

## Contents

Chapter 8: Business and Nonbusiness Earnings.....	128
Introduction .....	128
1. Allocation Methodology for Nonbusiness Earnings.....	129
2. Audit Adjustments when Nonbusiness Earnings are Reclassified.....	131
Business Earnings .....	131
1. Transactional and Functional Tests.....	132
2. Rule 23 – Business and Nonbusiness Earnings .....	134
Nonbusiness Earnings .....	138
1. Nonbusiness Earnings Examples.....	138
2. Expenses Related to Nonbusiness Earnings .....	139
Tax Impact of Earnings Classification .....	139
Unitary Earnings .....	140
1. Legal Analysis .....	141
2. Example – Nonunitary Business .....	143
Litigation – Unitary Business Principle .....	143
1. Finding: Nonunitary.....	143
2. Finding: Unitary Business Earnings .....	144
Audit Procedures.....	146

## Chapter 8: Business and Nonbusiness Earnings

### Introduction

The classification of income, receipts, or earnings as “business earnings” or “nonbusiness earnings” is unique to state taxation. Generally, this classification is only important when a taxpayer has multi-state operations. If there are no out-of-state operations, all earnings are classified as business earnings and are fully taxable. However, if there are out-of-state operations (with a “right to apportion”), income classified as business earnings is subject to apportionment and income classified as nonbusiness earnings is subject to direct allocation.<sup>1</sup> Directly allocated earnings are fully-taxable to the state the nonbusiness earnings are attributed. (See Chapter 14 on Apportionment and the section below on allocation.)

Business earnings apportioned to Tennessee and nonbusiness earnings that are directly allocated to Tennessee are subject to the 6.5% excise tax. Nonbusiness earnings are reported on Schedule M – Nonbusiness Earnings Allocation – and are either designated as being directly allocated to Tennessee or not. All business and nonbusiness earnings are included in adjusted federal income (loss) reported on Schedule J, Line 1 – Computation of Net Earnings Subject to Excise Tax. Nonbusiness earnings that are not allocated to Tennessee are removed from the excise tax base by an entry on Schedule J, Line 21, which is derived from the taxpayer’s entry on Schedule M, Line 8.

It is incorrect to conclude that business earnings are always subject to the excise tax and nonbusiness earnings are not. Business earnings that are not unitary to a taxpayer’s business activity within the state are not subject to the excise tax. However, nonbusiness earnings could be allocated 100% to Tennessee and, thus, be fully subject to the excise tax. A brief definition of business and nonbusiness earnings follows, but also see the sections on “business,” “nonbusiness,” and “unitary.”

Business earnings are:

- Earned from an activity that is in the regular course of business (transactional test) or related to the acquisition, use, management, or disposition of property that is integral to the taxpayer’s regular trade or business (functional test); and
- Unitary to the taxpayer’s business activity within the state.

Nonbusiness earnings are:

- All earnings other than business earnings.

### 1. Allocation Methodology for Nonbusiness Earnings

Direct allocation is a multi-state taxation method that attempts to tax nonbusiness earnings in the appropriate state. For example, nonbusiness rental income less expenses would be directly allocated to the state where the property is located. Nonbusiness earnings are directly allocated to Tennessee or another state in their entirety.

Allocation is based on the nature of the item or asset generating the income. One should use the following guidance to properly allocate nonbusiness earnings when reported.

If the income is from real or tangible property, the nonbusiness earnings are allocated to the situs or location of that property.

- Rents and Royalties from Real Property Allocated to Tennessee<sup>2</sup>
  - Net rents and royalties from tangible personal property are allocable to Tennessee if and *to the extent that the property is utilized* in this state. If the taxpayer's commercial domicile is Tennessee and the taxpayer is not organized under the laws of or taxable in the state where the property is utilized, then the entire earnings are allocated to Tennessee.
  - The extent of utilization of tangible personal property in Tennessee is determined by multiplying the rents and royalties by a fraction.
    - The numerator is the number of days the property is physically located in the state during the rental or royalty period in the tax year.
    - The denominator is the number of days the property is physically located out of the state (everywhere) during all rental or royalty periods in the tax year.
  - If a taxpayer cannot substantiate or ascertain the physical location of the property during a rental or royalty period - the tangible personal property is considered utilized in Tennessee if the property was located in Tennessee at the time the rental or royalty payer obtained possession.
- Capital Gains and Losses Allocated to Tennessee<sup>3</sup>

