DEPARTMENT OF STATE REVENUE

02-20140306.LOF

Letter of Findings: 02-20140306
Indiana Corporate Income Tax
For the Tax Years 2008 through 2010

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUE

I. Corporate Income Tax-Business/Non-business Income.

Authority: IC § 6-3-1-20; IC § 6-3-1-21; IC § 6-3-2-2; May Dept. Stores Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30.

Taxpayer maintains that income earned from the sale of the assets from two business divisions is "non-business income" allocated to a state other than Indiana.

STATEMENT OF FACTS

Taxpayer is an out-of-state domiciled manufacturing corporation operating several locations outside Indiana and one location in Indiana. In 2006, Taxpayer entered into an agreement to buy all of the stock of one of its competitors (hereinafter, "Acquired Corporation"), which was structured as a parent corporation and subsidiaries that were also domiciled outside of Indiana. Acquired Corporation's operations consisted basically of four operational divisions. Since Taxpayer was attempting to buy one of its competitors in an industry where there were only a few major competitors, Taxpayer, due to anti-fraud concerns, sought the advice of the Federal Trade Commission prior to entering into a purchase agreement with Acquired Corporation. The Federal Trade Commission investigated the merger and in a decision and order determined that Taxpayer could not acquire two of Acquired Corporation's operating divisions as Taxpayer would have an unfair monopoly in these markets. Specifically, the Federal Trade Commission's order ruled that Taxpayer's acquisition of the two divisions would "violate Section 7 of the Clayton Act, as amended, 15 U.S.C. § 18 and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. § 45." Thus, even though Taxpayer wished to obtain these two divisions it was not able to acquire them. Therefore, immediately prior to, and in coordination with, Taxpayer's acquisition of Acquired Corporation, Acquired Corporation and Taxpayer also entered into an agreement with a corporation that was unrelated to either Taxpayer or Acquired Corporation to purchase the assets of these two divisions. This unrelated corporation would then become Taxpayer's direct competitor in these markets, which would prevent Taxpayer's monopoly. After making this arrangement, Taxpayer and Acquired Corporation once again sought the advice of the Federal Trade Commission prior to entering into a purchase agreement with Acquired Corporation. Since Taxpayer and Acquired Corporation entered into an agreement with the unrelated third party, the Federal Trade Commission then granted its antitrust approval to the transactions, which did not create monopolies in any of the four markets. Thus, the Federal Trade Commission's approval allowed the third party to purchase the assets of the two divisions of Acquired Corporation and allowed Taxpayer to acquire Acquired Corporation.

Acquired Corporation had an Indiana location, and filed consolidated corporation income tax returns in Indiana. On its Indiana consolidated corporate income tax return for the 2006 tax year, Acquired Corporation classified the gains from the sales of the two divisions' assets, due to the Federal Trade Commissioner's order, to the unrelated party as non-business income. Regardless of Acquired Corporation's classification of this income from its sale of the assets of the divisions' as non-business income in Indiana, Acquired Corporation sustained a net operating loss for the 2006 tax year. However, Acquired Corporation reported net operating loss for the 2006 tax year was larger when this income was classified as non-business income as the non-business income was allocated outside of Indiana.

Taxpayer, after it acquired Acquired Corporation, merged Acquired Corporation into Taxpayer. Thus, Taxpayer, as the successor in interest of Acquired Corporation, reported net operating loss deductions on its 2008, 2009, and 2010 Indiana corporation income tax returns based upon Acquired Corporation's reported net operating loss for the 2006 tax year.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns for the 2008 through 2010 tax years and concluded that Taxpayer had not reported the correct amount of available net operating loss deductions. The Department's report concluded that the income that Acquired Corporation reported on its 2006 return from the sales of its two division's assets should have been classified as "business income." The Department's adjustment to Acquired Corporation's 2006 return resulted in a reduction of the net operating loss that Acquired Corporation reported for the 2006 tax year, which then reduced the amount of the net operating loss deductions that Taxpayer had available for the 2008, 2009, and 2010 tax years. Taxpayer protested the Department's adjustment to Acquired Corporation's 2006 return. An administrative hearing was conducted, and this Letter of Findings results.

I. Corporate Income Tax-Business/Non-business Income.

DISCUSSION

The Department adjusted Acquired Corporation's 2006 Indiana adjusted gross income tax return by reclassifying the gain from the sales of the assets from the two divisions from "non-business income" to "business income." The Department's adjustment resulted in a reduction of the net operating loss Acquired Corporation reported for the 2006 tax year, which then reduced the amount of the net operating loss deductions that Taxpayer had available in the 2008 through 2010 tax years at issue. Taxpayer protests the adjustments the Department made to its available net operating loss deductions asserting that the income derived from Acquired Corporation's sales of assets from the two divisions was properly report by Acquired Corporation as non-business income on the 2006 Indiana adjusted gross income tax return.

For purposes of determining a taxpayer's adjusted gross income tax liability, "business income" is apportioned between Indiana and other states. IC § 6-3-2-2(b). In contrast, "non-business income" is wholly allocated to Indiana, or wholly allocated to another state. IC § 6-3-2-2(g)-(k). Therefore, "[W]hether 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 Ct. 2001).

Under IC § 6-3-1-20, business income is defined as "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." Indiana's regulations, in 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30, expand on this definition. Under these regulations, "the critical element in determining whether income is 'business income' or 'non-business income' is identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-29. Moreover, "[t]he 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 non-business income." Id. In other words, whether income is derived from manufacturing cars, providing personal services, buying and selling real estate, managing intellectual property, or any other "type" or "category" is not relevant.

