State & Local Tax Alert

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Oregon Tax Court Finds Taxpayer Properly Treated Gain from Stock Sale and Income from Holding Company as Nonbusiness Income

The Oregon Tax Court recently ruled that gain realized from the sale of a subsidiary's stock and income from a subsidiary holding company was properly characterized as nonbusiness income not subject to apportionment.[1] In reaching its decision, the Tax Court applied the "transactional test" in determining that the sale of subsidiary stock was not "inextricably mixed" with the taxpayer's business conducted in Oregon.

Background

The taxpayer, a title insurance writer and operator throughout the United States, has been in existence since 1985. In an effort to grow its business, the taxpayer acquired several companies related to the title insurance industry, which consisted of approximately 300 different legal entities. Throughout the years, the taxpayer acquired an interest in six companies that were unrelated to the title insurance industry. Of these six companies, the taxpayer acquired an interest in the following two companies at issue in the case: Fidelity Sedgwick Holdings, Inc. (Sedgwick) and American Blue Ribbon Holdings LLC (Blue Ribbon).

In 2006, the taxpayer acquired a 40 percent interest in Sedgwick. Sedgwick was in the business of providing third party administration of workers' compensation claims. Sedgwick maintained its own books and records and the taxpayer did not commingle its operations with Sedgwick. In addition, the taxpayer's operations in Oregon did not depend upon its investment in Sedgwick and the taxpayer did not achieve any business efficiencies through its ownership in Sedgwick. In 2008, the taxpayer sold approximately one-fifth of its interest in Sedgwick, which it reported as business income on its 2008 Oregon tax return. In 2010, the taxpayer sold its remaining interest in Sedgwick, and reported gain from this sale as nonbusiness income on its 2010 Oregon tax return.

In addition, the taxpayer acquired and owned 100 percent of Blue Ribbon through its wholly-owned subsidiary during Blue Ribbon's bankruptcy proceedings. Blue Ribbon was a holding company that owned dining restaurants and a pie manufacturing business. The taxpayer was not a customer of Blue Ribbon, did not commingle its operations with Blue

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[1] *Fidelity National Financial, Inc. v. Department of Revenue*, Oregon Tax Court, No. TC-MD 140440D, Jan. 15, 2016.

Ribbon, and did not control Blue Ribbon. The taxpayer reported its income from Blue Ribbon as nonbusiness income on its 2010 and 2011 Oregon tax returns.

Reclassification of Taxpayer's Income at Audit

The Oregon Department of Revenue audited the taxpayer's returns for the 2009, 2010, and 2011 tax years. The Department reclassified the taxpayer's gains from its 2010 sale of Sedgwick stock from nonbusiness income to business income and reclassified the taxpayer's income received from Blue Ribbon from nonbusiness income to business income for 2010 and 2011. The taxpayer appealed the Department's decision to the Oregon Tax Court.

At issue in this case was whether the taxpayer's gains from the sale of its Sedgwick stock and income from Blue Ribbon was properly classified by the taxpayer as nonbusiness income.

Business Income and Nonbusiness Income

Business income is subject to apportionment as provided by the Uniform Division of Income for Tax Purposes Act (UDITPA) and Oregon's apportionment rules.[2] Nonbusiness income is not subject to apportionment but is allocated based on its source.[3] In determining whether income is classified as business or nonbusiness income, the Tax Court looked to Oregon's statutory definition of business income, which is defined 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, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.[4]

Citing *Pennzoil Co. v. Department of Revenue*, the Court noted that within this statute there are two separate tests: the "transactional test" and the "functional test."[5]

Sale of Sedgwick Stock

1. *Transactional Test*

Under the transactional test, business income is income arising from transactions and activities in the regular course of the taxpayer's trade or business.[6] Identifying the transaction that gave rise to the disputed income is the first step in the analysis. As noted by the Tax Court, the taxpayer's sale of Sedgwick's stock was the transaction that gave rise to the disputed income.

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[2] OR. REV. STAT. §§ 314.647 to 314.675.
[3] OR. REV. STAT. §§ 314.625 to 314.645.
[4] OR. REV. STAT. § 314.610(1).
[5] 33 P.3d 314 (Or. 2001).
[6] *Id.*

The second step in the analysis is determining whether the transaction occurred in the regular course of the taxpayer's trade or business. Transactions that occur infrequently may still occur in the taxpayer's trade or business if such transactions are customary or within the scope of activities in that particular trade or business.[7]

The Tax Court cited the decision in *Sperry & Hutchinson v. Department of Revenue*, which had similar facts.[8] In *Sperry*, the taxpayer's core business was selling promotional trading stamps to retailers throughout most of the United States, including Oregon.[9] The taxpayer also held short-term securities that were either used to maintain cash flow for its stamp business or for use in its other investment and acquisition activities.[10] The Tax Court in *Sperry* stated that "the relationship of the activity to Oregon's jurisdiction must be patent or be so 'inextricably mixed' with the Oregon activity that it is impossible to allocate specifically the profits earned by the processes conducted within its borders."[11] The Tax Court further held that only the investments used to maintain the stamp trading business' cash flow were integrated with the stamp business.[12] The Oregon Supreme Court affirmed the Tax Court's decision, indicating that the taxpayer's investments that were not used to maintain cash flow in the business were not apportionable to Oregon because the capital invested and the income derived from the investments were not a part of the trading stamp business being conducted in Oregon.[13]