- Capital gains and losses from sales of *real property* located in Tennessee are allocable to this state. Also, capital gains and losses from sales of *tangible personal property* are allocable to Tennessee, if:
  - The property was located in this state at the time of the sale; or
  - The taxpayer's commercial domicile is in Tennessee and the taxpayer is not taxable in the state in which the property had a situs.
- Capital gains and losses from sales of *intangible personal property* are allocable to Tennessee if the taxpayer's commercial domicile is in Tennessee.
  - Commercial domicile<sup>4</sup> is the location where the main overall operations of the company are directed and managed, which is generally the headquarters location of the company.
- Interest and Dividends Allocated to Tennessee<sup>5</sup>
  - Interest and dividends are allocable to Tennessee if the taxpayer's commercial domicile is in Tennessee.
- Patent and Copyright Royalties Allocated to Tennessee<sup>6</sup>
  - Patent and copyright royalties are allocable to Tennessee if, and to the extent, the patent or copyright is *utilized* by the payer in Tennessee or in a state where the taxpayer is not subject to tax and the taxpayer's commercial domicile is in Tennessee.
    - A patent is *utilized* in Tennessee to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states, or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state where the taxpayer is commercial domiciled.

- A copyright is *utilized* in Tennessee to the extent printing or other publications originate in Tennessee. If the basis of receipts from copyright royalties does not permit allocation to states, or if the accounting procedures do not reflect states of utilization, the copyright is utilized in Tennessee if the taxpayer is commercially domiciled in Tennessee.

## 2. Audit Adjustments when Nonbusiness Earnings are Reclassified

Nonbusiness receipts are reported and allocated on Schedule M and excluded from the standard apportionment schedule (Schedule N). Also, any property and payroll costs involved in the production of the nonbusiness earnings are properly excluded from Schedule N.

A common taxpayer error is reporting income as nonbusiness earnings when such income is unitary and meets the transactional or functional test. When this happens, audit adjustments are generally made to Schedules M, J, and N. This may result in a change to the franchise and excise tax liability for the tax year under examination. See the section Audit Procedures below for the specific audit adjustments when nonbusiness earnings are reclassified as business earnings.

**⚠ An audit reclassification of nonbusiness earnings to business earnings will generally cause a change in the apportionment ratio if the taxpayer has reported them as nonbusiness earnings for apportionment purposes. Changes to the ratio will impact both the franchise and excise tax.**

## Business Earnings

For Tennessee excise tax purposes, the term “business earnings” is defined as:<sup>7</sup>

- Earnings arising from transactions and activity in the regular course of the taxpayer’s trade or business or earnings from tangible and intangible property, if the acquisition, use, management, or disposition of the property constitutes an integral part of the taxpayer’s regular trade or business operations.

Essentially, earnings that arise from the conduct of the trade(s) or business operations of a taxpayer are business earnings and the taxpayer must show by clear and cogent evidence that

particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one regular trade or business in determining whether income is business earnings.

Because of this broad definition and because a taxpayer can have more than one trade or business, most income will be considered business earnings. The intent of the definition is that all earnings are considered business earnings unless clearly shown to be nonbusiness earnings.

**⚠ The default audit position is that all earnings are business earnings until proven otherwise.**

### 1. Transactional and Functional Tests

There are two different ways to determine if an item is business earnings.<sup>8</sup> The first way is commonly called the **transactional test**, which applies to:

- Earnings arising from transactions and activity in the regular course of the taxpayer's business. For example:
  - Earnings from the sale of inventory or interest earned on the business' checking account would fall into this category.
- A major consideration is whether the transaction is frequent in nature, as opposed to being a rare or extraordinary event.

A transaction that does not meet the transactional test may be business earnings if it meets the **functional test**. The functional test applies to:

- Earnings from tangible and intangible property, if the acquisition, management or disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
- Under this test, the asset generating the income is evaluated to see if it functions as a business asset. If it does, then the sale of the asset produces business earnings. For example:
  - A retail store that is in the business of selling clothes sells all its old store furnishings and fixtures.

