STATE OF NEW MEXICO
ADMINISTRATIVE HEARINGS OFFICE
TAX ADMINISTRATION ACT

IN THE MATTER OF THE PROTEST OF
CONAGRA FOODS FOOD INGREDIENTS CO. INC. **No 17-39**
TO ASSESSMENT ISSUED UNDER
LETTER ID NO. L0446856512

DECISION AND ORDER ON MOTIONS FOR SUMMARY JUDGMENT

A summary judgment hearing on the above-referenced protest occurred on January 20, 2017, before Brian VanDenzen, Chief Hearing Officer. At the hearing, Kyle Snedaker of ConAgra Foods Food Ingredients Co. Inc. ("Taxpayer") appeared, represented by attorneys Fred O. Marcus (appearing *pro hac vice*) and Jennifer Zimmerman of Horwood, Marcus, & Berk and local affiliated counsel Germaine Chappelle of Gallagher & Kennedy. Staff Attorney Peter Breen appeared representing the Taxation and Revenue Department ("Department"). Taxpayer presented four demonstrative exhibits during oral argument, all of which are preserved as part of the administrative record in this matter.

The matter came before the Chief Hearing Officer on the Taxpayer's September 19, 2016 Motion for Summary Judgment, the Department's October 17, 2016 Response to Motion for Summary Judgment, and Taxpayer's November 28, 2016 Reply to Department's Response. At the unopposed request of Taxpayer, the merits hearing in this matter was converted to the summary judgment motions hearing held on January 20, 2017, upon which this decision is rendered.

The parties submitted proposed findings of facts of conclusions of law on March 21, 2017 (Taxpayer) and March 24, 2017 (Department). Based on a review of the pleadings, the undisputed material facts, review of exhibits, the arguments presented, and the proposed findings of facts and

proposed conclusions of law, IT IS DECIDED AND ORDERED AS FOLLOWS[1]:

FINDINGS OF FACT

Procedural History

1. On February 25, 2013, under letter id. no. L0446856512, the Department assessed Taxpayer $259,407.00 in Corporate Income Tax, $51,881.40 in penalty, and $24,182.47 in interest for a combined total assessment of $335,470.87 for the reporting periods from May 31, 2008 through May 31, 2011.

2. On March 14, 2013, Taxpayer timely protested the Department's assessment, a protest received by the Department on March 26, 2013. As part of its protest, Taxpayer conceded to a portion of the assessment and included payment of $41,254.00 for that conceded amount with its protest letter.

3. On April 4, 2013, the Department acknowledged receipt of Taxpayer's protest.

4. On October 22, 2015, the Department requested a hearing in this matter with the Administrative Hearings Office, an agency that became independent of the Department under the 2015 Administrative Hearings Office Act[2]. Before the filing of that request, the Administrative Hearings Office had no knowledge of this matter and no statutory role in this matter.

[1] Where appropriate and consistent with the undersigned hearing officer's view of the facts and understanding of the law, portions of Taxpayer's proposed findings of fact, discussion, and conclusions of law were wholly or partially incorporated into this final decision and order.
[2] NMSA 1978, Section 7-1B-1 through 8 (2015). See 52nd Legislature, First Session, 2015, Senate Bill 356, Section 36 (temporary provision transferring all hearing officer personnel out of Taxation and Revenue to new, separate Administrative Hearing Office).

5. On October 29, 2015, the Administrative Hearings Office issued a Scheduling Order and Notice of Administrative Hearings, setting various discovery and motion deadlines, and scheduling a merits hearing on October 19, 2016.

6. On September 19, 2016, Taxpayer filed its motion for summary judgment in this matter, along with attached affidavit of Scott Messel.

7. On October 17, 2016, the Department filed its Response for Motion for Summary Judgment, with attached Exhibit A and B.

8. On October 17, 2016, Taxpayer moved to convert the merits hearing into a summary judgment hearing and vacated the scheduled October 19, 2016 hearing date.

9. On October 19, 2016, and through amended order on October 24, 2016, the Administrative Hearings Office continued the scheduled merits hearing and scheduled a summary judgment hearing on December 21, 2016.

10. On November 28, 2016, Taxpayer filed its reply to the Department's response, along with attached Exhibit A.

11. After consulting with the parties via email, on December 20, 2016, the Administrative Hearings Office *sua sponte* continued the summary judgment hearing to January 20, 2017.

12. On January 19, 2017, Taxpayer filed a Registration Certificate of Non-Admitted Lawyer, admitting Fred O. Marcus *pro hac vice* with local counsel Germaine Chappelle.

13. On January 20, 2017, the summary judgment motion hearing occurred, as described in the introductory paragraph of this decision and order.

