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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeals of: ) **HEARING SUMMARY**  
11 ) **CORPORATION INCOME TAX APPEAL**  
12 **RHEEM MANUFACTURING COMPANY<sup>1</sup>** ) Case No. 485872  
13 )  
14 )

15 

	Year	Proposed
	12/31/2003	<u>Assessment</u>
		\$225,850

17 Representing the Parties:

18 For Appellant: Robert L. Eichhorn, Rheem Manufacturing Co.  
19 Corporate Director of Taxes

20 For Franchise Tax Board: Edwin J. Champion, Specialist

22 QUESTION: Whether appellant has shown that respondent erred in its determination that gain from  
23 appellant's sale of shares of Watsco, Inc. (Watsco) stock was properly classified as  
24 business income.

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26 ///

28 <sup>1</sup> Appellant's headquarters is located in Atlanta, Georgia.

1 HEARING SUMMARY

2 Background

3 Appellant is a manufacturer of water heating, air conditioning and heating products that  
4 are sold through distributors to customers primarily in North America. Watsco is a publicly traded  
5 corporation and is the largest distributor of residential central air conditioners and supplies in the United  
6 States. (App. Open. Br., pp.1-2.) In 1989, Watsco acquired an 80 percent interest in Germaire  
7 Distributors, Inc. (Germaire), an air conditioning distributor, and appellant acquired a 20 percent  
8 interest. In 1990, Watsco and appellant each acquired a 50 percent interest in Heating and Cooling  
9 Supply, Inc. (H&C Supply), a central air conditioner and heater distributor. In 1993, Watsco acquired  
10 an 80 percent interest and appellant acquired a 20 percent interest in Comfort Supply, Inc. (Comfort), a  
11 central air conditioner and heater distributor. (Resp. Open. Br., p.2.)

12 In 1996, Watsco and appellant agreed that appellant would exchange its interest in  
13 Germaire, H&C Supply and Comfort for shares in Watsco. As a result of this transaction, Germaire,  
14 H&C Supply and Comfort became 100 percent-owned subsidiaries of Watsco and appellant held a 4.3  
15 percent interest in Watsco. Appellant's ownership interest in Watsco was diluted by the issuance of  
16 additional Watsco stock such that appellant held a 2.2 percent interest in 2003. (Resp. Open. Br., p.2 and  
17 p.4.)

18 In a Securities and Exchange Commission (SEC) Form S-3<sup>2</sup> dated January 24, 1997,  
19 Watsco made the following statements:

- 20
- “[Watsco] believes that it maintains a unique and mutually beneficial relationship with  
21 [appellant], and [appellant] has a well-established reputation of producing high-quality,  
22 competitively priced products.”
  - “[Watsco] believes that [appellant's] current product offerings, quality, serviceability and brand-  
23 name recognition allow [Watsco] to operate favorably against its competitors.”
  - “[Appellant] provides national advertising and participates with [Watsco] in cooperative  
24 advertising programs and promotional incentives that are targeted to both contractors and  
25  
26  
27

28 <sup>2</sup> A SEC Form S-3 is a registration statement to inform the SEC and the public of a stock offering.

1 homeowners.”

- 2 • “[Watsco] is [appellant’s] largest distributor and has been granted exclusive rights under
- 3 distribution agreements for [appellant’s] brand-name products in each of the most significant
- 4 market areas and many of the major metropolitan areas in the United States sunbelt.”
- 5 • “[Appellant] acquired minority common equity ownership interests in Germaire (20%), Comfort
- 6 Supply (20%), and Heating & Cooling Supply (50%) as a joint venture partner in the acquisition
- 7 of each of these subsidiaries.”
- 8 • “[Appellant’s] President and Chief Executive Officer serves as one of [Watsco’s] directors.”<sup>3</sup>
- 9 • “Germaire, [Comfort], and [H&C Supply] operate under distribution agreements with
- 10 [appellant] that extend through 2006 with annual renewals thereafter. . . [Those agreements]
- 11 contain provisions limiting the sale of products by such subsidiaries that are directly competitive
- 12 with [appellant’s] products.”

13 (Resp. Open. Br., p.3.)

14 In 2003, Watsco accounted for 24 percent of appellant’s air conditioning sales. Also, in  
15 2003 appellant sold its Watsco interest for a gain of \$28,447,304, which appellant reported as  
16 nonbusiness income on its 2003 California Franchise Tax return. (Resp. Open. Br., p.4.) On  
17 September 13, 2007, respondent issued a Notice of Proposed Assessment (NPA) assessing additional tax  
18 of \$225,850. Appellant protested the NPA and on March 11, 2009, respondent issued a Notice of  
19 Action (NOA) affirming the proposed assessment. Appellant filed this timely appeal of the NOA. (App.  
20 Open. Br., p. 2.)