- Because the furnishings functioned as a business asset, any gain from the sale of the furnishings would result in business earnings under the functional test.
- The functional test looks at the relationship between the underlying income-producing asset and the taxpayer's regular trade or business. If the underlying asset is integral, as opposed to incidental, to the taxpayer's business operations the functional test is met.

### *Example – Transactional Test*

The taxpayer in this example is a large company based outside the state. It has interest income from the investment of working capital generated by business operations. The taxpayer is not in the business of investing, and the investments are not managed or connected to Tennessee.

The transactional test shows that the investment interest income *is business earnings*:

- The interest income came from business operations.
- The account was occasionally used to fund business operations.

This example emphasizes that under the transactional test the income from the investment of working capital would be considered business earnings.

### *Example – Functional Test*

The taxpayer in this example was based and domiciled outside the state and sold intangible property to Tennessee customers (club memberships) before filing a final return. The corporation did not have any assets or employees based in the state. It sold its operations and assets to an unrelated entity and reported a gain for federal income tax purposes. The final franchise and excise tax return reported the gain as apportionable business earnings. This one-time sales transaction was not part of the taxpayer's regular business activities, but it met the functional test.

The functional test shows that the gain was business earnings because:

- The assets sold were used in the business.

- Even though a partial or complete liquidation is a one-time event, if the asset being sold is considered a business asset, then the income from the sale is business earnings.

## 2. Rule 23 – Business and Nonbusiness Earnings

TENN. COMP. R. & REGS. 1320-06-01-.23 (“Rule 23”) emphasizes that labels (e.g., manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income) do not determine whether income is business or nonbusiness earnings. Income of any type or class and from any source is business earnings if it arises from transactions and activity occurring in the regular course of trade or business.

Accordingly, the critical element in classifying earnings is to identify the transactions and activities that are elemental to a trade or business. Generally, all a taxpayer’s transactions and activities that are dependent on, or contribute to, the operations of its economic enterprise will constitute the taxpayer’s trade or business. Furthermore, the transactions and activities will be arising in the regular course of a trade or business and will constitute integral parts of a trade or business.

The following examples of business earnings are grouped by type of income – rents, gains or losses from sales of assets, interest, dividends, and patent and copyright royalties. (See the Nonbusiness Earnings section in this manual for an example of nonbusiness earnings.)

### *Rental Income*

- Rental income is business income if the taxpayer used the rental property in its trade or business or if the rental income from the use or management of the property constitutes an integral part of the taxpayer’s regular trade or business operations. For example:
  - The taxpayer operates a multi-state car rental business. The income from car rentals is business earnings.
  - The taxpayer is engaged in the heavy construction business where it uses equipment such as cranes, tractors, and earthmoving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business earnings.



- The taxpayer constructed a plant for use in its multi-state manufacturing business. 20 years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold 18 months later. The rental income is business income and the gain on the sale of the plant is business earnings.

### *Gain or Loss from Sale of Real, Tangible, or Intangible Property*

- Generally, gain or loss from the sale, exchange, or other disposition of real property or tangible or intangible personal property constitutes business earnings if the property, while owned by the taxpayer, was used in the taxpayer's trade or business operations, or if the income from the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. The gain from the sale of assets that functioned as business assets will result in business earnings under the functional test. For example:
  - In conducting its multi-state manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business earnings.
  - The taxpayer constructed a plant for use in its multi-state manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business earnings.
  - Same as the previous example, except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business earnings.
  - Same as the previous example, except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business earnings.

### *Interest Income*

- Interest income is derived from an intangible asset, such as a certificate of deposit or a note receivable. Interest is business earnings when the related intangible was created in the regular course of the taxpayer's trade or business operations or when income from the use or management of the intangible constitutes an integral part of the taxpayer's regular trade or business operations. For example:

- The taxpayer operates a multi-state chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business earnings.
- The taxpayer conducts a multi-state manufacturing business. During the year, the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bore interest. The interest income is business earnings.
- The taxpayer is engaged in a multi-state manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as workmen's compensation claims, rain and storm damage, machinery replacement, etc. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state and local tax obligations. The interest income is business earnings.
- The taxpayer is engaged in a multi-state money order and traveler's checks business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business earnings.