14. On January 24, 2017, the Administrative Hearings Office issued an order setting a post-hearing briefing submission order.

15. On March 21, 2017, Taxpayer submitted its proposed findings of fact and conclusions of law.

16. On March 24, 2017, the Department submitted its proposed findings of fact and conclusions of law.

Undisputed Material Facts

17. ConAgra Foods, Inc. ("ConAgra Foods"), headquartered in Omaha, Nebraska, is a packaged food company serving a wide variety of food customers.

18. Taxpayer, ConAgra Foods Food Ingredients, Company Inc., is a member of the ConAgra Foods consolidated federal group.

19. Taxpayer, whose commercial domicile is in Omaha, Nebraska, is a supplier of commercial food products including milled grain ingredients, vegetable products, seasonings, blends and flavors.

20. Prior to its May 2009 fiscal year end, ConAgra Foods' affiliated group operated in three reporting segments: Consumer Foods, International Foods, and Food and Ingredients.

21. Included in the Food and Ingredients reporting segment was the Trading and Merchandising business that included domestic and international grain merchandising, fertilizer distribution, agricultural and energy commodities trading and services, and grain, animal, and oil seed byproducts merchandising and distribution businesses.

22. ConAgra's Trading and Merchandising business operated the No. 3 grain-handling and storage system in the United States and was the No. 1 global source of fertilizer components.

The Trading and Merchandising business also had significant expertise in trading natural gas and crude oil.

23. In the mid-2000's, ConAgra Foods' management made the strategic decision to focus its business efforts on its core food business. ConAgra Foods' Trading and Merchandising business was viewed as a non-core business and the decision was made to completely divest that line of its business.

24. Osparie Management ("Osparie"), a leading commodity investment management firm, expressed interest in acquiring ConAgra Foods' Trading and Merchandising business.

25. Originally a joint venture transaction was proposed but ConAgra Foods' management wanted to completely divest itself of its Trading and Merchandising business.

26. Osparie originally wanted to purchase the Trading and Merchandising business for its book value. ConAgra Foods' management, however, thought the value of the business was higher.

27. Osparie ultimately agreed to a purchase price equal to book value plus $550 million.

28. Because it was necessary for Osparie to obtain financing for the transaction, Osparie required that the purchase price be paid in a combination of cash and payment-in-kind notes ("PIK Notes").

29. Ultimately, the purchase price agreed to by the parties and paid by Ospraie included $2.2 billion in cash, $550 million in PIK Notes, a short-term receivable of $37.2 million (related to payment of employee bonuses) and a four year warrant to acquire approximately 5% of the issued common equity of the subsidiary Osparie formed to acquire the business, Gavilon Holding LLC (this warrant expired and was never exercised).

30. ConAgra Foods' management would have preferred to have sold its Trading and Merchandising business for cash, but in order to realize its desired selling price, ConAgra Foods' management determined it would be necessary to accept the PIK Notes, short-term financing and warrant in addition to the cash consideration.

31. On March 27, 2008, ConAgra Foods entered into a sales agreement with Osparie Special Opportunities fund, an affiliate of Osparie Management, for the purchase of ConAgra Foods' Trading and Merchandising business for the agreed-upon purchase price.

32. As required by the sales agreement, but occurring prior to closing, ConAgra reorganized its domestic Trading and Merchandising business. The reorganization included the conversion of the C-corporation members of the Trading and Merchandising business into single member limited liability companies which were then transferred to a newly formed entity known as Gavilon Group LLC, and the transfer of the grain storage operations, a part of ConAgra Foods' Trading and Merchandising business, from Taxpayer to a newly formed single member limited liability company known as Gavilon Grain LLC.

33. To complete the acquisition of ConAgra's Trading and Merchandising business, Ospraie Special Opportunities Fund formed two holding companies — Gavilon Holdings LLC and its wholly owned subsidiary, GIH LLC.

34. On June 23, 2008, ConAgra Foods' sale of its domestic Trading and Merchandising business was completed when the membership interests in Gavilon Group LLC and Gavilon Grain LLC were sold to GIH LLC in a transaction treated as an asset sale.

35. The PIK Notes were issued by GIH LLC to Taxpayer as part of the sale proceeds related to the sale of Taxpayer's membership interest in Gavilon Grain LLC (containing the grain storage operations).

36. Upon receipt of the sales proceeds, ConAgra Foods' disposition of its Trading and Merchandising business and Taxpayer's disposition of its grain storage operations was complete, and their ownership and control of their respective segments of the Trading and Merchandising business ceased. The resulting gain on the divestiture transactions was calculated, reported to both Federal and State taxing authorities, including New Mexico, and taxed.

