**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS NUMBER: 03-0254**
**Adjusted Gross Income Tax**
**For the Year 1998**

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## ISSUES

**I. Business / Non-business Classification – Adjusted Gross Income Tax.**

**Authority:** Ind. Code § 6-3-2-2; Ind. Code § 6-3-1-20; Ind. Code § 6-3-1-21; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; *May Department Store Co. v. Indiana Dept. of State Revenue*, 749 N.E.2d 651, 656 (Ind. Tax 2001); *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001).

Taxpayer protests the Department's assessment of adjusted gross income tax with respect to taxpayer's sales of several businesses.

**II. Tax Administration-Limitations on refunds and protests**

**Authority:** Ind. Code § 6-8.1-5-2; Ind. Code § 6-8.1-9-1

Taxpayer's protest was filed within the statutory protest period for federal audit adjustments that taxpayer received, but not within three years of its initial tax return.

## STATEMENT OF FACTS

Taxpayer, an out-of-state company, is a business engaged in various media operations. For several years prior to the merger, taxpayer had also owned several Industry A entities, but had been phasing itself out of that business. During Year X, taxpayer acquired another media company, which was engaged in five lines of business, including Industries B and C. Taxpayer had only wished to acquire these lines of business from the media company; however, due to adverse federal tax consequences, taxpayer and media company agreed to allow taxpayer to acquire the stock of the media company. As a result, taxpayer now owned both properties in its two normal lines of business, Industry A in which taxpayer was phasing out its operations, and three lines in which it had no prior experience in management. Thereafter, taxpayer sold its interest in various properties. In the year in question, the properties sold included taxpayer's entire interest in taxpayer's Industry D, in which taxpayer had not previously engaged prior to merger. Taxpayer also disposed of its Industry E operations in two states in which the taxpayer had limited operations, though it kept

Industry E operations in a third state. Taxpayer also sold various Industry B operations and sold its remaining Industry A operations. Taxpayer retained the proceeds from all sales or dispositions and did not distribute such proceeds to shareholders.

Initially, taxpayer filed a 1998 return claiming that all of its income was in fact business income. However, taxpayer went through a federal audit which resulted in an increase in income. The Department assessed tax based on these adjustments. However, taxpayer filed a protest to the assessment, and subsequently an amended return. In its protest, taxpayer claimed that the proceeds from the sale of the various properties were non-business income, and therefore allocable to other states for Indiana adjusted gross income tax purposes. This protest was filed within the allowable time for a protest based on federal adjustments, but not for returns generally.

**I. <u>Business / Non-business Classification</u> – Adjusted Gross Income Tax**

**<u>DISCUSSION</u>**

In reviewing taxpayer's amended adjusted gross income tax returns, the audit reclassified certain of taxpayer's income. The audit concluded that taxpayer incorrectly classified gains from the sale of several businesses as "non-business income." The audit reclassified all four of these income categories as "business income."

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. Ind. Code § 6-3-2-2(b). In contrast, non-business income is allocated to Indiana or it is allocated to another state. Ind. Code § 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." *May Department Store Co. v. Indiana Dept. of State Revenue*, 749 N.E.2d 651, 656 (Ind. Tax 2001).

Taxpayer's argument, that all four of these income categories are "non-business income," is significant because if taxpayer is correct, all this income is allocated elsewhere and is not relevant in calculating taxpayer's Indiana adjusted gross income tax.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "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 constitutes integral parts of the taxpayer's regular trade or business operation. Ind. Code § 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." Ind. Code § 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula,

while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. *May*, 749 N.E.2d at 656. In that decision, the Tax Court determined that Ind. Code § 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. *Id*. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. *Id*. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* Ind. Code § 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "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 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business income therefrom depending upon but not limited to some or all of the following:

> (1) The nature of the taxpayer's trade or business.
>
> (2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.
>
> (3) The frequency, number and continuity of the activities and transactions involved.
>
> (4) The length of time the property producing income was owned by the taxpayer.
>
> (5) The taxpayer's purpose in acquiring and holding the property producing income.

The functional test focuses on the property being disposed of by the taxpayer. *Id*. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. *May*, 749 N.E.2d at 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed of by the taxpayer in a process integral to taxpayer's regular trade or business operations. *Id*. In *May*, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." *Id*. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the

sale was executed pursuant to a court order that benefited a competitor and not the petitioner. *Id*. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. *Id*. Therefore, the proceeds from the division's sale were not business income under the functional test. *Id*.