21 Contentions

22 Appellant’s Contentions

23 Appellant contends that the gain from the sale of its Watsco stock was non-business  
24 income which was not apportionable to California pursuant to Revenue and Taxation Code (R&TC)  
25 section 25120, subdivision (a). Appellant contends that the gain on the sale did not arise “from a  
26 transaction or activity in the regular course of its trade or business (the transactional test) and the  
27

28 <sup>3</sup> Appellant’s Chief Executive Officer was not a member of Watsco’s board of directors after December 31, 1996. (Resp. Open. Br., p. 4.)

1 acquisition, management and disposition of the shares did not constitute integral parts of [appellant's]  
2 regular trade or business (the functional test)." Appellant disputes respondent's conclusion that the  
3 functional test was satisfied because, appellant contends, it did not "possess a unitary relationship with  
4 Watsco, exercise any control over Watsco's business nor derive any special benefits of ownership from  
5 its investment in Watsco." (App. Open. Br., p. 3.)

6 First, appellant rejects the protest hearing officer's conclusion that the volume of  
7 intercompany sales between Watsco and appellant would make them unitary "absent unity of ownership.  
8 The manufacturer and distributor relationship between [appellant] and Watsco is an example of unity  
9 through contribution or dependency." In support of this conclusion, appellant states that the protest  
10 hearing officer cites *Edison California Stores v. McColgen* (sic)<sup>4</sup> (1947) 30 Cal. 2d 472 (*Edison*  
11 *California Stores*), which appellant contends, involves facts not at all similar or applicable to the facts  
12 presented in this appeal. Appellant maintains that the court in *Edison California Stores* held that all  
13 elements of a unitary business were present whereas none of these elements was present in the  
14 relationship between appellant and Watsco. For that reason, appellant argues that the case supports its  
15 own position. (App. Open. Br., pp. 3-4.)

16 Appellant also takes issue with the protest hearing officer's citation of *Hoechst Celanese*  
17 *Corporation v. Franchise Tax Board* (2001) 25 Cal. 4th 508 (*Hoechst Celanese*), in his "Reasons for  
18 Recommendation" as support for his conclusion that the transaction met the functional test. Appellant  
19 argues that in that case the taxpayer had, by various means, the control and use of pension fund assets  
20 that were an integral part of its regular trade or business. By contrast, appellant asserts, it did not  
21 exercise any control and had no use of Watsco's assets. For that reason, appellant contends that *Hoechst*  
22 *Celanese* is inapplicable here. Appellant adds that appellant and Watsco conduct normal commercial  
23 activities as buyer and seller which is clearly not sufficient to establish a unitary relationship to meet the  
24 functional test. (App. Open. Br., pp. 4-5.)

25 In its reply brief, appellant also disputes the arguments respondent makes in its opening  
26 brief with respect to the applicability of *Hoechst Celanese, supra*, based on respondent's  
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28 <sup>4</sup> It is McColgan not McColgen.

1 characterization of the facts presented. Specifically, appellant disputes respondent’s position that the  
2 test set forth in *Hoechst Celanese* was met because appellant and Watsco, as a manufacturer and  
3 distributor, had an “interwoven” and “inseparable” relationship and they worked “in concert to the  
4 benefit of both businesses.” Appellant contends that appellant and Watsco operated as separate and  
5 distinct entities that did not share any management or business decisions, did not share the same  
6 corporate officers or employees and Watsco entered into agreements with appellant’s competitors which  
7 reduced significantly (from 58 percent to 15 percent) Watsco’s purchases of appellant’s products from  
8 the time appellant purchased the stock until it was sold. In addition, appellant states that it disclosed in  
9 its Form S-3 dated January 24, 1997, that it was trying to reduce the share of products purchased from  
10 appellant and appellant booked its Watsco shares as a non-operating passive investment. (App. Reply  
11 Br., pp.3-4.)

