates a hospital and insurance business, employing over 7,900
24 people within the Long Beach enterprise zone. Employing that number of people in an economically
25 disadvantaged area, appellant argues, satisfies the intent and policy behind the enterprise zone. (Appeal
26 Letter, p. 8.) The Jewish Federation has a fitness center, operates clinics, hosts luncheons, and hosts
27 sports and fitness classes within the Long Beach enterprise zone. They charge fees to attend the
28 luncheons and classes; those fees sustain the organization and fund capital improvements and program

1 expansions. Those activities are, appellant argues, trades and businesses within the enterprise zone.
2 (*Id.*, pp. 8-9.) Similarly, the United Cambodian Community Center provides art, music, and dance
3 programs to Cambodian refugees in Long Beach, and has employees to oversee and maintain its
4 operations. (*Id.*, p. 9.) Bethany Missionary, appellant asserts, conducts fundraising activity that is a
5 trade or business; the missionary also requires the services of a pastor and maintenance people who are
6 engaged in trades and businesses within the enterprise zone. (*Id.*) Moreover, appellant asserts that these
7 entities have to generate profits in their activities in order to repay the loans to appellant. (*Id.*)

8 Subsequent to the initial briefing period, Appeals Division Staff requested additional
9 briefing to address the issue of whether R&TC section 24384.5 uses the phrase “trade or business” in a
10 similar sense as other tax statutes. Appellant contends that, although it was unable to find anything
11 directly on point to answer this question, R&TC section 23622.7, subdivision (a)(5) defines a taxpayer
12 as a corporation engaged in a trade or business within the enterprise zone.⁷ (App. September 20, 2007
13 Br., p. 1.) Accordingly, appellant asserts that it may be assumed that the phrase “trade or business” in
14 R&TC Section 24384.5 has the same use as in other statutes. (*Ibid.*)

15 Appellant states that respondent defines a nonprofit’s “unrelated trade or business” as
16 “any trade or business the conduct of which is not substantially related (aside from the need of such
17 organization for income or funds . . .) to the exercise or performance by such organization of its
18 charitable, educational or other purpose” (App. October 23, 2007 Br., p. 1.) Appellant contends
19 that this definition demonstrates that nonprofits can be engaged in a trade or business.

20 Appellant further argues that the phrase “trade or business” can refer to both the overall
21 purpose and to a discrete activity in which an organization is engaged. In support of its contentions,
22 appellant cites *Richmond Wholesale Meat Company v. Franchise Tax Board* (1995) 36 Cal.App 4th
23 990.⁸ Appellant argues that, while the Court of Appeal declined to define the phrase “trade or
24 business,” it relied on R&TC section 23101, which defines “doing business” as “actively engaging in
25 any transaction for the purpose of financial or pecuniary gain or profit,” and the court did not specify
26

27 ⁷ It appears to staff that appellant is referring to R&TC section 23622.7, subdivision (b)(5).

28 ⁸ Respondent notes that the California Supreme Court later directed that the Reporter of Decisions not publish the Appeals
Court opinion in the Official Reports. (1995 Cal. LEXIS 6623; see Resp. November 5, 2007 Br., exhibit S.)

1 that the pecuniary gain or profit be *taxable* gain or profit. Appellant states that the Appeals Court
2 defined the term “business” as “that which habitually busies or occupies . . . the time, attention, labor,
3 and effort of persons as a principal, serious concern or interest or for livelihood or profit” as support for
4 its contention that a nonprofit may conduct a “trade or business.” (App. September 20, 2007 Br., pp. 2-
5 3.)

6 Appellant maintains that the four United States Supreme Court cases cited by Appeals
7 Division Staff in the request for further briefing (*United States v. American Bar Endowment* (1986) 477
8 U.S. 105; *Texas Farm Bureau v. United States* (5th Cir. 1995) 53 F.3d 120; *North Ridge Country Club v.*
9 *Commissioner* (9th Cir. 1989) 877 F.2d 750; *Portland Golf Club v. Commissioner, supra.*) support
10 appellant’s position that a nonprofit can engage in a trade or business. These cases, appellant asserts,
11 demonstrate that nonprofit entities do engage in trade or business activities and are subject to tax only on
12 unrelated business income. Appellant contends that the Supreme Court in *United States v. American*
13 *Bar Endowment* (1986) 477 U.S. 105, stated that “Congress defined a “trade or business” as “any
14 activity which is carried on for the production of income from the sale of goods or the performance of
15 services.” (App. September 20, 2007 Br., p. 4.) Appellant maintains that the Supreme Court was not
16 asked to address whether a nonprofit entity could engage in a “trade or business” in these cases because
17 it was clear that a nonprofit entity can engage in a trade or business. (App. October 23, 2007 Br., p. 2.)

