04-100 XXXXXXXXXX

See Reply to Revision Request
IN THE MATTER OF
XXXXXXXXXX
CORPORATE INCOME TAX ASSESSMENT
DOCKET NO. 04-100
ACCOUNT NO. XXXXXXXXXX
01/01/01 THRU 12/31/01
$XXXXXXXXXX
RICK PRUETT, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings & Appeals upon a written protest dated April 28, 2003, signed by XXXXXXXXXX - President, on behalf of XXXXXXXXXX, the Taxpayer. The assessment was made by the Department of Finance and Administration as the result of an audit conducted by Neva Hathaway of the Corporate Income Tax Section of the Office of Income Tax Administration.
The hearing was held on Wednesday, November 12, 2003, at 10:15 A.M. in Little Rock, Arkansas. The Department was represented by Mike Wehrle, Revenue Legal Counsel. Appearing for the Department were Neva Hathaway, Auditor; and Scott Fryer, Audit Supervisor. Appearing for the Taxpayer were XXXXXXXXXX, XXXXXXXXXX – XXXXXXXXXX; and XXXXXXXXXX, Certified Public Accountant – XXXXXXXXXX.

ISSUE

Whether "goodwill" resulting from the sale of an operating division owned by the Taxpayer is apportionable business income? Yes.

FINDINGS OF FACT

The Taxpayer's Prehearing Information Request contained the following summary of information:

> XXXXXXXXXX, the Taxpayer, is in the business of selling air conditioning units and related supplies to commercial and residential customers in the XXXXXXXXXX. In March, 2001, the taxpayer executed a contract for the sale of one of its divisions which comprised the majority of its operating assets. The form of the sale was an asset sale. The contract allocated the purchase price which was disclosed on Form 8594 attached to the federal Form 1120S, and is reported as follows:

Inventories	$ XXXXXXXXXX
Accounts receivables	$ XXXXXXXXXX
Fixed assets	$ XXXXXXXXXX
Prepaid expenses and deposits	$ XXXXXXXXXX
Petty cash	$ XXXXXXXXXX
Goodwill	$ XXXXXXXXXX
Total	$ XXXXXXXXXX

> The sale resulted in $ XXXXXXXXXX in ordinary income from the sale of tangible personal property and $ XXXXXXXXXX in capital gain from the sale of goodwill.

> The gain from the sale of the tangible personal property was treated as "business income" consistent with the definition found in Arkansas Code Section 26-51-701(a) and has been apportioned under the rules found in Arkansas Code 26-51-702. The capital gain from the sale of goodwill was allocated under Arkansas Code Section 26-51-706(c) to the taxpayer's state of commercial domicile, which in this case is XXXXXXXXXX.

The Department's Prehearing Information Requested contained the following information:

> The taxpayer closed its "books" under *IRC* §1377(a)(2) on June 30, 2001. Under *IRC* §1377(a)(2), a corporate income taxpayer is authorized to close its books if it has a shareholder withdraw from its group and a major division of the company (i.e., taxpayer) is sold. The taxpayer resumed business on July 1, 2001, and closed out its books again at the end of the year (December 31, 2001).
>
> The taxpayer asked the Department whether it should file two short period Arkansas returns or one twelve month period Arkansas return. The Department advised the taxpayer to file a single one-year return and apportion its business income to Arkansas using the Arkansas three factor formula. The taxpayer filed its single Arkansas corporation income tax return on May 15, 2002, for the 2001 tax year. The return was filed using the three factors but it included two separate schedules for the two separate short periods noted above. The Department proceeded to adjust the return in the following manner:
>
> 1. The factors and income from the two separate periods were combined into one schedule.
> 2. The taxpayer's apportionable business income was then adjusted to include the $XXXXXXXXXX of goodwill realized from the sale of the division. Exhibit A.
>
> The taxpayer treated the capital gain attributable to the goodwill as non-business income and allocated the gain to XXXXXXXXXX, the state of its commercial domicile. The Department believes that since the sale of the division was a one-time transaction, the $XXXXXXXXXX of goodwill should be apportioned along with the actual gain realized from the sale of the division's assets. There is no Arkansas statutory authority or case law precedent authorizing the splitting of income realized from a single transaction into both business and non-business components.