12 Appellant further argues the U.S. Supreme Court consistently held in cases in which “the  
13 seller did not have a unitary relationship with the disposed entity, any gain or loss on the sale would be  
14 non business income that was not apportionable.” As support for this proposition, appellant cites  
15 *MeadWestvaco Corp. v. Illinois Dept. of Revenue* (2008) 553 U.S. 16 (*MeadWestvaco*) and *Allied Signal*  
16 *Inc. v. Dir., Div. of Taxation* (1992) 504 U.S. 768 (*Allied Signal*), in which in both cases, appellant  
17 asserts, the Court held the hallmarks of a unitary relationship had not been shown, including centralized  
18 management and economies of scale, and thus the functional test was not satisfied. In this regard,  
19 appellant contends that appellant held only 2 percent of the common shares of Watsco as of the date of  
20 the stock sale so appellant and Watsco did not share a centralized management structure. (App. Open.  
21 Br., p.5.)

22 Appellant notes the Court’s holding in *Allied Signal* specified certain indicia of a unitary  
23 relationship as follows: the entities do not conduct arm’s length transactions, the parent entity has a  
24 management role based on its own operational expertise and operational strategy, and the entities are  
25 engaged in the same line of business. Appellant maintains that its business relationship with Watsco  
26 was as a manufacturer with a distributor which is a different line of business. In addition, appellant  
27 asserts that appellant sold its products to Watsco at an arm’s length price and did not share any  
28 management advice with Watsco. Finally, appellant contends the sale of its interests in the distribution

1 companies in exchange for the Watsco shares is evidence that appellant did not have any desire to  
2 engage in this other line of business. (App. Open. Br., pp. 5-6.)

3 Appellant also asserts this Board “has consistently refused to find business income under  
4 the functional test where the taxpayer’s control and use of the property did not contribute materially to  
5 the production of business income and were separate from the taxpayer’s business.” In support of that  
6 proposition, appellant cites *Appeal of Occidental Petroleum Corp.* (83-SBE-119), decided on June 21,  
7 1983, which appellant states held that gain from a sale of stock was non-business income because the  
8 taxpayer had not integrated the stock into its unitary business at the time of sale.

9 Appellant also cites *Appeal of Mark Controls Corporation* (86-SBE-204), decided on  
10 Dec. 3, 1986, in which this Board held that the mere potential for the taxpayer to integrate with another  
11 corporation in which it purchased 49.5 percent of the shares (and an option to purchase all remaining  
12 shares) was insufficient to support a finding that gain on the sale of the shares was business income  
13 under the functional test. In that case, at the time of the stock purchase, the taxpayer acknowledged its  
14 intention of expanding the taxpayer’s operations to the United Kingdom. The taxpayer and the other  
15 corporation subsequently executed a licensing agreement and made approximately \$200,000 in  
16 intercompany sales. The taxpayer also placed a member of its board of directors on the other  
17 corporation’s board and that member became an officer of the other corporation. In addition, the  
18 taxpayer provided two of its officers to the other corporation in an attempt to improve the performance  
19 of the other corporation. Despite these steps, the Board held that there was no evidence the taxpayer’s  
20 employees had any influence over the other corporation’s policy or day-to-day operations, the  
21 intercompany transactions did not indicate any special economic advantage, there were no guaranteed  
22 purchase or sales between the corporations and neither corporation was afforded special pricing on its  
23 purchases. (App. Open. Br., p.6.)

24 Appellant argues that the cases cited by respondent in its opening brief to support  
25 respondent’s position actually support appellant’s position as follows:

- 26 • *Citicorp of North America, Inc. v. Franchise Tax Board* (2000) 83 Cal.App.4th 1403 – The  
27 taxpayer’s gain from the sale of four buildings, including its corporate headquarters, was  
28 determined to be business income. The taxpayer recognized the properties as part of its business

1 unit as it included them in the property factor used to determine business income in its  
2 apportionment formula. The properties were also managed by the taxpayer's subsidiary and  
3 were integrally related to the taxpayer's business operations. Unlike the taxpayer in *Citicorp*,  
4 appellant did not have any use of Watsco's property, did not include Watsco's property in its  
5 property factor, and had no management control of Watsco's business operations.

- 6 • *Times Mirror Co. v. Franchise Tax Board* (1980) 102 Cal.App.3d 872 - The taxpayer's gain on  
7 the sale of a 100 percent-owned subsidiary which was commonly managed and controlled by its  
8 parent company was characterized as business income. Unlike this taxpayer, appellant only  
9 owned 4 percent of the Watsco shares, exercised no control over Watsco's business and had no  
10 common employees or officers.
- 11 • *Allied Signal, supra* – The taxpayer's gain on the sale of stock in another corporation was not  
12 business income. The two companies did not have common management, officers or employees,  
13 each company operated autonomously and sales between the companies were arm's-length  
14 transactions and occurred in the ordinary course of business.