### *Dividends*

- Dividends from stock are business earnings if the stock arises out of or was acquired in the regular course of the taxpayer's trade or business operations or if the dividend income from the use or management of the stock constitutes an integral part of the taxpayer's regular trade or business operations. For example:
  - The taxpayer operates a multi-state chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock it owns. The dividends are business earnings.
  - The taxpayer is engaged in a multi-state manufacturing and wholesaling business. In connection with that business the taxpayer maintains special

accounts to cover such items as workmen's compensation claims, etc. A portion of the moneys in those accounts is invested in interest bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business earnings.

- The taxpayer and several unrelated corporations own all the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayers acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business earnings.
- The taxpayer is engaged in a multi-state heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and marketable securities) to current liabilities. To maintain an adequate bonding capacity, the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business earnings.
- The taxpayer received dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business earnings.

### *Royalties*

- Patent and copyright royalties are business income if the patent or copyright arises out of or was created in the regular course of the taxpayer's trade or business operations or if the royalty income from the use or management of the patent or copyright constitutes an integral part of the taxpayer's regular trade or business operations. For example:
  - The taxpayer is engaged in the multi-state business of manufacturing and selling industrial chemicals. In connection with that business the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The taxpayer's royalties are business earnings.
  - The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing

company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business earnings.

## Nonbusiness Earnings

Nonbusiness earnings are defined as all earnings other than business earnings.<sup>9</sup> In the case of an audit, the auditor will presume all income is business earnings. The auditor will, however, provide the taxpayer with ample opportunity to explain, using clear and cogent evidence, why certain income is properly classified as nonbusiness earnings.

Taxpayers, therefore, should strongly consider all earnings to be business earnings until they can establish otherwise.

**⚠ Taxpayers claiming nonbusiness earnings should maintain detailed records substantiating the salient facts in the event they are audited.**

See the Introduction section at the beginning of this chapter for a discussion on the allocation methodology used for nonbusiness earnings.

### 1. Nonbusiness Earnings Examples

#### *Rule 23 Provides One Example of Nonbusiness Earnings*

- The taxpayer is a heavy machinery manufacturer. It enters a multi-million-dollar deal to acquire the manufacturing assets of another similar business. As a result of the acquisition, the taxpayer becomes the owner of a small roadside market in Tennessee. The market is leased by a third-party lessee for \$1,000 per month. The taxpayer acquired the assets of the other company solely to expand its manufacturing operations. It had never operated the market and has no intent to engage in the business of leasing commercial real estate. The Taxpayer does not own any other similar property that it leases to others. The taxpayer intends to sell the market as soon as the current lease expires. The rental income from the market is *de minimis* in relation to the income derived from the taxpayer's manufacturing operations.
  - Under these circumstances, the rental income is nonbusiness earnings. The taxpayer would exclude the market from the property factor for purposes of the apportionment formula and would not claim the expenses relative to the market as business expenses.

There are many indicators in the above example evidencing that the rents did not rise to the level of a second line of business. Therefore, the earnings in this example fail the transactional test and cannot be classified as business earnings. If the rents are not business earnings, then by definition, they are classified as nonbusiness earnings and are reported on Schedule M.

## 2. Expenses Related to Nonbusiness Earnings

When nonbusiness earnings are properly reported on Schedule M, the related expenses must also be reported. For example, if a taxpayer has nonbusiness rental income, then all the expenses related to that property, such as insurance, depreciation, repairs, taxes, etc., would be nonbusiness-related expenses. Generally, in the absence of specifically identifiable expenses, it is assumed the related expenses are 5% of the nonbusiness earnings. However, in the case of nonbusiness *rental* earnings, in the absence of actual identifiable related expenses, it is assumed that related rental expenses are 50% of such nonbusiness earnings.<sup>10</sup>

Expenses related to nonbusiness income are netted against the income and in some instances, may exceed the income and result in a loss. For example, rental properties that become vacant and generate no rental income would still incur expenses. A nonbusiness loss would, in effect, be an add-back to the excise tax base, where nonbusiness earnings are a deduction. Both the income and expense items are first reported on Schedule M and then the net amounts are reported on Schedule J.

