In the Matter of the Appeal of:

BANK OF AMERICA CORP. AND
ITS AFFILIATES

HEARING SUMMARY
FRANCHISE AND INCOME TAX APPEAL
Case No. 983272

Year  Claim for Refund
2008  $5,692,009

Representing the Parties:
For Appellant:    Derick Brannan, PricewaterhouseCoopers
For Franchise Tax Board:  Thomas A. Lo Grossman, Tax Counsel III

ISSUE: Whether dividend income received from appellant’s investment in China Construction Bank constitutes business income.

HEARING SUMMARY

Section 40 Appeal

This appeal involves an amount in controversy that is $500,000 or more and thus is covered by Revenue and Taxation Code (R&TC) section 40, as explained in Staff Comments.
Background

Factual Background

Appellant Bank of America Corporation and its affiliates (Appellant or BAC) is headquartered in Charlotte, North Carolina. It provides “. . . a full range of banking, investing, asset management and other financial and risk management products and services.” (Appellant’s Opening Brief (AOB), p. 1.)

As discussed further below, appellant acquired an equity interest in China Construction Bank Corporation (CCB) in 2005. During the year at issue, 2008, appellant received $586,544,947 in dividends from CCB. After accounting for expenses, the net amount received was $581,608,044. (AOB, Exh. 1 [attachment to tax returns], and Exh. 2 [July 2, 2014 Audit Issue Presentation Sheet (AIPS)].) In this appeal, appellant argues that this income should be characterized as nonbusiness income, such that it is not apportionable by California.

Initial Investment

In 2005, appellant paid approximately $3 billion 1 to purchase a nine percent interest in CCB and a call option to purchase additional shares, pursuant to a Share and Option Purchase Agreement, dated as of June 17, 2005 (Purchase Agreement). The Purchase Agreement was between appellant and China SAFE Investments Limited, a state-owned investment company in the People’s Republic of China that was referred to as “Huijin.” Huijin was the principal shareholder of CCB. The call option provided appellant with the opportunity to purchase additional shares in order to increase its ownership stake to up to 19.9 percent. Appellant’s ownership interest in CCB “generally fluctuated between 8 and 11 percent, with a high ownership percentage of 19 percent in November of 2008.” (AOB, p. 4 and Exh. 4 [Purchase Agreement].)

Pursuant to the Purchase Agreement, appellant had the right to nominate an individual to CCB’s Board of Directors and to have that individual serve on the audit, compensation, and strategy committees of the Board. Appellant had no more than one seat on the Board, and the Board as a whole consisted of 15 to 19 people. (AOB, p. 4 and Exh. 4 [Purchase Agreement].)

1 The Purchase Agreement references a $2.5 billion purchase amount but it appears that the purchase price was ultimately approximately $3 billion. (See, e.g., Respondent’s Opening Brief (ROB), Exh. B [June 17, 2005 press release].)
Investment Agreement and Strategic Assistance Agreement

At the same time appellant entered into the Purchase Agreement, it also entered into an Investment Agreement and Strategic Assistance Agreement (SAA) with CCB. Pursuant to the Investment Agreement, appellant and CCB agreed that CCB would seek to conduct an initial public offering (IPO) and that appellant would purchase $500 million of shares in the IPO. Section 5.07 of the Investment Agreement provides that appellant will “cease to conduct any retail banking operations in [China] and [agree] not to commence new retail banking operations in [China].” However, this section of the agreement also states that appellant “may maintain the minimum number of existing branches in [China] required to conduct its global wholesale corporate business servicing its global clients[,]” provided that appellant agrees “to close any branch in [China] not required for such purpose . . . .” (AOB, p.5 and Exh. 5 [Investment Agreement].)

Pursuant to Section 3.01 of the SAA, appellant agreed to provide strategic assistance “in the areas of risk management/corporate governance, credit cards, consumer banking, global treasury services, information technology and other areas as may be agreed . . . .” Section 3.04 of the agreement provides that, while appellant may assist CCB in developing policies and practices, CCB would remain solely responsible for managing and conducting its operations. (AOB, Exh. 6 [SAA].)

Section 4.01 of the SAA states that appellant will provide approximately 50 employees to provide strategic assistance to CCB, and Section 4.02 states that the employees will continue to be paid by appellant. Staff’s understanding is that, pursuant to this provision, appellant provided the equivalent of roughly fifty full-time employees, but the actual number of employees who provided assistance varied. ² (Ibid.)

Appellant argues that the SAA primarily provided value to CCB, without providing any material operational value to appellant. Respondent argues that the SAA was part of a strategic partnership that was intended to benefit business operations.

² According to a July 2, 2014 Audit Issue Presentation Sheet, in 2008, there were a total of 83,550 “Total Project/Shared Experience Hours” in connection with the CCB investment. (AOB, Exh. 2, p. 5.) According to a September 3, 2013 press release, “[a]pproximately 3,100 Bank of America employees and 5,000 CCB employees have participated in SAA exchanges since 2005.” (ROB, Exh. N [press release].) Appellant states that the time spent by its personnel was “at its highest in 2007,” when its employees provided a number of hours of assistance that was equivalent to roughly 76 full-time employees, but that in other years appellant’s contribution of resources was much lower. (AOB, p. 5.)
Credit Card Memorandum of Understanding

Section 3.07 of the SAA states that appellant and CCB would “discuss in good faith the possibility of [CCB] transferring its credit card business to a new joint venture entity at an appropriate future time.” On April 20, 2007, appellant (through a subsidiary) and CCB entered into a Memorandum of Understanding [MOU] to create a credit card joint venture. However, the credit card joint venture was not formed because needed statutory changes could not be obtained from the government of China. In 2010, appellant and CCB terminated the MOU. Appellant points out that the credit card joint venture never occurred and the MOU was terminated, while respondent argues that the MOU evidences appellant’s intent to use the investment to expand its business. (See ROB, p.5 and Exh. H [MOU]; Appellant’s Reply Brief (ARB), pp. 4-5 and Exhs. 1-3; Respondent’s Reply Brief (RRB), pp. 7-8.)

Leasing Joint Venture

Pursuant to an Investment Contribution Agreement dated May 18, 2007, appellant and CCB agreed to establish a leasing joint venture named CCB Financial Leasing Joint Stock Company. The purpose of the joint venture was “to develop high-end customers in [the] finance leasing field, and adopt product innovation as the core competency of the [joint venture], build the top brand in China’s leasing industry, and become a professional financial leasing company . . . .” The Investment Contribution Agreement states that the scope of business would include, among other things, term deposits, assigning rent receivables, inter-bank lending, issuing bonds, economic consulting, and any other approved business. Its initial registered capital was 4.5 billion yuan. Appellant contributed 1,120,500,000 yuan (approximately $155 million) for a 24.9 percent interest in the venture. Appellant’s consent was generally required for certain major decisions, such as budgeting and operational policy, and appellant had a right to nominate one of the venture’s five directors. Appellant also had a right to nominate the Chief Operating Officer and up to two management personnel. (AOB, Exh. 7.)

Appellant argues that the leasing joint venture was separate from the equity investment, while the FTB argues that the equity investment enabled subsequent business activities like the leasing joint venture.

ATM Reciprocity and Wire Services

Appellant’s customers and CCB’s customers were able to use each bank’s ATMs and
wire transfer services. It appears that each bank’s customers could make withdrawals from the other
bank’s ATMs at no charge. (See AOB, Exh. 2, p. 6; Resp. Sept. 20, 2017 Add’l Info., Exhs. Q, R, S, T; 

Staff’s understanding is that appellant’s position is that this ATM agreement was similar
to agreements it had with other international banks in which it did not have an investment, and was not
related to its investment in CCB. Staff’s understanding is that respondent’s position is that appellant’s
agreement with CCB with regard to ATM services and wire transfers was a benefit arising from its
equity investment in CCB.

Growth in Loans in China

Between 2005 and 2011, appellant’s loan business in China expanded from $172 million
in 2005, to $285 million in 2008, to $3.9 billion in 2011. However, the parties dispute whether the
expansion of the loan business had a connection to appellant’s investment in CCB. (See ASRB, p. 5 and
Exh. 1 [excerpts from 10-Ks]; RRB, p. 5.)

Procedural Background

On its original California tax return for 2008, appellant reported the dividend income
received from CCB as business income. On May 30, 2013, appellant filed a letter with the FTB seeking
a refund of taxes paid for tax years 2008 through 2011. Among other things, appellant’s claim for
refund argued that the dividend income from CCB should be recharacterized as nonbusiness income. At
a pre-hearing conference, appellant notified staff that it had withdrawn its other grounds for a refund
claim, with respect to 2008 only. Appellant also agreed not to challenge audit adjustments for 2008 that
were included in an October 8, 2015 Notice of Proposed Overassessment (NPO). As a result, it appears
that the parties are in agreement that the only issue remaining with regard to the refund claim for 2008 is
whether the dividend income constitutes nonbusiness income. (AOB, pp. 1-2, Exh. 1 [refund claim];

On July 2, 2014, the FTB issued an AIPS in which the auditor recommended that the
income from appellant’s investment in CCB should be classified as business income. On October 8,
2015, FTB issued the above-referenced NPO which reflected a determination to deny the refund claim.
However, the FTB did not issue a formal refund denial. Appellant subsequently filed this appeal from
the FTB’s deemed denial of its refund claim for 2008.3

Contentions

Appellant’s Opening Brief4

Appellant argues that the FTB’s determination “is contrary to the facts and contrary to the California Supreme Court’s decision in Hoechst Celanese Corp. v. Franchise Tax Bd. (Hoechst Celanese) (2001) 25 Cal.4th 508. Appellant notes that it had only one of fifteen CCB Board of Director seats and argues that it was precluded from engaging in any management activities and could not sell its investment for at least three years. (AOB, p. 1.)

Appellant asserts that “California may not tax income from property or activities which do not share an integral relationship with the taxpayer’s trade or business conducted in California.”

Appellant notes that, in Hoechst Celanese, the California Supreme Court stated that the activities giving rise to the income must be “so interwoven into the fabric of the taxpayer’s business operations” that they are “indivisible” from the taxpayer’s business activities with both “giving value” to each other[,]” quoting Hoechst Celanese, supra, at page 532. Appellant argues that “contractual and regulatory limitations” on its investment “precluded [it] from having any control over CCB activities” and “prevented BAC and CCB from sharing the necessary integral relationship” for business income to arise. (AOB, p. 1; see also AOB, pp. 9, 12-14, ARB, pp. 1-2, 16-18.)

Appellant describes the banking reform assets that the Chinese government initiated in the early 2000s in response to concerns about the integrity of the Chinese banking system and the need for capital. Appellant states that, as part of this reform effort, the Chinese government contributed $45 billion to government-owned banks, including CCB, and “pursued knowledgeable foreign investors to help improve the antiquated Chinese banking system and fund the capital shortfall.” Appellant states

3 A pre-hearing conference was held in this appeal on September 7, 2017. At the pre-hearing conference, appellant provided the letter withdrawing certain refund claims that is noted above. Among other things, staff and the parties discussed the credit card MOU, the leasing joint venture, the use of ATMs, and the growth of appellant’s loan portfolio in China. At the conference, both parties provided additional evidence with regard to the use of ATMs. Following the conference, staff asked the parties to submit this evidence as additional exhibits, together with any other additional evidence that either party believed might be helpful to the Board’s resolution of the issues on appeal. Each party subsequently submitted additional exhibits, which were distributed to the Board on October 2, 2017.

4 Appellant filed its opening brief with its appeal letter.
that China’s admission to the World Trade Organization (WTO) accelerated reform efforts because WTO required China to open its banking services to foreign competition by the end of 2006. (AOB, pp. 2-3.)

Appellant notes that, in October 2005, CCB conducted an IPO, and Huijin, a state-owned investment company, acquired most of CCB’s shares. Appellant states that Huijin had the ability to control CCB’s board of directors and that, through Huijin, CCB “is ultimately owned and controlled by the government of the People’s Republic of China (PRC) and accountable to the Communist Party’s Central Organization Department.” (AOB, pp. 3-4.)

