

# Allocation: Double Taxation and Other Issues

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# Agenda

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- Constitutional Requirements for Sourcing Income
- Characterization of Income – Apportionable vs. Nonapportionable
- Sourcing of Income - Alternative apportionment
- Sourcing of Allocated Income
  - Apportionable
  - Common Traps
  - Allocable – Goodwill
  - Allocable – Capital Gains
  - Allocable – Interest
  - Allocable – Income From Partnerships

# Constitutional Requirements

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- Constitutional Requirements
  - Commerce Clause Requirement:
    - Tax must be fairly apportioned
      - Complete Auto Transit v. Brady*, 430 U.S. 274
  - Due Process Clause Requirements:
    - There must be a minimum connection between the taxing jurisdiction and the item being taxed.

# Constitutional Requirements

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- Constitutional Sourcing Requirements:
  - **Internal Consistency Test** - To be internally consistent, the tax must be structured so that if, hypothetically, each state imposed an identical tax, no multiple taxation would result.
  - **External Consistency Test** - The external consistency test requires that the state tax only that portion of the taxpayer's income which reasonably reflects its in-state activities.

# Characterization of Income: Apportionable vs. Nonapportionable

- ***Noell Industries, Inc. v. Idaho Tax Commission*, 167 Idaho 367 (2020) (2020).**
- Gain from out-of-state corporation's 2010 sale of interest in limited liability company is not apportionable to Idaho; the gain is non-business income from a passive investment.
- The Idaho Supreme Court found that between 2003 and 2010, the corporation's sole business was holding its investment in the LLC, and this type of gain is not "business income" under either the transactional or the functional test.
  - Under the transactional test, the corporation's primary function was holding its interests in the LLC and another business entity as a parent or holding company, and the one-time sale over a seven-year span does not constitute a "regular" trade or business.
  - Under the functional test's operational or passive investment test, the corporation held a passive investment in the LLC when its investment function was limited to mere financial betterment of the corporation in general, and the sale of its interest in the LLC was not "an integral, functional, or operative component to [its] trade or business." Further, under the functional test's unitary business test, the Court found that: (1) the corporation was a parent holding company with no shared control or operations over the LLC; (2) they had no shared centralized management, oversight, or headquarters; (3) they had a high level of separation between them; and (4) the presence of the corporation's founder in both companies as a member of their boards of directors and "high-level executive" did not support a unitary business finding.

## Characterization of Income: Apportionable vs. Nonapportionable

### ***Matter of Goldman Sachs Petershill Fund Offshore Holdings (Del.) Corp. v. New York City Tax Appeals Tribunal, 204 A.D.3d 469 (NY App. Div., 1<sup>st</sup> Dep't., 2022)***

- Does a London-based Goldman Sachs unit owe New York City income tax on its sale of interest in a city-based partnership?
- Foreign corporation (FC) owned a minority interest in an investment management company (IMC) doing 100% of its business in NYC. FC carried on no activities in NYC, had no presence there, was not unitary with and did not participate in management of the IMC. FC sold its interest for a large gain. FC claimed tax on the gain was an impermissible tax on activities outside NYC because investment decisions made and business acumen existed outside NYC.
- NYC's tax assessment upheld on the apportioned gain, finding that the privileges and immunities extended by NYC to the IMC doing business there inured to the benefit of the FC (relying on *Wisconsin v. J.C. Penney*, 311 U.S. 435 (1940)).

# Characterization of Income: Apportionable vs. Nonapportionable

## ***VAS Holdings & Investments LLC v. Commissioner of Revenue, 489 Mass. 669 (Mass. 2022)*** (Motions to file for rehearing granted to taxpayer and the state; case is still pending)

- The Massachusetts Appellate Tax Board ruled that capital gain recognized on a Florida S corporation's sale of its subsidiary a Massachusetts LLC was subject to corporate excise tax and nonresident composite tax.
- The S corporation did not have any activities in Massachusetts, and none of its shareholders were Massachusetts residents. The taxpayer contended that the Due Process and Commerce Clauses prohibited Massachusetts from taxing the income because the LLC's sale did not involve a minimum connection to Massachusetts or the availment of the protections and benefits of Massachusetts law. The Board concluded that the increase in value of the subsidiary was "inextricably connected to and in large measure derived from property and business activities in Massachusetts," which included improved management and staffing of a call center business. The Board ruled that these business activities "necessarily involved availment of the protection, opportunities and benefits given by Massachusetts" and these facets "supplied the requisite connection between Massachusetts and business activities that resulted in the" capital gain.
- MSJC decision (for now): After a lengthy discussion explaining why MA can constitutionally impose tax on the sale of the capital gain without applying unitary business principles, the Court concluded MA statutes required application of the UBP. Since the parties agreed there was no unitary relationship, no tax was due.

