This Week in State Tax (TWIST)

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Arkansas: State High Court OKs Allocation of Interest Expense Related to Spinoff

The Arkansas Supreme Court recently held in favor of the taxpayer that interest expenses incurred by the acquired company as part of a leveraged buyout were allocable to Arkansas. Murphy, an Arkansas-domiciled retail fuel seller, was spun-off from its original parent company, Murphy Oil Corporation, to Murphy USA, Inc. To fund this spin-off, Murphy issued $650 million in notes and credit agreements to be paid to Murphy USA. The taxpayer initially apportioned and deducted the interest payments associated with that debt from its corporate income in all states in which it was conducting business. Murphy later amended its Arkansas returns to treat the interest payments as nonbusiness expenses and fully allocated the interest expense to Arkansas, thereby reducing its Arkansas taxable income. After the Department of Finance and Administration (DFA) denied the requested refund, a circuit court granted summary judgement for the taxpayer.

On appeal, the state supreme court first ruled that under the Uniform Definition of Income for Tax Purposes Act (UDITPA) definitions of business and nonbusiness (which Arkansas had adopted), the interest was a deductible nonbusiness expense, as it did not arise from transactions and activity in the regular course of the taxpayer's trade or business. The court focused on the isolated nature of the transaction, distinguishing between the taxpayer's previous borrowing—which was used to fund expansions of its business—from the singular instance of taking on debt to finance a leveraged buyout. Because the latter activity occurred only once, it could not be considered part of the taxpayer's *regular* trade or business.
An alternative argument raised by the DFA was that Arkansas law disallowed deductions for expenses allocable to nonbusiness income. Arkansas law provides that "no deduction shall be allowed for … [e]xpenses otherwise allocable as deduction which are allocable to nonbusiness income." After determining that the text of the statute was ambiguous, the court interpreted the statute as applying only to nonbusiness income *allocable to other states*. Applying principles of statutory interpretation, the court held that the stated purpose of the above statute was to limit the deduction related to "tax exempt income," and thus the statute did not apply to Murphy's interest expense deduction.

Finally, the DFA argued that permitting the taxpayer to allocate the entire expense deduction to Arkansas when it had previously used it to reduce apportionable income in other states violated principles of fundamental fairness. The court rejected this argument, stating that its role was to interpret and apply Arkansas law, not to "adjust Arkansas tax returns based on unfairness to Tennessee, Mississippi, or other states." Please contact Asad Markatia with questions about Hudson v. Murphy Oil USA, Inc.

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