18 Appellant asserts that nonprofits often attempt to raise money through activities other
19 than contributions or by means that are outside of their charitable purpose and that when they do so
20 through a trade or business that is regularly carried on, they are subject to tax on that income under the
21 UBIT statutes found in IRC sections 511-513. (App. September 20, 2007 Br., p. 3.) Appellant
22 concludes that the existence of this mechanism for taxing unrelated business income shows that the
23 phrase “trade or business” refers to the organization’s overall purpose and to a discrete activity.
24 Appellant argues that, contrary to respondent’s contention, the unrelated business income tax statutes do
25 not require a nonprofit entity to be engaged in a trade or business with a for-profit motive, only that they
26 pay tax on income generated by activities beyond their charitable purpose. (App. October 23, 2007 Br.,
27 p. 1.)

28 Finally, appellant argues that respondent has placed undue emphasis on the word

1 “nonprofit.” The term “nonprofit” has nothing to do with the ability of an entity to earn profit or engage
2 in a trade or business, but refers to the restriction on the entity distributing profits to its members. (App.
3 April 9, 2007 Br., p. 1.) Appellant contends that the California Corporations Code sections 5140, 7140,
4 and 9140 (which pertain to Nonprofit Benefit, Mutual Benefit, and Religious Corporations) allow public
5 benefit corporations to carry on a business at a profit and apply any resulting profit to any activity in
6 which it may lawfully engage. (App. September 20, 2007 Br., p. 4.) Appellant maintains that these
7 sections of the Corporations Code define what a nonprofit corporation can and cannot do under the law
8 without violating their corporate charters or nonprofit status. (*Ibid.*) Appellant questions why, if such
9 entities are not allowed to earn a profit, there are laws that exempt their income from taxation. If there
10 were no profit generated, there would be no income to tax and no need for an exemption. (*Id.*, at p. 2.)

11 In addition, appellant maintains that respondent’s disallowance of the net interest
12 deduction for loans to nonprofits is contrary to the public policy underlying the enterprise zone program.
13 Appellant asserts that it is in the economic interest of the state to have one strong, combined, and
14 business-friendly incentive program to attract business to the state. (App. September 20, 2007 Br., p. 2
15 (citing Government Code § 7071, subdivision (b)).)

16 Respondent’s Contentions Regarding the Loans to Nonprofits

17 Respondent emphasizes that common definitions of “trade or business” require the
18 existence of a profit motive. Respondent then argues that a nonprofit organization cannot have a profit
19 motive as one of its purposes and, therefore, it cannot be engaged in a trade or business. (Resp.
20 November 20, 2006 Br., pp. 8-10.)

21 Respondent maintains that the term “trade or business” has been construed by the
22 Supreme Court and other tax statutes to require a taxpayer’s primary purpose in engaging in a trade or
23 business to be a profit motive. (Resp. November 5, 2007 Br., at pp. 1-3.) Respondent contends that,
24 instead, appellant has defined the term in a manner which is both novel and without support. (*Ibid.*)
25 Respondent argues that appellant’s definition of the term “trade or business” is flawed because, prior to
26 discussing the substantive issue, appellant equates the definition of “trade or business” with “doing
27 business.” (Resp. November 5, 2007 Br., p. 2.)

28 Respondent argues that a nonprofit cannot be formed for the purpose of making a profit

1 and that it must be formed for exclusively charitable purposes. Respondent cites R&TC section 23701,
2 subdivision (d) and California Corporations Code section 5111, in support of this contention.
3 Respondent maintains that to interpret the term “trade or business” in such a way as to refer to any
4 activity conducted by an organization that is designed to raise money is the functional equivalent of
5 removing the term “trade or business” from the statute. (Resp. September 21, 2007 Br., p. 3.) Therefore,
6 respondent argues that the “trade or business” as used in the net interest deduction statute refers to an
7 organization’s overall purpose and not, as appellant contends, to a particular discrete activity. (*Ibid.*)

8 Finally, respondent argues that appellant has not shown that the primary purpose of the
9 four nonprofit entities at issue was profit motivation as the statute requires. (Resp. November 5, 2007
10 Br., p. 4.) Therefore, respondent asserts that appellant still has not shown that these four entities were
11 engaged in a “trade or business.” (*Ibid.*) Respondent states that information available to it on California
12 Exempt Organization Business Income Tax Returns filed by LBMCMC, show that only LBMCMC was
13 engaged in an “unrelated trade or business” for the years at issue.⁹ (*Ibid.*) However, respondent
14 contends that because these returns do not indicate the location of the “affiliate” or the rental real estate
15 that appellant has not established that the “trade or business” was located in the enterprise zone. (*Id.* at
16 p. 5.)