## Tax Impact of Earnings Classification

How earnings are classified (business/nonbusiness) may have a large impact on the excise tax computed. The example below demonstrates the difference between a gain being classified as business or nonbusiness earnings. Assume an out-of-state taxpayer sold a tangible asset for a gain of \$3,500,000. The chart shows the tax impact of treating the gain as business versus nonbusiness when all of the gain was allocated to a state other than Tennessee.

Excise Tax Calculation	Business	Nonbusiness
Federal income or loss	\$5,000,000	\$5,000,000
<i>Less: Nonbusiness earnings</i>	-0-	(\$3,500,000)
Total Business Income – ( <i>sum of above</i> )	\$5,000,000	\$1,500,000
Apportionment Ratio (nonbusiness receipts are excluded from the apportionment factor)	45%	50%
Apportioned business income	\$2,250,000	\$750,000

Add: nonbusiness earnings directly allocated to Tennessee	n/a	-0-**
Excise tax base subject to tax	\$2,250,000	\$750,000
Excise tax 6.5% of tax base	\$146,250	\$48,750
** The nonbusiness earnings were allocated to a state other than Tennessee		

As demonstrated above, the excise tax is much greater if the out-of-state taxpayer classifies the gain as apportionable business earnings. There is less excise tax when the sale is classified as nonbusiness; the gain is removed from the apportionable excise tax base and allocated to a state other than Tennessee. No tax is computed on the nonbusiness gain because, in this example, it is allocated 100% to another state.

The apportionment ratio shown above is less when the \$3,500,000 gain is classified as business earnings. The apportionment ratio compares Tennessee receipts to everywhere receipts. In this case, the gain is included in the denominator of the receipts factor, but the numerator will reflect zero assuming the receipt is sourced to a state other than Tennessee. Nonbusiness earnings are allocated and not apportioned; so, they are never in the apportionment ratio.<sup>11</sup>

Multi-state taxpayers occasionally report nonbusiness earnings in error. Nonbusiness earnings are unusual, so taxpayers should be prepared to provide detailed documentation to support the nonbusiness classification. It is logical that if earnings were fully allocated to another state, the taxpayer would have paid an income tax in that other state. The other state's treatment of the income may support the taxpayer's classification choice, but it is not definitive in determining the classification for Tennessee excise tax purposes. See the section on Audit Procedures at the end of this chapter for more information.

**⚠ Business earnings are apportioned if a taxpayer is doing business and has substantial nexus both inside and outside of Tennessee.**

## Unitary Earnings

Business earnings, under the transactional and/or functional test, must also be unitary with operations in Tennessee to be subject to Tennessee excise tax. Earnings that are not unitary with the state can be removed or deducted from the tax base as nonbusiness earnings. The term "unitary," as it is used in this context, is not defined in the code or rules.<sup>12</sup> However, a business is unitary when the operation of one of its components or divisions depends upon and contributes to the operation of its other components. A business' activities and income would be

unitary with its Tennessee operations if they have a sufficient connection to or relationship with the business activities within Tennessee to subject them to Tennessee's tax.

The U.S. Constitutional argument is that Tennessee cannot tax earnings related to operations having no connection or relationship with the state. See the Commerce Clause and Due Process Clause discussion in Chapter 3 on Nexus.

Essentially, the Constitution prohibits a state from taxing income that cannot be attributed to the corporation's activities within the state. Income is apportionable if the business' operations within the state contribute to or benefit from the corporation's unitary business.

Tennessee's method of taxing interstate business does not isolate the intrastate income-producing activities from the rest of the business, but instead taxes an apportioned sum of the entity's multistate business if the business is unitary. Tennessee's apportionment method has been found to be constitutional. However, taxpayers may conclude that their intrastate and out-of-state activities (in whole or part) do not form part of a single unitary business that is apportionable for excise tax.

Earnings that are not unitary with the taxpayer's Tennessee operations should be reported as nonbusiness earnings on Schedule M.