37. The tax gain recognized on the sale of ConAgra Foods' and Taxpayer's respective segments of the Trading and Merchandising business, which included the face value of the PIK Notes, was approximately $645 million, was reported as apportionable business income and was included in the taxable incomes of the applicable domestic legal entities on their New Mexico corporate income tax returns for the fiscal year ended May 2009.

38. Following the sale of the Trading and Merchandising business to GIH LLC, neither Taxpayer, ConAgra Foods, nor any subsidiary or affiliate of ConAgra Foods, engaged in the grain merchandising, fertilizer distribution, agricultural and energy commodities trading and services, and grain, animal, and oil seed byproducts merchandising and distribution businesses.

39. Following the sale of the Trading and Merchandising business to GIH LLC, the Trading and Merchandising business, including Taxpayer's grain storage operations, were no longer included in ConAgra Foods' consolidated financial statements.

40. Following the sale of the Trading and Merchandising business to GIH LLC, Taxpayer's continuing business in New Mexico involved the sale of milled grain products, dehydrated vegetables and spices.

41. During the period in which the PIK Notes were held by Taxpayer, neither the principal nor the interest earned on the principal was earmarked for any operating purpose in Taxpayer's or ConAgra Foods' continuing businesses.

42. During the period in which the PIK Notes were held by Taxpayer, the PIK Notes were not pledged as security or collateral for any financing or used for any other business purposes in Taxpayer's or ConAgra Foods' continuing business operations.

43. During the period in which the PIK Notes were held by Taxpayer, they were reported on ConAgra Food's consolidated books and records as Other Assets. The PIK Notes were given no consideration by rating agencies looking at the stability of ConAgra Foods' consolidated balance sheet.

44. At no time did either Taxpayer or ConAgra Foods own any interest in Osparie, GH LLC or GIH LLC or any other member of the Osparie affiliated group of entities.

45. Following the sale of the Trading and Merchandising business to GIH LLC, none of the officers and directors of either ConAgra Foods, Taxpayer or any other member of the ConAgra Foods affiliated group was an officer or director of Osparie, GH LLC, GIH LLC or any other member of the Osparie affiliated group, and no officer or director of Osparie, GH LLC, GIH LLC or any other member of the Osparie affiliated group was an officer or director of ConAgra Foods, Taxpayer or any other member of the ConAgra Foods affiliated group.

46. Following the sale of the Trading and Merchandising business to GIH LLC, neither Taxpayer, ConAgra Foods or any other member of the ConAgra Foods' affiliated group had any right

to elect any officers or directors of Osparie, GH LLC, GIH LLC or any other member of the Osparie affiliated group.

47. There were no transfers between Taxpayer, ConAgra Foods or any affiliate or subsidiary of ConAgra Foods and GIH LLC of personnel, know-how, intellectual property, trade secrets, expertise or similar property other than what was acquired by GIH LLC as part of its acquisition of ConAgra Foods' Trading and Merchandising business.

48. Following the acquisition of ConAgra Foods' Trading and Merchandising business, GIH LLC established its own policies and practices and made its own business decisions regarding the acquired Trading and Merchandising business independently from ConAgra Foods, Taxpayer, or any affiliate or subsidiary of ConAgra Foods.

49. Following the sale of ConAgra Foods' Trading and Merchandising business to GIH LLC, ConAgra Foods, Taxpayer, and affiliates or subsidiaries of ConAgra Foods and GIH LLC were each separately responsible for their own legal, environmental, contracting, tax and finance, and insurance services, did not share pension or employee benefit plans, did not lend monies to each other or jointly borrow money, and did not guarantee each other's debt.

50. Following the sale of ConAgra Foods' Trading and Merchandising business to GIH LLC, there were no common employees between ConAgra Foods, Taxpayer, or any affiliate or subsidiary of ConAgra Foods and GIH LLC.

51. As of the June 23, 2008 sale of ConAgra Foods' Trading and Merchandising Business, ConAgra Foods, Taxpayer and other members of the ConAgra Foods affiliated group terminated all affiliate agreements with their former Trading and Merchandising business operations, with a few exceptions. ConAgra Foods and GIH LLC entered into several agreements,

including a Byproducts Service Agreement, a Grain Storage and Handling Agreement, a Sublease, and a Dried Dairy Products Agreement. Pricing was at arm's-length and no special incentives resulted from ConAgra Foods' former ownership of the Trading and Merchandising business.

52. ConAgra Foods and GIH LLC also entered into a Transition Services Agreement for a one-year period, pursuant to which ConAgra Foods committed to continue providing the same administrative support services to the Trading and Merchandising business as had been provided prior to the sale of ConAgra Foods' Trading and Merchandising business for consideration based on actual usage and arm's-length charges.

53. Neither ConAgra Foods, Taxpayer nor any affiliate or subsidiary of ConAgra Foods engaged in a unitary business with GIH LLC.