15 Appellant also contends that respondent misapplies *MeadWestvaco, supra* by arguing that “the shares of  
16 a distributor that accounts for 24% of air conditioning sales in a given year is a ‘unitary business asset’”.  
17 Appellant argues that respondent's reading of *MeadWestvaco, supra* ignores the holdings of the other  
18 cases cited above which made unitary business determinations based on the other factors as described  
19 above. (App. Reply Br., pp. 4-5.)

20 Appellant also argues that the formal decisions of this Board cited by respondent actually  
21 support appellant's position as follows:

- 22 • *Appeal of Borden, Inc.*, 77-SBE-007, Feb. 3, 1997 – Taxpayer's loss on sale of goodwill  
23 acquired and maintained to further unitary business constituted business income. By contrast,  
24 appellant received the Watsco shares in exchange for its divestment of ownership in the  
25 distribution business.
- 26 • *Appeal of Standard Oil Company of California*, 83-SBE-068, Mar. 2, 1983 – Dividends from a  
27 30 percent and 50 percent owned entity were business income because the income-producing  
28 property was integrally related to the unitary business of the taxpayer. The taxpayer acquired its

1 interests in the other companies to ensure supplies of crude oil and liquid natural gas for its  
2 petroleum operations and both companies were prohibited by agreement from selling crude oil to  
3 unrelated third parties. By contrast, Watsco purchased and distributed products of appellant's  
4 competitors and Watsco's Form S-3 indicates that appellant and Watsco did not have an  
5 exclusivity agreement. In addition, the percentage of equipment that Watsco purchased from  
6 appellant declined from 58 percent in 1996 to 15 percent during the period that appellant held its  
7 Watsco shares. Appellant argues that this evidence shows that appellant had a passive  
8 investment in Watsco and engaged in arm's-length business relationship with Watsco.

- 9 • *Appeal of Occidental Petroleum Corp., supra* - The gain on the sale of three of the taxpayer's  
10 100 percent owned companies was business income because the shares were acquired and  
11 managed to further appellant's unitary business. By contrast, appellant only owned a 4 percent  
12 interest in Watsco and exercised no management control.
- 13 • *Appeal of Mark Controls Corp., supra* - In its discussion of this opinion, respondent incorrectly  
14 states that appellant had a long-standing operational relationship with Watsco when, in fact, the  
15 two companies were in the relationship of a customer and supplier and shared no "operational  
16 commonalities."

17 (App. Reply Br., pp. 6-8.)

18 Appellant further states that respondent in its citation of *ASARCO, Inc. v. Idaho State Tax*  
19 *Comm'n.* (1982) 458 U.S. 307 has misunderstood appellant's argument that its small minority ownership  
20 interest in Watsco was insufficient to exercise management control over Watsco's business. Appellant  
21 points out that respondent quotes appellant's correct position to the effect that gain on the sale of shares  
22 in a corporation is not business income where the taxpayer lacked control over the corporation and "no  
23 unitary relationship existed between the parties." In addition, appellant asserts that respondent  
24 misrepresented appellant's statement that it accounted for the Watsco shares as an investment on its  
25 financial statements. Appellant states that it presents this fact as one item of evidence of its relationship  
26 with Watsco and not, as respondent implies, so the Board may rely on this fact alone in making its  
27 decision. (App. Reply Br., pp. 8-9.)

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1                   Respondent's Contentions

2                   Respondent contends that the gain from the sale of the Watsco stock meets the definition  
3 of business income pursuant to R&TC section 25120 as interpreted and applied by the Supreme Court in  
4 *Hoechst Celanese*. Respondent concedes that appellant's activity did not meet the transactional test  
5 under *Hoechst Celanese* but did meet the functional test because appellant and Watsco had an  
6 interwoven and inseparable relationship as manufacturer and distributor. Respondent asserts that the  
7 Court's functional test focused on the relationship between the property that generated the gain in terms  
8 of its acquisition, control and disposition and the taxpayer's business operations. In this regard,  
9 respondent states that appellant acquired its stock interest in Watsco, had the right to control and direct  
10 that interest and had the right to transfer that stock as evidenced by the sale. Furthermore, respondent  
11 contends, the evidence shows that the companies worked together for their mutual benefit. (Resp. Open.  
12 Br., pp. 5-7.)

