Business vs. Nonbusiness Income: When to Allocate and When to Apportion

THURSDAY, NOVEMBER 16, 2017, 1:00-2:50 pm Eastern

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Business vs. Nonbusiness Income

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Business vs. Nonbusiness Income – *When to Allocate and When to Apportion*

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and

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Business vs. Nonbusiness Income

- Allocation vs. Apportionment Principles
  - Business income is apportioned by formula amongst the various states where the corporation is doing business.
  - Nonbusiness income is allocated to the corporation's state of commercial domicile.
    - Special allocation rules in some states for certain types of income (e.g., income from real property allocated to location of real property).

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- A corporation's “commercial domicile” is generally the principal place from which the trade or business of the taxpayer is directed or managed.

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- Business income
  - limited by U.S. Constitution
  - defined by statute

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Business vs. Nonbusiness Income

- Constitutional limitations on characterizing income as apportionable business income.
  - Unitary business enterprise test: Income derived through the operation of a unitary business.
    - "The linchpin of apportionability in the field of state taxation is the unitary-business principle." Mobil Oil Corp. v. Comm'n of Taxes of Vermont, 445 U.S. 425, 437, 439 (1980)
  - Operational test: The transaction/asset serve an operational rather than an investment function of the business. Allied-Signal, Inc. v. Director, Div. of Tax'n, 504 U.S. 768 (1992).

  - Operational test inapplicable to sale of nonunitary business. MeadWestvaco Corp. v. Illinois Department of Revenue, 553 US 16 (2008).

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- <u>Unitary business tests</u>
  - <u>Mobil</u> test: Functional integration, centralization of management, economies of scale
  - Three unities test: Unity of ownership, operation, and use. <u>Butler Brothers v. McColgan</u>, 17 Cal.2d 664 (1941).
  - Contribution and dependency test: <u>Edison California Stores Inc. v. McColgan</u>, 30 Cal.2d 472 (1947).
  - Flow of value: <u>Container Corp. of Am. v. Franchise Tax Bd.</u>, 463 U.S. 159, (1983).

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- Operational or investment function?
  - Look to asset's use and its relation to taxpayer’s activities within the state
  - Look to unitary factors (other than ownership).
    - Independent or related to business activity?
    - Passive?

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- Statutory definition of apportionable business income.
  - UDITPA: "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 trade or business.
    - transactional test and functional test
  - All income is business income to the extent permitted by the Constitution.
  - All items of income after specifically allocated income (e.g., Louisiana).

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- Transactional test – Income from transactions and activities in the regular course of the taxpayer's trade or business
  - Income from operations
  - Income from the sale of business assets, where such sales are regular and consistent
    - For example, rental car companies generally sell cars after certain mileage or time owned
    - These transactions meet the transactional test due to the regularity

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- Functional test – Acquisition, management, and disposition of property constitute integral parts of the regular trade or business
  - Applies to assets used to generate business income
    - Fleet sales by a rental car company meet the functional test, since the cars were used to generate business income
  - “and” means “or”
    - E.g., Hoescht Celanese v. Franchise Tax Board, 25 Cal. 4th 508 (2001).

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- Characterization of specific types of income (usually from intangible assets)
  - Dividends
  - Interest
  - Capital gains
  - Royalty income
  - Sale of subsidiaries or partnerships that are integral parts of the taxpayer's trade or business
  - Sale of interests in non-unitary entities (e.g., entities that are not integral parts of the taxpayer's trade or business)

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- Income from partnerships
  - Business/nonbusiness income determination made at the partner or partnership level?
    - E.g., Alabama, California and Illinois require determination at partnership level.
    - E.g., Arizona and Pennsylvania require determination be made at the partner level
  - Some states presume partnership income is nonunitary
    - E.g., Arkansas, Louisiana, Mississippi and Oklahoma
  - Entity or Aggregate theory of partnerships?
    - Most states aggregate partnership income and factors with the corporate partner's business income and factors
    - Some states require tax determination at the entity level (partnership income apportioned at partnership level).

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- Expenses attributable to business/nonbusiness income (e.g., business/nonbusiness deductions). In re Appeal of Kroger Co., 270 Kan. 148 (2000).

Business vs. Nonbusiness Income

- Penalties – California regulation prevents application of accuracy-related penalty on understatements attributable to business/nonbusiness income distinction. Cal. Code Regs. 19164

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Recent Cases

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ComCon Production Services I, Inc. v. FTB, Second Appellate District, Case No. B259619, Dec. 14 2016 (unpublished)

- Comcast's receipt of a termination fee at the conclusion of a failed merger with Media One constituted business income under the transactional test.
- Comcast found not to be unitary with QVC, a television channel in which Comcast had a 57% ownership interest.
  – No centralization of management, functional integration, or economies of scale between the two entities.
- <u>Levi Strauss</u>, SBE No. 54705
  - SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buy out of a California corporation's stock were nonbusiness expenses wholly allocable to California
  - Case settled prior to the SBE hearing

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Xylem Dewatering Sols., Inc. v. Dir., Div. of Taxation, 2017 BL 117956, N.J. Tax Ct., No. 011704-2015, (April 7, 2017)

Gain from the IRC section 338(h)(10) deemed gain from the sale of assets is “non-operational income” allocable wholly to the taxpayer’s New Jersey principal place of business under McKesson Water Prods. Co. v. Dir., Div. of Taxation, 2009 BL 152619, 408 N.J. Super. 213 (N.J. Super. Ct. App. Div.2009).

In McKesson, the New Jersey Supreme Court held that under “functional” test, gain from IRC section 338(h)(10) election constituted “nonoperational” allocable income, because deemed asset sale and liquidation, with proceeds distributed to parent, amounted to cessation of business when parent did not invest proceeds in a business similar to the business it sold.

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Fidelity National Information Service Inc. v. FTB, Third Appellate District Case No. CO81522

- Taxpayer filed suit claiming gain from the sale of a minority stock interest was nonbusiness income.
- On December 31, 2015, the trial court ruled that the gains were business income.
- On October 3, 2017, the California Court of Appeal for the Third Appellant District reversed and remanded the case back to the trial court to determine whether the stock was a business asset when the taxpayer chose to sell it.

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ConAgra Foods, Inc., SBE Case Nos. 597512, 785058, 799162 (2015)

- Gain from the sale of stock in Pilgrim's Pride received from taxpayer's chicken processing business sale was nonbusiness income.
- The stock represented a minority interest (7 percent) in Pilgrim's Pride, a large publicly owned company.
- The taxpayer and Pilgrim's Pride were managed and operated independently, with no sharing of officers or directors.
- Although the taxpayer entered into a supply agreement with Pilgrim's Pride, the agreement merely provided that taxpayer would offer Pilgrim's Pride the first opportunity to provide chicken at fair market value and in volumes similar to past volumes.

ConAgra Foods, Inc., SBE Case Nos. 597512, 785058, 799162 (2015) continued . . .

- Taxpayer sold its fresh beef and pork operations to Swift Foods, a new joint venture, and received cash, notes and a 46 percent equity interest in the joint venture. The joint venture was formed to hold the taxpayer's fresh beef and pork operations, which constituted substantially all of the operating assets of the joint venture.
- The taxpayer provided debt financing for the new venture and continued to use fresh beef and pork from the operations as an integral part of its packaged food business.
- The SBE ruled that the income earned from taxpayer's equity and debt interests in the joint venture was business income.

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- THANK YOU…ANY QUESTIONS PLEASE FEEL FREE TO CONTACT US:

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