**⚠ Apportionable business income must be both: 1) business earnings (transactional or functional tests); and 2) unitary to in-state operations.**

## **1. Legal Analysis**

Courts have ruled that there is no single controlling factor, but rather all factors should be examined in combination, to determine whether income is unitary with the activity of the taxpaying entity in the state. Any reasonable connection to in-state operations would establish a unitary relationship of the income. The courts have used three methods to help make this determination:

- Three Unities Test;
- Contribution or Dependency Test; and
- Factors of Profitability Test.

### *Three Unities Test*

This test concludes that a unitary relationship is established if there is unity of ownership, unity of operation, and unity of use between in-state and out-of-state operations.

- *Unity of Ownership* – common control between entities.
  - Control is generally evidenced by ownership between entities in excess of 50%, but it also can be demonstrated through constructive or tiered ownership, whereby an entity has significant influence.
- *Unity of Operation* – the performance of certain functions by one entity on behalf of the entire group.
  - Unitary operations are evidenced by central purchasing, advertising, or management; common training; intercompany financing; common personnel such as attorneys, accountants, etc.; common insurance; common use of facilities, etc.
- *Unity of Use* – a centralized executive force and general system of operation.
  - Demonstrated by major policy decisions, central management, intercompany services, and overlapping officers and directors.

### *Contribution or Dependency Test*

This test focuses on whether business done within the state is dependent on or contributes to business outside the state.

- This test can be met under a concept known as flow-of-value through financial arrangements, exchange of materials or expertise, etc.

### *Factors of Profitability Test*

Under this test, the functional integration of assets, centralization of management, and economies of scale, and whether the business components under consideration contribute to each other and the business as a whole, would provide evidence of a unitary relationship.



- Indications that this test is met include product flow between affiliates, centralized functions of operation such as purchasing, manufacturing, and financing, and interaction of personnel at upper management levels and approval for major policy decisions.

**⚠ “Unitary business” or “unitary group,” as defined in the code, apply specifically to financial institutions filing a combined return (Form FAE174) with a unitary group. This definition does not apply to the taxation of income under the unitary principle. Tenn. Code Ann. § 67-4-2004(52) should not be cited in nonbusiness or nonunitary discussions.**

## 2. Example – Nonunitary Business

An entity with an investment portfolio had unaffiliated money managers who manage its excess funds. These funds were not derived from working capital, and the proceeds were not used in the business to fund operations or as working capital. The independent investment managers had control to make investment decisions. None of the investment activity related to, or took place in, Tennessee. Under these circumstances, the investment income is considered nonbusiness earnings and is non-allocable to Tennessee.

Note, however, that this determination is based on a very specific fact pattern and auditors will gather and examine all the relevant facts each time they are confronted with a unitary vs. nonunitary decision. Note also, that courts have held one division or component of a taxpayer’s business may “add to the riches” of that entity and yet remain a “discrete business enterprise” whose earnings are nonunitary.<sup>13</sup>

## Litigation – Unitary Business Principle

Courts have frequently addressed both the nonunitary principle and the assertion that earnings are nonbusiness under the transactional and functional tests. Following are summaries of several court cases decided on the unitary/nonunitary issue. These cases demonstrate the importance of making an evaluation based on all available documents and pertinent facts.

### 1. Finding: Nonunitary

Below are three Tennessee cases where the courts found that certain earnings were nonunitary.

- In the *Louis Dreyfus Corp.* case,<sup>14</sup> the taxpayer had a distinct division located outside of the state that earned interest income. This division had no operational connection to the

taxpayer's regular agricultural commodity business in Tennessee. The court held that the interest income earned by the out-of-state division was not taxable in Tennessee, because there was no unitary connection of money, operations, and management to the commodity business. Therefore, even though under the functional test the interest income was business earnings, it was not taxable since it was nonunitary.