54. The interest income earned on the PIK Notes was reported as nonbusiness income in New Mexico, and was sourced to Nebraska, Taxpayer's commercial domicile.

55. Taxpayer directly owned and operated the grain elevators in New Mexico. In anticipation of the sale of its grain storage operations, Taxpayer transferred its grain storage operations to a disregarded single member LLC ("SMLLC") and sold its SMLLC interest which it treated as an asset sale for tax purposes.

56. Proceeds from the sale of the Trading and Merchandising Business were not used by Taxpayer but by ConAgra Foods to (i) fund a share repurchase, (ii) pay down commercial paper borrowings outstanding as of the beginning of ConAgra Foods' fiscal 2009 tax year and (iii) pay income taxes on the gain recognized on the transaction.

57. The Department conducted an audit of Taxpayer' New Mexico corporate income tax returns for the tax years at issue and reclassified the interest income earned on the PIK Notes from allocable nonbusiness income to apportionable business income.

58. As a result of that audit, the Department issued the assessment detailed in finding of fact #1.

DISCUSSION

At issue in this protest is whether interest income on Taxpayer's PIK notes is business income apportionable and subject to New Mexico Corporate Income Tax or whether it is nonbusiness income, not subject to New Mexico tax under Uniform Division of Income for Tax Purposes Act ("UDITPA") and applicable Commerce Clause and Due Process Clause requirements.

Burden of Proof and Standard of Review.

Pursuant to NMSA 1978, Section 7-1-17 (C), the assessment issued in this case is presumed correct. The Taxpayer has the burden to overcome the presumption of correctness that attached to the assessment. *See Archuleta v. O'Cheskey*, 1972-NMCA-165, ¶11, 84 N.M. 428. Unless otherwise specified, for the purpose of the Tax Administration Act, "tax" is defined to include interest and civil penalty. *See* NMSA 1978, § 7-1-3 (X). Under Regulation 3.1.6.13 NMAC, the presumption of correctness under Section 7-1-17 (C) extends to the Department's assessment of penalty and interest. *See Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue*, 2006-NMCA-50, ¶16, 139 N.M. 498, 503 (agency regulations interpreting a statute are presumed proper and are to be given substantial weight). Moreover, "[w]here an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute,

and the right must be clearly established by the taxpayer." *Wing Pawn Shop v. Taxation and Revenue Department*, 1991-NMCA-024, ¶16, 111 N.M. 735 (internal citation omitted); *See also TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-7, ¶9, 133 N.M. 447.

Summary Judgment is appropriate when there is no genuine dispute as to any material fact and the moving party is entitled to prevail as a matter of law. *See Romero v. Philip Morris, Inc.*, 2010-NMSC-035, ¶7, 148 N.M. 713. In controversies involving a question of law, or application of law where there are no disputed facts, summary judgment is appropriate. *See Koenig v. Perez*, 1986-NMSC-066, ¶10-11, 104 N.M. 664. If the movant for summary judgment makes a prima facie showing that it is entitled to a judgment as a matter of law, the burden shifts to the opposing party to show evidentiary facts that would require a trial on the merits. *See Roth v. Thompson*, 1992-NMSC-011, ¶17, 113 N.M. 331. Even if the nonmoving party does not file their own motion for summary judgment, summary judgment may be granted to the nonmoving party if there is no genuine dispute of fact, they are entitled to judgment as a matter of law, and the moving party was generally on notice of the nonmoving party's counter-claim in its response to the moving party's summary judgment pleading. *See Martinez v. Logsdon*, 1986-NMSC-056, ¶12, 104 N.M. 479. The Department did not dispute any of the facts asserted in Taxpayer's motion for summary judgment, but did assert two additional undisputed, material facts, which have been adopted in this decision.

UDITPA, and Apportionment and Allocation of Income

Under NMSA 1978, Section 7-2A-3, New Mexico levies an income tax on the "the net income of every domestic corporation and upon the net income of every foreign corporation employed or engaged in the transaction of business in, into or from this state or deriving any income from any property or employment within this state." As used under the Corporate Income and

Franchise Tax Act, the term "corporations" includes corporations, joint stock corporations, certain real estate trusts, financial corporations, banks, other business associations, limited liability companies and partnerships taxed as corporations under the Internal Revenue Code. *See* NMSA 1978, § 7-2A-2 (D).

Taxpayer does not dispute that it is subject to New Mexico Corporate Income Tax. Instead, the question in this case turns on the allocation of Taxpayer's income from the interest on the PIK notes. There is no dispute that upon sale of the line of business, Taxpayer fully allocated the value of that transaction (including the cash and the value of the PIK notes) and paid the apportioned tax in New Mexico. However, after completion of that sale, Taxpayer has allocated the tax on the interest income to its state of domicile, Nebraska. In contrast, the Department in audit determined that the PIK interest represented business income from the sale of a line of the business, and thus was subject to apportionment and taxation in New Mexico. In essence, the issues in this case turns on statutory apportionment under UDITPA and related constitutional concerns.