17 Contentions Regarding Loan to Alevy/Amusement

18 In its appeal letter, appellant contends that Alevy/Amusement used the proceeds of the
19 loan in the trade or business of investing in commercial paper, which they did from their office in the
20 Long Beach enterprise zone. Appellant states that Alevy/Amusement purchased the note from Tokai
21 Bank for the purpose of profiting from the income stream generated by the note. Alevy/Amusement
22 may have other trades or businesses that are operated outside the enterprise zone (i.e., their real estate
23 holdings), but those are discrete operations that should be considered separate from the business of
24 investing in the Tokai Note. (Appeal Letter, pp. 4-5.) Furthermore, the fact that Alevy and Amusement
25 could foreclose on the Sylmar Square Shopping Center and become the title-holder of the property does
26 not mean that they obtained the loan to further their real estate business. In fact, Alevy and Amusement
27

28 ⁹ Respondent states that in the interest of protecting LBMCMC’s privacy, it has not provided copies of these returns, but will do so upon request of either appellant or the Board.

1 have not foreclosed on the shopping center and they continue to derive income from the note. (*Id.*, p. 5.)

2 Respondent contends that, for purposes of the net interest deduction, the trade or business
3 of the debtor must be “located solely” within an enterprise zone, and the debtor must use the proceeds of
4 the loan solely within the enterprise zone. Respondent argues that R&TC section 24834.5 is
5 unambiguous, and its use of the word “located” requires a focus on the physical location of the debtor’s
6 trade or business. Accordingly, the phrase “located solely within” requires that the debtor operate a
7 trade or business that is physically situated exclusively in the enterprise zone. In this case, respondent
8 argues that Alevy/Amusement does not operate a business located solely within the Long Beach
9 enterprise zone, noting that Amusement owns numerous parcels of real estate, most of which are outside
10 the enterprise zone. (Resp. November 20, 2006 Br., pp. 10-11.)

11 Respondent argues that appellant has mischaracterized Alevy/Amusement as having a
12 trade or business of investing in commercial notes. Alevy/Amusement’s purpose in obtaining the loan
13 from appellant, and subsequently using the loan to purchase the Tokai Bank note, was to acquire the
14 Sylmar Square Shopping Center. At the time of the loan, Tokai Bank had initiated foreclosure
15 proceedings against the shopping center. Alevy/Amusement and appellant were aware of the
16 foreclosure proceedings, and the loan documents indicated that the foreclosure on the property was the
17 primary source of repayment. The loan documents also provide that, if an outside bidder did not
18 purchase the shopping center, appellant would obtain the shopping center and then would quitclaim the
19 property to Amusement. Thus, respondent argues, the underlying investment was in the shopping
20 center. Because the shopping center is real property located outside the enterprise zone, the trade or
21 business was not located solely in the enterprise zone. (Resp. November 20, 2006 Br., pp. 11-12.)

22 Respondent next argues that, even if Alevy/Amusement were engaged in the trade or
23 business of investing in notes, the statute does not allow us to ignore the other business activities of the
24 debtor. Here, respondent contends, Alevy and Amusement were conducting other business activities
25 outside of the Long Beach enterprise zone. (Resp. November 20, 2006 Br., pp. 11-12.)

26 Respondent notes that the net interest deduction is just one of several tax incentives
27 designed to promote economic investment and activity within enterprise zones. The other incentives
28 contain provisions that limit their application to income or tax that is apportioned to the enterprise

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2 zone.¹⁰ According to respondent, that limitation encourages economic activity within the zones while
3 limiting the cost of the incentives. The net interest deduction, however, contains no such limitation, in
4 that it may be used to offset any California-source income, regardless of whether it is specifically
5 attributable to an enterprise zone. So, respondent contends, the net interest deduction requires a
6 different approach to limiting the cost of the incentive. The cost of the net interest deduction is limited
7 by limiting its availability to creditors who provide capital to entities engaged in a trade or business
8 located exclusively within the enterprise zone. (Resp. November 20, 2006 Br., pp. 12-13.)