13                   Respondent also cites *Citicorp, supra*. and *Times Mirror Co., supra*, as cases in which the  
14 courts held that gain from the sale of assets, real property and stock, respectively, was business income  
15 based on the relationship of the assets and the taxpayers' business operations. Respondent also cites  
16 *Allied Signal, supra* in which the court held the taxpayer's gain from the sale of a 20.6 percent interest in  
17 another corporation was not business income because the taxpayer and the corporation operated  
18 completely independent of each other; there were no intercompany sales. Furthermore, even though  
19 there were sales by the corporation's subsidiaries to the taxpayer, those sales were minute compared to  
20 the corporation's total sales and they were arm's length transactions that did not arise from the  
21 taxpayer's investment in the corporation. Finally, respondent notes the court considered that income  
22 may be considered business income absent a unitary relationship between the payor and payee. For  
23 example, interest earned on short-term deposits in a bank located in another state if that interest income  
24 is part of the working capital of the taxpayer's unitary business. Respondent then concludes that it  
25 appears the relationship between a manufacturer and distributor is stronger than that between a depositor  
26 and a bank. (Resp. Open. Br., pp. 7-8.)

27                   After summarizing the holding in *MeadWestvaco, supra*, respondent points out that legal  
28 commentators cautioned against misreading that decision too broadly to mean a determination that no

1 unitary business relationship exists precludes application of the functional test. Respondent notes the  
2 Court explained that there are two tests for determining whether income is includable in the  
3 apportionable base as follows: if two corporations are treated as one business because they are unitary  
4 and if the asset that generates the gain served an operational function in the taxpayer's business.  
5 Respondent concludes that the second test was met because, respondent argues, the Watsco stock was  
6 integral to appellant's business because Watsco accounted for 24 percent of appellant's air conditioning  
7 sales in 2003. (Resp. Open. Br., pp. 8-9.)

8 Respondent also cites "relevant cases" of this Board and summarizes those decisions as  
9 follows:

- 10 • *Appeal of Borden, Inc., supra*. in which the Board found that goodwill was acquired and  
11 maintained in furtherance of a unitary business.
- 12 • *Appeal of Standard Oil Company of California, supra*, in which the Board held that "if the  
13 income-producing property in question is integrally related to the unitary business activities of  
14 the taxpayer, the income is business income subject to formula apportionment."
- 15 • *Appeal of Occidental Petroleum Corp., supra*, in which the Board held that gain on the sale of  
16 the taxpayer's stock acquired and managed to further the taxpayer's unitary business operation  
17 was business income while gain from the sale of other stock was not business income because  
18 that stock had not been integrated into the taxpayer's business.
- 19 • *Appeal of Mark Controls Corp., supra*, in which the Board held that gain on the sale of stock in  
20 two different corporations was not business income. With respect to one corporation, the  
21 taxpayer acquired a 49.5 percent interest and an option to acquire the remaining interest and  
22 expressed a desire to eventually control and integrate that corporation into the taxpayer's  
23 business. However, the taxpayer never actually integrated the corporation and eventually sold  
24 the stock. With respect to the other corporation, the taxpayer acquired a 20 percent interest as an  
25 investment and there were no intercompany sales.

26 Respondent states that appellant never intended to acquire a majority interest in or to control Watsco but  
27 appellant did acquire stock in the distributors of its products and appellant had a long-standing  
28 operational relationship with Watsco and the other distributors which also had exclusive distribution

1 agreements with appellant. Respondent then asks rhetorically: “How can that manufacturer and  
2 distributor relationship of [appellant] and Watsco, Inc. be unrelated given the facts of this appeal?”  
3 (Resp. Open. Br., pp. 9-11.)

4 Respondent concludes the evidence shows that appellant’s acquisition, management and  
5 disposition of the Watsco stock were integral parts of appellant’s business. In support of its conclusion,  
6 respondent asserts that “[t]here is a material flow of value between manufacturer and distributor” and  
7 “the volume of appellant’s products sold is directly related to the quality of the product and the skill of  
8 the distributor.” Respondent also asserts that the least expensive form of advertising is a customer’s  
9 strong recommendation which is unlikely if the customer “is not pleased with the quality of the product,  
10 ease of the transaction and skill of the installer.” (Resp. Open. Br., pp. 11-12.)