Appellant states that, in 2005, China was “one of the fastest-growing economies in the world, with 1.3 billion consumers.” Appellant argues that foreign banks that wished to profit from that economy “could choose to expand their own retail banking business when the competitive market was expected to open up at the end of 2006 pursuant to the WTO mandate, or they could invest immediately in one of the state-owned banks and profit indirectly from the ongoing banking reform efforts . . . .” Appellant further argues that it “chose the latter course and, as a result, specifically limited its banking activities in China to those of an investor and advisor.” Appellant states it invested because it recognized the growth potential in a Chinese bank that was preparing for an IPO and notes that its CEO Ken Lewis said it made sense “to consider an investment in China” in order to tap into economic growth. (AOB, p. 4.)

Appellant notes that its share ownership never rose above 20 percent and that it never had more than one seat on the CCB Board of Directors, which consisted of 15 to 19 people. Appellant emphasizes that “. . . the investment agreements made it very clear that appellant would “not oversee or manage [CCB’s] operations, which will remain [CCB’s] responsibility.” Appellant states that the Investment Agreement limited the information CCB provided to appellant “to financial statements and an audit opinion prepared by outside auditors[,]” citing Section 5.02(a) of the Investment Agreement. (AOB, p. 4.)

Appellant argues that, “[i]n return for the opportunity to earn returns on its investment in CCB, BAC offered its expertise.” Appellant notes that Mr. Lewis stated that appellant saw “value in combining [CCB’s] local knowledge and distribution with BAC’s product expertise, technology and
experience with size and scale. . . .” Appellant argues that it is notable that “Mr. Lewis did not predict operational value for BAC.” (AOB, p. 5.)

Appellant states that when it acquired its interest in CCB, “it had a very limited presence in China with only three corporate banking offices . . . , and no apparent intention to open any further branch offices in China.” Appellant notes that, as part of its investment, it agreed not to conduct retail banking operations in China and further agreed not to invest in banking institutions engaged in retail banking in China. (Ibid.)

Appellant argues that its “investment reflected a corporate decision to earn money in China through investment in one of China’s state-owned banks and not through expansion of [its] own banking activities.” Appellant further argues that it provided “cash and expertise to CCB in order to enhance the return on its investment.” (Ibid.)

Appellant notes that it entered into the SAA as a condition of its investment and “agreed to assist CCB in adopting international best practices in risk management, corporate governance and management, credit cards, consumer banking, global treasury services and information technology.” Appellant observes that, pursuant to its agreement, the assistance provided was “advisory and/or strategic in nature[,]” and that CCB’s operations remained “solely” its responsibility. (AOB, pp. 5-6.)

Appellant states that, in addition to the activities covered by the SAA, it “helped CCB establish and enhance its leasing operations when it entered into an Investment Contribution Agreement for the establishment of the CCB Financial Leasing Joint Stock Company in May of 2007, entered into a Credit Card [MOU] dated April 20, 2007, and agreed to share some credit card licensing information by agreement dated September 18, 2008.” Appellant asserts that “[i]n each case, [it] provided some further cash contribution or expertise . . . without receiving any corresponding operational benefit from CCB in return.” (AOB, p. 6.)

Appellant argues that its “participation in the CCB investment was orchestrated to bring CCB into the modern age of banking and help bolster the Chinese banking system.” Appellant further argues that “. . . CCB received tremendous value from BAC’s expertise and strategic assistance, and
BAC received a meaningful return on its investment through dividends and capital gains.”

Turning to the federal law, appellant quotes *ASARCO Inc. v. Idaho State Tax Comm’n* (1982) 458 U.S. 307 (ASARCO), 315, in which the United States Supreme Court stated “a State may not tax values earned outside its borders.” Quoting ASARCO, appellant argues that the “linchpin of apportionability . . . is the unitary-business principle” and states that courts must “look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.” Quoting *Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768 (Allied-Signal), 787, and other cases, appellant argues that if the activity giving rise to the income is “unrelated to [the activities carried out in the taxing] State,” then the income is not apportionable by the state. Appellant argues that “financial returns alone do not establish a relationship sufficient to include income in the apportionable tax base.” (AOB, pp. 6-7.)

Appellant discusses and emphasizes the United States Supreme Court decision in ASARCO. Appellant notes that, in ASARCO, the Court held that Idaho “could not tax dividends from stock which had no connection to the State of Idaho.” Appellant observes that the Court found that the dividend-paying subsidiaries represented “discrete business enterprise[s]” that in “any business or economic sense [had] nothing to do with activities” of the taxpayer in Idaho. (AOB, p. 7.)

Appellant discusses each of the foreign companies that paid the dividends at issue in ASARCO. With regard to Southern Peru Copper Corp., which was one of these companies, appellant notes that ASARCO owned 51.5 percent of its voting stock and purchased roughly 35 percent of its mining output. Appellant further notes that ASARCO provided services to the subsidiary, such as purchasing service and traffic service. Appellant argues that “[e]ven though ASARCO provided these services . . . , relied on Southern Peru for copper and could have asserted operational control over

5 In footnote 47 of its opening brief, appellant states that, in 2009 through 2011, it “sold nearly all of its holdings in CCB and so received both capital gain income and dividend income related to the CCB investment in those years.” Appellant states that it filed refund claims treating that income as nonbusiness income and that “those years are still pending at protest with the FTB due to other issues.” Appellant adds that it “expect[s] that . . . income received after 2008 from the CCB investment will be treated the same as dividend income related to the ownership of CCB stock as determined by the Board for the 2008 tax year in the instant appeal.”

6 In the opinion, the Court states, quoting another Supreme Court decision, that “[i]n order to exclude certain income from the apportionment formula, the company must prove that ‘the income was earned in the course of activities unrelated to [those carried out in the taxing] State.” (Allied-Signal, supra, at p. 787 [citations omitted].)
Southern Peru, the court concluded that dividends paid to ASARCO were nonbusiness income.” (Ibid.)

With regard to ASARCO Mexicana, S.A., which was another company from which ASARCO earned income, appellant notes that this subsidiary was in the same general line of business as ASARCO, was formerly ASARCO’s wholly owned subsidiary, and received technical and sales services from ASARCO. However, the subsidiary operated independently of ASARCO and did not sell its output to ASARCO. Appellant notes that the Court found that income from this subsidiary also constituted nonbusiness income. (Ibid.)

With regard to three other companies from which ASARCO earned income, appellant notes that ASARCO held between 34 and 53 percent off their stock and purchased between one and six percent of their output for use in its business, but that ASARCO could not “direct the affairs of the investments” due to contractual restrictions or an antitrust decree. Appellant notes that the Court also found that income from these investments could not be treated as apportionable business income.

(AOB, pp. 7-8.)

With regard to California law, appellant focuses on the California Supreme Court opinion in Hoechst Celanese, supra. Appellant states that, “under the functional test, corporate income is business income ‘if the acquisition, management, and disposition of the [income-producing] property constitute integral parts of the taxpayer's regular trade or business operations[,]’” quoting R&TC section 25120, subdivision (a). Appellant notes that, in Hoechst Celanese, the court found that the functional test had two components: “first, whether the taxpayer has sufficient ‘control and use of the income-producing property;’ and second, ‘whether the taxpayer’s control and use of the property. . . [is] an integral part[] of the taxpayer’s regular trade or business operations[,]’” quoting Hoechst Celanese at page 529. (AOB, pp. 8-9.)

Appellant states that, with regard to whether the taxpayer has sufficient control or use of the property, Hoechst Celanese required that the taxpayer must “(1) obtain some interest in and control over the property, (2) control or direct the use of the property, and (3) transfer, or have the power to transfer, control of the property in some manner.” Appellant notes that Hoechst Celanese also required

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7 As respondent has not asserted on appeal that the transactional test applies, appellant’s contentions regarding the transactional test, which can be found on pages 8 to 9 of its opening brief, are not summarized here.
that the control and use of the property must “contribute materially to the production of business income[,]” quoting *Hoechst Celanese*, and that the control or use of the property must be an integral part of the taxpayer’s regular business operations. Appellant further notes that *Hoechst Celanese* stated that the term “integral” requires an organic unity in which the property is, quoting *Hoechst Celanese*, so “interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable from the taxpayer's business activities with both 'giving value' to each other.” (AOB, p. 9.)

Appellant argues that *Hoechst Celanese* found that income from a pension reversion constituted business income because acquisition, management and disposition of the income-producing property, the pension trust and assets, were an integral part of the business. Appellant notes that the pension trust and assets were created in order to retain employees and attract new employees and that, based on the material impact on the workforce, the acquisition, management and disposition of the assets were an integral part of the business. (AOB, pp. 9-10.)

Appellant argues that the Board applied the standards of *Hoechst Celanese* in the *Appeal of Pacific Bell Telephone Company*, Case No. 378042, decided September 20, 2011 (*Pacific Bell*), 8 and unanimously found that income from Pacific Bell’s minority interest in its foreign subsidiaries could not be integral parts of the taxpayer’s domestic telecommunications business. Appellant further argues that the Board rejected the FTB’s argument that “a one-way flow of value, from investor to investee, without some degree of operational integration, was sufficient to find business income.” (AOB, p. 10.)

Appellant also points to FTB Legal Ruling 2012-01 and notes that it cited *Hoechst Celanese* and the *Appeal of Occidental Petroleum* (*Occidental*), 83-SBE-119, decided June 21, 1983, “for the proposition that income from stock will be business income if there is [quoting Legal Ruling 2012-01] ‘actual integration’ between the taxpayer’s regular business and the assets and business activities represented by the stock.” Appellant further notes that FTB Legal Ruling 2012-01 stated that, in *Occidental*, it is determinative that, at the time of the sale, “no actual operational relationship existed[]” between the stock and the activities represented by the stock and the operations of the taxpayer’s business.” Appellant further notes that Legal Ruling 2012-01 provided three scenarios which

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8 Under the Board’s rules, *Pacific Bell* may not be cited as precedent as it was not adopted in a precedential opinion.
illustrated that, goals to obtain operational advantages were not enough unless the goals were achieved. (Ibid.)

Applying these authorities to the facts here, appellant argues the dividend income does not constitute business income because appellant “did not have the requisite degree of control over its investment and the investment did not (and could not) share an integral relationship with BAC.” In support, appellant notes that Chinese law limited its ownership stake to no more than 20 percent and argues that, “as CCB’s majority shareholder, the Communist Chinese Government had absolute control over CCB.” Appellant states that it had only one seat on the 15-member Board of Directors and argues that it “controlled zero executive or management functions for CCB and had no rights to commercial information beyond access to fundamental financial information . . . .” Appellant further argues that, “[p]erhaps most importantly, BAC needed permission from CCB to sell its investment at any time during the ‘lockup’ period immediately following the investment.” (AOB, pp. 11 – 12.)

Citing Hoechst Celanese, appellant argues that there was no “actual integration” between its regular business “and the assets and business activities represented by the stock.” Appellant further argues that the investment could not become interwoven into its business. In support, appellant contends that “ . . . the investment-related contracts and the Chinese regulatory climate required that the two businesses remain separate.” Appellant asserts that, while it provided funding and expertise to CCB, “the value BAC obtained was through growth on its investment.” Appellant further asserts that its investment “did not enhance BAC’s global or domestic competitive position.” (AOB, p. 12.)

Appellant argues that, “[c]ompared to ASARCO, [its] investment in CCB had even less to do with BAC’s trade or business and nothing to do with [its] activities in California.” Appellant also argues that, in Occidental, the Board determined that investment returns were nonbusiness income even though the taxpayer in that appeal “had a greater ownership percentage, greater representation on the respective Boards of Directors, and no apparent limitations on their ability to conduct independent business operations in competition with the investments.” Appellant contends that its “business operations received no material benefit from its investment in CCB[,]” and therefore should, like the investment returns in Occidental, be treated as nonbusiness income. (AOB, p. 13.)

