

Missouri- Income from trust is nonbusiness income

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In brief

The Missouri Administrative Hearing Commission recently held that interest income and capital gains earned from a taxpayer's investment in a rabbi trust were items of nonbusiness income. Missouri taxpayers should be aware of the decision as a unique example of nonbusiness income. While other Missouri nonbusiness income decisions addressed the sale and liquidation of separate and distinct businesses, *MINACT* found nonbusiness income to exist when the taxpayer had a 'total lack of control' over the source of the income. [*MINACT, Inc. v. Director of Revenue*, Missouri Administrative Hearing Commission, No. 10-1951 RI, 1/28/13]

In detail

Facts and procedural history

During the 2007 tax year, *MINACT, Inc.* (*MINACT*) was a corporation domiciled in Mississippi whose primary function was managing the US Department of Labor's Job Corps Centers located in several states, including Missouri.

MINACT established a nonqualified, unfunded deferred executive compensation plan (Plan) for a group of key managerial and executive employees. The plan allowed for the use of an irrevocable 'rabbi trust,' which was a trust established to fund the Plan for *MINACT*'s employees. Characteristics of the trust included:

- *MINACT* was the grantor of the trust.
- The trustee was a third party bank, independent from *MINACT*, located outside of Missouri.
- *MINACT* had no power to direct the trustee to return or otherwise divert any trust assets.
- *MINACT*'s contributions and any income that the trust earned from such contributions could only be used by the trust to pay trust benefits.

Because the trust was a grantor trust under federal tax law, *MINACT* was required to report the trust's earnings as taxable income. On its 2007 Missouri corporate income tax return, *MINACT* treated interest

income and capital gains generated by the rabbi trust as nonbusiness income allocable to Mississippi. However, the Director of Revenue disallowed *MINACT*'s treatment of the income as nonbusiness income. *MINACT* appealed the decision to the Commission.

Interest income and capital gains generated by trust were nonbusiness income

Consistent with the Uniform Division of Income for Tax Purposes Act (UDITPA), Missouri defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business [transactional test] and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the

taxpayer's regular trade or business operations [functional test]."

In this case, the Commission ruled that the income from the rabbi trust failed the transactional test because MINACT's investment in the trust was not a business transaction in which it regularly engaged. Rather, MINACT's regular business was the management of Job Corps Centers.

Similarly, the income from the rabbi trust failed the functional test because

- MINACT had no involvement in any acquisition, management, or disposition of any trust property or income.
- There was no relevant 'acquisition' involved in the trust.
- The trustee, not MINACT, managed and disposed of trust assets.
- MINACT exercised no control over the trust and could not access the trust corpus or income.
- MINACT's regular business was running the Job Corps Centers.

The Commission distinguished MINACT's facts from that of a similar California Supreme Court case in *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 321 (Cal. 2001). While MINACT's Plan and trust was similar to Hoechst's pension plan, the facts were substantially different due to MINACT's 'total lack of control'

over the operation of the trust. Primarily, Hoechst retained the power to amend or discontinue the pension plan, appoint and replace trustees, administer the pension plans, and determine the right of any person to receive benefits. The Commission found that Hoechst's control and active role over trust operations was indicative of the trust being a business transaction in which Hoechst engaged in the regular course of its business, resulting in any income derived from such trust being business income. Whereas MINACT's total lack of control over the trust supported a finding that the trust was not within its regular course of business.

Accordingly, the Commission held that the income MINACT earned from its investment in a rabbi trust did not constitute business income. The income was properly classified as nonbusiness income allocable to Mississippi, MINACT's commercial domicile.

The takeaway

The Commission provided that MINACT presented a 'case of first impression.' While there appear to be no published Missouri decisions addressing trust income, there certainly are past business/nonbusiness decisions, several of which result in a finding of nonbusiness income. The Missouri Supreme Court held, in 2007's *ABB C-E Nuclear Power, Inc.* decision, that gain from the sale and liquidation of a

subsidiary by its parent in an IRC Sec. 338(h)(10) transaction was nonbusiness income. The sale and liquidation of the subsidiary was a one-time, extraordinary event that did not generate business income under either the transactional test or the functional test because it was not a type of business transaction in which the subsidiary regularly engaged, nor was it a disposition of the sort that constituted an integral part of the subsidiary's ordinary business.

Similarly, *Ensign-Bickford Industries, Inc.*, decided by the Commission in 2011, held that capital gains from the sale of a taxpayer's interest in a commercial explosives business and the interest earned on those capital gains were nonbusiness income for Missouri corporate income tax purposes. The taxpayer was getting out of the commercial explosives business, and the disposition of that business was a one-time extraordinary event, even if it was accomplished through a multi-step, multi-year process.

Taxpayers engaging in a one-time extraordinary sale and liquidation or receiving income similar to MINACT's income from a trust over which it had no control should consider whether a business/nonbusiness analysis would be valuable to determine the amount of income sourced to Missouri.

Let's talk

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