## Characterization of Income: Apportionable vs. Nonapportionable

### ***2009 Metropoulos Family Trust v. Franchise Tax Board, Super. Ct. No. 37-2020-00011877-CU-MC-CTL, D078790 (Cal. App., May, 27, 2022).***

- Whether income received by a nonresident trust's share of the sale of a DE S Corp's CA subsidiary is apportionable business income. Is the character of the income different in the trust's hands?
- DE S Corp sold a CA subsidiary and characterized the income as business income on its own return. The nonresident shareholders of the S Corp followed this characterization, paid California income tax, then sought a refund. Shareholders claimed the income had a different character in their hands (income derived from the sale of intangible goodwill) than it did in the S Corp's hands because a CA individual income tax rule stated income from intangibles is sourced to the individual's domicile. The trusts conceded the S Corp and CA subsidiary were a unitary business.
- The trust shareholders were bound to treat the income as business income because the S Corporation treated the income as business income on its own return. Under CA law, the character of income is determined at the corporate level; income passes through to the shareholders in exactly the same form as received by the S Corporation.



## Characterization of Income: Apportionable vs. Nonapportionable

***Paz v. N.J. Dir., Div. of Taxn.*, No. A-4452-16T4 (N.J. Super. Ct., App. Div., Jan. 31, 2019) (Unpublished), aff'g *Xylem Dewatering Sols., Inc. v. N.J. Dir., Div. of Taxn.*, 30 NJ Tax 41 (N.J. Tax Ct. 2017).**

- Gain that an out-of-state resident made from the deemed sale of assets of a New Jersey S corporation pursuant to an election under IRC §338(h)(10) is nonoperational (nonbusiness) income wholly allocated to New Jersey as the S corporation's domiciliary state.
- The Appellate Court rejected the individual's argument that the Tax Court "improperly deferred" to the Division of Taxation's argument regarding the construction of the Gross Income Tax Statute. After reviewing the Tax Court's decision, the Appellate Court found that it fully and fairly reviewed the record before making independent determinations on the issues.

## Characterization of Income: Apportionable vs. Nonapportionable

### ***YAM Special Holdings, Inc. v. Minn. Commissioner. of Revenue, A20-0021 (Minn. Aug. 12, 2020).***

- YAM operated the Go Daddy business. YAM had no physical presence in Minnesota, nor did it have an interest in any business entities or assets that were in Minnesota. About 1% of YAM's revenue came from transactions with Minnesota customers.
- The Minnesota Supreme Court held that the imposition of corporate income tax on an apportioned share of income from the sale of a partial interest in Go Daddy did not violate the Due Process Clause of the US or Minnesota Constitutions because the income is business income of a unitary business that had a sufficient connection to Minnesota.
- The Court also determined that the income was not nonbusiness income as defined in the Minnesota statute. The Court noted that the statute codifies an earlier decision of the court holding that Minnesota cannot apportion income if a taxpayer and the corporation that was the source of the income do not have a unitary business relationship, and if the income from the sale serves an investment function rather than an operational function. The court stated that this statutory provision did not apply to YAM because YAM conceded that it and its operating subsidiaries formed a unitary business at the time of the transaction.

## **Vectren Infrastructure Services Corp. v. Department of Treasury, 2021 WL 4487042 (Docket No. 345462)**

- *Vectren* involves an S-Corporation that was sold in a 338(h)(10) transaction. The taxpayer included the gain on the sale of its assets in the denominator of the sale factor for purposes of calculating Michigan business tax. The Department of Treasury excluded such gain from the sales factor and the taxpayer submitted a request for alternative apportionment.
- With the gain, the sales factor was approximately 15%, and without it was approximately 70%.
- The evidence demonstrated that prior to the year of sale, the sales factor was typically around 7%.
- Without providing the appropriate alternative, the Michigan Court of Appeals held exclusion of the factor unconstitutionally distorted how the income earned on the sale of the entity was earned.
- This case has had an extensive procedural history, and the case is currently set to be heard by the Michigan Supreme Court for the second time.

## ***State Tax Assessor v. Kraft Foods Group, Inc., Decision 2020 ME 81 (ME Supr. Jud. Ct., 2020).***

- On March 1, 2010, Kraft sold its frozen pizza product line assets for roughly \$3.7 billion.
- The Court also vacated the lower court's decision to partially abate substantial underpayment penalties assessed.
- Finally, the Court ruled that a separate assessment by the Maine State Tax Assessor for the same period at issue was not barred by the statute of limitations, as the taxpayer did not provide substantial authority for its original reporting of the gain.