- In the *L.M. Berry & Co.* case,<sup>15</sup> the taxpayer had dividend income from less-than-80% owned foreign subsidiaries. Although the subsidiaries conducted a similar line of business as the taxpayer, the court held that there was not a unitary connection between the foreign subsidiaries and the Tennessee operations of the taxpayer. The court listed over 20 facts that indicated there was no operational or otherwise connection to the state or U.S. operations.
- In the *Siegel-Robert, Inc.* case,<sup>16</sup> the taxpayer had interest income earned on investment funds that was not needed for operational purposes. The investments were in Treasury securities that were either reinvested or held to potentially acquire other businesses. The taxpayer asserted that the investment income was nonbusiness, and that its investment activities were conducted entirely outside of the state and not unitary with Tennessee. The court agreed with the taxpayer. While it appeared that the use of the investment proceeds to acquire other businesses served an operational purpose, it was never established. For the years at issue, there was never any business acquisition or use of investment proceeds that had any relation or connection to the taxpayer's in-state operations.
  - Note, this case is very fact specific and does not set a specific precedent. Rarely will interest income be nonunitary. Auditors will evaluate very closely the facts of a taxpayer under audit when their facts are like the very specific facts of this case.

## 2. Finding: Unitary Business Earnings

Below are three Tennessee court cases that found earnings to be unitary.

- In the *Newell Window Furnishing, Inc.* case,<sup>17</sup> the taxpayer reported a gain as nonbusiness earnings and claimed it was nonunitary. As a corporation doing business in the state, the taxpayer was required to pay an excise tax on the amount of income it reported for federal income tax purposes. The corporation had made an election for federal purposes to treat the sale of its stock as an asset sale under IRC § 338(h)(10). Corporations typically make this election for federal purposes so that the purchaser of

the business can apply the full purchase price as the new basis for assets and write-off the price with depreciation expense in future years. However, by making this election, the seller has a taxable gain on those assets. The court held that the gain was business earnings under the functional test and that the sale and income was unitary with Tennessee.

- In the case of *Blue Bell Creameries, LP*,<sup>18</sup> the taxpayer acquired and sold the stock of its holding company in the context of a reorganization of the business entities within the unitary business for a \$120,000,000 gain. The taxpayer claimed the gain as nonbusiness earnings because it was from a one-time extraordinary transaction, the sale of stock of the holding company. The Tennessee Supreme Court concluded that although the gain was not business earnings under the transactional test, it was business earnings based on the functional test from the statutory definition of business earnings. The court stated that the functional test does not look at whether the disposition is a regular part of the taxpayer's business, but whether the asset being disposed of constitutes an integral part of the taxpayer's regular business. The acquisition and sale of stock was a necessary step in the corporate reorganization of the business entities which all profit from the overall business. The stock transaction helped accomplish a reduction of expenses for the business and increased the net earnings of the overall business. Therefore, the stock sale helped contribute to the production of regular earnings from the sale of the taxpayer's normal business products.
  - The taxpayer also advanced a constitutional argument based on the unitary principle. The taxpayer did not prevail on that argument since the taxpayer's acquisition and disposition of stock was part of an overall plan of reorganization that the taxpayer helped accomplish by selling the stock. Therefore, the court concluded that the taxpayer and the holding company were not discrete separate business enterprises, but that they were connected, or unitary, as they engaged in a stock transaction to reorganize the business to maximize its regular business profits.
- In the case of *H.J. Heinz Co., LP*,<sup>19</sup> the taxpayer deducted dividend income from a wholly-owned investment company, HJH One, LLC, as nonbusiness earnings. The investment company owned preferred shares of stock in the taxpayer. The taxpayer treated the dividends as nonbusiness because it was merely passive investment income. The court, citing *Blue Bell*, held that the dividend income was integral to the taxpayer's regular business because the stock served an operational rather than an investment function, which allowed the taxpayer's business operations to prosper.

- The taxpayer also advanced a constitutional argument based on the unitary principle. The court noted that a 2001 reorganization was undertaken to benefit the entire Heinz group. HJH One, LLC came into existence as part of that reorganization and conducted no business except to receive dividends in the Heinz Co. stock. HJH One, LLC distributed this dividend income to the taxpayer in the form of partnership investment income. The court concluded that taxation of the dividend income that the taxpayer received from HJH One, LLC was constitutional because the taxpayer's ownership of HJH One, LLC served an operational function.

## Audit Procedures

Auditors will reclassify nonbusiness/nonunitary earnings reported by the taxpayer to business earnings unless the taxpayer can show by clear and cogent evidence that particular earnings should remain classified as nonbusiness earnings. Auditors will not reclassify business earnings to nonbusiness/nonunitary earnings unless clear and cogent evidence exists.