11 In its reply brief, respondent contends that appellant raised new arguments and presented  
12 new facts in appellant’s reply brief. Specifically, respondent contends that appellant argues it acquired  
13 and managed the Watsco stock not to further its unitary business but “as compensation for distribution  
14 businesses that Appellant was divesting.” Respondent states that “appellant’s ‘distribution businesses’”  
15 were appellant’s ownership interests in Germaire, H&C Supply, and Comfort Supply. Respondent  
16 contends that divestiture of a business does not convert a business asset to a nonbusiness asset absent  
17 some evidence the nature of that asset has been changed. Rather, respondent argues that the evidence  
18 shows the Watsco stock was a business asset as appellant’s ownership interest in a distribution business.

19 In addition, respondent maintains the Watsco stock was received as payment for  
20 appellant’s stock in Germaire, H&C Supply, and Comfort Supply. Respondent then cites *Appeal of*  
21 *General Dynamics Corporation* (75-SBE-037), decided on June 3, 1975, in which this Board held that  
22 gain on the sale of stock received as payment for the sale of a business asset was business income. In  
23 that case, the taxpayer sold aircraft to a third-party and when the third-party defaulted on its payments,  
24 the taxpayer agreed to restructure the sale by accepting cash, a note and third-party stock.  
25 Approximately four years later the taxpayer sold the shares and classified the gain as non-business  
26 income. The Board held that gain was business income reasoning the taxpayer was engaged in a unitary  
27 business that included the purchase and sale of aircraft and the third-party stock was received in the  
28 ordinary course of business. (Resp. Reply Br., pp. 2-3.)

1 Respondent argues that appellant's ownership interest was not a passive investment as  
2 appellant had a "long, continuing and significant business relationship" with Watsco. Respondent  
3 asserts that this business relationship contributed to Watsco's ability to expand its business which in turn  
4 indirectly contributed to an increase in the value of appellant's Watsco stock. For support, respondent  
5 quotes a passage from Watsco's company history between 1988 and 1991, which describes Watsco's  
6 acquisition of other distributors and appellant's role in those acquisitions. Respondent concludes that  
7 when Watsco was unable to raise sufficient funds to acquire all the stock of another distributor,  
8 appellant would step in and acquire the remaining shares and later sell those shares to Watsco. By that  
9 means, Watsco became the largest distributor in the nation which increased the value of appellant's  
10 Watsco stock. Respondent also contends that appellant and Watsco continued to have a business  
11 relationship after the stock sale as evidenced by the fact that appellant's former CEO and chairman of its  
12 board of directors now serves on Watsco's board of directors. (Resp. Reply Br., pp. 3-5.)

13 Finally, respondent argues that the reduction of sales of appellant's products by Watsco  
14 is not evidence of a conversion of the stock to a nonbusiness asset. As support, respondent cites *Appeal*  
15 *of American Biltrite, Inc.*, (92-SBE-026), decided November 19, 1992, in which the taxpayer held stock  
16 in another company which initially was the major supplier of synthetic rubber to the taxpayer – about 90  
17 percent - in the 1950s. At the time that the taxpayer sold its stock in 1975 and 1976, the taxpayer argued  
18 that the company was no longer a major supplier but the Board held that even the 20 percent then  
19 supplied by the company was "so significant that ownership of the supplier's stock is an integral part of  
20 the [taxpayer's] business." Respondent notes that for 2003, appellant's products were 15 percent of  
21 Watsco's total sales and the sales between appellant and Watsco are 25 percent of appellant's total sales.  
22 So, respondent concludes that appellant's Watsco stock was an integral part of appellant's business.  
23 (Resp. Reply Br., pp. 5-6.)

24 Appellant's Supplemental Brief

25 In its supplemental brief, appellant argues respondent misrepresented appellant's position  
26 by stating that appellant argued in its reply brief the stock was converted to a nonbusiness asset.  
27 Appellant asserts it contended that the Watsco stock was a nonbusiness asset from the date of purchase  
28 and requests that respondent's argument not be considered by the Board. Appellant further argues that

1 respondent implies the acquisition of the Watsco stock was a continuation of appellant's involvement in  
2 the distribution business but respondent ignores that appellant had no management or control over the  
3 Watsco business. (App. Supp. Br., pp. 1-2.)

4 Appellant contends that respondent's reliance on *Jim Beam Brands Co. v. Franchise Tax*  
5 *Board* (2005) 133 Cal.App.4th 514, is misplaced because that case involved the sale of a wholly-owned  
6 subsidiary that both parties stipulated contributed materially to the income of the group and was a  
7 unitary business. There the court held the taxpayer's acquisition, management and disposition of its  
8 interest in the other company were integral to the taxpayer's regular business operations. Appellant  
9 argues its ownership of Watsco stock did not meet the management requirement that the court in *Jim*  
10 *Beam Brands* held was evidence of an integral relationship. Appellant also takes issue with  
11 respondent's reliance on *Appeal of American Biltrite, Inc., supra*, because appellant never argued that it  
12 converted the stock to a nonbusiness asset. Furthermore, appellant states that respondent makes it  
13 appear appellant continued to manage a distribution business when in fact the Watsco stock was merely  
14 an investment. (App. Supp. Br., pp. 3-4.)