While the statute may not extend apportionment beyond the constitutional Commerce Clause and Due Process Clause limitations articulated by the Supreme Court, the analysis begins with the applicable New Mexico statute. Like many states, New Mexico has adopted the UDITPA to address apportionment and allocation of income earned by multistate or multinational entities. *See* NMSA 1978, §§7-4-1 through 7-4-21; *see also ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 311 fn.3 (1982) (short discussion of history of UDITPA) ; *see also J. Hellerstein & W. Hellerstein*, State Taxation, ¶9.01 (3rd ed. 2001-2015) (discussion of history of adoption of UPDITA, or similar statutory regimes, by numerous states). UDITPA distinguishes between business income and nonbusiness income with only business income being subject to apportionment. *See* NMSA

1978, §7-4-10 (A) (2013) ("…all business income shall be apportioned...").

"Business income" is defined under NMSA 1978, Section 7-4-2 (A) (1999), as

> …income arising from transactions and activity in the regular course of the taxpayer's trade or business and income from the disposition or liquidation of a business or segment of a business. "Business income" includes income from tangible and intangible property if the acquisition, management or disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Conceptually, New Mexico's statutory scheme under Section 7-4-2 (A) adopts three tests to determine whether the income is business or non-business income. First, under Section 7-4-2 (A), is a "transactional test," where income is considered business income when the income arose from "transactions and activity" occurring in the "regular course of the taxpayer's trade or business." Second, under the "disposition test," income is considered business income when the income arose from the disposition of a business or segment of a business. *See* § 7-4-2 (A). And finally, Section 7-4-2 (A)'s last sentence creates a "functional test," where income is considered business income when the income arose from "tangible and intangible property if the acquisition, management or disposition of the property constitute an integral part of the taxpayer's regular trade or business operations." In contrast, "nonbusiness income" is defined under UDITPA as "all income other than business income." NMSA, §7-4-2 (E).

Numerous Department regulations provide further guidance on the UDITPA distinction between business and nonbusiness income. In addition to essentially reiterating the statutory definition of business income, Department Regulation 3.5.1.9 (A) NMAC adds that "[i]n essence, all income which arises from the conduct or the disposition or liquidation of trade or business operations of a taxpayer is business income." Regardless of the name, label, or classification used to describe

the income, Department Regulation 3.5.1.9 (A) NMAC indicates that

> [i]ncome of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of particular trade or business. In general, all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and constitute integral parts of, a trade or business.

In addressing whether interest income constitutes business income under UDITPA, Department Regulation 3.5.1.10 (D) NMAC provides additional guidance:

> "Interest income" is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

In concept, the broad principals of business income as defined under UDITPA and the accompanying Department regulations are not inconsistent or incompatible with the touchstone constitutional Due Process and Commerce Clause standard for apportionment, the unitary business principal. *See Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 786 (U.S. June 15, 1992) (generally noting that UDITPA, while never expressly adopted by the Supreme Court as the constitutional standard, is not incompatible with that standard). An overview of those constitutional standards, as articulated by the United States Supreme Court, provides guidance on the application of UDITPA to this matter.

Generally, a state may not impose an income tax on the value earned outside of its border under the Due Process and Commerce Clauses of the United States Constitution. *See ASARCO Inc. v.*

Idaho State Tax Commission, 458 U.S. 307, 314 (1982). Specifically, the Commerce and Due Process Clauses of the United States Constitution impose distinct but parallel limitations on New Mexico's power to tax value earned from out-of-state business activities. *See Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425, 454 (1980); *Norfolk & Western R. Co. v. Missouri Tax Comm'n.*, 390 U.S. 317, 325, n.5 (1969). However, a state may tax an apportioned share of a multistate entity's income earned outside of its territory if the activity that generated that income was part of a "unitary business." *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 19 (U.S. Apr. 15, 2008); *Allied-Signal*, 504 U.S. at 772; *Hunt Wesson v. Franchise Tax Bd.*, 528 U.S. at 460; *Exxon Corp. v. Wisconsin*, 447 U.S. 207, 224 (1980); *Mobil Oil Corp.*, 454 U.S. at 442. "[T]he linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil Corp.*, 445 U.S. 425, 439. Taxpayer bears the burden of establishing by clear and cogent evidence that the state seeks to tax extraterritorial values. *Allied-Signal*, 504 U.S. 768, 782, citing *Exxon Corp*. 447 U.S. 207, 224.