9 Appellant replies by arguing that the debtor's intent in obtaining the loan is irrelevant,
10 and requests that the Board ignore the intentions of Alevy and Amusement and instead focus on what
11 actually happened with the loan. What happened, appellant argues, is that Alevy and Amusement
12 acquired only a note from Tokai Bank, and did not acquire title to the Sylmar Square property.
13 Appellant argues that the acquisition of the Tokai Bank note was not unlike the trade or business of
14 investing in stock. An entity with an office located in an enterprise zone could borrow funds to make
15 investments in stock in order to generate income from gains, interest, and dividends. Such an entity
16 would be using borrowed funds solely for activity within the enterprise zone. (App. December 27, 2006
17 Br., p. 4.)

18 Respondent argues that Alevy/Amusement's intent in obtaining the loan is relevant
19 because the statutory requirements must be met at the time the loan is made. Respondent maintains that
20 Alevy and Amusement obtained the loan with the intention of acquiring the Sylmar Square property, and
21 only after the acquisition was unsuccessful did they engage in the trade or business of investing in notes.
22 That new trade or business began after the loan was made and therefore does not meet the statutory
23 requirements. (Resp. March 5, 2007 Br., p. 6.)

24 As evidence that Alevy/Amusement intended to use the loan proceeds to acquire the
25 Sylmar Square property, respondent points to the following:

- 26 ✓ Tokai Bank began foreclosure proceedings on Sylmar Square in June 1998.
- 27

28 ¹⁰ Income is generally apportioned by comparing the taxpayer's payroll and property located in the zone to payroll and property located elsewhere in California.

- 1 ✓ In August 1998, the Alevy’s attempted to purchase Sylmar Square. The draft purchase
2 agreement stated that the Alevy’s would pay off the loan to Tokai Bank, and the bank would
3 cancel foreclosure proceedings. An amended purchase agreement stated that Mr. Alevy was
4 “committed in principle to buy the shopping center.”
- 5 ✓ In September 1998, the Alevy’s entered into an agreement with Tokai Bank to purchase the
6 note for \$7 million. The note and the trust deed on the Sylmar Square property were
7 assigned to Alevy and Amusement.
- 8 ✓ Appellant made a loan to Alevy/Amusement in November 1998. The security for the loan
9 was the trust deed on the Sylmar Square property. The loan documents stated that
10 foreclosure was anticipated to continue and the foreclosure would be the primary source of
11 repayment.
- 12 ✓ Subsequently, the owners of Sylmar Square filed for bankruptcy and they sold the property to
13 an unrelated party in December 1999.

14 (Resp. March 5, 2007 Br., pp. 3-4.)

15 Appellant does not appear to contest respondent’s characterization of the events
16 surrounding the issuance of the Alevy/Amusement loan. Rather, appellant reiterates that
17 Alevy/Amusement never acquired title to the Sylmar Square property and argues that the Board should
18 ignore the intentions of the parties at the time the loan was made. (App. April 9, 2007 Br., p. 2.)

19 STAFF COMMENTS

20 Staff offers the following outline of issues for potential discussion.

- 21 1. *Can a nonprofit organization engage in a trade or business as that term is used*
22 *R&TC section 24384.5?*

23 At the hearing, respondent should be prepared to clarify its position that a nonprofit
24 cannot engage in a “trade or business.” It appears to staff that the weight of authority supports

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2 appellant's position on this issue.¹¹

- 3 2. *If a nonprofit can engage in a trade or business for purposes of R&TC section*
4 *24384.5, what activities constitute a trade or business for a nonprofit? In this*
5 *connection, does the trade or business of a nonprofit consist only of business*
6 *activities generating profits that are subject to UBIT, only the sale of goods or*
7 *services for income or profit, any activities that generate revenue, or any regular*
8 *activities of the nonprofit?*

9 For example, appellant argues that the trade or business of LBMMC includes all of its
10 medical operations, while respondent notes that only a small portion of LBMMC's activities generated
11 unrelated business taxable income. Much of the briefing in this appeal has focused on the broader
12 question of whether a nonprofit can engage in a trade or business. However, even if one assumes that a
13 nonprofit can engage in a trade or business, the issue of what constitutes a trade or business for this
14 purpose remains. Accordingly, the parties should be prepared to discuss this issue further at the hearing.

