Not Done Yet: Recent Developments in Business/Nonbusiness Income Decisions

With more and more states turning to maximize apportioned income to the extent allowed under the U.S. Constitution,[1] one day perhaps we will see an end to questions about whether certain items of income were "business income" or "nonbusiness income" under the traditional statutory definitions provided by the Uniform Division of Income for Tax Purposes Act ("UDITPA").

That day has not yet arrived. Recent state decisions include several taxpayer victories and, as always, the decisions vary based on a taxpayer's specific facts and the ways that the definitions have been interpreted in the taxpayer's state. Taxpayers should continue to evaluate their business/nonbusiness positions to determine appropriate treatment and, in particular, there may be opportunities for taxpayers domiciled in constitutional maximum apportionment states to take nonbusiness income positions in other jurisdictions that retain the traditional business/nonbusiness income definitions.

Hard deal leads to Calif. nonbusiness income treatment for overseas dividends from minority interest. *In the matter of Bank of America Corp.*[2] the taxpayer prevailed at the California State Board of Equalization in treating its dividends from a minority interest in a Chinese bank as nonbusiness income. Bank of America had acquired a minority interest in China Construction Bank Corporation ("CCB") that ranged between 8% and 19%. CCB paid substantial dividends to its shareholders, including Bank of America. Bank of America treated the dividends as business income on its return and later filed a \$5.7 million refund claim with California asserting the nonbusiness income classification.

The basis of the taxpayer's position was that this was a one-way flow of value as part of a difficult business circumstance. The taxpayer seemingly had been forced into investing in CCB in connection with a Strategic Assistance Agreement under which the taxpayer provided risk strategic advice and assistance regarding management/corporate governance, credit cards, consumer banking, global treasury services, information technology, and in other areas. This assistance was provided by about 50 Bank of America employees.

The situation presented a close question about the dividend proceeds from a minority investment. There clearly was not a unity of control between CCB and the taxpayer: Bank of America got one seat on CCB's board, and the facts showed that it never had any real ability to control or seriously affect CCB's business decisions. However, the dividend income was part of a strategic investment by Bank of America in connection with access to the Chinese market, and the assistance that Bank of America provided to CCB derived from the core competencies of its banking business. A unique circumstance that seems to have worked in Bank of America's favor was the apparent efforts of China's bureaucracy to block Bank of America's ability to operate in China, essentially forcing the taxpayer into its strategic partnership with CCB.

The taxpayer's arguments prevailed, in part due to sympathy over the roadblocks China sets up against foreign investment. The Board of Equalization decided in favor of Bank of America in a 4-1 decision. This was one of the last decisions made by the Board of Equalization before the Office of Tax Appeals began hearing cases in 2018.

Sale of 49% interest results in business income in N.M. In a contrasting fact pattern to *Bank of America*, a New Mexico administrative law judge treated

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proceeds from the sale of a large minority interest in a company that had at one point been a 100%-owned subsidiary as business income.[3] The taxpayer was the U.S. subsidiary of a U.K. agricultural commodities merchant. It had two subsidiaries that it spun off as the publicly traded Westway Group Incorporated ("WGI"), in which the taxpayer had a roughly 49% interest and three of seven seats on the WGI board.

The taxpayer and one of the WGI subsidiaries entered into a long-term strategic alliance contract, under which the WGI subsidiary provided storage services to the taxpayer for roughly 20 years. WGI and the taxpayer also had a shared services agreement under which the taxpayer provided back office services to WGI. After several years of these arrangements being in place, the taxpayer sold off its interest in WGI to a private equity company. The taxpayer treated its gain on the sale as nonbusiness income.

The proceeds, however, were found to be business income under New Mexico's modified definition of "business income":[4] the facts satisfied both the state's disjunctive functional test[5] and also the "dispositional test" under which the sale of a business or business segment results in business income.[6] The historic relationship of WGI's operations as a spinoff of the taxpayer, as well as the ongoing close operational relationship of the taxpayer and WGI, compelled this result. The fact that the interest sold was only a minority 49% interest did not persuade the administrative law judge that nonbusiness income treatment was required. The taxpayer's constitutional arguments were similarly rejected based on the ongoing operational relationship between the taxpayer and WGI.

