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Indiana - Asset sale, land sale, and termination fee examined for business/nonbusiness and apportionment treatment

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In brief

A recent Supplemental Letter of Findings examined a taxpayer's income derived from an asset sale, a land sale, and a merger termination fee and concluded that:

- The business income generated from the sale of a facility located outside of Indiana subject to an instalment sale contract was sourced outside of Indiana because the subject property was located outside of Indiana;

- Two land parcels, previously treated as business property and included in the taxpayer's property factor, could not be converted into nonbusiness property simply because the adjoining facility was sold and the land was held as investment property and not immediately put to use in the taxpayer's business; and

- The income from a merger termination fee was classified as business income because, under the functional test, compensation for effort and costs incurred during an acquisition was deemed to be essential and integral parts of the taxpayer's business operations.

[Indiana Supplemental Letter of Findings 02-20100199 (6/27/2012)].

In detail

The taxpayer was an out-of-state company doing business in Indiana through an LLC (Indiana LLC). The taxpayer filed a separate Indiana corporate income tax return, not consolidated with any other entity. On audit, the Indiana Department of Revenue (Department) determined that the taxpayer misclassified three transactions as nonbusiness income: (1) the taxpayer's sale of a non-Indiana facility; (2) the taxpayer's sale of two parcels of non-Indiana land adjacent to the facility; and (3) a termination fee that resulted from an unsuccessful merger. The taxpayer protested and, following a hearing, a September 28, 2011 Letter of Findings denied the protest. The taxpayer requested a rehearing, which is the subject of the June 27, 2012 Supplemental Letter of Findings summarized here.

The taxpayer advanced three arguments supporting that the transactions were not taxable: (1) the asset sale income, while business income, was sourced wholly to the location of the asset because it was sold pursuant to an instalment sale contract; (3) the land sold was converted into nonbusiness income because it was held for investment purposes; ad (4) the income from the termination fee was not in furtherance of the taxpayer's business purpose.

Income from the instalment sale contract was business income, but apportioned outside of Indiana

The Department found that the receipt from the instalment sale was business income, but for apportionment purposes was not included in the Indiana numerator. During the initial hearing, the taxpayer asserted that the asset sale involved nonbusiness income and the Department disagreed. At the rehearing, the taxpayer agreed that the asset sale involved business income, but argued that Indiana's apportionment provisions required that the income be apportioned outside of Indiana.

Indiana Code § 6-3-2-2.2(a) provides that receipts from instalment sales contracts secured by real property are attributable to Indiana if the secured property is Indiana property. The taxpayer claimed, and the Department agreed, that its asset sale was sold pursuant to an instalment sale contract and, since the secured property was non-Indiana property, none of the income from its sale could be apportioned to Indiana. .

Income from the land sales was business income because the land was used in the taxpayer's business and there was no identifiable event that established its conversion to nonbusiness property.

The taxpayer argued that its land sales were nonbusiness income because, after the sale of the adjoining facility, the land was not used in the taxpayer's business, but rather was held solely for investment purposes. The taxpayer relied on Indiana guidance generally providing that income from property held for investment purposes, and removed from the property factor, is nonbusiness income. However, property is included in Indiana's property factor when such property is actually used or is "capable of being used" to produce business income. Furthermore, property must remain in the property factor until permanent withdrawal is established by an identifiable event converting it into nonbusiness income.

The taxpayer contended that the sale of its adjoining facility and the subsequent holding of the land without developing it was the identifiable event converting it to nonbusiness income. However, the Department noted that the taxpayer admitted it would have developed the parcels of land for other entertainment purposes if subsequent state law changes allowed for it. The Department found that holding onto the land waiting for state law to change was not an "identifiable event" that established the land's "permanent withdrawal" and conversion to nonbusiness income.

Income from the termination fee was business income because it was essential and integral to the taxpayer's business

Indiana defines apportionable business income 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 constitute integral parts of the taxpayer's trade or business operations." Indiana views this definition as comprising an independent "transactional" test and "functional" test, the satisfaction of either will qualify an item of income as business income. The parties agreed that the termination fee did not satisfy the transactional test, therefore the issue in dispute regarded whether the termination fee satisfied the functional test.

In *May Department Stores v. IDOR,* the tax court held that in order for the sale of an asset to meet the functional test, the asset must have been acquired, maintained ***and*** disposed of in furtherance of the taxpayer's business purpose. The *May* court found that the mandated, involuntary sale of stores pursuant to a court order did not result in business income because there was nothing in the facts to support that the taxpayer strategically supported the disposition of its stores as part of its business purpose.

The taxpayer here asserted that its facts were similar to those found in *May* because its merger termination fees were not a part of its business purpose. The Department disagreed and observed that the taxpayer entered into a merger agreement to "gain access" to new markets in the industry and part of the merger agreement involved a termination fee. The taxpayer's documentation provided that its "strategic plan is to continue to grow its . . . business by . . . making selected acquisitions . . . to achieve economies of scale." Accordingly, the Department viewed that the taxpayer's business was dependent, in part, on its successful completion of mergers. The Department recognized that the taxpayer deducted as "business expenses" those expenses incurred in the process of acquiring assets through merger. The "termination fee" at issue: (1) helped taxpayer to ensure its desired result of completing an acquisition; (2) was intended to prevent a seller-company from entertaining higher bidders and breaching the merger agreement; and (3) served as a remedy to compensate the taxpayer for its effort and costs incurred during the acquisition. Accordingly, the Department found that income attributed to the termination fee is business income because the termination fee was an essential and integral part of the taxpayer's business operations.

Actions to consider

This ruling affirms the need for taxpayers to ensure that arguments advanced to the Department are consistent with marketing or other external communications they produce because such documentation could be used by the Department to contradict a taxpayer's assertions. The Department referenced such material in refuting the taxpayer's arguments that it was not unitary with the operations that were sold.

Also interesting is the conclusion around the termination fee. Indiana now joins the ranks of Arizona and California in providing guidance classifying a termination fee as business income.

Let's talk

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