DEPARTMENT OF STATE REVENUE

02-20110133.LOF

Letter of Findings Number: 02-20110133
Adjusted Gross Income Tax
For Tax Years 2005-07

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ISSUE

I. Adjusted Gross Income Tax–Business/Non-Business Income.

Authority: May Dep't Store Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001); IC § 6-3-1-20; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer protests the reclassification of income from non-business income to business income.

STATEMENT OF FACTS

Taxpayer is an out-of-state business which is a member of an affiliated group which files Indiana adjusted gross income tax ("AGIT") returns. The affiliated group filed Indiana AGIT returns for 2005, 2006, and 2007, and later filed an amended AGIT return for 2006. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had AGIT liabilities for 2006 and 2007. The majority of the AGIT liability for 2006 resulted from the Department's reclassification of certain income as "business income" rather than "non-business income" as reported by Taxpayer. The Department therefore issued proposed assessments for AGIT and interest for 2006 and 2007. Taxpayer protested the Department's reclassification of that income and the portion of the 2006 AGIT liability which resulted from that reclassification. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Business/Non-Business Income.

DISCUSSION

Taxpayer protests the reclassification of income from the sale of a consumer products line as business income for 2006. Taxpayer states that its main line of business is in non-consumer products and that it acquired the consumer products line in a merger which occurred prior to the audit years. At hearing, Taxpayer explained that this merger was undertaken in order for Taxpayer to acquire a single, specific non-consumer product which was manufactured by the other entity ("Other Entity") involved in the merger. Other Entity produced consumer products as well as the specific non-consumer product. After the merger, Taxpayer continued to produce and market the consumer items until it sold the consumer products line in 2006. Taxpayer argues that this sale was conducted in order to streamline its operations which would allow it to focus on its core, non-consumer products business. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The Department relied upon 45 IAC 3.1-1-29 in determining that the income in question was business income. 45 IAC 3.1-1-29 states:

> "Business Income" is defined as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business.
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> Nonbusiness income means all income other than business income.
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> The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating 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.

Also, the Department referred to 45 IAC 3.1-1-30, which states:

> For 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 therefrom depending upon but not limited to some or all of the following:
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> (1) The nature of the taxpayer's trade or business.
> (2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period.
> (3) The frequency, number, or 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.

Also of relevance is IC § 6-3-1-20, which provides:

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 operations.

Further guidance in determining business income under Indiana law is found in May Dep't Store Co. v. Indiana Dep't of State Revenue, 749 N.E.2d 651 (Ind. Tax 2001), in which the Indiana Tax Court determined that IC § 6-3-1-20 provides for both a transactional test and a functional test in determining whether income is business or non-business in nature. Id. at 662-3. Taxpayer states that the sale of its subsidiary does not meet either the transactional test or functional test and that the income from the sale is therefore non-business income.

In May, the court looked to 45 IAC 3.1-1-29 and 30 for guidance in determining whether income is business or non-business income under the transactional test. These regulations state, "[T]he 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." Id. at 664. 45 IAC 3.1-1-30 lists several factors in making this determination. These include the nature of the taxpayer's trade or business; substantiality of the income derived from activities and relationship of income derived from activities to overall activities; frequency, number or continuity of the activities and transactions; length of time income producing property was owned; and taxpayer's purpose in acquiring and holding the property producing income. In May, the court found that the transactional test was not met when a retailer sold a retailing division to a competitor because the taxpayer was not in the business of selling entire divisions. Id. at 664.

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. Id. 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. The court in May defined "integral" as necessary or essential to complete the whole. Id. at 664-5. The court held that May's sale of one of its retailing divisions was not "necessary or essential" to May's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not May. In essence, the court determined that because May was forced to sell the division in order to reduce its competitive advantage, the sale could not be integral to May's business operations. Therefore, the proceeds from the sale were not business income under the functional test.

As part of the protest process, Taxpayer was able to provide documentation and analysis which established that the sale of the division in question was not part of its normal business operations. Also, Taxpayer provided documentation and analysis which established that the sale was not necessary or essential to its regular trade or business, since the division in question was not acquired, managed, and disposed of by Taxpayer in a process integral to Taxpayer's regular trade or business. Taxpayer has established that the sale of the division in question does not meet either the transactional test or the functional test as provided in May. The income from the sale of the consumer products division was therefore non-business income as reported by Taxpayer. Taxpayer has met its burden under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is sustained.

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