Appellant further argues that the FTB applied the wrong legal standard when it proposed
to deny its claim for refund. Appellant contends that, in response to its position that “CCB did not provide any material operational value to BAC and was not indivisible or inseparable from [its] trade or business, the FTB summarily concluded” as follows, quoting the FTB:

Auditor disagrees with the above conclusion as unity is not a requirement for investment income to be classified as business income. This income is from the same trade as taxpayer’s core business. Also, taxpayer actively employed its resources in managing this investment and creating value to [CCB] as evidenced by intercompany documents and activities.

Appellant argues that the FTB “applied the wrong test and reached the wrong conclusion” because the statutory standard “is not unity, is not whether the income arose from the ‘same trade as taxpayer’s core business’ and is not whether the taxpayer actively employed resources in the management of the investment.” Appellant reiterates that the actual standard, as set forth in the statute and clarified by Legal Ruling 2012-01 and Hoechst Celanese, is “whether income, or the activity giving rise to that income, is integrally related to the taxpayer’s trade or business.” Appellant argues that the necessary integral relationship can only be established “when the property or activity giving rise the income is so [quoting Legal Ruling 2012-01 which quotes Hoechst Celanese] ‘interwoven into the fabric of the taxpayer’s business operations that it becomes ‘indivisible’ or inseparable from the taxpayer’s business activities with both ‘giving value’ to each other.’” (AOB, pp. 13-14.)

Respondent’s Opening Brief

In its factual background, the FTB notes that the PRC joined the WTO in the early 2000s. The FTB states that, “[a]s of 2006, pursuant to WTO rules, foreign banks were to be allowed much deeper access to PRC markets . . . .” The FTB argues that, “[i]n anticipation of this, foreign banks, including Appellant, rushed in to exploit the PRC market[,]” which “put banks like Appellant and established PRC banks like CCB in competition.” (ROB, p. 2.)

The FTB contends that, as the 2006 WTO deadline approached, “. . . the PRC
government made a policy decision that co-opted foreign banks like Appellant by offering them minority stakes in PRC banks in return for surrendering their retail banking businesses and providing foreign experience, technology, and know-how to their PRC partners.” (FTB’s emphasis.) The FTB states that these transactions “were accompanied by PRC laws preventing foreign banks from acquiring controlling interests in PRC banks.” Quoting appellant’s 2005 Annual Report, the FTB argues that foreign banks were able to combine “local knowledge and distribution with their own product expertise, technology and experience managing growth and scale.” Respondent argues that the foreign banks “thereby benefit[ed] their other lines of business outside of retail banking.” The FTB argues that, here, “. . . the other lines of banking business benefitted were corporate banking with other multinational corporations and planned expansion into the credit card business[,]” citing appellant’s 2005 Annual Report.10 (ROB, p. 2.)

The FTB argues that, by allowing foreign banks to continue corporate banking, “. . . the strategic partnerships allowed foreign banks to continue their relationships with foreign businesses that it wanted to invest in the PRC.” The FTB further argues that, with its “strategic partnership” with CCB, appellant was allowed “to maintain a banking footprint sufficient to continue to service it’s foreign, mostly American, business clients . . . , and gained a partnership with CCB it planned to utilize to assist those clients.” The FTB contends that, as nearly half of appellant’s income came from non-consumer banking services, and “because consumer banking services included credit card services – which would be expanded . . . under the agreement with CCB – Appellant retained many ways to operate profitably in the PRC.” (ROB, p. 3.)

The FTB argues that appellant’s statements show that, in addition to seeking to expand its credit card business, appellant “sought to replicate in the PRC what it had accomplished in Mexico with its purchase of Banco Santander in 2002.” The FTB further argues that, in that transaction, appellant “purchased a stake to create a strategic relationship with a Mexican bank that would help Appellant better serve Appellant’s customers who had ties to both the United States and Mexico, and who required

10 In footnote 7 of its brief, the FTB states that, according to appellant’s 2005 10-K, at page 18, appellant’s non-consumer banking services generated $28,047 million [i.e., $28.047 billion] of revenue, “which was 49.2 percent of its total revenue for that year.”
access to banking services in Mexico [footnote omitted].” The FTB contends that “[s]imilarly, . . .
Appellant sought a strategic partnership in the PRC that would help it better serve its U.S.-based
multinational clients who required access to banking services in the PRC.” (ROB, pp. 3-4.)

The FTB states that appellant executed the SAA to provide technical training and
executed the Investment Agreement to acquire shares. The FTB argues that, pursuant to the Investment
Agreement, appellant gave up its retail banking business but “was expressly allowed to keep enough
banking branches to continue its corporate banking business. The FTB argues that the agreements were
linked with one another and considered by the parties to be a “singular strategic agreement or
partnership[,]” citing a June 17, 2005 press release. (ROB, pp. 4-5.)

Citing appellant’s 2005 Annual Report, the FTB argues that, according to appellant’s
own statements, it “intended to leverage its long-term strategic partnership with CCB to benefit its credit
card and corporate banking businesses, which it retained.” Quoting the 2005 Annual Report, the FTB
argues that “both partners saw significant added value[,]” and the agreement was an example of how
appellant used other businesses to “create organic growth opportunities.” (ROB, p. 5.)

The FTB argues that, “[a]fter obtaining its minority stake, Appellant promptly began
transferring technology and know-how to CCB[,]” and spent “millions of dollars” flying its personnel
into and out of China, and “hundreds of thousands of man-hours” working with CCB. The FTB further
argues that appellant entered into “several planned joint ventures with CCB[,]” including a MOU to
establish a credit card joint venture, a financing joint venture, an agreement to provide training, and an
agreement to license intellectual property “for the credit card business established in the credit card
MOU.” (ROB, pp. 5-6.)

Turning to the applicable law and cases, the FTB states that “[t]his appeal involves
application of the functional test of business income.” Citing Hoechst Celanese at page 533, the FTB
argues that the court “relied on and was greatly deferential to prior decisions of your Board, and stated
that its interpretation of the functional test was in accord with your Board’s interpretations of the
business income cases from the Eighties and Nineties.” The FTB argues that Hoechst Celanese
articulates a two prong test, with the first prong being whether the taxpayer “had sufficient power over a
particular property such that it could ‘acquire, manage, and dispose’ of it if it wished for the asset to be
considered a business asset[]” and the second prong being whether the property was “integral” to the taxpayer’s regular trade or business.” (ROB, pp. 6-7.)

The FTB describes the facts of Hoechst Celanese as follows. The FTB notes that it involved a pension reversion, which occurs when a pension fund is overfunded such that there is a residual amount that reverts to the company that funded the pension plan. The FTB states that the pension fund is itself legally owned and managed by a pension trustee, and further states that Celanese “did not make individual investment decisions . . . .” The FTB argues that, in order to obtain the reversion income, Celanese had to comply with provisions of the Employee Retirement Income Security Act (ERISA), which required that Celanese “enter into an elaborate two-year process that involved forming new trusts, funding those trusts according to the requirements of federal law, and winding up its pension plans[],” citing Hoechst Celanese at page 515. (ROB, pp. 7-8.)

The FTB contends that the facts of Hoechst Celanese demonstrate that it is a “low hurdle” to satisfy the first prong of the functional test, which requires control. In support, the FTB argues that “Celanese had a reversion in a highly regulated trust with assets to which it did not hold legal title, the investment decisions of which it did not control, and for which it was required to wind up the relevant pension plans in a complicated two-year process in order to obtain.” The FTB argues that, despite these facts, “the attenuated interest in the reversion held by Celanese still counted as fulfilling the first prong of [Hoechst Celanese].” (ROB, pp. 8-9.)

The FTB contrasts the facts of Hoechst Celanese with the facts concerning appellant’s ownership stake in CCB. The FTB argues that, “[a]lthough Appellant’s stake in CCB was subject to a lock-up provision, which temporarily barred its sale by Appellant, Appellant had legal title to its stock . . . unlike in [Hoechst Celanese].” The FTB further argues that, unlike Celanese, appellant did not have “to create funded trusts in order to exchange its property for cash.” For these reasons, the FTB concludes that the first prong of the functional test is satisfied. (ROB, p. 8.)

The FTB next discusses how Hoechst Celanese applied the second prong of the functional test, which requires that the property be “integral” to the taxpayer’s regular trade or business. The FTB contends that, despite the fact that the taxpayer had only a reversionary interest in the pension fund assets, the court found that “. . . because the pension fund reversion, which by definition could not
be used to pay or retain employees, was part of a pension fund that was itself part of a broad plan to attract and retain employees, the indirect connection was enough to find that the pension reversion was integral to . . . Celanese’s business.” (ROB, pp. 8-9.)

In contrast, the FTB argues that “[a]ppellant intended to and did enter into banking and financial business transactions in the PRC using its stake in CCB as a means to achieve this result.”

The FTB argues that appellant’s “surrender of its PRC, Hong Kong, and Macao retail banking businesses . . . were business decisions to exploit the PRC market in partnership with CCB rather than to be in competition with Appellant’s business partner.” (ROB, p. 9.)

The FTB argues that appellant had greater control over its stake in CCB than the taxpayer in Hoechst Celanese. The FTB argues that “if anything,” the lockup provision evidences that appellant’s stake in CCB had an operational function, because an inability to sell an investment would be a problem for an investor who was hoping to sell the asset at a gain. In contrast, the FTB argues that a lock-up provision is less concerning to an owner that holds the asset “as part of a going concern” rather than to be sold at a profit. (ROB, pp. 9-10.)

The FTB argues that appellant’s argument, that it only obtained value through a return on its investment, is contradicted by the facts. The FTB contends that the record, and appellant’s contemporaneous statements, show that appellant “planned to and did use its minority stake in CCB as part of a strategic partnership . . . to increase its business operations in PRC.” (ROB, p. 10.)

The FTB further contends that “[t]he fact that Appellant and CCB are in the same line of business certainly suggests that Appellant, a bank, bought an interest in CCB, another bank, as part of Appellant’s banking business rather than as a portfolio investment.” The FTB argues that, according to appellant’s contemporaneous statements, its acquisition strategy was designed to “create greater organic growth opportunities[,]” citing appellant’s 2005 Annual Report. The FTB argues that, in addition to appellant’s own statements, “the many joint ventures and agreements entered into between Appellant and CCB” evidence an integral relationship. (ROB, pp. 10-11.)

The FTB further argues that the Appeal of CTS Keene, Inc., et al., 93-SBE-005 (CTS

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11 In support, the FTB cites appellant’s 2005 Annual Report, the MOU for a credit card venture, the Investment Contribution Agreement for the leasing joint venture, and a 2008 training plan executed pursuant to the SAA.
Appeal of Bank of America Corp. and its Affiliates

Keene, decided February 10, 1993, is “directly on point” and requires a finding of business income. The FTB notes that, in CTS Keene, the taxpayer, a U.S. company, purchased stock in a foreign company and simultaneously entered into a licensing agreement with a British company. The taxpayer “surrendered some European businesses that created competition between it and its new British affiliate[,]” but later sold its shares while maintaining the license agreement. The FTB argues that the Board “found that CTS Keene’s gain from the sale of stock in its British affiliate was business income because there was a clear connection between CTS Keene’s stock purchase and the licensing agreement.” The FTB states that the Board “also held that because CTS Keene had never intended to obtain a controlling interest . . . , there was nothing preparatory to the stock purchase.” (ROB, pp. 11-12.)

The FTB contends that, “similar to [CTS Keene], Appellant entered into a simultaneous strategic assistance and stock purchase agreement . . . .” The FTB further contends that “[a]ppellant announced that the arrangement was just the beginning of a long-term partnership that would benefit Appellant’s business in the PRC.” Then, the FTB argues, “consistent with what it said it would do, Appellant entered into additional joint ventures that expanded Appellant’s businesses in the PRC.” (ROB, p. 12.)

The FTB argues that, as in CTS Keene: appellant’s stock purchases and agreements were entered into “as part of a larger plan to generate income from the taxpayer’s core businesses[;]” “there was nothing preparatory to the purchase of a minority interest” because appellant could not have obtained a larger interest under Chinese law; “appellant surrendered assets that would have created friction between it and its affiliate, but when in the hands of the affiliate strengthened both parties; appellant provided additional capital in a second stock purchase; and “[a]ppellant retained mutually strategic operational agreements after the shares had been sold.” (Ibid.)