**B. <u>Industry D</u>**

Taxpayer argues that its income from the sale of one of its acquired businesses, a company engaged in Industry D, is considered non-business income and therefore should be subject to allocation rather than apportionment.

With respect to the transactional test, taxpayer's income was not sufficiently recurring to constitute business income within the transactional test stated above. Further, under the functional test, the sale was not of assets which were integral parts of the taxpayer's regular trade or business operations. Taxpayer had only acquired the business as a necessary part of an acquisition of other desired assets.

While the fact that taxpayer did retain the earnings from the sale for its own overall business purposes gives rise to an inference that the income derived from the disposition is actually business income, taxpayer's overall operations did not include Industry D. Accordingly, the income derived from the sale is not business income.

Taxpayer has acknowledged that at least some portion of the gain with respect to the sale was properly allocable to Indiana, as opposed to taxpayer's original return which listed all of the income as allocable to non-Indiana sources. The exact amount is subject to further audit review.

**C. <u>Industry A</u>**

Taxpayer also argues that the sale of Industry A operations in three large urban markets was non-business income under both the transactional and functional tests. In effect, taxpayer argues that the sale of the Industry A operations does not meet the transactional test because taxpayer's business does not normally consist of the sale of entire lines of business. Further, taxpayer argues that the transaction does not meet the functional test because the Industry A operations were not an integral part of the company's overall enterprise.

With respect to the transactional test, it is unclear whether taxpayer's income was sufficiently recurring to constitute business income within the transactional test stated above. With respect to the functional test, taxpayer voluntarily left Industry A to concentrate on Industries B and C. As such, the sale was a voluntary business decision on the part of the corporation, a refocusing of its overall operations, unlike the forced sale of the division in *May* that the court noted was done to reduce its market concentration in its line of business. Further, the ownership, management and operation of Industry A operations were part of taxpayer's overall enterprise for decades.

Also, taxpayer retained the earnings from the sale of the Industry A operations. The retention of earnings by taxpayer allowed the business to further focus on its main enterprises-Industries B

and C. Combined with the other factors above, taxpayer's Industry A operations constituted an integral part of taxpayer's overall business for several years, and accordingly the disposition of that business resulted in business income.

Finally, it its worth noting that in Indiana, as in other states, taxpayer had claimed expenses and depreciation related to these businesses as business expenses, reducing its income apportionable to Indiana. In *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324, (Cal. 2001), a company had established a retirement pension plan for its employees. The company had no rights to the surplus assets until the termination of the pension plan and satisfaction of benefits. *Id.* at 328-329. In 1983, the company had decided to recapture the surplus in order to prevent its use in a potential takeover bid, and accordingly divided the original pension plan and trust into two separate pension plans and trusts, one for active employees and one for retirees. *Id.* at 329. Then, the company purchased annuities to cover the pensions for retired employees, and terminated the trusts. This triggered the reversion of a sizable surplus to the company, which the company maintained in its general fund. *Id.* at 329-330. In deciding that the income in question was business income, the court noted that the pension plan was part of the company's overall strategy in finding and maintaining employees for its business operations. Further, with respect to the income, the court noted that the taxpayer had received a deduction for its pension contributions for all the years. Accordingly, the court noted, the recapture of income resulting from that deduction was equitable in light of the circumstances. *Id.* at 343.

In noting taxpayer's business operations, taxpayer had received the benefit of its Industry A operations to its overall corporate operations for several years, and during those years had received tax deductions apportionable to Indiana for its expenses and depreciation. Accordingly, just as the court in *Hoechst Celanese* had noted that taxpayer's prior treatment of expenses effectively dictated a recapture of those benefits on the same theory when taxpayer realized income, here taxpayer has realized business income on the sale of the assets from which it had derived business deductions.