CONCLUSIONS OF LAW

In order to fairly apportion and allocate income arising from the operation of a multistate business, Arkansas has adopted the Uniform Division of Income For Tax Purposes Act [UDITPA]. Generally, UDITPA is a procedural vehicle by which states can resolve conflicts among themselves and aggrieved taxpayers. Land O'Frost, Inc. v. Pledger, 308 Ark. 208, 823 S.W.2d 887 (1992). UDITPA governs the manner in which the State of Arkansas may impose a corporate income tax on the earnings of a multistate corporation doing business within this state. Pledger v. Getty Oil Exploration Co., 309 Ark. 257, 831 S.W.2d 121 (1992).

"Goodwill" is an intangible asset of a business that is created by favorable factors such as location, product quality, reputation, and managerial skill. "Goodwill" is taxable as part of the gross income that are gains, profits and income arising from the transaction of business within Arkansas. Generally, it is an amount above the book value that a buyer is willing to pay for an asset. This enhanced value to tied to the business or product. While it can be valued for amortization purposes under Internal Revenue Code § 1974 and separately classified for accounting purposes, it is fundamentally derived from the asset being sold.

§ 706 of UDIPTA provides for the allocation of the capital gain or loss from the sale of an intangible to the Taxpayer's commercial domicile. As noted by Scott Fryer in the Department's brief, this section is not determinative of the pending issue as it only has application if the income is determined to be nonbusiness under § 704. So the issue remains whether goodwill is nonbusiness income.
Arkansas law defines the term "business income" and "nonbusiness income" as follows:

> **Ark. Code Ann. § 26-51-701. Definitions.**
>
> As used in this subchapter, unless the context otherwise requires:
>
> (a) "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 regular trade or business operations; [emphasis added]
> ... .
> (e) "Nonbusiness income" means all income other than business income;

From the definition of business income, two [2] traditional tests have evolved. The first test, commonly referred to as a "transactional test" classifies income as business income if it arises from transactions and activity in the regular course of the taxpayer's trade or business. The second test, commonly referred to as a "functional test" classifies income as business income if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations. Satisfaction of either test in the vast majority of states adopting UDITPA is sufficient to render the income apportionable provided the State establishes nexus to both the Taxpayer and the activity which produced the income.

The parties have agreed that that the State of Arkansas has sufficient nexus to tax the sale of the Taxpayer's operating division. Further, the parties agree that the "transactional test" does not apply to this sale. The only issue is whether the requirements of the "functional test" are met.

The Supreme Courts of Tennessee and Kansas have recently considered cases where they applied the functional test. In Union Carbide Corporation v. Huddleston, 854 S.W.2d 87 (Tenn. 1993), the Tennessee Supreme Court stated, in part:

> Other jurisdictions ... have applied what is referred to as the 'functional test,' which focuses on the language stating that 'business earnings' include 'earnings 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.' ... In contrast to the transactional test, **income from the sale of an asset will be considered business income under the functional test if the asset produced business income while it was owned by the taxpayer, regardless of the extraordinary nature or infrequency of the transaction disposing of the property and giving rise to the gain. Therefore, no significance is attached to the fact that a transaction involves a liquidation.** [emphasis added].

In Re Tax Appeal of the Kroger Co., 270 Kan. 148 (2000), the Kansas Supreme Court stated, in part:

> The functional test, rather than focusing on the particular transaction giving rise to the income as required by the transactional test, focuses on the utilization of the property in the business.

> [citation omitted]. **Under the functional test, gain from the sale of property is business income if the property was used in the taxpayer's business operations.** [emphasis added].

Under the Union Carbide Corporation and Kroger rationales, the assets held by the Taxpayer produced apportionable business income in Arkansas prior to their sale. The enhanced value, or goodwill, is derived from those assets and apportionable as business income attributable to that source. The fact that the income may be categorized for tax purposes doesn't make the income severable into business and nonbusiness components.

The sale itself is further evidence the disposition of the property constitutes an integral part of the Taxpayer's business. From the Corporate Income Tax Return, the $XXXXXXXXXX assigned to goodwill is the largest valuation of any listed asset. Of the total $XXXXXXXXXX sale, 37.28% is for goodwill. There is ample evidence from these figures that the prior acquisition and management of the business assets operationally related to the enhanced value paid for the business. In summary, the Department was correct in determining that the "goodwill" was business income subject to apportionment.