The FTB further argues that appellant has not carried its burden of showing that the income at issue is nonbusiness income. In support, the FTB notes that Title 18 of the California Code of Regulations, section (Rule) 25120, subdivision (a), provides that “the income of a taxpayer is business income unless clearly classifiable as nonbusiness income.” The FTB argues that appellant has not shown evidence of a “passive investment intent” and that CTS Keene found such evidence to be
necessary in order to characterize income as nonbusiness income. (ROB, p. 13.)

The FTB also contends that the *Appeal of Mark Controls Corporation*, 86-SBE-204

(*Mark Controls*), decided December 3, 1986, rehg. den. April 7, 1987, should be distinguished because in *Mark Controls* there was only “limited involvement by the taxpayer’s employees in the target company,” while appellant “invested enormous amounts of time and money in CCB.” The FTB further contends that appellant’s employees were “constantly traveling” to China in order to advance “the strategic partnership between CCB and appellant.” (Ibid.)

With regard to *Pacific Bell*, *supra*, the FTB notes that it was a nonprecedential decision, and argues that it “does not provide a factual background in the determination” or a basis for making comparisons. (ROB, p. 14.)

With regard to *ASARCO*, *supra*, the FTB contends that appellant has not applied it correctly in light of how the Board subsequently interpreted *ASARCO* in *Occidental, supra*, 83-SBE-119. The FTB states that, in *Occidental*, the Board “held that when the asset at issue was stock, stock sales that met the functional test were those stocks that [quoting *Occidental*] ‘had been acquired and managed in furtherance of the actual operation of the appellant’s unitary business.’” The FTB argues that this interpretation of *ASARCO* “is entirely consistent with and anticipated the subsequent U.S. Supreme Court decision in *Allied-Signal [supra*, 504 U.S. 768].” The FTB contends that, in *Allied Signal*, “the Court held that what is required for a finding of business income is that a capital transaction serve an operational rather than investment character.” (ROB, p. 14.)

**Appellant’s Reply Brief**

Appellant reiterates that it held only one seat on the 15-member CCB Board of Directors, “was forced to abandon its retail banking operations . . .,” could not control CCB’s operations, “was limited in the manner in which it could support its existing corporate client base, and was subject to burdensome limitations on its ability to sell its CCB investment.” Appellant argues that this “array of contractual and regulatory limitations” prevented “any meaningful operational ties with CCB” and “also prevented BAC from enhancing any unrelated business efforts in China so long as [it] held the CCB investment.” (ARB, p. 1.)

Appellant contends that the FTB’s brief includes “incorrect or incomplete assertions” that

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*Appeal of Bank of America Corp. and its Affiliates*  

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requires that appellant correct the factual record. Appellant argues that it had no ability to control or integrate its investment. Appellant states that, between 2005 and 2011, it owned between 8 and 19 percent of CCB, and reiterates that it could not sell its shares for a lock-up period extending from three to six years. Appellant argues that the investment agreements made it “very clear” that it could not control management functions for CCB, that it could not expand its retail banking presence, and that it could not enter into any similar agreements with another bank in China. Appellant reiterates that CCB was controlled by the PRC and appellant’s ownership could not exceed 20 percent. (ARB, pp. 2-3.)

Appellant generally argues that the FTB “exaggerates” the relevance of its agreements with CCB. With regard to the MOU for a credit card joint venture, appellant states that it “did not participate in a credit card joint venture with CCB.” Appellant states that the FTB’s primary support for its arguments that appellant sought to grow its credit card business “is a statement in BAC’s 2005 Annual Report and a 2010 business school case study intended to provide material for a class discussion.” Appellant argues that “...the case study provides no independent authority and provides no value to the Board in its consideration of the ... appeal.” (ARB, p. 4.)

Appellant contends that, while it and CCB “did discuss the possibility” of forming a credit card joint venture, such a joint venture “never came to fruition.” Appellant states that the formation of the joint venture was contingent on approvals from the Chinese government which never occurred. Appellant states that, as a result, the joint venture never occurred, and the MOU was terminated in 2010. Appellant summarizes that, “[r]egardless of any aspirational intent expressed in 2005 to enter into a credit card joint venture, such a joint venture never took place.” (ARB, pp. 4-5.)

With regard to the SAA, appellant argues that it “only benefitted CCB. Appellant further argues that, while the agreement required it to provide assistance to CCB, the agreement “did not obligate CCB to provide anything to BAC.” Appellant contends that, “[b]ecause the SAA did not provide any operational value to BAC,” the activities under the SAA “are of limited relevance” to the business income inquiry. (ARB, pp. 5-6.)

With regard to the FTB’s statements that appellant invested “enormous” amounts into CCB with appellant’s employees “constantly” traveling to China, appellant states that it “committed the amount of personnel and related expenses required to fulfill its obligation under the SAA.” Appellant
argues that it provided hours of assistance that were equivalent to roughly 43 to 76 full-time employees and that this is immaterial considering that it had over 200,000 employees during those years. Similarly, appellant argues that its costs related to the SAA “represented no more than 0.01189% of its total operating expenses[,]” which was “certainly not a material amount relative to the amount invested.”

(ARB, p. 6.)

With regard to the leasing joint venture, appellant argues that the venture was requested by CCB and that appellant “exited the venture as soon as possible.” Appellant states that the venture was formed in 2007 and that “CCB contributed 75.1% of the registered capital and BAC contributed 24.9% of the registered capital, amounting to roughly $155M.” Appellant further states that it agreed to provide advisory services to CCB leasing personnel but it “did not have management authority or control of the purported ‘joint venture.’” Appellant argues that it wanted to exit the venture but was contractually prevented from doing so for five years, at which time it could “put its shares to CCB at book value[,]” citing the Investment Contribution Agreement. Appellant contends that it notified CCB that it wanted to exercise the put option early and that, as a result, CCB purchased appellant’s interest in the venture in November of 2012. (ARB, pp. 6-7.)

Appellant disputes the FTB’s contention that appellant’s ownership in CCB helped expand appellant’s non-retail banking services. Citing Section 4.07 of the Investment Agreement, appellant argues that it “was prohibited by contract from expanding its non-retail banking presence in PRC.” Appellant notes that the Investment Agreement required it to only “maintain the minimum number of existing branches in the PRC required to conduct its global wholesale corporate business servicing its global clients[.]” (ARB, p. 8.)

Appellant argues that the FTB does not support its assertions other than with a statement in appellant’s 2005 Annual Report that the investment would enable appellant “to better serve [its] multinational clients who do business in China.” Appellant contends that “[a]t best, [this statement] suggests that BAC negotiated with CCB to keep its existing client base and perhaps provide them with better service, but in no way does the statement indicate that BAC had any hope of expanding its business in China.” (Ibid.)

With regard to the FTB’s references to appellant’s investment in Banco Santander,
Appellant argues that that the FTB “misreads the evidence . . . .”\textsuperscript{12} Appellant notes that the FTB once more references appellant’s statements in 2005, but, appellant argues, those statements “are aspirational at best and are irrelevant for purposes of establishing actual factual integration as required . . . for a business income determination. (ARB, pp. 8-9.)

Appellant argues that, contrary to the FTB’s assertions, its investment in CCB was not strategic to appellant. Appellant contends that the FTB does not define what it means and if the FTB means that appellant “thought about its decision to invest in the Chinese economy” then it agrees. However, appellant argues, “[t]o the extent that the FTB intends to suggest that a ‘strategic’ investment necessarily means an operational or ‘integral’ relationship as required by California law, we disagree.” (ARB, p. 9.)

Appellant argues that “. . . the FTB’s repeated use of terms like ‘strategic partnership’ and ‘strategic relationship’ is misleading in the context of this appeal[,]” and that “arbitrary labels should not matter.” Rather, appellant argues, “as reflected in the FTB’s Legal Ruling 2012-01, the law requires ‘an actual operational business relationship of some significance’ between ‘the taxpayer and the entity represented by the stock at issue.’” (ARB, p. 9.)

Appellant contends that the terms of the SAA expressly required it to provide services to CCB, rather than the reverse. Appellant therefore argues that “. . . the SAA reflects a one-way flow of assistance from BAC to CCB.” (ARB, p. 10.)

Appellant argues that the FTB “misreads the 2005 Annual Report to conclude that [quoting the FTB] ‘the strategic partnership agreement was entered into by the parties because [here, the FTB is quoting the Annual Report] ‘both partners saw added value’ in the strategic partnership,’ and that BAC had used the investment in CCB to [here, the FTB is again quoting the Annual Report] ‘create organic growth opportunities.’” Appellant argues that, “[i]n fact, the annual report language [is] referring to organic growth references BAC’s acquisition of MBNA.” With regard to the statement in the Annual Report

\textsuperscript{12} In footnote 43 to appellant’s reply brief, it argues that the FTB misreads a 2002 press release by claiming that appellant’s investment in Banco Santander was intended to help appellant serve its own customers who required access to banking in Mexico. Appellant argues that the press release “says nothing about BAC’s customers receiving services in Mexico[,]” and instead states that Banco Santander saw the investment “as an opportunity to capture an extension of the Mexican market across the border.” Appellant argues that its “stated aspirational benefit from the investment was to potentially gain expertise to better serve its customers in the Hispanic community.”
Report that both parties saw added value, appellant asserts that it “may have hoped to obtain some meaningful value in addition to the return on investment . . . , however the facts show plainly that [it] obtained no such value.” (ARB, p. 11.)

Appellant states that the FTB did not provide support for its contention that appellant sold its Asian retail portfolio in order to avoid friction with CCB. Instead, appellant argues that it sold “its Hong Kong and Macau . . . franchise . . . because it ‘did not have the economies of scale to remain competitive[,]’” citing an August 24, 2006 press release. (ARB, p. 11.)

Appellant argues that the FTB misreads or ignores the case law and its own Legal Ruling. Appellant reiterates the three-part “control and use” test set forth in Hoechst Celanese and argues that, in its holding, the court noted that Hoechst “exercised control over the plan and its assets through various committees” and, for example, controlled the appointment of trustees and fund managers and the administration of the plan and its assets and thereby “directed the plan’s overall investment strategy.” In light of the foregoing, appellant disputes the FTB’s contention that the requirement of control is a “low hurdle” on the ground that the taxpayer did not hold legal title to the assets. (ARB, pp. 12-14.)

Appellant reiterates that its investment was subject to a lockup, that it had only one seat on the Board of Directors, that it did not control management functions for CCB, that its ownership was limited to 20 percent, and that CCB was owned by the PRC. Appellant argues that, examining these facts under Hoechst Celanese’s three-part “control and use” test, it “did not obtain control over CCB, did not control or direct the use of the CCB investment, and for a period of time did not have the power to transfer its ownership in CCB.” (ARB, p. 15.)

Appellant further argues that, even if it had adequate control, its control and use of the property must be an “integral part[ ] of the taxpayer’s regular trade or business operations[,]” citing Hoechst Celanese at page 529. Appellant reiterates that Hoechst Celanese, at page 532, requires that the

\[\text{13} \text{ Page 20 of the Annual Report states that “[b]oth partners see significant added value in combining [CCB]’s local knowledge and distribution with BAC’s product expertise, technology and experience in managing growth and scale.” The Annual Report also states that “[o]ne part of BAC’s growth strategy is to identify, invest in and acquire businesses that combine with the bank’s core strengths to create greater organic growth opportunities.” It explains that appellant’s acquisition of MBNA positions it as a dominant player in the credit card industry and that “[t]he value of such positioning becomes even clearer as we help our new partner, [CCB], leverage its strong market position to become a leader in credit cards and other diverse consumer products . . . .” It concludes that “[t]hese investments demonstrate the power of growing by recognizing important strategic opportunities.”}\]
property be interwoven into the taxpayer’s business with each giving value to each other such that the property contributes materially to business income. Appellant argues that, “rather than acknowledge[ing] the critical importance of the pension plan” to Hoechst’s employee retention and recruitment efforts, which the court found to be “an essential part of any business operation[,]” the FTB “attempts to diminish the significance of the court’s finding as requiring only an ‘indirect’ relationship . . . .” Appellant further notes that Hoechst Celanese found the employee benefit to be “integral” and that the pension assets “contributed materially to Hoechst’s production of business income via their effect on Hoechst’s labor force[,]” and thereby the property became “interwoven into and inseparable from the taxpayer’s business operations.” Appellant argues that, in contrast, its investment did not materially contribute to business income, did not create a two-way flow of value, and did not become interwoven into its operations. (ARB, pp. 16-18, quoting Hoechst Celanese at pp. 532, 535-536.)