Similar to *Sperry*, in this case, the Tax Court stated that for the sale of stock to be considered a transaction in the regular course of business, the sale must have been "inextricably mixed" with the taxpayer's business being conducted in Oregon. The Tax Court stated that there was no connection between the taxpayer's sale of Sedgwick stock and the business that it was conducting in Oregon. As a result, the purchase and sale of Sedgwick stock was not so "inextricably mixed" with the taxpayer's title insurance business that the gain from the sale of Sedgwick stock could not be segregated from the taxpayer's revenue generated in Oregon. Furthermore, the Tax Court indicated that although the taxpayer expended substantial effort to grow Sedgwick prior to selling it, the taxpayer's investment in Sedgwick was akin to a passive investment rather than serving as an operational function. The investment in Sedgwick was not integrated with the taxpayer's title insurance business as it was a discrete business activity, unrelated to the business that the taxpayer was conducting in Oregon. Thus, the taxpayer's sale of Sedgwick stock was not business income under the transactional test.

2. *Functional Test*

The functional test requires that the "acquisition," "management," "use or rental," and "disposition" of property be an "integral part of a taxpayer's regular trade or business."[14]

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[7] OR. ADMIN. R. 150-314.610(1)-(A)(4)(b); *see also Pennzoil*, 33 P.3d 314.
[8] *Sperry & Hutchinson Co. v. Department of Revenue*, 5 OTR 301, 310 (1973), *aff'd*, 527 P.2d 729 (Or. 1974).
[9] *Sperry*, 5 OTR at 302.
[10] *Id.* at 304-305.
[11] *Id.* at 310-311.
[12] *Id.* at 311-313.
[13] *Id.* at 331-332.
[14] *Terrace Tower U.S.A. v. Department of Revenue*, 16 OTR-MD 131, 136 (1999).

The disposition of an asset that is integral to a taxpayer's business will satisfy the functional test regardless of whether such disposition is a "regular" occurrence in the business.[15] The Department conceded that if the Tax Court were to conclude that the gain from the sale of Sedgwick stock was not business income under the transactional test, then the gain from the sale would not meet the functional test for business income. As a result, the Tax Court did not analyze the taxpayer's sale of Sedgwick stock under the functional test. Concluding that the transactional and functional tests were not met, the Tax Court held that the taxpayer properly classified the sale as nonbusiness income not subject to apportionment.

Income Attributed by Blue Ribbon

The Tax Court did not provide an in-depth analysis on the issue of whether income attributed from Blue Ribbon to the taxpayer was nonbusiness or business income, as both parties' arguments were substantially the same as those arguments with respect to the sale of Sedgwick stock. The Department argued that the taxpayer's interest in Blue Ribbon was part of its unitary business because the taxpayer was in the secondary activity of buying, managing, and selling interests in other companies. However, the Tax Court disagreed with the Department, stating that the taxpayer's trade or business in Oregon was its title insurance business and not the buying and selling of other companies. It further provided that the taxpayer's interest in Blue Ribbon was not so "inextricably mixed" with that business as to require the use of apportionment. Thus, the Tax Court concluded that the taxpayer's interest in Blue Ribbon was nonbusiness income not subject to apportionment.

Commentary

This case provides a detailed analysis on the distinction between nonbusiness and business income by the Oregon Tax Court. It is particularly helpful to taxpayers as it applies the "transactional test" to two different scenarios: gain from the sale of stock and income attributed by a wholly-owned subsidiary. Taxpayers doing business in Oregon who are engaged in secondary investment activities should look to this case for guidance in determining whether income from those investments might be classified as business or nonbusiness income. As the Tax Court indicated, to be considered business income, the sale must be "inextricably mixed" with the taxpayer's business activities. Thus, taxpayers seeking to avoid having their investment income from being characterized as business income should take the necessary steps to ensure that their secondary investment activities are not commingled or supporting the taxpayer's core business activity in the taxing state.

Furthermore, as an interesting side note, the Tax Court did not address why the taxpayer's 2008 sale of Sedgwick stock had been reported as business income even though the Tax Court held that taxpayer's 2010 sale of Sedgwick stock was nonbusiness income. While unclear from the Tax Court's decision, one might speculate that in 2008 the taxpayer was considering making these stock sales part of its core business activity, or was planning to retain the rest of Sedgwick as a business more integral to the taxpayer's core business, which is why it reported income from its initial sale of Sedgwick stock as business income.

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[15] *Crystal Communications, Inc. v. Department of Revenue*, 20 OTR 111, 129 (2010).

In contrast, the sale of Sedgwick in 2010 essentially was a "final" sale that evidenced the lack of integration of Sedgwick into the taxpayer's core business.

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