

30th ANNUAL

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Investee Apportionment: Finding the Limits of the Unitary Business Principle

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Agenda

- Historical Framework, Source Income and the Unitary Business Principle
- Recent Cases Involving “Investee Apportionment”
- Apportionment Issues and Cases

Early income tax constitutional cases

- *Shaffer v. Carter*, 252 U.S. 37 (1920) (non-resident subject to tax on income generated from his in-state ownership interests in oil-producing land, oil and gas mining leaseholds, and other property used in the production of oil and gas)
- *Travis v. Yale & Towne Manufacturing, Co.*, 252 U.S. 60 (1920) (non-resident company required to withhold taxes on wages of employees engaged in business in the state)
- *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920) (upholding property-based corporate income tax apportionment formula imposed upon multistate business)

Source income cases

- *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937) (tax imposed on capital gain realized by non-resident on sale of a seat on the New York Stock Exchange)
- *Curry v. McCanless*, 307 U.S. 357 (1939) (tax imposed upon income derived from intangible assets held in trust administered in the state for the benefit of a non-resident beneficiary)
- *International Harvester v. Wisconsin Dep't of Taxation*, 322 U.S. 435 (1944) (withholding tax imposed on dividends paid by in-state company to non-resident stockholders) (follow-up case to *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940))

The unitary business principle

- *Mobil Oil Corp. v. Comm’r of Taxes*, 445 U.S. 425 (1980) (the “linchpin of apportionability in the field of state taxation is the unitary business principle”)
- *Allied-Signal, Inc. v. Director*, 504 U.S. 768 (1992) (tax imposed on an apportionable share of a multistate business carried on in part in the state is the “unitary business principle”)
- *MeadWestvaco Corp. v. Illinois Dep’t of Revenue*, 553 U.S. 16, 128 S.Ct. 1498 (2008) (tax can be applied to “an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a unitary business”)

Investor vs. investee apportionment

- *Allied-Signal, Inc. v. Director*, 504 U.S. 768 (1992) (state cannot tax parent corporation on the gain from the sale of a subsidiary corporation using the factor attributes of the parent because the business of the entities were unrelated)
- *Allied-Signal, Inc. v. Comm’r of Finance*, 79 N.Y.2d 73 (1991) (city tax permissible with respect to dividends from, and capital gain from the sale of, a subsidiary where the income is apportioned using the subsidiary’s factor attributes)
- *Allied-Signal, Inc. v. Tax Appeals Tribunal*, 645 N.Y.S. 2d 895 (Sup. Ct. 3d Dept. 1996) (similar conclusion upholding a state tax)

VAS Holdings & Investments LLC v. Comm’r, 489 Mass. 669 (2022)

- “We find persuasive the Court of Appeals of New York's decision in *Matter of Allied-Signal Inc.*, 79 N.Y.2d at 80-83, rejecting an argument similar to the one pressed here by VASHI that the only constitutionally permissible method of taxing capital gains and dividend income was the unitary business principle. Instead, the court upheld New York City's taxing methodology, which applied a tax that reflected the nexus between New York City and the entities that generated the taxpayer's investment income.”

VAS Holdings & Investments LLC v. Comm’r, 489 Mass. 669 (2022)

- Taxpayer assessed tax on gain from sale of interest in a partnership doing business in Mass. on the basis of regulation
- Mass. Supreme Judicial Court reversed Appellate Tax Board in favor of the DOR, finding regulation exceeded statutory authority
- In lengthy dicta, court stated that, under U.S. constitution, unitary business relationship between parent and subsidiary unnecessary to tax gain where subsidiary giving rise to the gain had sufficient in-state activity

Corrigan v. Testa, 149 Ohio St.3d 18 (2016)

- Ohio Rev. Code 5747.212, generally requires apportioning sale proceeds of 20% or greater voting nonresident owner's interest in PTE using PTE's factors
- Ohio Supreme Court found "as applied" Due Process Clause violation where nonresident owner of PTE sold 79% interest and was not actively involved in day-to-day operations of business
- Distinguished by *T. Ryan Legg Irrevocable Trust v. Testa*, 149 Ohio St.3d 376 (2016), which affirmed assessment against nonresident trust under R.C. 5747.212 on gain from sale of a business where trust grantor was an Ohio resident who founded and managed that business
- 134th Ohio General Assembly Am. Sub. H.B. 515 redefined "business income"

Noell Indus., Inc. v. Idaho Tax Comm'n, 167 Idaho 367 (2020)