Appellant argues that the CTS Keene decision involved different facts is of “limited value” in this appeal. Appellant emphasizes that in CTS Keene the Board found that the stock purchases and the licensing agreements “expanded AB’s [the subsidiary’s] manufacturing and marketing of CTS’s [the taxpayer’s] products in Europe and which generated royalties to CTS that undoubtedly constituted business income.” Appellant also argues that in CTS Keene the taxpayer “expanded the market for its own products by selling its subsidiary and supplying capital to AB – its European distributor – [quoting the decision] ‘putting AB in a stronger position to enhance the sale of CTS’s products in Europe.’” Appellant contends that the companies thus had a “material flow of value [that] each provided to the other.” (ARB, pp. 19-20.)

In contrast, appellant contends, it “did not have a pre-existing business relationship with CCB[,]” “did not expand its regular trade or business by virtue of its investment” and could not do so due to “contractual and regulatory restraints,” and “was not motivated by a plan to generate income from BAC’s core business.” Appellant further contends that, perhaps most importantly, it and CCB “did not have any meaningful intercompany transactions that provided any benefit to BAC, and CCB, unlike AB, did not promote or enhance BAC’s operations in any meaningful way.” (ARB, p. 20.)

Appellant summarizes the facts of Mark Control, supra, and argues that the decision shows that, even if a taxpayer intends to integrate stock into its business, business income does not arise
when neither the stock nor the underlying assets or activities become an integral part of the taxpayer’s business. Appellant notes that in *Mark Controls* the Board found “no evidence” that the shared director influenced “corporate policy or day-to-day operations” and that the fact that the licensing agreement continued after the sale of stock “was insufficient to compel a business income determination because, while there was [quoting the opinion] ‘potential for actual integration into [Mark Controls’] ongoing business,’ such integration never occurred.” Appellant further notes that the Board found that “mere potential” for integration is not enough, even when Mark Controls had representation on the board of directors and sent “a few key employees to try to improve the company’s performance . . . .” (ARB, pp. 21-22.)

Appellant argues that it had “much less of an integral relationship with CCB than the taxpayer and the investment in [Mark Controls].” Appellant notes that Mark Controls had a 49.5 percent interest and an option to acquire 100 percent of the company, while it was limited to no more than a 20 percent interest. Appellant further notes that Mark Controls and its subsidiary, Weir, “had intercompany sales and licensing agreements related to Mark Controls’ products . . . .” and argues that it and CCB did not have such sales and agreements. Appellant also observes that Mark Controls sent two “key employees” to “smooth the way for Weir’s eventual integration” and argues that, in contrast, the employees it sent to CCB “were not executives and their activities had nothing to do with integrating CCB into BAC’s business.” (ARB, p. 22.)

With regard to *ASARCO*, appellant argues that it is “relevant precedent” and that FTB seems to argue that subsequent decisions “interpret ASARCO in a way that is somehow inconsistent” with appellant’s position. Appellant states that it cannot “properly respond” to the FTB’s arguments because the FTB’s reasoning is unclear. Appellant argues that the FTB’s citation to *Occidental*, *supra*, and *Allied-Signal*, *supra*, for the principle that investments may serve an operational function is “not contrary” to appellant’s position in *ASARCO* and “certainly do not warrant the FTB’s disregard of valid Supreme Court precedent.” (ARB, p. 23.)

With regard to *Pacific Bell*, appellant states that the FTB objected to appellant’s references to the decision on the ground that the relevant facts are not in the record. Appellant argues that the relevant facts are found in the Hearing Summary for that appeal, which appellant provides.
Appellant further argues that, while *Pacific Bell* is not precedential, “the factual similarities between it and the case at issue are too strong to ignore.” Appellant contends that Pacific Bell also “never had a plan to integrate its foreign investments into its regular business” and could not do so due to various regulatory and logistical constraints, and also “held only a minority interest such that it could not exercise sufficient control” of its investments to make their operations an integral part of its regular business. (ARB, p. 24.)

**FTB’s Reply Brief**

The FTB argues that “... [a]ppellant’s annual report, public statements, and an academic study” demonstrate that it “was investing in a PRC bank to expand its own business in the PRC.” In support, the FTB cites the 2005 Annual Report, a June 17, 2005 press release, and a business school case study entitled “Bank of America and the Chinese Credit Card Market.”14 (RRB, p. 2.)

With regard to the SAA, the FTB disputes appellant’s contention that the agreement “did not obligate CCB to provide anything to Appellant[.]” The FTB argues that this is incorrect because Section 3.07 of the agreement “is the basis whereby CCB agreed to enter into negotiations to enter into a joint venture for credit cards, which negotiations were apparently fruitful and resulted in an MOU ... .” The FTB argues that, as this was one of appellant’s “stated objectives [citing to the 2005 Annual Report], it was a thing of value to Appellant, and therefore evidenced a two-way flow of value.” The FTB further argues that the SAA was “part of a single integrated agreement under which Appellant acquired a stake in CCB.” (RRB, pp. 3-4.)

The FTB notes that appellant argues that the money and resources it committed to the SAA were not material to appellant in light of its large operations. The FTB states that it “agrees that Appellant is large and it follows that the costs of any individual project will be dwarfed by the sheer size of Appellant.” (FTB’s emphasis.) However, the FTB argues, despite appellant’s size, its strategic partnership with CCB was material to appellant, as evidenced by the fact appellant “... decided its agreement with CCB was worth mentioning on the first page of its 2005 annual CEO letter to shareholders.” (RRB, p. 4.)

14 The case study states that it was written “solely to provide material for class discussion.” The FTB argues that, while appellant objected to the study, it provides “an expert analysis by a credible and neutral third party ... .” (RRB, p. 3.)
The FTB contends that, contrary to appellant’s arguments on appeal, but consistent with its public statements, “. . . [a]ppellant did expand its non-retail banking presence in the PRC.” The FTB argues that “[a]ppellant consistently expanded its loan portfolio in the PRC every year during the years 2005-2011 as indicated by its SEC filings for those years.” (RRB, p. 5.)

The FTB argues that appellant wrongly contends that the FTB misread appellant’s 2005 Annual Report. The FTB notes that appellant argues that “. . .the red passage at the bottom of Exhibit A, page 20[,] was about Appellant’s purchase of MBNA, a credit card company, and not its acquisition of a minority stake in CCB.” The FTB argues that it is correct and appellant’s objection is incorrect.

The FTB contends that the first paragraph of this section of the Annual Report “discuss[es] . . . how acquiring businesses combine with Appellant’s core strength to create organic grown opportunities.” The FTB states that the second paragraph “starts with a discussion of MBNA and online payments, then seamlessly and organically, moves into a discussion of CCB’s potential value as a partner in the PRC credit card market.” The FTB states that the third paragraph references to “these investments” as demonstrating “the ability to grow through strategic opportunities.” The FTB argues that “the plural phrase ‘investments’ [shows] that the discussion . . . was about both CCB and MBNA and how the two were both organic growth opportunities for Appellant’s core business and with each other.” (RRB, p. 6.)

The FTB disputes appellant’s contention that the FTB did not provide evidence to substantiate the FTB’s contention that appellant “divested its Hong Kong retail banking business to avoid friction with CCB.” The FTB argues that support for its contention is provided by Section 5.07(c) in which appellant “agreed to discuss in good faith its future plans for its Hong Kong franchise.” The FTB contends that “[t]his provision in the context of a clause designed to avoid competitive friction between CCB and Appellant suggests CCB saw Appellant as a potential competitor in Hong Kong.”

The FTB further contends that this interpretation is “validated by subsequent events” as CCB ultimately purchased appellant’s Hong Kong franchise after previously trying unsuccessfully to buy into the Hong Kong market through another investment. (RRB, p. 7.)

With regard to appellant’s contentsions regarding improper labeling of exhibits, the FTB

15 Section 5.07(c) states: “The parties further agree to discuss in good faith future plans for [appellant]’s corporate business in China and its Hong Kong franchise.”
states that the MOU “is in fact an agreement to enter into a joint venture.” The FTB argues that the MOU was “binding” and “was one of Appellant’s planned benefits from entering into a strategic agreement with CCB.” The FTB further argues that appellant “followed through on the terms of the MOU by licensing its intellectual property to CCB[,]” citing the FTB’s Exhibit which is entitled “Agreement to License Confidential Information.” The FTB notes that the MOU provided that the parties would form a credit card joint venture but that laws had to change in order to for the joint venture to occur and those laws were not changed. (RRB, pp. 7-8.)

With regard to the lockup provision restricting appellant’s right to sell shares, and the legal limitations on foreign ownership, the FTB states that it previously addressed these issues in its opening brief. The FTB asserts that *Hoechst Celanese* “cannot be read to provide Appellant with authority to find nonbusiness income from a lack of control over day-to-day management, since that would contradict the holding of [*Hoechst Celanese*].” (RRB, pp. 8-9.)

With regard to appellant’s minority ownership interest in CCB, the FTB points to *CTS Keene, supra*, in which ownership “fluctuated between 10 and 20.5 percent” and business income was found. With regard to the fact appellant did not control CCB’s Board of Directors, the FTB argues that *Hoechst Celanese* “is not a good analogy . . . since the pension fund . . . did not have a board of directors.” Instead, the FTB points to *CTS Keene, supra*, and states that the Board “did not even mention whether CTS Keene had seats” on the board. The FTB also points to *Mark Controls, supra*, arguing that, in that case, the taxpayer “had only one Member on the Board, [and] that fact did not seem to drive your Board’s analysis.” The FTB concludes that “[s]ince your Board found the issue immaterial, [the FTB’s opening brief] did not address it either.” (RRB, p. 9.)

With regard to appellant’s contention that it could not obtain control over CCB, the FTB contends that “. . . [a]ppellant’s documents indicate an intent to use its strategic relationship with CCB to further its other business interests in the PRC.” The FTB argues that appellant never intended to obtain control. Instead, respondent contends, appellant’s statements “discuss a strategic partnership[,]” citing to appellant’s 2005 Annual Report. The FTB further argues that appellant’s stock purchase “was not a preparatory step to acquire more control later as in *Mark Controls*.” Instead, the FTB contends, appellant’s “purchase was intended to provide its partner with capital and create a strategic partnership,
as in *CTS Keene.*” (RRB, pp. 9-10.)

The FTB argues that *CTS Keene* is controlling and cannot be distinguished. The FTB disputes appellant’s statements that “neither the investment agreement nor the strategic assistance agreement contemplate the expansion of Appellant’s trade or business” and “the CCB investment was not motivated by a plan to generate income from Appellant’s core business.” The FTB acknowledges that the agreements “only explicitly promise *negotiations* to enter a [credit card joint venture,]” but argues that “... in the context of contemporaneous statements by appellant, what actually happened, and outside analysis, Appellant’s statements are misleading.”16 (RRB, p. 10.)

The FTB notes that, in appellant’s closing argument with respect to *CTS Keene,* appellant argues that it “did not expand its business into the PRC by entering into a joint venture with CCB.” Citing appellant’s reply brief, the FTB argues that it is “undisputed that Appellant, a bank, was a party to a joint venture in the PRC with CCB, also a bank[,] to provide financial leasing services.” The FTB argues that appellant seems to contend that because the venture was CCB’s idea, and because it exited the joint venture “‘as soon as practicable’[] that this joint venture is not evidence that Appellant was ‘expanding its business in the PRC by entering into joint ventures.’” The FTB further argues that appellant “is mistaken because Appellant’s business activity in the PRC did expand and some of that expansion included the financial leasing joint venture . . . .” (RRB, p. 11.)

