



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CALAVO GROWERS OF CALIFORNIA)

For Appellant: Gerald E. Mason
Certified Public Accountant

For Respondent: Gary M. Jerrit
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Calavo Growers of California against proposed assessments of additional franchise tax in the amounts of \$10,435 and \$197,743 for the income years ended October 31, 1978, and October 31, 1979, respectively.

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The primary issue presented by this appeal is whether gain realized by appellant from the sale of certain citrus groves constitutes business income. If we determine this gain to be business income, additional issues presented concern in what year the sale took place and whether the gain is properly taken into account under the installment method.

Appellant is a unitary business which markets California avocados and companion crops, including citrus fruits. Since the 1950s, appellant has also marketed fruit grown in Dade County, Florida. During the 1960s, in connection with its Florida operation, appellant entered into a business relationship with two corporations owned by a single individual, Lucerne Packing Company and H.L. Properties, Inc. (Lucerne and Properties). Appellant made loans to these companies in order to ensure that appellant would have a continuous supply of fruit and access to modern packing facilities in Florida. In 1967 Lucerne and Properties defaulted on the notes, and, as a result, appellant obtained ownership of certain raw land and citrus groves previously owned by those companies. Appellant states that it wanted to sell these properties as soon as feasible and, in order to obtain a better **price**, began to make the land a producing operation. Some small parcels were sold immediately, but a decision to sell the remaining land was not made until 1973. The first major sale took place in 1976, and the final one took place in 1979. On its California franchise tax returns for the income years during which appellant operated the Florida groves, appellant treated the groves as part of its unitary business. Income from the groves was reported as business income subject to apportionment, and property, payroll, and sales associated with the groves were included in appellant's apportionment factors. On its franchise tax return for the year ended October 31, 1978, appellant acknowledged the sale of the citrus groves which are the subject of this appeal, but it treated the gain from that sale as nonbusiness income, wholly allocable to Florida. Upon audit, respondent determined the gain to be business income, subject to formula apportionment, and further determined that the gain was properly accounted for under the installment method. It issued proposed assessments for the income years 1978 and 1979 which reflect these determinations. These proposed assessments were affirmed after appellant's protest, giving rise to this appeal.

Appellant contests respondent's characterization of the gain from the sale of the Florida groves as

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business income. In the event we agree with respondent's characterization of the income, appellant contends that the sale took place, for tax purposes, during the income year ended October 31, 1977, rather than 1978. It further contends that the gain should not be accounted for under the installment method.

The first issue is governed by the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), found in section 25120 through 25139 of the Revenue and Taxation Code. UDITPA sets forth rules which determine what portion of the income of a multistate taxpayer is subject to California franchise tax. Section 25128 provides that all business income must be apportioned by formula, while section 25123 provides that nonbusiness income must be allocated as set forth in sections 25124 through 25127. Capital gain from the sale of real property, if it constitutes nonbusiness income, is allocated to the state in which the property is located. (Rev. & Tax. Code, § 25125.)

Business and nonbusiness income are defined in section 25120 as follows:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

* * *

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

Respondent's regulations interpret the above section as including in business income "all income which arises from the conduct of trade or business operations of a taxpayer." (Cal. Admin. Code, tit. 18, § 25120, subd. (a) (art. 2.5).) The regulations also provide, in pertinent part, as follows:

* Unless otherwise noted, all statutory references are to the Revenue and Taxation Code as in effect during the appeal years.

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The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transaction's and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business. and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2.5.)

The regulations further provide:

Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(2) (art. 2.5.)

Appellant's income from the Florida groves clearly falls within the definition of business income set forth in the above statute and regulations since the operation of the groves was an integral part of appellant's unitary business. Appellant became involved with Lucerne and Properties and made the loans which led

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ultimately to appellant's ownership of the groves to protect its business by ensuring that it had adequate supplies of fruit and access to packing facilities. Once ownership of the groves was obtained, appellant improved the land and operated the groves. During this time, appellant reported income from the groves as business income and included the groves in its calculation of its property, payroll and sales factors.

Appellant apparently does not dispute that while it operated the groves, they constituted part of its unitary business. Rather, it contends that income resulting from the sale of these assets is, nevertheless, nonbusiness income. As support for its position, appellant cites decisions from Kansas and New Mexico which held that gain from an extraordinary or occasional sale of an asset is not business income. (McVean & Barlow, Inc. v. Bureau of Revenue, 88 N.M. 521 [543 P.2d 489] (1975); Western Natural Gas Co. v. McDonald, 202 Kan. 98 [446 P.2d 781] (1968).) In the Appeal of Borden, Inc., decided on February 3, 1977, we decided the issue raised by appellant. We specifically rejected the reasoning of the Kansas and New Mexico decisions and explained that section 25120 contains two alternative tests for determining the character of income, the transactional test and the functional test. Under the functional test, income from the disposition of an asset is generally business income if the asset produced business income; there is no requirement that the transaction giving rise to the income occur in the regular course of the taxpayer's trade or business, so long as the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

For the reasons discussed above, we conclude that appellant's gain from the sale of the Florida groves is business income.

Although appellant initially reported that the sale of the groves occurred during income year 1978, it now contends that the sale actually occurred during income year 1977. Appellant bases this conclusion on the fact that before the end of income year 1977, appellant and the purchaser had agreed on the terms of the sale and all contingencies had been removed. While this may be true, it does not follow that the sale took place at that time. The sale of real property takes place for tax purposes either when legal title is transferred or when possession of the property and the benefits and burdens of ownership

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are transferred. (Appeal of Western Orbis Company, Cal. St. Bd. of Equal., Aug. 1, 1974; Rev. Rul. 69-93, 1969-1 Cum. Bull. 139.) Appellant concedes that legal title was not transferred until income year 1978 and has presented no evidence indicating that appellant transferred possession and the benefits and burdens of the groves to the purchaser prior to the end of income year 1977. Therefore, it has failed to prove any error in respondent's determination of the year in which the sale took place.

The final issue raised by appellant is whether the gain from the sale of the groves is properly taken into account under the installment method. During the years involved in this appeal, section 24668 allowed the seller of real property to report the gain from certain sales under the installment method. However, installment sale treatment was not automatic; the taxpayer had to elect such treatment. (Appeal of Western Asphalt & Refining Co., Cal. St. Bd. of Equal., Dec. 17 1964.) Appellant contends that it made no election to report the gain from the sale of the Florida groves on the installment basis and that the entire gain is therefore properly included in its income in the year of the sale. Respondent argues that appellant elected to report the gain on the installment basis in that it attached to its state return a copy of the installment sales computation schedule appellant filed with its federal tax return. We cannot agree with respondent. The schedule was attached in order to provide information and to reconcile appellant's state return with its federal. Given the fact that appellant did not report the gain from the groves as part of **its** California income, we fail to understand how it could have made any election concerning the method by which gain should be reported for California purposes. Since appellant did not elect installment sale treatment, the entire taxable gain is properly included in appellant's income **for its income year ended October 31, 1978**, the year of the sale.

For the above reasons, respondent's action **must** be modified to reflect our determination that the gain was improperly accounted for under the installment sale method. In other respects, respondent's action must be affirmed.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Calavo Growers of California against proposed assessments of additional franchise tax in the amounts of \$10,435 and \$197,743 for the income years ended October 31, 1978, and October 31, 1979, respectively, be and the same is hereby modified in accordance with the foregoing opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 28th day of February, 1984, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman
Ernest J. Dronenburg, Jr., Member
Conway H. Collis, Member
William II. Bennett, Member
Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9