- Found taxation of gain from subsidiary unconstitutional where sale was outside ordinary course of business, lacked operational function, entity was not unitary, and owner was not actively involved in day-to-day operations.
- Petition for Writ of Certiorari denied, 141 S. Ct. 1391 (Feb. 22, 2021)

J.P. Morgan Trust Co. of Delaware v. Franchise Tax Bd., 79 Cal. App. 5th 245 (2022) pet. den., The 2009 Metropoulos Family Trust v. Cal. Franchise Tax Bd., No. S 275377 (Cal. S. Ct., Aug. 24, 2022)

- Goodwill sourced as business income under corporate tax regulation, not as intangible income under personal income tax statute
- Trusts conceded business was unitary, and gain from asset sale was apportionable business income to corporation
- Court found outcome would have been the same under statute: integration of goodwill into CA business gave situs in state, and statute is not “all or nothing” allocation, thus avoiding constitutional challenge

Matter of Smith, 2023-OTA-069P, California Office of Tax Appeals (Dec. 7, 2022, released Mar. 2023, precedential)

- Calif. nonresident held liable for tax on apportioned distributive share of gain from holding company's sale of LLC interest in operating company ("Opco"), where both entities taxed as partnerships
- OTA applies business apportionment regulation over nonresident intangible sourcing statute, extending *Metropoulos* holding re: S Corps to partnerships
- Focuses on entities' unitary relationship to classify gain as business income under the functional test, and for Opco's factors to "flow up" to holding company – absent unitary relationship, 0% California apportionment
- Finds unitary relationship despite 3rd party majority control of Opco board

In the Matter of the Appeal of Buehler, 2023-OTA-215P (Cal. Off. Tax App. Feb. 28, 2023, precedential)

- Calif. resident sought credit for taxes paid to Mass. on sale of partnership interest
- Credit requires sourcing gain to Mass. using Calif. rules
- OTA concludes gain sourced 100% to Calif., taxpayer's domicile
- Rejects finding partnership interest had business situs in Mass., and that taxpayer's active involvement rendered the relationship unitary, requiring apportionment

Apportionment Considerations Concerning the Sale of a Business

- If investee apportionment is used, is the location of the investee or the location of the investee's customers the correct metric? (*See Goldman Sachs Petershill.*)
- The sale of a segment of a business that has a different apportionment composition? (*See Kraft.*)
- The sale of a business for which the apportionment formula is drastically different in the year of the sale. (*See Vectren discussion.*)
- The sale of a business with foreign operations that are not reflected in the business' apportionment formula.

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., 1st Dep't., 2022).

- 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 by FC and FC's 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)).
- "The Tribunal rationally determined that petitioner failed to demonstrate that the City impermissibly sought to impose the GCT upon income attributable to activities carried on outside its borders. . . . The nexus between the City and petitioner's capital gain is Claren's activities in the City, which generated petitioner's investment income (on which petitioner paid taxes to the City)"

State Tax Assessor v. Kraft Foods Group, Inc., 2020 ME 81, 235
A.3d 837 (Supr. Jud. Ct., 2020).

- On March 1, 2010, Kraft sold its frozen pizza product line assets for roughly \$3.7 billion.
- Kraft argued that alternative apportionment was necessary because the frozen pizza line had less sales into Maine than Kraft's other product lines.
- The Maine Supreme Judicial Court determined that Kraft was not entitled to alternative apportionment of this income because the single sales factor apportionment method fairly reflects the Maine business activity of both the corporation and the affiliate.
- In so holding, the court said that applying the sales factor to the income from the sales is consistent with the Legislature's stated preference of calculating the sales factor using total sales (i.e., gross receipts) rather than net profits (i.e., profit) and such application is not unfair to the corporation.
- According to the court, the facts of this case did not present the "exceptional circumstances" necessary to justify the use of an alternative apportionment method; rather, inclusion of the gross receipts in the sales factor "fairly reflects the extent" of the corporation's business activity in the state.

Vectren Infrastructure Servs. v. Dep't of Treas., No. 345462, 2023 Mich. LEXIS 1150, (Mich., July 31, 2023)

- Mich. Supreme Court reversed Mich. court of appeals; found apportionment formula was constitutional as applied to taxpayer's gain
- "The first question in any multistate business tax apportionment dispute is whether the taxed entity is a unitary business, which then triggers the ability for states to tax under their individual business/corporate tax apportionment statutes."
- Affirmed use of statutory apportionment formula where gain was part of unitary business, found taxpayer needed to show apportionment ratio was not an accurate reflection of in-state activity *in the year of sale*

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Questions?

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