The FTB contends that *Mark Controls* is distinguishable because, in that appeal, the taxpayer purchased a minority stake as a preparatory step to acquire the whole company and integrate the company into its business. However, the taxpayer encountered difficulties and abandoned the project, and the Board found that “the potential for integration was not sufficient . . . .” The FTB asserts that this case is different because appellant did everything it could to enter into the credit card joint venture. Moreover, the FTB contends that even if the credit card MOU was deemed to be a preparatory step, “... [a]ppellant’s entry into a joint financing company[] and [a]ppellant’s increasing commercial banking business in the PRC[] represent the kind of integration that Appellant sought from the beginning of its relationship from CCB.” (RRB, pp. 11-12.)

16 In support, the FTB provides citation to page 20 of the 2005 Annual Report, the credit card MOU, and the Investment Contribution Agreement to establish a leasing joint venture.
With regard to Pacific Bell, the FTB argues that it is insufficient for appellant to point to the Hearing Summary, transcripts and briefing of the case to show that the facts were similar. The FTB asserts “[t]he problem with this approach is that your Board is the fact[-]finding tribunal and determines the facts of a case in its decision.” The FTB further asserts that “[t]he ‘facts’ in the briefing, transcripts, and hearing summary that Appellant cites to are contentions . . . , some of which your Board might have found credible and material . . . .” The FTB thus reasons that the facts “as found by your Board are in the decision of [Pacific Bell] and do not contain enough detail to make factual analogies . . . .”17 (RRB, pp. 12-13.)

The FTB argues that its “position in this appeal is consistent with [its] analysis in Legal Ruling 2012-01.” In support, the FTB notes that the ruling requires an “actual operational business relationship of some significance” for a finding of business income, and argues that it has shown such “an actual operational business relationship of some significance” in this appeal. (RRB, p. 13.)

Appellant’s Supplemental Reply Brief

Appellant acknowledges that while “much” of its brief “repeats material from prior submissions, the materials illustrate the consistency of BAC’s position as originally set forth in [its] refund claim . . . .” Appellant outlines the basic facts and legal arguments it made in prior briefing. Appellant emphasizes Hoechst Celanese and its position that appellant and CCB “did not share organic unity, were not indivisible or inseparable, and CCB did not provide material value to BAC’s operations.” (ASRB, pp. 1-4.)

Appellant notes that, “[f]or the first time on appeal, the FTB in its reply brief notes that BAC’s loan portfolio grew in China during the years of the CCB investment.” Appellant argues that, while its loan portfolio in China did grow, “that increase had no relation to [its] investment in CCB.” Appellant further argues that the FTB “does not show or even suggest a link between the CCB investment and [its] loan portfolio . . . .” (ASRB, pp. 4-5.)

Appellant notes that, as evidence of growth, the FTB points to appellant’s 2004 annual report, which did not list China as an emerging market, while appellant listed China in 2005 as an

17 The Board’s determination in Pacific Bell was set forth in a brief “Letter Decision,” rather than full written opinion. As noted previously, Pacific Bell may not be cited as precedent.
emerging market. Appellant argues that its investment CCB alone caused it to list China as an emerging market in 2005. Appellant argues that, “. . . [its] loan exposure to the Chinese market was not substantial enough to list that market separately until 2009[,] and a number of factors were likely involved in that increase[,]” citing its 2009 10-K at page 75. Appellant states that: first, it acquired Merrill Lynch in 2009, which brought with it exposure to foreign markets; second, global markets “began to recover around 2009 . . so organic growth of [its] business is to be expected . . . .” (ASRB, p. 5.)

Appellant contends that the FTB’s “repeated” references to its 2005 Annual Report “provide limited, if any, value to the Board . . . .” Appellant asserts that the statements in the 2005 Annual Report “express aspirational goals . . . – none of which came to fruition.” Appellant further asserts that, while the statements in the 2005 Annual Report “clearly identify a goal to gain from the ‘investment’ in CCB[,]” the evidence does not support the FTB’s conclusion that it was engaged in a material “strategic partnership.” (ASRB, p. 6.)

Appellant argues that the 2005 Annual Report discussion only shows that it “made a large investment outside the course of its regular . . business and felt it was appropriate to discuss that investment with its shareholders.” Appellant further argues that, if one accepts that discussion in letters to shareholders is “indicative of the relationship of an investment to the regular trade or business, no letters to the shareholders in subsequent annual reports with the exception of 2006” reference the CCB investment. Appellant asserts that this shows that the investment “was not important or material to [it] in any subsequent year.” (Ibid.)

Appellant contends that the business school case study provided by the FTB is not reliable and “provides no factual support” for its statement that appellant wanted to expand its ties with CCB in order to create a credit card joint venture. Appellant further contends that “[e]ven if the Board assumes that the case study provides some evidentiary value on appeal, all the document suggests – at most – is that BAC hoped to ‘create a joint venture [to explore] the credit card business in China.” Appellant notes that the study was prepared for class discussion and states that it was written based on published sources so that its views “are not necessarily those of BAC or any of its employees.” (ASRB, pp. 7-8.)

Appeal of Bank of America Corp. and its Affiliates
Appellant disputes the FTB’s contention that the SAA shows a two-way flow of value due to the clause providing that the parties would enter into negotiations about a credit card joint venture. Appellant reiterates that no credit card venture ever took place and argues that the FTB has neither provided evidence of “actual integration” nor “asserted any material flow of value to BAC from its investment in CCB.” (ASRB, p. 8.)

Appellant argues that, in footnotes 1 and 2 of its briefs, the FTB wrongly focuses on the dollar amount and impact in future years when these facts are not relevant to “the proper interpretation of the facts and the law.” Appellant contends that “[t]he multiple references to the amount in dispute run contrary to the [FTB]’s principles of tax administration . . . ,” which, appellant quotes, establish that:

. . . it is the responsibility of each person in the [FTB], charged with the duty of interpreting the law, to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ‘protecting the revenue.’ The revenue is properly protected only when the true meaning of the statute is ascertained and applied.

(ASRB, pp. 8-9, quoting FTB’s Statement of Principles of Tax Administration.)

Appellant argues that “[t]he FTB is wrong on the law.” Appellant notes that the FTB acknowledges the lockup provision, the fact appellant could not own more than 20 percent of CCB, and the fact that appellant could have only one seat on the 15-member Board of Directors. Appellant argues that the FTB “[n]onetheless . . . concludes that these limitations are somehow undermined by the facts of CTS Keene or Hoechst Celanese.” However, appellant contends, neither of these cases involved an investor that was subject to the foregoing limitations. (ASRB, p. 10.)

Appellant asserts that the FTB’s suggestion that Hoechst Celanese found that the taxpayer “did not control the day-to-day investment decisions ignores both the plain reading of the law and the factual basis for the court’s conclusion.” Appellant states that, “[w]hile the FTB correctly notes that the taxpayer did not control day to day investment decisions,” the FTB “conveniently ignores” other evidence of control cited by the court. Appellant notes that the court found that “Hoechst exercised control over the plan and its assets through various committees composed of its officers and employees[.]” by, for example, controlling “(1) the appointment of trustees over the pension plan assets; (2) the appointment of investment fund managers; and (3) the administration of the plan and its assets.” [quoting Hoechst Celanese at pages 514-515] Appellant argues that “[i]gnoring these facts leads to a
skewed view of the law and the wrong legal conclusion.” (ASRB, pp. 11-12.)

Appellant contends that the FTB “evade[s] any meaningful discussion of the standard established by *Hoechst Celanese* for an integral relationship” and states that the FTB’s only assertion of a two-way flow of value is based on a credit card joint venture that did not occur. Appellant further contends that the FTB “refuses to address the substantive requirement that CCB must materially contribute to BAC’s production of apportionable business income in order for sale of the investment interest to also give rise to business income.” (ASRB, p. 12.)

Appellant argues that the FTB overemphasizes *CTS Keene*, supra, as it was issued “almost 20 years prior to the California Supreme Court’s decision in *Hoechst Celanese*[]” and was only cited by *Hoechst Celanese* once and then only as evidence that California has separate transactional and functional tests for business income. Appellant observes that *CTS Keene* stated there was a “clear connection” between the taxpayer’s stock purchases and the licensing agreements which “expanded AB’s [the subsidiary’s] manufacturing and marketing of CTS’s [the taxpayer’s] products in Europe and which generated royalties to CTS that undoubtedly constituted business income.” Appellant further observes that *CTS Keene* found that the taxpayer’s goal was to “help create a broader worldwide market” for the unitary group’s products. (ASRB, pp. 13-14.)

In contrast, appellant argues, CCB did not create a broader market for its products or enhance its product sales overseas. Appellant further argues that the FTB incorrectly asserts that the credit card MOU and leasing joint venture enhanced appellant’s business. Appellant reiterates that the credit card joint venture never occurred. With regard to the leasing joint venture, appellant asserts that it “was not contemplated as part of BAC’s investment in CCB and was a separate agreement in which BAC agreed to help CB establish its own leasing operations.” Appellant further asserts that the leasing joint venture did not expand its business activity in China. Appellant argues it had an interest in profits of the joint venture “but did not conduct the leasing operations” which were not included in appellant’s books. Appellant notes that the FTB references growth in appellant’s loan activity in China, but states that this growth had “nothing to do with BAC’s investment in CCB.” Appellant argues that there was a two-way flow of value in *Keene*. (ASRB, pp. 14-15.)

With regard to *Mark Controls*, supra, appellant reiterates that potential to integrate is not
enough to support a business income finding. Appellant stresses that it disagrees with the FTB’s argument that its motive for investing was to generate business income by expanding its business in China and further that, even if that were true, its motive for investing “is not determinative of business or nonbusiness treatment . . . .” Appellant contends that the FTB essentially argues that appellant “tried really hard (but unsuccessfully) to integrate CCB with [appellant’s] business . . . .” However, appellant contends, the FTB’s argument is contrary to the finding in Mark Controls and FTB Legal Ruling 2012-01 that intent to integrate, without actual integration, is not sufficient to support a business income finding. (ASRB, pp. 15-16.)

Applicable Law

As an equitable and constitutional method for taxing corporations that do business in multiple states and countries, California, like many other states, has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). (See Rev. & Tax. Code, §§ 25120 – 25141.) Under this scheme of taxation, a taxpayer’s income is divided into business or nonbusiness income. Business income is apportionable to each state by use of a formula. Nonbusiness income, however, is allocable only to the taxpayer’s commercial domicile. (Hoechst Celanese, supra, 25 Cal.4th 508, at pp. 508, 513.)

R&TC section 25120, subdivision (a), states that “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. R&TC section 25120, subdivision (d), states that “nonbusiness income” means all income other than business income. California Code of Regulations section 25120, subdivision (a), provides that the income of a taxpayer is business income unless clearly classifiable as nonbusiness income.

R&TC section 25120, subdivision (a), provides two alternative tests, the “transactional” test and the “functional” test, to determine whether income constitutes business income. (Hoechst Celanese, supra, at pp. 508, 520-526.) Under the “transactional” test, the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer’s trade or business. (Id. at p. 526.) Under the “functional” test, income from property is considered business income if the acquisition, management, and disposition of the property were “integral parts” of the
taxpayer’s regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Id. at p. 527.) If either of those two tests is met, the income will constitute business income. Respondent’s determination regarding the character of the income under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Twentieth Century-Fox Film Corporation, 89 SBE-007, Mar. 2, 1989.) In addition, as provided in California Code of Regulations section 25120, subdivision (a), the income of a taxpayer is business income unless “clearly classifiable” as nonbusiness income. (Appeals of Fairmont Hotel Company, 95-SBE-004, June 29, 1995.)

In this appeal, the FTB argues that the functional test applies such that the dividend income is taxable as business income. Appellant argues that neither the transactional test nor the functional test is satisfied and that its refund claim properly recharacterizes the dividend income as nonbusiness income. (See, e.g., ROB, p. 7; AOB, pp. 11 - 14.)