## *Common Trap*

- Assuming all nonbusiness income is allocable to the location of domicile.
  - Goodwill
  - Capital Gain
  - Interest
  - Dividends

# Sourcing of Income: Allocable Income

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## ***Goodwill:***

- **Tektronix Inc. v. Department of Revenue, 354 Or. 531 (OR Sup. Ct., 2013).**
  - Tektronix sold its printer division, which sale included intangible assets, including goodwill.
  - The Oregon Supreme Court concluded that Tektronix was not in the primary business of selling off divisions; therefore, the receipts from the goodwill and other intangibles were excluded from the sales factor pursuant to ORS 314.665(6)(a), which provides an exclusion from the sales factor for gross receipts from the sale of intangible property that are not derived from the taxpayer's primary business activity.
  - The Oregon Supreme Court held that the taxpayer's receipts attributable to goodwill upon the sale of a division to an unrelated corporation were not derived from the taxpayer's business activity.
  - In reaching this determination, the Supreme Court rejected the Tax Court's conclusion that ORS 314.665(6)(a) applied only to gross receipts from liquid assets, such as treasury function gross receipts. The Supreme Court determined that neither the plain language nor the legislative history of ORS 314.665(6)(a) limited its applicability to liquid assets.

# Sourcing of Income: Allocable Income

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## ***Goodwill:***

- **In re Appeal of Imperial, Inc., Case Nos. 472648; 477927 (July 13, 2010).**
  - The California State Board of Equalization ruled that gain from the sale of stock sold pursuant to a Section 338(h)(10) election constituted business income.
  - The SBE determined that the functional test was satisfied because the goodwill represented the residual value of Imperial's business operations after its "hard" assets were valued and the goodwill was essential to the ability to conduct Imperial's business.
  - The SBE also held that the gross receipts from the sale were excludable from the company's California sales factor under the incidental or occasional sale exception pursuant to California Regulation 25137(c)(1)(A). The exclusion was deemed justified because the sale created a substantial amount of gross receipts (more than 60%) relative to the taxpayer's total gross receipts for the year.

## ***Capital Gains:***

- Gains from sales of real property
  - Allocated to the location of the real property
    - Tenn. Code Ann. § 67-4-2011(c)
    - Pa. Stat. Ann. § 7401(3)(2)(1)(6)
- Gains from sales of tangible personal property
  - Allocated to the State where the property had a situs OR to the taxpayer's commercial domicile if taxpayer not taxable where property had situs
    - Tenn. Code Ann. § 67-4-2011(c)
    - Pa. Stat. Ann. § 7401(3)(2)(1)(6)
  - Allocated to the State where the property is located
    - Minn. Stat. § 290.17, Subd. 2(b)
- Gains from the sales of intangible property
  - Allocated to the taxpayer's commercial domicile
    - Tenn. Code Ann. § 67-4-2011(c)
    - Pa. Stat. Ann. § 7401(3)(2)(1)(6)



# Sourcing of Income: Allocable Income

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## ***Interest:***

***In the Matter of Conagra Foods***, No. 17-39 (N.M. Admin. Hearings Off. Sept. 15, 2017).

A multistate corporation's interest income from payment in kind (PIK) notes it received as part of the sale and disposition of its grain elevator business is nontaxable nonbusiness income under the Uniform Division of Income for Tax Purposes Act and the requirements of both the Commerce and Due Process clauses of the US Constitution.

The New Mexico Administrative Hearings Office (AHO) found the PIK interest income is not business income under the transactional test because the income did not arise from transactions and activity in the regular course of the corporation's trade or business.

## *Partnership Level Approach:*

- Partners combine their share of the partnership apportionment factors with their other apportionment factors.
  - This is typically referred to as “flow-through” or “flow-up” apportionment
  - Called “partner-level” apportionment
  - Majority view
- Example:
  - If a corporation has a 60% interest in a partnership, the corporate partner would calculate its own apportionment factor by including 60% of the partnership’s sales, property, and payroll (assuming that the state uses a three-factor apportionment formula)

## *Partnership Level Approach:*

- Partnership income is apportioned to the state using only the partnership's own apportionment factors.
- Owners of the partnership then allocate their distributive share of post-apportionment income to the appropriate state.
- Example:
  - Corporate partner has a 60% interest in a partnership which earns \$100 of income.
  - If apportionment is calculated at the partnership level and the partnership computes a 50% apportionment factor in a state, the partner would include \$30 of partnership income in its tax base in that state, which is 60% of the partnership's income in the state after apportionment.
    - (i.e.,  $\$100 \times 50\% = \$50$ , and  $\$50 \times 60\% = \$30$ )

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# *Questions*