Furthermore, 45 IAC 3.1-1-30, in relevant part, in providing context for the "regular course of a taxpayer's trade of business" explains:

> 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:
> (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, 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.

See also May, 749 N.E.2d at 664 n.13.

On the other hand, non-business income is defined in the negative. IC § 6-3-1-21 provides that "'non-business income' means all income other than business income." Therefore, only that income that cannot be classified as business income will be considered non-business income. Thus, resolution of the legal issue depends on whether the income derived from these sales meets the definition of "business income."

Indiana employs two tests to determine if income is "business income." Income qualifies as "business income" if the income satisfies the criteria of either test. The first test, the "transactional test," derives from the statutory language, "income arising from transactions and activity in the regular course of the taxpayer's trade or business . . . ." IC § 6-3-1-20. This test focuses on the nature of the particular transaction. The second test, the "functional test," derives from the statutory language, "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." Id. Generally speaking, under the functional test, "all gain from the disposition of a capital asset is considered business income if the asset disposed of was used by the taxpayer in its regular trade or business operations." May, 749 N.E.2d at 659 (citations and quotations omitted).

Under the transactional test, "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 3.1-1-29 (emphasis added). Gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. Under this test, the "controlling factor by which business income is identified is the nature of the particular transaction giving rise to the income." May, 749 N.E.2d at 658 (citing General Care Corp. v. Olsen, 705 S.W.2d 642, 644 (Tenn. 1986)). In deciding whether a specific transaction generated business income, relevant considerations include "(1) the frequency and regularity of similar transactions, (2) the former practices of the business, and (3) the taxpayers' subsequent use of the income." Id. at 659.

In the instant case, Acquired Corporation did not regularly, or previously, engage in the complete liquation of operating divisions. Therefore, there is no question that the income from the transactions in question–i.e. Acquired Corporation's sales of all of the assets of two of its divisions in order to sell itself to Taxpayer–do not meet the transactional test. However, since income qualifies as "business income" if the income satisfies the criteria under either the transaction test or the functional test, the income's qualification under the functional test must also be addressed.

"The functional test focuses on the property being disposed of by the taxpayer." Id. at 664. 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 this test, the property generating income must have been "acquired, managed, and divested or disposed of by the taxpayer" in a "process . . . integral to the taxpayer's regular trade or business operations." Id. (Emphasis in original). Moreover, "[i]t is not enough that the property was used to generate business income for the taxpayer prior to its disposition. The disposition too must be an integral part of the taxpayer's regular trade or business operations." Id. at 664 . The Indiana Tax Court defined "integral" as "part of or [a] constituent component necessary or essential to complete the whole." Id. at 664-65. The Indiana Tax Court observed in May that while the asset that was disposed of by the taxpayer was "unquestionably an integral part of [the taxpayer's] business operations," the disposition of the asset was pursuant to a court ordered divestiture for the benefit of a competitor and not for the benefit of the taxpayer. Id. at 665. The court concluded that "[u]nder these circumstances, this divestiture (or disposition of assets) could not have constituted an integral part of [the taxpayer's] regular trade or business operations." Id. at 665. Thus, the court's conclusion that the taxpayer's sale of one of its retailing divisions was not necessary or essential to its regular trade or business, was based, in part, on the fact that the sale was executed pursuant to a court order that benefited a competitor, not the taxpayer. Id. at 665. Since the sale of the department store's division was found to be not a "necessary" or "essential" part of the taxpayer's business, the proceeds from sale of the division were not business income under the functional test. Id. Accordingly, though not dispositive standing alone, whether the income derived from the disposition benefited the taxpayer's trade or business or in reality, benefited a third-party, and whether the transaction was voluntary or involuntary are relevant factors to consider under the functional test. See Id.

In the present case, before Taxpayer could acquire Acquired Corporation, the Federal Trade Commission's order required Acquired Corporation to sell off the assets of two of its divisions prior to the acquisition. Therefore, Acquired Corporation and Taxpayer entered into agreements with one of Taxpayer's competitors for the competitor to acquire the assets of those two divisions. Both Taxpayer and Acquired Corporation would have preferred to sell all four divisions to Taxpayer; however, pursuant to the Federal Trade Commission's order, the assets from the two divisions were instead sold to one of Taxpayer's competitors. Comparing the analysis used in May to Taxpayer's and Acquired Corporation's situation, Acquired Corporation was in a similar situation to the taxpayer in May. Like the taxpayer in May whose acquired corporation sold one of its retailing divisions prior to May's acquisition which benefited one of May's competitor because of anti-trust court order, Acquired Corporation also sold the assets from the two divisions to one of Taxpayer's competitor's because of the Federal Trade Commission's anti-trust order. Id. at 654-55. Therefore, as the taxpayer in May's gain reported to the acquired corporation from the sale of the retailing divisions which was executed pursuant to a court order which benefited a competitor was found not to be necessary or essential to regular trade or business, Acquired Corporation's gain from the disposition of the assets of the two divisions pursuant to the Federal Trade Commission order which benefited Taxpayer's competitors is also not necessary or essential to its regular trade of business. Id. at 665. Therefore, since the disposition of the assets is not necessary or essential to Acquired Corporation's regular trade of business, the gain from the disposition of the assets is not business income under the functional test.

For the aforementioned reasons, the Department concludes that Acquired Corporation's original classification of the income from the sales of the assets from two of its divisions as "non-business income" was correct.

FINDING

Taxpayer's protest is sustained.

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