The functional test focuses on the income-producing property and the “critical inquiry” is the “relationship between this property and the taxpayer’s business operations.” A taxpayer’s control and use of the income-producing property must be part of the taxpayer’s normal or typical business activities. In providing meaning to the term “integral” in the statute, a determination must then be made as to whether the property has a close enough relationship to the taxpayer to satisfy the functional test. Thus, “integral’ requires an organic unity between the taxpayer’s property and business activities whereby the property contributes materially to the taxpayer’s production of business income.” (Hoechst Celanese, supra, at pp. 528-530.)

The Court in Hoechst Celanese further explained that:

Forming these interpretations of the statutory language into a cohesive whole, we conclude that income is business income under the functional test if the taxpayer’s acquisition, control and use of the property contribute materially to the taxpayer’s production of business income. In making this contribution, the income-producing
property becomes interwoven into and inseparable from the taxpayer’s business 
operations. Such an interpretation of the functional test flows from the ordinary meaning 
of the statutory language and the California decisions that formed the basis for the 
UDITPA definition of “business income.”

(Hoechst Celanese at p. 532.)

The Court noted (Hoechst Celanese, at pp. 533-534) that its interpretation of the 
functional test was consistent with the Board’s prior decisions:

. . . . On the one hand, the SBE has consistently found business income under the 
functional test where the taxpayer’s control and use of the property contributed materially 
to the production of business income and became an indivisible part of the taxpayer’s 
business. For example, . . . the SBE found that dividends from a joint venture were 
business income because these ventures “contributed materially to the production of 
operating income . . . and clearly served to further the operation of” the taxpayer’s 
business. (Standard Oil, supra, [citations omitted].) Finally, the SBE held that income 
from stock sales constituted business income because “the assets and activities 
represented by the stock were fully integrated and functioning parts of [the taxpayer’s] 
existing unitary business.” (Occidental Petroleum, supra, [citations omitted].)

On the other hand, the SBE has consistently refused to find business income under the 
functional test where the taxpayer’s control and use of the property did not contribute 
materially to the production of business income and were separate from the taxpayer’s 
business. . . . Similarly, the SBE held that income from the sale of stock in a company 
constituted nonbusiness income where the taxpayer exercised no control over and 
received no special benefits from that company. (Mark Controls, supra, [citations 
 omitted].) . . .

In the Appeal of Occidental Petroleum, supra, the Board found that the gains that the 
taxpayer and its affiliates realized from the sales of stock in various corporations constituted business 
income. The taxpayer, a California corporation which also had its commercial domicile in this state, 
was an explorer and developer of oil and gas properties. The Board noted that “. . . each of the stock 
sales . . . was made pursuant to a specific corporate plan to consolidate or expand the unitary business in 
accordance with an established natural resources[] orientation.”

With respect to the taxpayer’s sales of stock in three subsidiaries (Cofesa, Waiawa 
Realty, and Oxytrol), the Board found that the transactions involving these unitary subsidiaries gave rise 
to business income under the functional test, as the stock of each of these entities had been acquired (or 
created) and managed in furtherance of the actual operation of the taxpayer’s unitary business. The
Board concluded that, at the time the various decisions to sell the stock of these entities was made, the assets and activities of these entities were fully integrated and functioning parts of the taxpayer’s existing unitary business.

The Board, however, reached a different conclusion regarding the taxpayer’s sale of stock in two other subsidiaries, Tenneco and Island Creek. Although the taxpayer’s purpose in acquiring the stock of each was to expand its unitary business, the Board concluded that neither of these stockholdings, nor their assets and activities, constituted integral parts of the taxpayer’s existing unitary operations at the time that the taxpayer decided to sell the stock that it held in these entities. Moreover, the Board found that at no time did these entities possess more than the potential for actual integration into the taxpayer’s ongoing business. The Board therefore concluded that the sale of stock in these entities constituted nonbusiness income because such mere potential was insufficient to support a finding that the gains from these sales was business income under the functional test.

In the *Appeal of Mark Controls*, supra, the Board found that the capital gain realized from a taxpayer’s sale of stock constituted nonbusiness income. The taxpayer, a Delaware corporation with its commercial domicile in Illinois, was a manufacturer of flow control products, environmental control products, and lavatory fixtures and conducted some of these manufacturing activities in California. In 1971, the taxpayer purchased a 49.5 percent interest in Weir (a corporation from the United Kingdom and a manufacturer of ball and butterfly valves) and held an option to purchase the balance of Weir’s outstanding shares. The taxpayer intended to expand its marketing and manufacturing operations to the United Kingdom and it executed a licensing agreement with Weir. There was approximately $200,000 in annual intercompany sales between the parties during the appeal years and the taxpayer placed one of its directors on Weir’s board of directors. That individual also became an officer of Weir. The taxpayer believed that Weir was mismanaged and, in 1974, in an attempt to improve Weir’s performance, the taxpayer sent two of its executives to work at Weir. In 1976, after its efforts to improve Weir’s operations and profitability failed, the taxpayer sold its interest in the

18 There was a second transaction at issue in the *Appeal of Mark Controls*—the taxpayer’s sale of stock in Walthon, a corporation in which the taxpayer held 20 percent of that company’s outstanding shares. The Board found that the sale of this stock was also properly classified as nonbusiness income.
company, realizing a gain on the stock sale.

The Board found that the taxpayer’s actions were, at most, preparatory to integrating Weir into the taxpayer’s unitary business and that the taxpayer’s actions and intent did not result in Weir’s stock, assets, or activities becoming an integral part of the taxpayer’s business. The Board further found that at no time did Weir possess more than a potential for actual integration into the taxpayer’s ongoing unitary business operations. As a result, the Board concluded that mere potential was insufficient to support a finding that a gain from such a stock sale was business income under the functional test.

In the CTS Keene, supra, the Board found that the gain realized from a taxpayer’s sale of stock in a British corporation constituted business income. In 1965, the taxpayer’s parent company entered into a licensing agreement with AB Electronic Components, Ltd. (AB Electronic), an unrelated British corporation, to manufacture and market the parent company’s products in Great Britain and Europe. In 1970, the parent company later purchased 10 percent of AB Electronic’s stock and extended its licensing agreements with AB Electronic. In 1979, the parent company purchased additional shares of AB Electronic, increasing its ownership interest to 20.5 percent of AB Electronic’s common stock, with the goal of extending the relationship between the companies. Finally, in 1982, the parent company sold all of its AB Electronic stock for a gain and reported the gain as nonbusiness income to its commercial domicile outside of California.

The Board concluded that the gain realized was business income under the functional test. The Board found that: (1) the parent company’s stockholding in AB Electronic was integrally related to the group’s unitary business and was an asset that served an operational function in that business (rather than merely an investment function); and (2) the parent company’s two purchases of stock in AB Electronic, and the licensing agreements between the two companies, expanded AB Electronic’s manufacturing and marketing of the parent company’s products in Europe and generated royalties to the parent company which constituted business income. The Board also concluded that the facts present here were distinguishable from those present in the Appeal of Mark Controls, as there was nothing “preparatory” about the taxpayer’s actions, as the taxpayer’s apparent business goal was fully accomplished by becoming a minority shareholder in AB Electronic (i.e., by supplying AB Electronic
with new capital and assisting AB Electronic’s efforts of becoming a more effective promoter of the parent company’s products in Europe).

In addition to the UDITPA and case law, Regulation 25120 provides in part:

(a) Business and Nonbusiness Income Defined. . . .

. . .

For purposes of administration of [R&TC] Sections 25120 to 25139 inclusive, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.

. . .

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 transactions 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. . . .

. . .

(1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

. . .

(c) Business and Nonbusiness Income; Application of Definitions. . . .

. . .

(2) Gains or losses from sales of assets. 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. . . .

. . .

(4) Dividends. Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer’s trade or business operations or where the purpose for acquiring and holding the stock is related to or incidental to such trade or business operations. . . .
The United States Supreme Court has spoken on a State’s ability to tax nondomiciliary corporations and the impact of the Due Process and Commerce Clauses of the United States Constitution on such taxation. The Supreme Court has held that a gain from the sale of stock can constitutionally be apportioned even if the previously-affiliated company was not part of the same unitary business, as long as the stockholding served an operational function rather than an investment function.

In Allied-Signal, supra, 504 U.S. 768, 772, the Supreme Court stated that States can only tax nondomiciliary corporations if there is a “minimal connection” between a corporation’s interstate activities and the State and there is a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. The Court further stated that a State need not attempt to isolate a corporation’s intrastate income-producing activities from the rest of the corporation’s business, but instead could tax an apportioned sum of the corporation’s multistate business if the business was unitary. However, the Court pointed out a State could not tax a nondomiciliary corporation’s income if the income was derived from an unrelated business activity which constituted a discrete business enterprise.

The Supreme Court in Allied-Signal (Allied-Signal, supra, at p. 780) further noted that, where the business activities of a dividend payor have nothing to do with the activities of the recipient corporation in the taxing State, Due Process concerns may preclude apportionability because there is no underlying business. Accordingly, the Court noted that in ASARCO and F.W. Woolworth Co. v. Taxation and Revenue Dep. of N.M., (1982) 458 U.S. 354, it struck down States’ attempts to include unrelated business activities, not derived from unitary businesses, in taxpayers’ apportionable tax base.

The Court (Allied-Signal, supra, at pp. 780-781) then summarized the ASARCO decision as follows:

The principal question in ASARCO concerned Idaho’s attempt to include in the apportionable tax base of ASARCO certain dividends received from, among other companies, the Southern Peru Copper Corp. [Citations omitted.] The analysis is of direct relevance for us because we have held that for constitutional purposes capital gains should be treated as no different from dividends. [Citations omitted.] . . . [ASARCO] was one of four of Southern Peru’s shareholders, owning 51.5% of its stock. Under an agreement with the other shareholders, ASARCO was prevented from dominating Southern Peru’s board of directors. ASARCO had the right to appoint 6 of Southern Peru’s 13 directors, while 8 votes were required for the passage of any resolution.
Southern Peru was in the business of producing unrefined copper (a nonferrous ore), some of which it sold to its shareholders. ASARCO purchased approximately 35% of Southern Peru’s output, at average representative trade prices quoted in a trade publication and over which neither Southern Peru nor ASARCO had any control. We concluded that “ASARCO’s Idaho silver mining and Southern Peru’s autonomous business [were] insufficiently connected to permit the two companies to be classified as a unitary business.” [Citations omitted.]

Finally, the Supreme Court also held that “the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. . . . What is required instead is that the capital transaction [must] serve an operational rather than an investment function.” (Allied-Signal at p. 787.)

STAFF COMMENTS

As noted under the heading “Applicable Law,” the FTB’s determination of whether income constitutes business income is presumed correct, and the taxpayer has the burden of proving error in that determination. (Appeal of Twentieth Century-Fox Film Corporation, supra.) In addition, as provided in California Code of Regulations section 25120, subdivision (a), the income of a taxpayer is business income unless “clearly classifiable” as nonbusiness income.

The FTB points to public statements which suggest on their face that appellant intended to obtain operational benefits from its purchase of stock in CCB.19 The case law is clear that a mere intent to use an asset in the business is not sufficient - by itself - to cause income from the asset to constitute business income. (See, e.g., Mark Controls, supra; Occidental, supra.) Actual integration is required. However, in this appeal, there is additional evidence, apart from appellant’s public statements of intent, of operational business ties between appellant and CCB (e.g., the leasing joint venture). At the hearing, the FTB should be prepared to address appellant’s arguments that its public statements of intent were aspirational and that such operational ties were unrelated to its investment in CCB and/or immaterial. Appellant should be prepared to address whether, considering all the evidence, it has established that the income at issue is “clearly classifiable” as nonbusiness income.