The United States Supreme Court has held over the years in a wide range of factual contexts that the constitutional test for establishing whether two or more companies are unitary is dependent on whether there is functional integration, centralization of management, and economies of scale between the companies. *See F.W. Woolworth Co. v. Taxation and Revenue Dep't*, 458 U.S. 354 (1982); *See also ASARCO*, 458 U.S. 307 (1982); *See also Exxon*, 447 U.S. 207 (1980). Additionally, the Court, in *Allied-Signal*, stated that a non-domiciliary state can tax income from intangible property even if the income payer and payee are not engaged in the same unitary business, so long as the capital transaction serves an operational function, and not an investment function. *See Allied-Signal*, 504 U.S. at 787. Hence, for example, a State may include

in the apportionable income of a non-domiciliary corporation interest earned on short-term deposits in a bank located in another state if the deposits form part of the working capital of the corporation's unitary business. *Id*. And, in *Container Corp. v. Franchise Tax Bd*., the Court noted that capital transactions can serve an investment function or an operational function, finding that corn futures contracts in the hands of a corn refiner seeking to hedge against increases in corn prices are operational rather than capital assets. *Container Corp. v. Franchise Tax Bd.,* 463 U.S. 159, n.19 (1983); *citing Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 50-53 (1955).

In 2008, the United States Supreme Court clarified its statement in *Allied-Signal* in the *Mead* case. *See MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008). In *Mead*, the Court noted that its references to operational function in *Container Corp*. and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The Court explained that the concept of operational function simply recognized that an asset can be part of a taxpayer's unitary business even if the unitary business relationship doesn't exist between the payee and the payor. In the example given by the Court in *Allied-Signal*, the taxpayer was not unitary with its banker, but the taxpayer's short-term deposits (which represented working capital and thus operational assets) were clearly unitary with the taxpayer's business. In *Corn Products*, the taxpayer was not unitary with the counterparty to its hedge, but the taxpayer's futures contracts (which served to hedge against the risk of an increase in the price of a key cost input) were likewise clearly unitary with the taxpayer's business. In the examples in *Allied Signal* and *Corn Products*, the payor was not a part of the taxpayer's unitary business but the asset clearly was. The conclusion that the asset served an operational function was merely instrumental to the constitutionally relevant conclusion that the asset was a part of the unitary

business being conducted in the taxing state rather than a discrete asset to which the State had no claim.

Distilling the Supreme Court's constitutional jurisprudence in this area into a brief summary, pursuant to the holdings in *Allied Signal* and *Mead*, an item of income is subject to apportionment either if (1) the taxpayer/payee and the income payor are engaged in a unitary business, or (2) the asset that generated the income was itself used as part of the taxpayer's unitary business operations in the taxing state. Thus, New Mexico may only tax the interest income earned on the PIK Notes if: 1) Taxpayer and the Buying Parties were engaged in a unitary business or 2) the PIK Notes were used as part of Taxpayer's unitary business operations in New Mexico.

Under these general statutory and constitutional principles, Taxpayer's PIK income is nonbusiness income not subject to apportionment under UDITPA. Beginning with the application of Section 7-4-2 (A)'s first "transactional test," the PIK interest income does not arise from "transactions and activity" occurring in the "regular course of the taxpayer's trade or business." Taxpayer specifically divested itself of the line of business in question in 2008 through its sale of the grain elevator business to GIH LLC/Ospraie Management. The undisputed facts clearly indicate that the interest income Taxpayer received on its PIK Notes did not arise from transactions and activity in the regular course of Taxpayer's trade or business, which consisted of the manufacture and distribution of commercial food products including milled grain ingredients and a variety of vegetable products, seasonings, blends and flavors. Similarly, and as discussed in more detail in the constitutional analysis, under the third functional test articulated in Section 7-4-2 (A)'s last sentence, the income did not arise from "tangible and intangible property if the acquisition,

management or disposition of the property constitute an integral part of the taxpayer's regular trade or business operations."

The closest test, and the reason why the Department had reasonable grounds to conduct the audit and initially issue the assessment, is Section 7-4-2 (A)'s "disposition test" where income is considered business income when the income arose from the disposition of a business or segment of a business. This dispositional test portion of the statue was added by the Legislature in response to the New Mexico Court of Appeals' decision in *McVean & Barlow, Inc. v. Bureau of Revenue*, 1975-NMCA-128, 88 NM 521. In *McVean & Barlow, Inc.*, the Court of Appeals had found that income from the liquidation of a line of business was non-apportionable, non-business income under UDITPA because it arose from a one-time transaction not part of that taxpayer's line of business. This statutory overruling of *McVean & Barlow, Inc.* made clear that the Legislature intended the proceeds from the disposition of a line of business to be considered business income under UDITPA subject to apportionment.

