Indiana – Subsidiary sales treated as business income and interest expense disallowed

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In brief

A recent Letter of Findings held that the income from a taxpayer's subsidiary sale qualified as business income. Indiana taxpayers should be aware that the decision found that the US Supreme Court *Meadwestvaco* decision did not require that a unitary relationship exist between the taxpayer and its subsidiary in order to apportion the income from the subsidiary's sale.

Additionally, the Letter of Findings disallowed taxpayer's related party interest expenses because the expenses resulted in a failure to 'fairly reflect' Indiana income. Indiana taxpayers should be aware that the decision could be interpreted to apply Indiana's addback (for intangible expenses and related intangible interest expenses) to related party loan interest expense.

In detail – Income from subsidiary sale is business income

Facts

During the years at issue, Taxpayer was a multinational corporation specializing in science and technology disciplines including high-performance materials and specialty chemicals. On its 2001 Indiana corporate income tax return, Taxpayer treated income from the sale of a subsidiary as nonbusiness income sourced to its corporate domicile, Delaware. On audit, the Indiana Department of Revenue reclassified the income as business income, resulting in increased Indiana tax liability.

Transactional and functional test for business income

In its Letter of Findings (LOF), the Department recognized that Indiana defines business income utilizing both the transactional and functional tests. The transactional test provides that income is taxable as business income if the income arises from transactions that occur in the regular course of a taxpayer's trade or business. The LOF did not reach the question regarding whether the subsidiary's sale qualified under the transactional test because, as described below, the transaction qualified as business income under the functional test (although, the LOF suggested that the transaction arguably qualified under the transactional test due to Taxpayer's regular engagement of acquiring and selling divisions of its business).

Subsidiary sale qualifies as business income under the functional test

The LOF describes that, under the functional test, income is considered business income if the acquisition, management, and disposition of the property at issue constitutes integral parts of a taxpayer's business.

Taxpayer argued that its interest in the subsidiary was merely an investment and therefore its sale was unrelated to Taxpayer's primary business purpose. The Department reviewed public information, including Securities and Exchange Commission filings, Taxpayer's website, and public statements to establish that Taxpayer had a history of developing its specialized industry business (of which the subsidiary was a part) over a period of decades.

Accordingly, the LOF determined that the *acquisition and management* of the subsidiary were integral to Taxpayer's business operations in its specialized industry line of business since the subsidiary was essential to the creation of this line of business. Additionally, the *disposition* of the subsidiary was integral to Taxpayer's business operations because the disposition was an unforced, voluntary business decision on the part of Taxpayer.

Department finds that unitary analysis not required to apportion business income

Taxpayer argued, consistent with the US Supreme Court decision in *Meadwestvaco v. Illinois Department of Revenue*, that the unitary business principle is the key factor in determining whether a state may tax a portion of the gain from the sale of a business. The LOF concluded that Taxpayer 'fundamentally misreads' the *Meadwestvaco* decision because the US Supreme Court did not address whether a unitary relationship existed.

The takeaway

The LOF's conclusion that *Meadwestvaco* did not require a unitary analysis is a curious one (click here for our summary of the decision). *Meadwestvaco* generally held that the Illinois Appellate Court could not rule on the apportionment of proceeds from a taxpayer's liquidation of a division (a scenario similar to that found in the LOF) without addressing whether a unitary relationship existed. The US Supreme Court remanded the case to the lower Illinois courts to conduct a unitary analysis. The LOF appears to rest on the fact that the US Supreme Court did not address whether the parties were unitary. While this may be true, the reason for the US Supreme Court not addressing the factual unitary issue was because this determination was left for the lower courts to decide.

The LOF's conclusion that the *disposition* of Taxpayer's subsidiary was integral to Taxpayer's business was determined in reference to an Indiana Tax Court decision, *May Department Store*. In *May,* the Tax Court determined that the taxpayer's forced sale of its subsidiary, compelled by an antitrust settlement, could not be in the taxpayer's regular course of business. The Department reasoned that Taxpayer's subsidiary sale was integral to its business merely because it was a voluntary sale.

In detail – Interest expense deduction disallowed

Facts

During the 1999 – 2007 audit period, Taxpayer deducted interest expense payments made to a subsidiary (Loan Sub) pursuant to a loan. On audit, the Department found that these intercompany transactions resulted in a failure to 'fairly reflect' Taxpayer's Indiana source income and should therefore be disallowed. The audit disallowed approximately $3.1 billion in interest expenses.

Pre-2006 interest expense – did not fairly reflect income

The Department has the power to distribute income among two or more controlled businesses in order to 'fairly reflect' a taxpayer's Indiana income. The Department cited several reasons for disallowing the intercompany interest expense, including that: (1) the interest rate was approximately twice that of the prime rate, (2) there was no timely expectation of repayment of the loans, (3) interest was never actually paid, but rather accrued and rolled over into a new loan, (4) Loan Sub had no employees and its only activity was to hold the master note between it and Taxpayer.

The LOF determined that, looking to the substance of the transaction, that Loan Sub was "merely a paper company with no employees" and that the transaction "was not in substance a loan." Accordingly, the LOF held that Taxpayer could not "utilize the interest expense deduction to distort its Indiana income tax obligations by unfairly reducing its taxable Indiana income."

2006 and 2007 interest expense

During the 2006 and 2007 tax years, Indiana required taxpayers to add back related party expenses relating to: (1) intangible expenses and (2) directly related intangible interest expenses. An exemption generally exists to the extent that tax avoidance was not the principal purposes of the transaction.

For its 2006 and 2007 tax years, Taxpayer presumably argued that Indiana's addback statute applied and that Taxpayer qualified for the business purpose exemption. The LOF is not clear, but the ruling suggests that the addback statute applied to disallow or add back Taxpayer's related party interest expense.

10% underpayment penalty

Indiana imposes a 10% underpayment penalty unless the failure to pay tax was due to reasonable cause. The LOF found that Taxpayer's treatment of loan interest did not demonstrate reasonable cause.

The takeaway

Indiana's addback provision is limited to intangible expenses and directly related intangible interest expenses. Intangibles are defined as "patents, patent applications, trade names, trademarks, service marks, copyrights, trade secrets, and substantially similar types of intangible assets." There is no separate provision for the addback of interest expenses not related to intangibles like, for example, interest relating to a loan. Indiana taxpayers should be aware that the LOF could be interpreted as supporting that related party interest expenses relating to loans are subject to the addback. Nevertheless, the LOF does support that the Department may disallow intercompany interest expense s using its discretionary authority.

Let's talk

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