15 Appellant distinguishes *Appeal of General Dynamics Corporation, supra*, which  
16 involved the acquisition of stock as a portion of the consideration of a sale made in the ordinary course  
17 of business of the taxpayer's subsidiary. Because the stock was received as an integral part of the  
18 taxpayer's business, appellant argues, the gain on the sale of that stock was business income. Appellant  
19 maintains that it received the Watsco stock in a transaction that was not in the regular course of  
20 appellant's business. If the Watsco stock had been received as consideration for a sale of air  
21 conditioning equipment, appellant argues, the gain on the sale of the stock would be business income  
22 consistent with *Appeal of General Dynamics Corporation*. (App. Supp. Br., p. 5.)

23 Appellant also distinguishes *Appeal of American Biltrite, Inc., supra*, on the ground that  
24 appellant's acquisition of a small interest in Watsco was never intended to be a means of securing a  
25 distributor for appellant's products. Appellant argues that in *American Biltrite* the taxpayer's acquisition  
26 of shares in a synthetic rubber company was intended to assure the taxpayer's supply of a raw material  
27 vital to its business. In addition, the taxpayer held a 30 percent representation on the other company's  
28 board, which had a significant influence on major management decisions and the taxpayer and three of

1 its competitors owned the company. By contrast, appellant argues that it had no representation on  
2 Watsco's board after the year it acquired the stock and none of appellant's employees or management  
3 was involved in Watsco's business. Appellant also argues that its former CEO and board chairman  
4 joined the Watsco board after he left appellant which is further proof that appellant and Watsco are  
5 independent, and thus not unitary companies. (App. Supp. Br., pp. 5-6.)

6 Applicable Law

7 R&TC section 25120, subdivision (a), states that "business income" means income  
8 arising from transactions and activity in the regular course of the taxpayer's trade or business and  
9 includes income from tangible and intangible property if the acquisition, management, and disposition  
10 of the property constitute integral parts of the taxpayer's regular trade or business operations. R&TC  
11 section 25120, subdivision (d), states that "nonbusiness income" means all income other than business  
12 income.

13 R&TC section 25120, subdivision (a), provides two alternative tests, the "transactional"  
14 test and the "functional" test, to determine whether income constitutes business income. (*Hoechst*  
15 *Celanese Corporation v. Franchise Tax Board supra*, 25 Cal. 4th 508, 520-526.) Under the  
16 "transactional" test, the relevant inquiry is whether the transaction or activity that gave rise to the  
17 income arose in the regular course of the taxpayer's trade or business. (*Id. at p. 526.*) Under the  
18 "functional" test, income from property is considered business income if the acquisition, management,  
19 and disposition of the property were "integral parts" of the taxpayer's regular trade or business  
20 operations, regardless of whether the income was derived from an occasional or extraordinary  
21 transaction. (*Id. at p. 527.*) If either of those two tests is met, the income will constitute business  
22 income. Respondent's determination regarding the character of the income under either test is presumed  
23 correct, and the taxpayer has the burden of proving error in that determination. (*Appeal of Twentieth*  
24 *Century-Fox Film Corporation*, 89-SBE-007, Mar. 2, 1989.)

25 California Code of Regulations, title 18, section 25120, subdivision (c)(2), provides that  
26 gain or loss from the sale, exchange, or other disposition of real, tangible, or intangible personal  
27 property constitutes business income if the property was used in the taxpayer's trade or business during  
28 the period that the taxpayer owned the property. That section provides, however, that if such property

1 was used for the production of nonbusiness income or otherwise was removed from the property factor  
2 before its sale, exchange, or other disposition, the gain or loss will constitute nonbusiness income.

3 The functional test focuses on the income-producing property and the “critical inquiry” is  
4 the “relationship between this property and the taxpayer’s business operations.” Pursuant to the  
5 statutory language, there is a two-part inquiry. First, the taxpayer’s interest in and power over the  
6 income-producing property must be examined. Secondly, if the taxpayer has a sufficient interest in the  
7 income-producing property for the purposes of the statute, it must be determined whether the taxpayer’s  
8 control and use of the property are an integral part of the taxpayer’s regular trade or business operations.  
9 (*Hoechst Celanese, supra*, 25 Cal.4th at pp. 528-529.)