In Hoechst Celanese, supra, at pages 531 to 532, the California Supreme Court explained

19 For example, appellant stated that “[t]he partnership with [CCB] will enable BAC to better serve our multinational clients who do business in China[.]” and that it was “one example of how we are recognizing opportunities to expand our business.” (ROB, Exh. A, p. 21 [p. 20 of Annual Report].)
that an asset can be “integral” to the regular business even if it is not “necessary or essential” to the business. However, the court explained, “integral” requires more than that an asset simply contributes to the regular business. In an effort to find a middle ground, the court found that integral requires that “the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income[,]” and that, “[i]n making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer’s business operation.”

Applying the foregoing standard, the parties may want to discuss the following business activities.

**Leasing Joint Venture.** Staff’s understanding, from the pre-hearing conference, is that the leasing joint venture generated business income for appellant. While appellant has argued that the leasing joint venture was separate from its investment in CCB, a September 7, 2007 press release quotes appellant’s CEO Ken Lewis as stating that the leasing joint venture was “another benefit of [appellant’s] close partnership with CCB.” The press release further states that the venture is “the fourth customer program offered by the two banks following the successful launch of their free ATM withdrawal, remittance services and joint credit card venture.” In a May 11, 2009 conference call with investors, Mr. Lewis was asked what value appellant received from its investment in CCB apart from stock appreciation. In his answer, Mr. Lewis listed the leasing joint venture (and also noted the dividends received, a credit card joint venture, and corporate banking opportunities arising from referrals).

Mr. Lewis described the relationship with CCB as a “pretty dynamic relationship with a lot of discussion going back and forth with ways we can do business together and then some cash coming out.” (Resp. Sept. 20, 2017 Add’l Info., Exhs. U [press release] & V, p. 7 [transcript].)

**ATM Reciprocity and Wire Services**

- An October 27, 2006 press release states that a joint pilot program between CCB and appellant will offer free wire transfers to and from China as a benefit to both bank’s customers. It further states that the pilot program is only available in the United States in Alameda, San Francisco and...
San Mateo counties, and that the ATM and wire transfer program is a “part of the progress and alliance both banks have been engaged in since signing [the SAA]...”. (Resp. Sept. 20, 2017 Add’l Info., Exh. Q.)

- An August 9, 2007 news release states that more than 100 million yuan was withdrawn from the ATMs of the two banks between April 2006 and April 2007, with 99 percent of this amount being amounts withdrawn by appellant’s customers from CCB’s ATMs. The news release states “[t]he monthly remitted money of CCB registered a 10-fold increase within the two months after the direct remittance service started in October 2006.” (Resp. Sept. 20, 2017 Add’l Info., Exh. R.)

- Appellant’s 2006 Annual Report states that, since purchasing the CCB stock, appellant has “partnered [with CCB] on many projects” and that, during 2006, appellant “rolled out several products for the customers of both companies, including free ATM use and free remittance, which lets customers send money without charge to loved ones overseas.” (Resp. Sept. 20, 2017 Add’l Info., Exh. W, p. 19 [p. 17 of the Annual Report].)

- A November 27, 2007 press release states that, since April 1, 2006, appellant’s “customers traveling to China had free access to withdraw cash from over 17,000 foreign-enabled CCB ATMs[,]” and that CCB’s customers holding “Happy Investor cards enjoyed the same benefit on any of nearly 17,000 BOA ATMs across the United States.” (Resp. Sept. 20, 2017 Add’l Info., Exh. S.)

- Appellant’s 2017 website indicates both that it has “a special partnership” with CCB which allows for the avoidance of the ATM fee and also that CCB was one of appellant’s many Global ATM Alliance Partners. (Resp. Sept. 20, 2017 Add’l Info., Exh. T, p. 9; App. Sept. 20, 2017 Add’l Info., Attach. 2.)

  
  
  
  Growth in Loans in China. According to appellant’s reports on Form 10-K, its loans, leases and loan commitments in China increased from $172 million in 2005, to $236 million in 2006, to

20 At the hearing, the parties may wish to discuss both whether any ATM reciprocity and special wire transfer arrangements were related to appellant’s purchase of stock in CCB and whether any ATM reciprocity and special wire transfer arrangements benefited California customers of appellant.
$262 million in 2007, to $285 million in 2008, to $3.9 billion in 2011.\(^{21}\) (ASRB, Exh. 1.) Appellant argues that this increase was unrelated to its equity stake in CCB and was in part due to general economic conditions. The FTB should be prepared to explain whether or how this increase was related to appellant’s investment in CCB. Appellant should be prepared to address Mr. Lewis’s statement to investors that the CCB investment opened up corporate banking referral opportunities. (Resp. Sept. 20, 2017 Add’l Info., Exh. V, p. 7 [transcript].)

**Brand Recognition, Know-How and International Experience.**

- A September 3, 2013 press release states that appellant will continue to benefit from the SAA after the sale of its CCB stock through “increased brand recognition in China and enhanced international experience for [its] employees.” It further states that approximately 3,100 of appellant’s employees have participated in exchanges with CCB since 2005. Appellant’s CEO Brian Moynihan is quoted as saying that “[t]he Bank of America-CCB relationship continues to bring substantial benefits to each company.” Mr. Moynihan further states that appellant and CCB “have built a strategic partnership based on shared operational expertise, and our clients in China and Asia recognize BAC’s ongoing association with one of the world’s leading financial institutions.” (ROB, Exh. M.)


**Credit Card MOU.** Staff questions whether the credit card MOU is probative, because the planned credit card joint venture never occurred. The Board’s precedent is clear that mere potential integration or an intent to integrate is not, by itself, sufficient for a finding of business income.

With regard to *ASARCO*, staff notes that, in *Allied-Signal, supra*, at page 787, the United States Supreme Court stated that “the payee and the payor need not be engaged in the same unitary business . . . .” The Court further noted that, in *ASARCO*, while it rejected the contention that the stock investments were accumulated to benefit future operations, it “did not dispute the suggestion that had

\(^{21}\) Based on these Form 10-Ks, appellant’s total foreign exposure in China, including loans, securities, other financing and derivative assets, increased from $3.4 billion in 2005 (including its stake in CCB) to $7.3 billion in 2011.
that been so the income would have been apportionable.” Staff further notes that ASARCO (as well as Allied-Signal) address constitutional limitations on state taxation, and the Board cannot refuse to enforce a statute on the basis of it being unconstitutional, unless an appellate court has determined that such statute is unconstitutional, and, furthermore, the Board has a long-established policy of declining to consider constitutional issues.

At the hearing, the parties should be prepared to discuss the requirement that income “materially” contribute to business income. Staff notes that this requirement does not mean that the asset must be profitable; an asset that is used in business operations can produce a business loss or materially contribute to a business that merely breaks even. It appears to staff that materiality does not require that the contribution to income be specifically quantified or that the asset generate a large percentage of the company’s business income. If it did, a large multistate corporation with operational assets relatively evenly spread across all the states could, in theory, have no business income in many states because the percentage of income (or loss) from assets in many individual states might be relatively immaterial. Further, multi-state apportionment formulas are necessary precisely because the values flowing to and from parts of a unitary business are often difficult to quantify. (See, e.g., Container Corp. v. Franchise Tax Board (1983) 463 U.S. 159, 164-166.)

One of the requirements for a finding of business income is that the taxpayer have sufficient control over the income-producing asset to use the asset in its production of business income. Appellant argues that it could not control its equity interest in CCB because it was subject to a lock-up

22 Staff notes that in ASARCO, the taxpayer’s primary operation in the taxing state of Idaho was the operation of a silver mine, while the subsidiaries in question produced copper, fabricated metal products and, in the case of an Australian subsidiary, mined and processed copper, lead, zinc and silver. The Court found, at p. 328 of its opinion, that activities of the subsidiaries “had nothing to do with activities” of the taxpayer in Idaho.

23 Cal. Const., art. III, § 3.5; Appeal of Aimor Corp., 83-SBE-221, Oct. 26, 1983; Appeals of Walter R. Bailey, 92-SBE-001, Feb. 20, 1992; Appeal of John H. Grace Co., 80-SBE-115, Oct. 28, 1980; Appeal of Vortox Manufacturing Company, 30-SBE-017, Aug. 4, 1930.) However, the Board has stated that the limits on its ability to decide a constitutional issue do not mean that it can ignore existing constitutional limitations when interpreting the applicable statutes. (Appeal of John H. Grace Co., supra.)

24 In the seminal case of Butler Bros. v. McCollgan (1942) 315 U.S. 501, at pages 508 to 509, the United States Supreme Court noted (citing the California Supreme Court) that, while the omission of California sales might not effect purchasing power, this argument sweeps too broadly because it could be made, state by state, for all states, and it was fair to assume that the San Francisco operations contributed a share to the centralized management of the unitary enterprise and the income earned. (See also the California Supreme Court opinion, which the U.S. Supreme Court affirmed, at 17 Cal.2d 664, 669.)
that prevented it from selling the interest for a number of years. However, many investments are subject
to limitations on sale, whether due to contract or applicable law, and it appears to staff that temporary
restrictions on sale are simply one part of the “bundle” of rights, privileges and obligations that
accompany ownership. (See, Hoechst Celanese, supra, at p. 529.)25 Appellant also argues that it did not
have the requisite control because it could not control the operations of CCB. However, it appears to
staff that the relevant inquiry is whether appellant controlled the stock it held in that it was able to
exercise the rights associated with the stock (such as the right to name a director and, after a lock-up
period, to sell the stock) and subject to the obligations accompanying the stock acquisition (such as the
obligation to provide strategic services). (SeeCTS Keene, supra [finding that control of the investee
corporation was not necessary for a finding of business income].)

The parties may wish to discuss how appellant reported income from the leasing joint
venture. Staff notes that appellant’s equity interest in the leasing joint venture also had restrictions on
sale, and presumably generated a relatively small percentage of appellant’s income. Further, appellant
did not have a controlling interest in the joint venture or control its day-to-day operations. However,
staff’s understanding from the pre-hearing conference is that appellant agrees that income from the joint
venture is business income and only argues that the leasing joint venture was separate from its
ownership of CCB stock.

Section 40

As noted previously, this matter is subject to R&TC section 40. Therefore, within 120
days from the date the Board’s vote to decide the appeal becomes final, a written opinion (i.e.,
Summary Decision or Formal Opinion) must be published on the Board’s website. (Cal. Code Regs.,
tit. 18, § 5552, subds. (b), (f).) The Board’s vote to decide the appeal cannot become final any sooner

25 Hoechst Celanese, at pages 528 to 529, states that “...the taxpayer must: (1) obtain some interest in and control over the
property; (2) control or direct the use of the property; and (3) transfer, or have the power to transfer, control of that property
in some manner.” However, the Court also cautions that the taxpayer need not own the property, that “[o]wnership is not a
single concrete entity but a bundle of rights and privileges as well as of obligations[,]” and that the phrase “‘acquisition,
management, and disposition’ encompasses the myriad of ways that corporations may control and use the rights and
privileges commonly associated with property ownership.” The Court further notes that comments to UDIPTA indicate that
income is business income if the property is “used” in the business and that it was “...clearly contemplated that the
functional test would focus on the taxpayer’s control and use of the property and not on legalistic formulations of property
ownership.”
than 30 days following the date of the Board’s vote. (Cal. Code Regs., tit. 18, § 5460, subd. (a).) If a
petition for rehearing is filed within that period, the Board’s decision cannot become final before the
petition for rehearing is resolved.

Unless the Board directs otherwise, any proposed Summary Decision would not be
confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5));
accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will
consider and vote on the Summary Decision. A taxpayer may request that the Board hold in abeyance
its vote to decide the appeal so the taxpayer may review the Board’s written opinion prior to the
expiration of the 30-day period for the filing of a petition for rehearing. If the vote is held in abeyance,
the proposed Summary Decision will be confidential until it is adopted by the Board. (Cal. Code Regs.,
tit. 18, § 5551, subd. (b)(5).) Any request that the Board’s vote be held in abeyance should be made in
writing to the Board Proceedings Division prior to the hearing or as part of oral argument at the
hearing. Any such request would then be considered by the Board during its deliberations on the
appeal.

Appeal of Bank of America
Corp. and its Affiliates

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