

Appeal of Nicholas Turkey Breeding Farms,
Inc., Taxpayer, and Arbor Acres Farm, Inc.,
Assumer and/or Transferee

The question presented is whether income received from the rental and eventual sale of four South Carolina farm is business income apportionable by formula or nonbusiness income specifically allocable to South Carolina.

During the appeal years, Nicholas Turkey Breeding Farms, Inc. (hereinafter referred to as **appellant**), was engaged in the turkey breeding business. At one time, appellant was the primary breeder of 60-70 percent of all large white turkeys produced in the world. As a primary breeder, appellant developed genetically improved turkeys for sale to secondary breeders, who raised the turkey for meat. Originally, appellant sold several strains of turkey poults to the secondary breeders. Later, it converted to another method of operation involving the sale of foundation eggs to its customers, who would hatch the eggs to produce parent breeder turkeys, who would then be used to breed the turkeys raised for the commercial production of meat. The sale of foundation eggs was appellant's method of operation during the appeal years.

Modern turkey breeding, as practiced by appellant, involves crossing different strains of turkeys. Appellant apparently used three separate strains in its business. Two strains were crossed to produce a hybrid strain called the female line. A third strain was a pure bloodline known as the male line. Hens from the female line were then bred with toms from the male line to produce the three-way cross turkey ultimately sold commercially by appellant's customers. The toms from the female line and the hens from the male line were surplus products which appellant either discarded or "grew out" for sale as meat. This growing out process consumed 18-20 weeks for meat turkeys, while the breeding stock turkeys had to be grown out for about 30 weeks before they were of egg-producing age.

Until 1964, all of appellant's operations were conducted exclusively in California. In that year, however, appellant bought four farms in South Carolina and set up separate complexes of brooding, growing, laying, and dark houses for each of its three strains of turkeys. The South Carolina operations involved both egg production and growing out surplus stock for meat. In 1967 or 1968, these operations began to be adversely

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affected by two diseases, fowl cholera and leucocytozoan infection. When the latter disease proved ineradicable, it was a major factor in appellant's decision to terminate its South Carolina activities beginning in 1972. During the next several years, appellant **moved** the salvageable portions of these operations to California and leased the four farms to third parties, who used them to raise turkeys for meat. Each lease gave the lessee an option to purchase the property, and each option was eventually exercised during the appeal period,

On its returns for the years in issue, appellant excluded the rental income from, and the gains on the sale of, the South Carolina farms from apportionable **business income**. Appellant's theory **was** that the **leases** converted the farms into nonbusiness assets the entire income from which was specifically allocable to South Carolina. Upon examining the returns, **however, respon-** dent determined that all of this income should have been included in appellant's business income. Respondent, accordingly, issued proposed assessments reflecting this determination, and the assessments also included other adjustments arising from federal audit changes to appellant's federal returns for all three appeal years. Appellant has not disputed the part of the assessments based on the federal action, but it does object to respondent's ruling on the business income issue.

Since its adoption by California in 1966, the Uniform Division of Income for Tax Purposes Act (**UDITPA**) (Rev. & Tax. Code, **SS** 25120-25139) has provided a comprehensive statutory scheme of apportionment and allocation rules to measure California's share of the income earned by a taxpayer engaged in a multistate or multinational unitary business. UDITPA distinguishes between "business income," which must be apportioned by formula, and "nonbusiness income," which is allocated to a specific jurisdiction according to the provisions of sections 25124 through 25127. 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

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constitute integral parts of the taxpayer's regular trade or business operations.

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

The statutory definition of business income provides two alternative tests for determining the character of income. The "transactional 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. The "functional test" provides that income is business income if the acquisition, management, and disposition of the 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.)

Capital gains and losses from sales of real property are apportioned by formula if they come within the definition of business income (Rev. & Tax. Code, § 25128), but are allocable to the state in which the property is located if they constitute items of nonbusiness income. (Rev. & Tax. Code, § 25125.) The labels customarily given items of income, such as rents or capital gains, are of no aid in determining whether the income is business or nonbusiness income: the gain or loss on the sale of property, for example, may be business or nonbusiness income, depending on the relation to the taxpayer's trade or business. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2.5).)