If income is reported as nonbusiness/nonunitary earnings, the auditors will request:

- A written, detailed explanation of the circumstances of the income that includes:
  - Source of the earnings
  - The nature of the income (interest, gain, etc.)
  - The nature of the asset that generated the earnings and its connection to the business
  - A description of pertinent activities, relationships, locations and dates
  - The names and pertinent business activities of other entities that were a party to the transaction and their relationship with the taxpayer
  - Ownership percentages of affiliates (if applicable)
  - How the amount was calculated
  - If the income was segregated from the taxpayer's working capital
- Copies of documents that support the taxpayer's narrative.
  - Depending on the situation, this may include financial statements, detailed tax and accounting records, bank and brokerage statements, contracts, purchase/sale agreements, board minutes, state and federal tax returns and reports.

Auditors will evaluate the above information in relation to Tenn. Code Ann. §§ 67-4-2004(4) and (33), and TENN. COMP. R. & REGS. 1320-06-01-.23 (2016), and relevant court decisions. Based on the specific facts, they may adjust the return and reclassify nonbusiness earnings as apportionable business earnings. Audit adjustments may include:

- Removal of the reclassified amount from Schedule M.
- Removal of the amount reported on Schedule J, Line 21.
- An increase to the apportionment factors reported on Schedule N to include property, payroll, or sales amounts related to the reclassified earnings

All relevant documents reviewed or created during the audit will be retained in the Department's audit workpaper file.

---

<sup>1</sup> Tenn. Code Ann. § 67-4-2010(a)

<sup>2</sup> Tenn. Code Ann. § 67-4-2011(b)

<sup>3</sup> Tenn. Code Ann. § 67-4-2011(c)

<sup>4</sup> Tenn. Code Ann. § 67-4-2004(10)

<sup>5</sup> Tenn. Code Ann. § 67-4-2011(d)

<sup>6</sup> Tenn. Code Ann. § 67-4-2011(e)

<sup>7</sup> Tenn. Code Ann. § 67-4-2004(4)

<sup>8</sup> The definition of business earnings was broadened in 1993 with Public Chapter 282 to include the functional test. Prior to this amendment, only the transactional test was used to determine business earnings. Note that many cases decided prior to the 1993 law change are no longer applicable. Examples of these “old law” court cases include *General Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986) (liquidation of all assets), *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993) (partial liquidation of assets), *Federated Stores Realty, Inc. v. Huddleston*, 852 S.W.2d 206 (Tenn. 1993) (partial liquidation of assets), and *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994) (sale of partnership interest). In fact, the Court stated in *Associated Partnership I*, which was decided after the law change, that its decision would have been different if it had been decided under the amended law.

<sup>9</sup> Tenn. Code Ann. § 67-4-2004(33)

<sup>10</sup> TENN. COMP. R. & REGS. 1320-06-01-.23(3)

<sup>11</sup> Tenn. Code Ann. § 67-4-2010(b)

<sup>12</sup> The “unitary” definition found at Tenn. Code Ann. § 67-4-2004(52) applies only to financial institutions.

<sup>13</sup> *Louis Dreyfus Corp. v. Huddleston*, 933 S.W.2d 460 (Tenn. Ct. App. 1996)

<sup>14</sup> *Id.*

<sup>15</sup> *L.M. Berry & Co. v. Huddleston*, No. 01A01-9809-CH-00487, 1999 WL 976528 (Tenn. Ct. App. Oct. 28, 1999)

<sup>16</sup> *Siegel-Robert, Inc. v. Johnson*, No. M2008-02228-COA-R3-CV, 2009 WL 3486625 (Tenn. Ct. App. Oct. 28, 2009)

<sup>17</sup> *Newell Window Furnishing, Inc. v. Johnson*, 311 S.W.3d 441 (Tenn. Ct. App. 2008)

<sup>18</sup> *Blue Bell Creameries, LP v. Roberts*, 333 S.W.3d 59 (2011)

<sup>19</sup> *H.J. Heinz Co., LP v. Chumley*, No. M2010-00202-COA-R3-CV, 2011 WL 2569755 (Tenn. Ct. App. June 28, 2011)