DECISION AND ORDER

The assessment of tax and interest are sustained. The file is to be returned to the appropriate section of the Department of Finance and Administration for further proceedings in accordance with this Administrative Decision and applicable law. Pursuant to Ark. Code Ann. § 26-18-405 (Repl. 1997), unless the Taxpayer requests in writing within twenty (20) days of the mailing of this decision that the Commissioner of Revenue revise the decision of the Administrative Law Judge, this Administrative Decision shall be effective and become the action of the agency. The revision request may be mailed to the Assistant Commissioner of Revenue - Policy & Legal, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. The Commissioner, within twenty (20) days of the mailing of this Administrative Decision, may revise the decision regardless of whether the Taxpayer has requested a revision. A Taxpayer may seek relief from the final decision of the Administrative Law Judge or the Commissioner of Revenue on a final assessment of a tax deficiency by following the procedure set forth in § 26-18-406.

OFFICE OF HEARINGS & APPEALS
RICK L. PRUETT
ADMINISTRATIVE LAW JUDGE
DATED: March 17, 2004

Reply to Revision Request

October 5, 2004

XXXXXXXXXX
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XXXXXXXXXX
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RE: IN THE MATTER OF: XXXXXXXXXX
Docket 04-100
Revision Request

Dear XXXXXXXXXX:

This letter is in response to your request for a revision of the administrative decision entered in this matter on March 17, 2004. The administrative decision sustained the Corporation Income Tax Section's assessment of corporate income tax in the amount of $ XXXXXXXXXX.

Facts

A review of the facts indicates that in March of 2001 the taxpayer, XXXXXXXXXX, executed a contract for the sale of one of its divisions. The division was sold for $ XXXXXXXXXX, of which $XXXXXXXXXX was attributable to the division's "goodwill." The taxpayer closed its accounting books under *IRC* §1377(a)(2) on June 30, 2001. Under *IRC* §1377(a)(2), a corporate income taxpayer is authorized to close its books if it has a shareholder withdraw from its group and a major division of the corporation is sold. The taxpayer resumed business on July 1, 2001, and closed out its books again at the end of the year on December 31, 2001. The taxpayer asked the Department whether it should file two short period Arkansas returns or one twelve month period Arkansas return. The Department advised the taxpayer to file a single twelve month period return and apportion its business income to Arkansas using the Arkansas three-factor formula.

The taxpayer filed its single Arkansas corporation income tax return on May 15, 2002, for the 2001 tax year. The return was filed using the three factors but it included two separate schedules for the two separate short periods noted above. The Department proceeded to adjust the return by combining the factors and income from the two separate periods into one schedule. The taxpayer's apportionable business income was then adjusted to include the $XXXXXXXXXX of goodwill realized from the sale of the division. The taxpayer had treated the capital gain attributable to the goodwill as non-business income and allocated the gain to XXXXXXXXXX, the state of its commercial domicile. The Department determined that since the sale of the division was a one-time transaction, the $XXXXXXXXXX of goodwill should have been apportioned along with the actual gain realized from the sale of the division's assets. The taxpayer cited no Arkansas statutory authority or case law precedent authorizing the splitting of income realized from a single transaction into both business and non-business components. The Department therefore issued a Notice of Proposed Assessment to the taxpayer of corporation income tax in the amount of $XXXXXXXXXX on April 1, 2003.

Issues

I. Is the $XXXXXXXXXX of capital gain associated with the goodwill of a division that was sold by the taxpayer apportionable business income?

II. If the $XXXXXXXXXX of capital gain associated with the goodwill is determined to be apportionable business income, should the gain attributable to the goodwill be included in the denominator of the taxpayer's Arkansas sales factor?

Analysis

Issue I

As noted above, the issue in this case is whether or not the capital gain attributable to the goodwill of a division is business or non-business income. The Department's position on this issue is twofold: First, the proceeds from the sale of the taxpayer's division should not be separated into proceeds attributable to real and tangible personal property on the one hand and proceeds attributable to the intangible goodwill on the other for the purpose of determining business income. Secondly, if the sale is nevertheless divided into two categories, the goodwill proceeds should still be classified as business income because the sale satisfies the requirements of the "functional" multi-state income test.