Respondent's regulations provide that gain or loss on the sale of property is 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

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the property factor before its sale... the gain or loss will constitute nonbusiness income. (See Regulations 25729 to 25131 inclusive.)

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

Rental income is considered business income

if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is **includible** in the property factor under **Regulations** 25129 to 25131 inclusive.

(Cal. Admin. Code, tit. 18, reg. 25120, **subd. (c)(1)** (art. **2.5).**)

According to these regulations, the characterization of the gain on the sale depends upon the characterization of the rental income and whether the property, while rented, was includible in the property factor. Regulation 25129 provides guidelines for determining whether property is to be included in the property factor:

(a) . . . The property factor of the **apportionment** formula . . . shall include all real and tangible **personal** property owned or rented by the taxpayer and used during the income year 'in the regular course of such trade or business. . . . Property used in connection with the production of nonbusiness income shall be excluded from the property factor. . . .

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(b) . . . Property shall be included in the **property** factor if it is actually used or is available for or capable of being used during the income year in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or

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property held as a reserve **source of** materials shall be included in the factor. **For example, a** plant temporarily idle or raw **material reserves** not currently being processed are includible in the factor. ... Property used in the regular course of the trade or business of the taxpayer shall **remain in the** property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of non-business income, its sale, or the lapse of an extended **period** of time (normally, five **years**) during which the property is held for sale.

(Cal. **Admin. Code, tit. 18, reg. 25129, subds. (a)-(b)**  
(art. 2.5).)

Applying these regulations and the statutory' definition of business income to the facts of this case, we believe that appellant's South **Carolina** farms began **producing** nonbusiness income when they were leased out to other parties, and that the farms should have been withdrawn from the property factor when their lease terms began. The evidence shows that an **ineradicable** disease rendered those **farms** unusable for producing turkey eggs, appellant's principal product. Appellant decided, therefore, to terminate its South Carolina operations **and** proceeded to do so **in an** orderly fashion. Upon being leased out, the farms were no longer being used in appellant's business, nor were they "available for **or** capable of being **used**" in appellant's business, within the meaning of regulation 25129, subdivision **(b)**. While it **is** true, as respondent points out, that the farms were **still** capable of being used to raise turkeys, since the lessees in fact used them for that purpose, the only fair reading of **the regulation** is that the property in question must be usable during the income year by the taxpayer in its own trade or business. In this case, the farms were not so usable, both because of the disease infestation and because the farms were under **extended-term** leases to unrelated parties. Since the permanent withdrawal of the farms from appellant's business was established by the leasing out, the property was not properly includible in the property factor. Accordingly, both the rental income and the gain on the sales of the farms **were** correctly reported by the appellant as

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nonbusiness income specifically allocable to South Carolina. **Respondent's** action in this matter will be modified to reflect this determination,

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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 **HERESY** ORDERED, ADJUDGED AND DECREED,  
pursuant to section 25667 of the Revenue and Taxation  
Code, that the action of the Franchise Tax Board on the  
**protests** of Nicholas Turkey Breeding Farms, Inc.,  
Taxpayer, and Arbor Acres Farm, Inc., Assumer and/or  
Transferee, against proposed assessments of additional  
franchise tax in the amounts of \$906.95, **\$25,087.32**, and  
**\$6,112.70** for the income years **ended February 28, 1975**,  
**February 29, 1976**, and **February 28, 1977, respectively**,  
be and the same is hereby modified in accordance with our  
opinion herein.

Done at Sacramento, California, this 7th day  
of May , 1987, by the State Board of **Equalization**,  
with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett,  
Mr. Carpenter and Ms. Baker present.

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| <u>Conway H. Collis</u>          | , Chairman |
| <u>Ernest J. Dronenburg, Jr.</u> | , Member   |
| <u>William M. Bennett</u>        | , Member   |
| <u>Paul Carpenter</u>            | , Member   |
| <u>Anne Baker*</u>               | , Member   |

\*For Gray Davis, per Government Code section 7.9