Against that Legislative intent, it is undeniable that Taxpayer initially received the PIK notes as part of the sophisticated financing mechanism of the sale and disposition of its grain elevator business, and in that sense on the surface there is some indication that the income came from the disposition of the business segment. However, of critical importance under this test is the fact that Taxpayer fully apportioned the proceeds from the sale of the line of business, including the full face value of the financing instrument PIK notes, as business income in New Mexico and paid the corresponding tax to New Mexico for that business income in the fiscal year ending in May 2009. In other words, at the time of the disposition of its line of business, when this test was clearly met, Taxpayer fully apportioned and paid corresponding tax on the value of the sale of that business,

including the face value of the PIK notes, as required under Section 7-4-2 (A)'s dispositional test added by the Legislature in response to *McVean & Barlow*. This is not the *McVean & Barlow* case that the Legislature overruled in adopting the dispositional test because Taxpayer in fact allocated and paid the corresponding tax on income gain from the sale and disposition of the line of the business.

The question remains whether the subsequent interest income derived from the PIK notes is apportionable business income or is non-business income allocated solely to Taxpayer's domiciliary state. After surveying the landscape of cases in UDITPA and non-UDITPA states addressing apportionment and allocation of interest income, Hellerstein and Hellerstein note in the leading treatise on state taxation that the weight of authority finds that the origin of the investment leading to the interest income itself is not dispositive of whether the interest income can be qualified as apportionable business income or non-apportionable nonbusiness income. *See J. Hellerstein & W. Hellerstein*, State Taxation, ¶9.09 (3) (3rd ed. 2001-2015) Instead, Hellerstein and Hellerstein suggest that the "critical question is the relationship of the interest-bearing investment to the taxpayer's existing trade or business." *Id*.

After already apportioning and paying the appropriate New Mexico corporate income tax after the complete disposition of the line of business (including the face value of the PIK notes) in 2009, there remains no meaningful relationship left between the PIK notes and Taxpayer's line of business. Taxpayer is not in the regular business of holding, trading, exchanging PIK notes or other sophisticated financial instruments. Nor does Taxpayer's operational purpose benefit from possession of such sophisticated financial instruments unrelated to Taxpayer's core business products and services. Taxpayer completely divested itself of the line of business in question, apportioned and paid tax on the business income it received on the disposition. There is no evidence that Taxpayer uses the

interest income for some operational function like as a hedge against changes in commodity pricing. Since Taxpayer is no longer in that line of business, has no ownership interest, control of the other company, functional integration, centralized management, or economies of scale with the other company, the interest income received at this point is simply investment income not related to a unitary business enterprise or Taxpayer's line of business.

Similarly, under the constitutional analysis espoused in the Supreme Court jurisprudence, after completion of the sale in 2008, there was no unitary relationship between Taxpayer and GIH LLC/Ospraie Management. There is no evidence or contention that Taxpayer and GIH LLC/Ospraie Management had functional integration, centralized management, or economies of scale. As the Department conceded, there was no evidence that Taxpayer and GIH LLC/Ospraie Management had a crossover of corporate officers, overlapping ownership/equity interests, common employees, or influence/control over each other. Further, as the Department again conceded, Taxpayer terminated all contract with the sold entity at the time of the sale and then entered new agreements where appropriate in arm's length negotiations. Quite simply, the undisputed facts indicate Taxpayer and GIH LLC are unrelated business enterprises.

Despite this, the Department asserts that the unitarian analysis is not required given that both Taxpayer and GIH LLC are physically present in the New Mexico. However, while the physical presence certainly gives New Mexico jurisdiction to impose a tax, it does not establish what amount New Mexico may constitutionally apportion in accord with the Commerce Clause and Due Process Clause Supreme Court jurisprudence. The mere fact that two companies are physically present in the same state, as the Department's argument, falls well short of meeting the unitary-business principle articulated by the constitutional case law and would in fact largely

eviscerate that standard. *See Allied-Signal, Inc.*, 504 U.S. 768, 786-787 ("it does not follow… that apportionment of all income is permitted by the mere fact of corporate presence within the State."). Nor does the fact as the Department argues that Taxpayer subsequently entered into arms-length contracts, without any other control, equity interest, or overlapping management/employees, meet the unitary-business principle required under the applicable jurisprudence.

Indeed, many of the Department's arguments center around Taxpayer's actions at the time of the disposition of the grain elevator line of business (the Department cited ConAgra's 10-K for 2009 to show that ConAgra used the proceeds of the disposition of the line of business to pay down debt) in 2008. While those arguments clearly demonstrate why Taxpayer was required to apportion the proceeds at the time of the disposition of the business to New Mexico under both the dispositional test and the unitary business principle constitutional standard, Taxpayer in fact already did fully apportion the proceeds of the sale of the line of business, including the face value of the PIK notes in 2009. Thus, the Department's written arguments are not particularly helpful on the question of how to treat the subsequent PIK note interest income.