## C. <u>Smaller Industry B Operations</u>

Taxpayer argues that the sales of five smaller Industry B operations in another state, as part of what can best be described as a concentration of its Industry B operations into larger areas, was non-business income within the meaning of Indiana's adjusted gross income statute . Taxpayer argues that the sales of Industry B operations do not meet the transactional test because taxpayer's sales of Industry B operations are unusual events. Further, taxpayer argues that the income is non-business income under the functional test because smaller Industry B operations were not integral to its main business

With respect to the transactional test, it is unclear whether taxpayer's income was sufficiently recurring to constitute business income within the transactional test stated above. Under the functional test, taxpayer's primary line of business is Industry B. Though taxpayer's operations are generally concentrated in larger urban areas, taxpayer has supplied and continues to supply a number of Industry B operations covering smaller population bases. As such, the Industry B operations constituted an integral part of taxpayer's business, and thus their sale constituted business income. Further, the sales were part a voluntary business decision on the part of the

corporation, unlike the forced sale of the division in *May* that the court noted was done to reduce its market concentration in its line of business.

Also, taxpayer retained the earnings from the sales of the Industry B operations. The retention of earnings by taxpayer allowed the business to further focus on its main enterprises. Combined with the other factors above, taxpayer's sales of Industry B operations, assets related to its main line of business, is business income.

Further, as with Industry A, taxpayer had claimed expenses and depreciation related to its Industry B operations as business expenses, reducing its income apportionable to Indiana. Accordingly, the sale of those Industry B operations, taxpayer's business assets for which it had apportionable business income and expense treatment under Indiana's tax statutes for many years, is also business income when those assets are sold. *Id.*

**D. Industry E**

Taxpayer argues that the gain from the disposal of its Industry E operations in two states, acquired in its merger is also non-business income and therefore subject to allocation rather than apportionment. In particular, taxpayer argues that the transactional test was not met because the disposal of the Industry E operations was an extraordinary event Further, taxpayer argues that the disposal of its Industry E operations did not result in business income because the Industry E operations were not essential to taxpayer's main Industry E operations in a third state, and that it was also not part of its main enterprise of Industries B and C.

With respect to the transactional test, taxpayer's income was not sufficiently recurring to constitute business income within the transactional test stated above. Under the functional test, taxpayer's primary businesses were Industries B and C operations. However, in the period from 1995 until its ultimate disposition of its Industry E operations, taxpayer represented that this was part of its regular operations. Further, taxpayer used the proceeds from its various Industry E operations sales to maintain the overall day-to-day operations of the larger corporate whole. To state that the income produced by the sale of a business operated by taxpayer is non-business income, while the deductions for the expenses paid by that same income is business income is an incongruity that the *Hoechst Celanese* court disallowed, and which is properly disallowable here. Accordingly, the gain realized by the taxpayer on this line of business is business income.

**FINDING**

Taxpayer's protest is sustained with respect to its sale of its Industry D business, subject to audit determination of the amount allocable to Indiana, subject to the discussion in Part II. Taxpayer's protest is denied with respect to its sales of Industry B, A, and E operations.

**II. Tax Administration-Limitations on refunds and protests**

## DISCUSSION

Taxpayer was assessed additional tax based on its federal audit adjustments. When taxpayer received the assessment, it filed a protest and amended return based on a portion of its overall income being non-business income. While the protest and amended return were timely *vis-à-vis* the federal adjustments per Ind. Code § 6-8.1-5-2, they were late with respect to the normal three-year period. *Id.*; Ind. Code § 6-8.1-9-1. In this type of situation, taxpayer cannot claim a refund or offset with respect to its previously-reported income. However, with respect to the additional income that was determined to be due, taxpayer is entitled to treat the items that constituted the additional income as resulting in business or non-business income, and then apportion or allocate the additional income appropriately. For instance, a taxpayer claimed originally that it had $10,000,000 of business income, ten percent (10%) of which actually constituted non-business income. This business/non-business character of this income may not be revisited if the statute of limitations (including extensions) for that year has passed, and the amount of tax due and payable with respect to that return and that income stands as filed. However, if an additional $1,000,000 of income is reportable as the result of federal audit adjustments, $200,000 of which resulted from items that had been treated originally as business income but which actually constituted non-business income, and $800,000 of which resulted from items that constituted business income, the taxpayer or the Department, as appropriate to the fact situation, can treat the $200,000 as non-business income and allocate it to an appropriate jurisdiction, while the $800,000 of business income is apportioned by statute.

## FINDING

Taxpayer's protest is further sustained only to the extent that such income in controversy arose from the federal audit adjustments and reportable only there, and denied with respect to the extent that the income was reported on the initial return.

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