



87-SBE-016

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
INCO EXPRESS, INC.) No. 85R-202-MW
)

For Appellant: Craig Iskra
Secretary/Treasurer

For Respondent: A. Jovanovich
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), 1 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Inco Express, Inc., for refund of franchise tax in the amount of \$5,244 for the income year 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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The question presented by this appeal is whether interest income earned by appellant from short-term certificates of deposit was properly characterized by the Franchise Tax Board (FTB) as apportionable business income.

Appellant, a Washington corporation, is a common carrier engaged in the interstate trucking business. During the year in issue, appellant was doing business in 10 western states, including California, and British Columbia and had applied for authority to do business in a total of 40 states. During the appeal year and several immediately preceding years, appellant had apparently been retaining earnings so that it would not need to borrow money at high interest rates. These earnings were apparently invested in short-term certificates of deposit when not being used in appellant's business. They were also apparently intended to be used eventually to purchase land to be used in connection with the expansion of appellant's business.

Appellant owned property in Downey, California (the Downey business park), from which it received rental income from commercial and industrial tenants. The minutes of the meeting of appellant's board in February 1981 reveal that Mr. DiPietro, appellant's president and sole shareholder, was searching for a location in King County, Washington, "for a truck terminal to which access would be more convenient and which would further permit the expansion of the company's operation into the warehousing field by creation of a large enough facility to include space for a warehouse division." (App. Ex. A at 3.) The minutes of the annual meeting of the shareholder and directors, held in August 1981, recite that Mr. DiPietro was continuing his land search "for the purpose of relocating the company's facilities or building new expanded facilities to be used as a terminal, warehousing division or business park." (Resp. Ex. A at 3.) Land was located and purchased in December 1981, apparently with a large cash amount made possible by appellant's retention and accumulation of funds. The record does not reveal whether or how the raw land purchased was developed.

Appellant is engaged in a unitary business and, apparently, computed its California tax liability on the basis of a combined report and formula apportionment. For the year at issue, the Downey business park was considered a nonbusiness asset producing nonbusiness income and the Kings County land was not included in the

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property factor, "since the land was not as yet ready to be used in the unitary business." (Resp. Br. at 8.) The FTB, in an audit, characterized appellant's short-term certificates of deposit as "the investment of surplus idle working capital" (Resp. Br. at 2), and interest earned on the certificates as business income, **apportionable** among the states in which appellant did business. This resulted in a proposed assessment of additional tax. The FTB applied a previous overpayment by appellant to the additional amount determined to be due and appellant filed this timely appeal.

When a taxpayer is engaged in a unitary business, its California taxable income must be determined under the provisions of the Uniform Division of Income for Tax Purposes Act (**UDITPA**), found in sections 25120 through 25139. (Rev. & Tax. Code, § 25101; Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).) "Business income" 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.

Business income is apportioned to this state using a three-factor formula. (Rev. & Tax. Code, § 25128,) Nonbusiness income is specifically allocated as provided in sections 25124 through 25127. (Rev. & Tax. Code, § 25123.) Nonbusiness interest income is allocable to the state of the taxpayer's commercial domicile. (Rev. & Tax. Code, § 25126.) The FTB contends that appellant's interest income is apportionable business income, making an apportioned amount of the interest taxable by California.. The appellant argues that the interest income is nonbusiness income, all of which is specifically allocable to appellant's commercial domicile, Washington.

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The definition of business income in section 25120 provides two alternative tests for determining the character of income. The "transaction test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. Alternatively, the "functional test" provides that income is business income if the acquisition, management, and disposition of property giving rise to the income were integral parts of the taxpayer's regular business operations, regardless of whether the income was derived from an **occasional** or extraordinary transaction. (Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

The regulation under section 25120 provides that income is to be considered business income unless it is **clearly** classifiable as nonbusiness income, (Cal. Admin. Code, tit. 18, reg. 25120, **subd.** (a) (art. 2.5).)

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).)

More specifically, the regulation also provides that

Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

(Cal. Admin. Code, tit. 18, reg. 25120, **subd.** (c)(3).)

Appellant's basic argument is that, in 1981, it "earmarked" certificates of deposit for investment in

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nonbusiness property and, in fact, purchased the property in December of that year. (Appeal Ltr. at 2.) However, appellant **apparently concedes** that ~~some~~ portion of the interest income is business income - either \$2,500 (Appeal Ltr. at 1) or five percent of the interest income from the certificates (App. Reply Ltr., Nov. 19, 1985, at 2).

Appellant's argument is based on the premise that the interest income "should be treated and classified as the asset [] which it ultimately purchased (non-business land to be used for the non-business Business Park)." (App. Reply Ltr., Nov. 19, 1985, at 4.) However, the relevant inquiry under the statute and regulations is not what asset was **purchased** with the income, but whether the intangible which created the income is related **to the taxpayer's unitary business. We find that this inquiry** is clearly answered in the affirmative and that the interest income is properly characterized as apportionable business income.

The certificates of **deposit** from which the income arose were apparently **short-term** investments of extra cash which appellant kept available so that it could draw on its own **cash reserves** rather than pay interest on borrowed money. Short-term investment in order to maximize the income of what would otherwise be merely idle funds awaiting their need in appellant's business is simply prudent and **customary** corporate money management. Therefore, these certificates of deposit can be considered as arising in the regular course of appellant's business as well as **acquired**, managed, and disposed of as integral parts of **appellant's** regular business operations.

Appellant asserts that the certificates were earmarked in 1981 for the purchase of a nonbusiness asset, but, even if that would make a difference in the characterization of the interest **income**, appellant has not provided any convincing evidence that such was the case. None of the corporate meeting minutes indicate that there was any segregation or earmarking of any particular funds for the purchase of land, nor do we know whether all or just part of the interest income was used to purchase the land.

We must conclude, based on the relevant statutes and regulations and on the record before us, that the FTB properly characterized appellant's interest

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income as apportionable business income. Respondent's
action, therefore, must be sustained.