- 15 3. *With respect to the specific four loans at issue here, what trade(s) or business(es)*
16 *are the borrowers engaged in (assuming that nonprofits can engage in a trade or*
17 *business)?*

18 At the hearing, appellant should be prepared to further explain and specifically identify
19 its view of the relevant trade(s) or business(es) with respect to each of the four loans at issue here. With
20 regard to the Alevy/Amusement loan, appellant has indicated that the relevant trade or business is the
21 discrete business of purchasing notes, which, appellant contends, is separate from Alevy/Amusement's

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¹¹ California nonprofit law expressly recognizes the right of nonprofit organizations to "carry on a business at a profit." (See Cal. Corp. Code, § 5140, subd. (l).) In addition, through its imposition of the UBIT (the Unrelated Business Income Tax), the Internal Revenue Code recognizes the ability of nonprofit organizations to carry on a "trade or business" for tax purposes. (See Int.Rev. Code, §§ 511-513.) The UBIT also makes a distinction between a trade or business that is related, versus unrelated, to the organization's tax-exempt purpose. (See Int.Rev. Code, § 513(a).) Federal case law reveals numerous examples of courts discussing whether a tax-exempt organization's particular activities are motivated by profit, and whether a particular "trade or business" is related or unrelated to the organization's charitable purpose. (See e.g., *United States v. American Bar Endowment* (1986) 477 U.S. 105; *Texas Farm Bureau v. United States* (5th Cir. 1995) 53 F.3d 120; *North Ridge Country Club v. Commissioner* (9th Cir. 1989) 877 F.2d 750; *Fraternal Order of Police, etc. v. Commissioner* (7th Cir. 1987) 833 F.2d 717; *Portland Golf Club v. Commissioner, supra*; *West Virginia State Medical Ass'n v. Commissioner, supra*.)

1 real estate business. Appellant may wish to clarify whether this discrete business of purchasing notes
2 included other note purchases and constituted an activity that was engaged in with “continuity and
3 regularity” under *Commissioner v. Groetzinger, supra*. With regard to LBMMC, appellant appears to
4 contend that all of its operations constitute a trade or business. With regard to the Jewish Federation,
5 appellant appears to focus on fee-based programs offered by it and argue that they constitute a trade or
6 business. However, with regard to the Bethany Missionary, appellant has argued that both the fund-
7 raising activities of missionaries and the pastor’s or minister’s activities should be considered a trade or
8 business. Finally, with regard to the UCCC, appellant appears to argue that its trade or business includes
9 its programs in arts, music and dancing.

10 The parties should be prepared to discuss their view of what limits are implied by the
11 term “trade or business.” (Appellant has argued that the use of the term is meant to exclude only
12 activities of a personal nature, such as loans to purchase a car or house for personal use.) Respondent
13 should be prepared to discuss whether, in its view, appellant has defined the relevant trade(s) or
14 business(es) too broadly or too narrowly on the facts here (assuming that nonprofits can engage in a
15 trade or business). In this connection, the parties may wish to discuss any analogous legal authorities
16 that could cast light on how to determine the scope of a particular trade or business.

- 17 4. *With respect to each specific trade or business at issue here, at the time of the*
18 *incurrence of the debt, (a) was the trade or business located “solely” with an*
19 *enterprise zone, and (b) was the debt incurred “solely in connection with activity*
20 *within the enterprise zone[,]” as required by R&TC section 24384.5?*

21 As applied to this case, appellant must show, with respect to each of the borrowers at
22 issue, that both of the above two conditions were satisfied. The burden falls on appellant to prove those
23 assertions. (See *Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980; *Appeal of*
24 *Janice Rule*, 76-SBE-099, Oct. 6, 1976.)

25 With regard to the Alevy/Amusement loan, the facts appear to show that the loan was
26 obtained with the intent of acquiring the Sylmar Square shopping center. Although appellant argues that
27 the Board should ignore the intent and instead focus on subsequent events, there is authority to the effect
28 that the determination of a person’s trade or business necessarily involves an examination of that

1 person’s motivation in engaging in a particular activity. (See *Commissioner v. Groetzinger, supra*, 480
2 U.S. at p. 35.) Moreover, R&TC section 24384.5 requires that the debtor meet certain conditions “at the
3 time the indebtedness is incurred.” Therefore, the intent of the borrowers appears to be relevant in
4 determining whether they were engaged in a qualifying trade or business at that particular time. Also, as
5 part of its argument that specific real estate activities each constitute a separate trade or business,
6 appellant indicates that respondent allowed interest deductions for loans used to purchase qualifying real
7 estate within an enterprise zone. (App. December 27, 2006 Br., p. 4.) The parties may wish to discuss
8 whether or how these other loans, which were apparently issued in connection with real estate
9 transactions, are distinguishable from the Alevy/Amusement loan in this appeal.

10 The parties should also be prepared to discuss whether each of the other debts, including
11 the debt incurred by LBMMC, was incurred “solely” in connection with activity in the enterprise zone.

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15 Farmers and Merchants_km

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