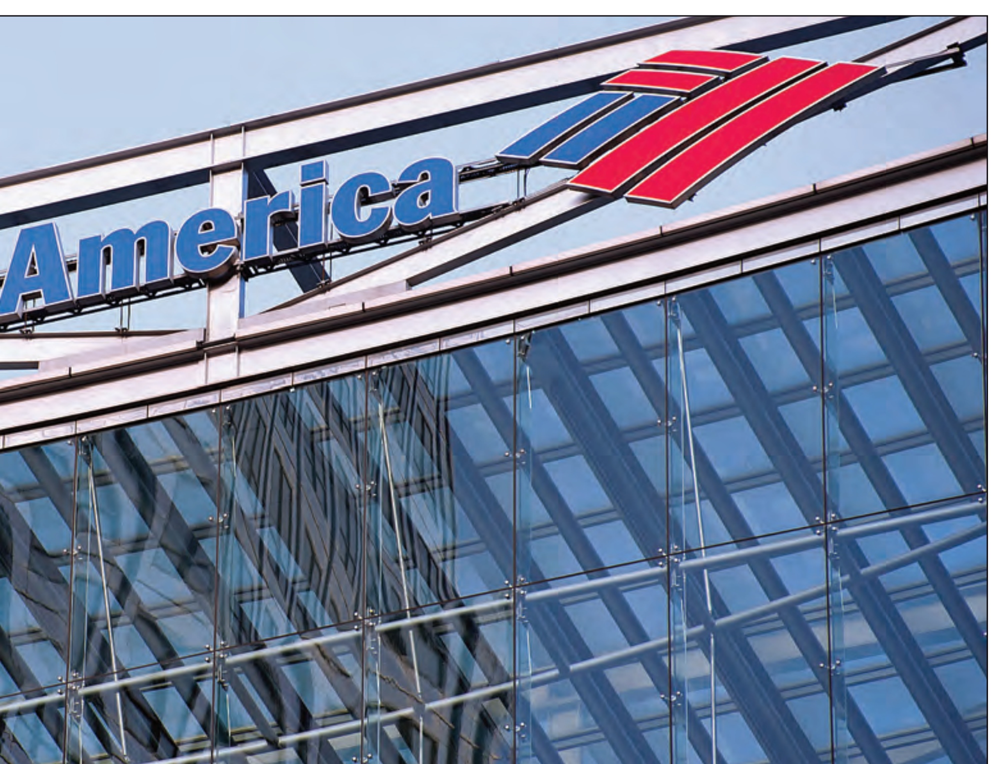
But once it's sold: post-sale interest as nonbusiness income. Another New Mexico administrative decision led to a better result for the taxpayer, where post-sale interest income was found to be nonbusiness income.[7] The taxpayer, a subsidiary of ConAgra Foods, had divested a business unit to an unrelated third party. Post-sale ongoing relationships were limited to a one-year transition services agreement and various arm's-length commercial transactions. Following the divestiture sale, the acquiror ran the business independently.

To maximize its sales price, the taxpayer sold the business for a combination of cash and payment-in-kind ("PIK") notes that generated interest. Neither the PIK notes nor the interest payments received under the notes were used in the taxpayer's operating business.

The initial gain on the sale of the business was reported as business income, consistent with New Mexico's dispositional test. The ongoing PIK note interest payments were reported as nonbusiness income. The New Mexico Taxation and Revenue Department adjusted these, however, to treat the interest income as business income.

The Administrative Hearings Office rejected the department's position, which essentially was based on some sort of trailing concept since the PIK notes ultimately derived from the taxpayer's business divestiture. The tribunal found that New Mexico had gotten its fair share of tax on the gain from the sale of the business that had been reported as business income. The ongoing interest under the PIK notes was separate and more in the nature of investment income, such that the dispositional test did not apply. The transactional test did not apply because it was not part of the taxpayer's regular trade or business. Finally, the functional test did not apply because the interest was not associated with any operational function. As such, the interest income was properly classified as nonbusiness income.