10 STAFF COMMENTS

11 The dispute here is whether appellant’s gain from the sale of the Watsco stock meets the  
12 functional test whereby the acquisition, management, and disposition of the shares of stock constituted  
13 integral parts of appellant’s regular trade or business operations. Appellant contends the functional test  
14 was not met because appellant and Watsco operated as separate companies in an arm’s length business  
15 relationship, appellant had no management or other decision-making control over Watsco and there was  
16 no sharing of corporate officers or employees between the two companies. In support of that contention,  
17 appellant points out that Watsco entered into agreements with appellant’s competitors which resulted in  
18 a significant reduction of Watsco’s purchases of appellant’s products.

19 Respondent contends that the functional test was met because appellant’s acquisition,  
20 management and disposition of the Watsco stock were integral parts of appellant’s business based on a  
21 material flow of value between appellant and Watsco. Respondent asserts that the volume of appellant’s  
22 products sold is directly related to the quality of the product and the skill of the distributor. Respondent  
23 argues that the Watsco stock was integral to appellant’s business because Watsco accounted for 24  
24 percent of appellant’s air conditioning sales in 2003.

25 With respect to gain on the sale of stock, as case law and Board precedent decisions  
26 show, the functional test is satisfied and such gain is business income if the taxpayer and the corporation  
27 are in a unitary business relationship (*Allied Signal, supra* and *MeadWestvaco, supra*), if the ownership  
28 interest enables the taxpayer to exercise some degree of control over the corporation’s business (*Appeal*

1 of *Mark Controls Corp., supra*) or if the taxpayer derives special benefits of ownership from its stock  
2 holding in the corporation (*Appeal of Standard Oil Company of California, supra.*)

3 As set forth in Watsco's SEC Form S-3, appellant and Watsco held common equity  
4 ownership interests in Germaire, Comfort Supply and H&C Supply as joint venture partners. Those  
5 companies operated under distribution agreements with appellant (extending through 2006 with annual  
6 renewals thereafter) that limited the sale of products that were directly competitive with appellant's  
7 products. At that time, Watsco was appellant's largest distributor and was granted exclusive distribution  
8 rights for appellant's brand-name products in several key market areas. The Form S-3 also stated that  
9 Watsco had a "unique and mutually beneficial relationship with appellant" based on appellant's "current  
10 product offerings, quality, serviceability and brand-name recognition" which were factors that enabled  
11 Watsco "to operate favorably against its competitors." In addition, appellant and Watsco had  
12 "cooperative advertising programs and promotional incentives that are targeted to both contractors and  
13 homeowners."

14 According to the Form S-3, it appears that appellant's stock holdings in Germaire,  
15 Comfort Supply and H&C Supply were an integral component of appellant's strategic business  
16 relationship with Watsco. As stated above, the other features of that strategic relationship were the  
17 distribution agreements that appellant had with those three companies that limited the sale of appellant's  
18 competitors' products, the distribution agreements between appellant and Watsco with exclusivity  
19 provisions, and the joint advertising and promotional activities. Thus, based on available information, it  
20 appears that the Germaire, Comfort Supply and H&C Supply stock could be found to have served an  
21 operational function in appellant's business and, thereby, considered to have constituted an integral part  
22 of appellant's regular trade or business. Therefore, it appears that the stock at that time could be found  
23 to constitute a business asset under the functional test. At the hearing, appellant should be prepared to  
24 discuss the business relationship between appellant and Watsco as seemingly demonstrated by the Form  
25 S-3. Appellant should also be prepared to explain whether any of the other features of its business  
26 relationship with Watsco changed after the acquisition of the Watsco stock.

27 Respondent contends that the exchange for the Watsco stock did not "convert" a business  
28 asset - the Germaire, Comfort Supply and H&C Supply stock - to a nonbusiness asset. In support of

1 that position, respondent cites *Appeal of General Dynamics Corp., supra* but, as appellant points out,  
2 that appeal involved stock that was considered business income under the transactional test. At the  
3 hearing, respondent should be prepared to explain why *Appeal of General Dynamics Corp., supra* is not  
4 distinguishable and to provide any additional authorities for support. Both parties should be prepared to  
5 discuss the manner in which a change in the form of a business asset may convert it to a nonbusiness  
6 asset.

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