Turning back to the case law for further guidance, even without a unitary-business relationship between the entities, it is still possible to apportion the tax on the income consistent with the constitutional requirements if the asset resulting in the income serves an "operational rather than investment function." *Allied-Signal, Inc.*, 504 U.S. 768, 787; *See also Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159. *Mead* provided further clarity on this point, indicating that the concept of operational function means that an asset can be part of a taxpayer's unitary business even if the unitary business relationship doesn't exist between the payee and the payor.

In 2008, Taxpayer divested itself of its grain storage operation line of business by selling its assets to GIH LLC/Ospraie Management, fully apportioning the value of that transaction (including the face value of the PIK notes) to New Mexico. Again, important to this analysis, at the time of the sale and divesture of the grain elevators, Taxpayer apportioned the full value of the transaction including the face value of the PIK notes used to finance that transaction to New Mexico. After the divesture of the grain elevators, the proceeds of which were apportioned in New Mexico, Taxpayer was no longer in that line of business. As the Supreme Court in *Allied-Signal, Inc.*, 788, makes clear, "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." After the divestment in the line of business in 2008, the interest received on the PIK notes was not integral to Taxpayer's continuing business operations in New Mexico but rather served as an investment function. Again, Taxpayer is not in the regular business of holding, trading, exchanging PIK notes or other sophisticated financial instruments. And unlike in *Corn Products Refining Co.* case, there is no clear business operational benefit related to the interest on the PIK notes to Taxpayer like a hedge on Taxpayer's main products. Taxpayer has shown that the PIK note interest income was earned in the course of activities unrelated to its New Mexico business activities, meeting the requirements for the Due Process and Commerce Clause limitations on apportionability. *See Allied-Signal, Inc.*, 504 U.S. 768, 787, quoting *Exxon*, 447 at 223.

In sum, the undisputed material facts established that the PIK interest income is non-business income and thus not apportionable as a matter of law in New Mexico under UDITPA and the constitutional Due Process and Commerce Clause standards as articulated in Supreme Court

jurisprudence. For that reason, Taxpayer's motion for summary judgment is well-taken and should be granted. *See Koenig v. Perez,* 1986-NMSC-066, ¶10-11, 104 N.M. 664.

CONCLUSIONS OF LAW

A. Taxpayer filed a timely, written protest of the Department's assessment and jurisdiction lies over the parties and the subject matter of this protest.

B. There is no genuine dispute as to any material fact, summary judgment is appropriate in this matter. *See Romero v. Philip Morris, Inc.,* 2010-NMSC-035, ¶7, 148 NM 713.

C. At the time Taxpayer disposed of its grain elevator line of business, it fully apportioned and paid tax on the proceeds of that sale, including the face value of the PIK notes, to New Mexico, as required under the dispositional clause of UDITPA, NMSA 1978, Section §7-4-2 (A).

D. Taxpayer's subsequent interest income from PIK notes amounted to non-business income under UDITPA, NMSA 1978, Section §7-4-2 (A) & (E) because the income did not meet the transactional test, the dispositional test, or the functional test articulated under the definition of business income.

E. Because Taxpayer was a not a unitary-business with GIH LLC/Ospraie Management and because the interest income on the PIK notes was not integral to Taxpayer's line of business, the income was not apportionable to New Mexico consistent with the Due Process Clause and Commerce Clause. *See Allied-Signal, Inc.*, 504 U.S. 768, 787; *See also Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159; *See also Exxon Corp*. 447 U.S. 207, 224.

F. Consequently, although Taxpayer otherwise was clearly subject to New Mexico Corporate Income Tax, the nonbusiness interest income in question in this protest was not

apportionable to New Mexico under UDITPA and instead was properly allocated to Nebraska, Taxpayer's state of domicile.

For the foregoing reasons, Taxpayer's motion for summary judgment **IS GRANTED** and Taxpayer's protest **IS GRANTED**. Aside from the $41,254.00 amount of the assessment that Taxpayer conceded was due and owing (and for which Taxpayer has already submitted payment), the remaining assessed tax, penalty and interest **IS ORDERED ABATED**.

DATED: September 15, 2017

Brian VanDenzen, Esq.
Chief Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by *filing a notice of appeal with the New Mexico Court of Appeals* within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may begin preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals,

which occurs within 14 days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

CERTIFICATE OF SERVICE

I hereby certify that I mailed the foregoing Decision and Order to the parties listed below this 15th day of September 2017 in the following manner: