

# PUBLICATION

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## Slicing Shadows, Whipsaws and Flow-Through Entities: Tennessee and New Jersey Unitary Business Case Studies

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When it comes to state income taxation, the Supreme Court of the United States (SCOTUS) noted in its 1983 decision, *Container Corp. of America v. Franchise Tax Board*, that apportionment of income of multistate businesses "bears some resemblance...to slicing a shadow." The problem for taxpayers is those slicing the shadow are states and they can use whipsaws in doing so.

The unitary business principle is central to the constitutional limits on state taxation of corporate income . Before a state can require a non-domiciliary corporate taxpayer to apportion its income to and be taxed by the state, that income must have been earned in the course of the corporation's "unitary business."

Two cases from Tennessee and another from New Jersey are recent illustrations of state courts applying the unitary business principle to flow-through entities involving passive investments and activities. But the courts came to opposite conclusions. These decisions reflect just some of the challenges confronting flow-through entities engaged in multistate business and their corporate partners or members.

### Overview of the Unitary Business Principle

As a constitutional matter, the test of whether divisions of a single entity or multiple, affiliated entities are engaged in a unitary business is a three-part test of centralized management, functional integration and economies of scale. (Although, in states that require corporate taxpayers to file and pay income tax based on a "unitary combined report" of income and apportionment factors, such as California, Illinois, Texas and 20 other states, including the District of Columbia, additional requirements under state law, regulations and case law must also be satisfied). If the test is satisfied, then a state may require the filing of a combined report of income and apportionment factors, or require the inclusion of intangible income (dividends, interest, capital gains, etc.) in business income subject to apportionment.

Following the SCOTUS decisions in *Container Corp. of America* and *Allied-Signal, Inc. v. Director, Division of Taxation*, an "operational function" test could also be argued to have been another means to determine the existence of a unitary business. However, in *MeadWestvaco Corp. v. Illinois Dept. of Revenue*, SCOTUS made it clear that the so-called "operational function" test applied (and had always applied) only to questions of whether a discrete asset of a business generates apportionable income. Such an asset could be described as a "unitary asset." But "[w]here, as here, the asset in question is another business, we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." The question in *MeadWestvaco* was whether the Lexis/Nexis business unit was "unitary" with the larger (then Mead Corp.) business enterprise. *MeadWestvaco* was a fact pattern requiring application of the three-factor or "unitary enterprise" test, and SCOTUS held that "the state courts erred in considering whether Lexis served an 'operational purpose' in Mead's business" after determining that Lexis and Mead did not satisfy the unitary enterprise test.

With this background in mind, we can compare how Tennessee and New Jersey courts have recently applied the unitary business principle to passive investments and activities involving flow-through entities and how similarly situated taxpayers could be whipsawed, or benefited, as the case may be.

## *Blue Bell Creameries, LP v. Roberts*

As part of a business reorganization, a taxpayer-limited partnership (LP) was formed to operate an ice cream production, sales and distribution business. The Blue Bell group's parent holding company, BBC-USA, Inc., was a partner of the LP. The reorganization also included the conversion of BBC-USA to S corporation status which required a taxable stock redemption resulting in a capital gain to the LP for federal income tax and Tennessee Franchise, Excise Tax purposes.

In its 2011 decision in *Blue Bell*, the Tennessee Supreme Court first had to address whether the LP's capital gain was apportionable "business earnings" under state law. On its Tennessee Franchise, Excise Tax Return, the LP had reported the capital gain as "nonbusiness earnings" allocable to its commercial domicile located in Texas (therefore not subject to Tennessee excise tax). Since 2004 Tennessee's statutory definition of "business earnings" has included the so-called "functional test." In *Blue Bell*, the court adopted the interpretation of the functional test used by the California Supreme Court in *Hoechst Celanese Corp. v. Franchise Tax Board*, to define business income or earnings.

The Tennessee Supreme Court held that the LP's acquisition and sale of BBC-USA stock was an "integral part" of the LP's business operations, because it "was a necessary step in the reorganization" and the reorganization served useful business purposes. (The business goal or purpose of the reorganization, which was in part to provide for federal flow-through tax treatment and reduction in federal tax expense and expenses of compliance, is a consistent theme in the decision).

The Tennessee Supreme Court then moved to address the unitary business principle. The court stated the issue as "whether the Stock Transaction and reorganization are unitary with Taxpayer's ice cream business" or, stated another way, was the BBC-USA stock a unitary asset of the LP's ice cream business? The Tennessee Supreme Court then applied the operational function test and found it satisfied, because the reorganization transactions giving rise to the gain served business purposes. However, in *ASARCO, Inc. v. Idaho State Tax Comm'n* and *Allied-Signal*, SCOTUS rejected the business purposes of transactions as having any unitary significance. In doing so, the *Blue Bell* decision may have elevated business purpose in Tennessee unitary business controversies to a prominence never intended by the long-standing SCOTUS precedents, including *ASARCO* and *Allied-Signal*.

Notwithstanding the Court's reliance on business purpose, because the case involved gain from a discrete asset, the Tennessee Supreme Court could have concluded its opinion. No question of enterprise unity appears to have been presented by the facts. Nonetheless, despite *MeadWestvaco* and the limited question before it, the Tennessee Supreme Court addressed "enterprise unity."

Although SCOTUS has consistently held in *Mobil Corp.*, *Container*, *Allied-Signal* and most recently in *MeadWestvaco* that its three-prong unitary enterprise test (and only this test) applies to questions of "enterprise unity," the Tennessee Supreme Court focused on the passive nature of BBC USA's business and stated the three-prong test (and other traditional state court unitary business tests) were "ill-suited for assessing Taxpayer and BBC USA's relationship because all three tests require a comparison" of active business operations. The Court applied no test or definition to determine whether the LP and BBC USA satisfied "enterprise unity." Instead, the Tennessee Supreme Court concluded that the LP failed to satisfy its burden of proof with "clear and cogent evidence showing that BBC USA operates a business enterprise that is discrete from that of Taxpayer."

The constitutional unitary enterprise test and its state court counterparts have been applied to fact patterns involving passive holding companies, passive activities or other non-active ownership fact patterns. Indeed, *Allied-Signal* involved a minority stock investment, *ASARCO* involved corporate relationships where control

and active management was absent and *Mobil* included a parent holding company. In addition, other states, such as Arizona and California, have applied the traditional unitary enterprise tests for determining whether passive holding companies were includible as part of a unitary business enterprise. As a result, *Blue Bell* could be seen as nothing but a standard of proof case. While the unitary business principle protects taxpayers as a limit on state taxation, the Tennessee Department of Revenue's excise tax assessment that treated the capital gain as apportionable earnings was given almost presumptive deference, leaving the taxpayer with the heavy burden of proving the assessment incorrect with "clear and cogent evidence" under an uncertain unitary business standard.

### **H.J. Heinz Company, L.P. v. Chumley**

The LP in *H.J. Heinz* operated a food products manufacturing, sales and distribution business. The LP owned the only interest in a single member limited liability company, HJH One, which was treated as a disregarded entity for federal income tax, but not Tennessee Franchise, Excise Tax purposes. (For franchise, excise tax purposes, a single member LLC whose sole owner is not a corporation is treated as a separate taxable entity.) HJH One was an investment company that owned preferred stock in the LP's ultimate parent company. HJH One received dividend income on its preferred stock, which was then apparently distributed to the LP as "partnership investment income." The LP argued that the income was from a passive investment and was "nonbusiness earnings" wholly allocable outside Tennessee to the LP's state of commercial domicile, Pennsylvania. Unlike *Blue Bell*, which involved gain from the sale of a discrete asset (stock), *H.J. Heinz* involved a different question -- whether the LP's investment income received from HJH One was income from a unitary business enterprise conducted inside or outside of Tennessee by the LP and HJH One.

With respect to the constitutional unitary business issue, the Tennessee Court of Appeals held that the LP and HJH One were engaged in a unitary business because the prior business reorganization benefitted the Heinz group, including the LP and HJH One, and HJH One's passive investment company operations were not a discrete business enterprise.

In its 2011 decision, the Tennessee Court of Appeals followed *Blue Bell* and did not apply the three-prong constitutional unitary enterprise test. Thus, the first Tennessee Court of Appeals decision after the Tennessee Supreme Court's *Blue Bell* decision appears to stand for the proposition that the unitary enterprise test is not applied to passive businesses or activities in Tennessee. Further, despite *ASARCO* and *Allied-Signal*, the Tennessee Court of Appeals found enterprise unity existing simply because of the business purposes and benefits to the Heinz group from the prior business reorganization.

### **Blue Bell and Heinz -- The Aftermath**

In determining whether their income is apportionable under the unitary business principle, Tennessee Franchise, Excise taxpayers are left with a number of questions:

1. Given *ASARCO* and *Allied-Signal*, did the Tennessee courts really intend to elevate business purpose to such prominence in making Tennessee unitary business determinations? Was the reasoning that the constitutional unitary enterprise test was "ill suited" to the passive fact patterns simply because taxpayers did not satisfy challenging standards of proof? If not, then what unitary enterprise test applies if not the constitutional test or any of the other state court tests?
2. Whither Dreyfus? The results in *Blue Bell* and *H.J. Heinz* are a far cry from the analysis and test applied by the Tennessee Court of Appeals in its 1996 decision in *Louis Dreyfus Corp. v. Huddleston*, where the court applied the stricter "interdependence of basic operations test" of a unitary enterprise. To what degree will Tennessee-based taxpayers benefit from *Blue Bell* and *H.J. Heinz* and how will

the Tennessee Department of Revenue react given an apparent conflict between *H.J. Heinz* and *Dreyfus*?

3. How will the rationale that the unitary enterprise test(s) are inapplicable to passive holding companies or activities impact the definition of "unitary business" applicable to financial institution affiliated groups that are required to file Tennessee unitary combined reports of income and apportionment factors and will include bank holding companies, investment companies and other passive entities?

These and other questions will undoubtedly need to be sorted out in the coming years.

### **BIS LP, Inc. v. Director, Div. of Taxation**

While the questions in *Blue Bell* and *H.J. Heinz* were whether gain or income recognized by a passive limited partnership and from a passive investment, respectively, could be apportioned to and taxed by Tennessee, the question in *BIS LP* was one of state taxing jurisdiction.

The taxpayer's only asset, and only connection to New Jersey, was a 99 percent limited partnership interest in a limited partnership that did business in New Jersey and other states. The general partner was the taxpayer's parent, a holding company. Under statute in New Jersey, a foreign corporate limited partner is considered to do business in the state and is subject to the Corporation Business Tax under state law if, in addition to other factors, the corporate limited partner is unitary or integrally related with the business of a limited partnership in New Jersey. The New Jersey appellate court held that the state did not have jurisdiction to tax because the corporate limited partner was not unitary or integrally related with the limited partnership. Because the taxpayer was passive and was engaged in a different business than the partnership (the taxpayer was an investment company and the partnership was a banking information data processing business), the court ruled functional integration and economies of scale were absent. In addition, sharing a mailing address and having some of the same corporate officers did not represent centralized management between the taxpayer and limited partnership.

Thus, under fact patterns of passive business activities, Tennessee and New Jersey courts have come to opposite unitary business determinations. Further, while the New Jersey courts applied the unitary enterprise test to a passive relationship, the Tennessee courts considered the unitary enterprise test "ill suited" to the passive fact pattern.

### **What You Should Know**

There are at least three universal take-aways from the decisions of the Tennessee and New Jersey courts:

4. the unitary business principle is subject to inconsistent application by different state courts;
5. unitary business controversies are fact intensive and strong factual record development is as important, if not more so, than the legal standards employed; and
6. what is good for the goose is always good for the gander. For example, New Jersey-based corporate limited partners may find themselves disadvantaged by *BIS LP*, while Tennessee-based corporate limited partners or holding companies may realize tax benefits as a result of *Blue Bell* and *Heinz*.

What should also be clear is that taxpayers are confronted by critical interpretative dilemmas with respect to capital gains, dividends, interest and other items of intangible income, often, but certainly not only, resulting from their passive investments or activities. Advance evaluation and planning is in order whether a discrete item of income, gain or loss is concerned or a unitary filing option is under consideration.