With regard to the Department's first position, the sale of a division can be structured to include as many classes of assets as the parties to the transaction agree to. The sale of a division may take place in a single transaction or a series of transactions. However, it is not proper to divide the income from the sale of a single business segment into separate components resulting in favorable "non-business" income status for a part of the single transaction. The sale of the taxpayer's division should be either entirely business income or entirely non-business income.

With regard to the Department's second position, the taxpayer claims the goodwill was not an integral part of its trade or business operations. The taxpayer notes that the sale of the division is the only such sale in the taxpayer's 35 year history. Because the sale of the division was a unique, one-time occurrence, the sale does not satisfy the multi-state income "transactional" test. However, the sale of goodwill does satisfy the "functional" test. The functional test does not look at the frequency or regularity of transactions. Frequency or regularity of a certain type of transaction falls within the scope of the transactional test. The purpose of the functional test is to determine the extent of a taxpayer's utilization of certain property that is being sold. If the property serves only an investment function, the gain realized upon the sale of such property does not meet the functional test and is therefore non-business income. On the other hand, if the property being sold had an operational function while in the hands of a taxpayer, the property satisfies the functional test and the gain is therefore business income. Generally speaking, most activities of a business enterprise will affect its goodwill and goodwill is utilized each day a business operates. Because the intangible goodwill that was sold in this case constituted an integral part of the taxpayer's regular trade or business operations and served an operational rather than an investment function, the capital gain income attributable to the goodwill therefore satisfies the functional test. *Corporation Income Tax Regulation 1998-1*, §2.26-51-701, states that:

> **[g]ain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property, while owned by the taxpayer, was used in the taxpayer's trade or business.** However, if the property was utilized for the production of non-business income before its sale, exchange or other disposition, the gain or loss will constitute non-business income. (emphasis added)

The division's goodwill was utilized in the taxpayer's business in the production of business income. Therefore, the capital gain realized on the sale of the goodwill should be considered apportionable business income.

Issue II

The taxpayer argues that if the capital gain realized on the sale of the goodwill is business income (because it satisfies the functional test by constituting an integral part of the taxpayer's regular trade or business operations), then the gain must be included in the denominator of the taxpayer's Arkansas sales factor for the same reason. The taxpayer also notes that under Ark. Code Ann. §26-51-715, the sales factor denominator is to include the total sales from everywhere during the tax year in question. The taxpayer reasons that since the goodwill capital gain was a portion of its total sales from everywhere, the gain should therefore be included in its sales factor denominator.

Two Corporate Income Tax Regulations, §1.26-51-715 and §2.26-51-715, are brought into play under these circumstances. These regulations, which address what "sales" should be included and excluded from the sales factor, were adopted in the manner required by Arkansas law including a review and approval by the Arkansas General Assembly. The goodwill capital gain must be excluded from the denominator of the taxpayer's sales factor for two reasons. First, the proceeds attributable to the sale of a division are not proceeds from the sale of goods or products sold to the taxpayer's customers in the ordinary course of its trade or business. Under *Regulation* §1.26-51-715(l), for a taxpayer such as XXXXXXXXXX engaged in the business of manufacturing goods, the term "sales" includes all gross receipts from the sale of such goods or products held by a taxpayer primarily for sale to customers in the ordinary course of its trade or business. Secondly, the goodwill is intangible in nature and the $XXXXXXXXXX of capital gain is not readily attributable to any particular income producing activities of the taxpayer. Under *Regulation* §2.26-51-715, where business income from intangible property cannot readily be attributed to any particular income producing activity of a taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. Goodwill proceeds are not the same as proceeds derived from the sale of manufactured goods. Goodwill is not attributable to any particular income producing activity. Consequently, the goodwill capital gain proceeds must be excluded from the denominator of the taxpayer's Arkansas sales factor under *Regulation* §2.26-51-715.

Conclusion

The administrative decision is sustained. This letter concludes your administrative remedies. If you wish to pursue this matter in circuit court, you should refer to the procedures for judicial relief set forth in Ark. Code Ann. §26-18-406.

Sincerely,

Tim Leathers
Commissioner of Revenue