Sale of subsidiary as nonbusiness income under Ind.'s strict definition of "business income." In *E.I. DuPont De Nemours*



1 The model revisions to UDITPA adopted by the Multistate Tax Commission in July 2015 include changing the term for income to be apportioned from "business income" to "apportionable income" and defining "apportionable income" generally as all income for which apportionment is allowable under the U.S. Constitution. These model revisions have accelerated a process already underway in which states have been broadening the definition of income subject to apportionment toward its constitutional limits.

2 Cal. Board of Equalization, No. 983272 (decided Nov. 14, 2017).

3 *In the matter of Agman Louisiana, Inc,* N.M. Admin. Hearings Office, No. 17-47 (Dec. 5, 2017).

4 *See* N.M. Stat. Ann. § 7-4-2(A) (1978).

5 If "acquisition, management, *or* disposition of the property constitute integral parts of the taxpayer's regular trade or business." (Emphasis added.)

6 "[I]ncome from the disposition or liquidation of a business or segment of a business."

7 *In re ConAgra Foods Food Ingredients Co. Inc.*, N.M. Admin. Hearings Office, No. 17-39 (Sept. 15, 2017).

8 79 N.E.3d 1016 (Ind. Tax Ct. 2017). This case also involved several other issues not directly relevant to the business/nonbusiness income classification questions at issue in this article.

9 Indiana moved to maximum apportionment to the limits of the U.S. Constitution for tax years beginning on or after January 1, 2016.

10 *See May Dep't Stores Co. v. Ind. Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax Ct. 2001).

& Co. v. Indiana Dep't of State Revenue,[8] the Indiana Tax Court classified the gain on the sale of a relatively independent subsidiary as nonbusiness income based on the definition then in effect in the state. The taxpayer originally had had a joint venture pharmaceutical venture with Merck, in which DuPont eventually bought out its partner. While owned by DuPont, the pharmaceutical subsidiary operated largely independently, except for some startup services. After three years as a sole owner of the pharmaceutical subsidiary, DuPont sold it to another pharmaceutical company resulting in a $4 billion gain.

DuPont treated the gain as nonbusiness income on its Indiana return. The Indiana Department of Revenue did not object in the year of the return, but did later reclassify the income so as to deny the use of net operating loss ("NOL") carryforwards in a subsequent year. DuPont protested and then appealed to the Tax Court.

The Tax Court applied the UDITPA definition of "business income" that was then in effect in Indiana,[9] which the Tax Court previously had read narrowly. The transactional test was not met because DuPont showed that its regular business was industrial, agricultural, and chemical manufacturing. The Department's argument that buying and selling businesses was part of DuPont's regular trade or business was rejected. The functional test also was not met: While Indiana recognized the functional test, it was interpreted conjunctively and narrowly to require that acquisition, management, and disposition all be integral parts of the taxpayer's regular trade or business.[10] Under DuPont's facts, even if acquisition and disposition of the subsidiary were integral parts of DuPont's business, the subsidiary had not been managed as an integral part of DuPont's regular manufacturing business. The Tax Court also determined that nonbusiness income treatment was consistent with the constitutional unitary business principle because there was limited management oversight, only arm's length flows of value, and no economies of scale.

As states move to constitutional maximum apportionment, will business/nonbusiness cases leave a hangover? In the recent cases addressed in this article, the tribunals generally sought to explain why their business/nonbusiness income determinations were consistent with the constitutional unitary business principle and relevant U.S. Supreme Court case law. As states move into the new paradigm of maximizing apportionable income to the limits of the U.S. Constitution—as, for example, in Indiana—query whether the constitutional analyses from legacy business/nonbusiness income decisions will shape outcomes under the new paradigm. At the same time, however, the ultimate test becomes federal law, which should presumably be consistent among states rather than vary as do state court interpretations of state statutory definitions, however uniform they might purport to be. In any event, questions about apportionability of items of income may well continue to be fact-specific, contentious questions in the years to come. ■