

PUBLICATION

Spotlight on Tennessee: Business Earnings Addressed by State Supreme Court

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Business structures are often reorganized to assist in isolating liabilities, support discrete product brands and address favorable tax environments. However, in certain fact situations, unintended Tennessee excise tax consequences can result from certain reorganizations. Such was the outcome of the Tennessee Supreme Court's recent decision in *Blue Bell Creameries, LP v. Richard Roberts, Commissioner of Revenue*, published January 24, 2011.

The Holding

In *Blue Bell*, the Supreme Court of Tennessee held that a reorganization transaction implemented and controlled by the out-of-state parent having no business operations of its own (Holding Company), where such transaction produced capital gains taxable for federal purposes to the partners of a limited partnership subsidiary doing business in Tennessee (Taxpayer Subsidiary), served an operational function in the analysis of whether those gains should be taxable as business earnings under Tennessee's excise tax to Taxpayer Subsidiary. Under these particular and complex facts, the reorganizational activities conducted by Holding Company were determined to produce business earnings for Taxpayer Subsidiary since such reorganizational activities served to increase the net gain from Taxpayer Subsidiary's ice cream business.

Facts

Holding Company is located outside Tennessee with no presence in this state. A Subsidiary (First Subsidiary) of Holding Company historically produced, distributed and sold Blue Bell ice cream from various locations, one such location being in Tennessee. In order to minimize federal income taxes and thus increase net gains from the ice cream business, Holding Company reorganized to qualify as an S corporation and also created Taxpayer Subsidiary as a Delaware limited partnership for purposes of succeeding to First Subsidiary's Blue Bell ice cream business.

In furtherance of that restructuring, Holding Company caused all the assets and liabilities of First Subsidiary (including operations of the ice cream business) to be transferred to Taxpayer Subsidiary. Also as part of this reorganization, and because of S corporation restrictions on the number of shareholders, certain shareholders in Holding Company transferred their stock to Taxpayer Subsidiary and thereafter Holding Company redeemed such shares (Stock Redemption). The capital gains realized that such Stock Redemption were taxable for federal purposes to the partners in Taxpayer Subsidiary because of its federal pass-through status.

However, the state of Tennessee includes limited partnerships among the taxable entities for franchise and excise tax purposes. Accordingly, Taxpayer Subsidiary filed a Franchise, Excise Tax Return, but did so classifying these capital gains for excise tax purposes as non-business earnings allocable outside this state -- and, not subject to this state's excise tax. On audit, the Department of Revenue (Department) reclassified the capital gains as business earnings subject to apportionment for excise tax purposes and issued a deficiency assessment. After paying the assessed tax, Taxpayer Subsidiary filed suit in the Davidson County Chancery Court demanding a refund.

Judgment was awarded to Taxpayer Subsidiary for such refund by the Chancery Court and such judgment was upheld by the Tennessee Court of Appeals, with both courts determining that the capital gains from the Stock Redemption constituted non-business earnings allocable outside Tennessee and, thus, not subject to this state's excise tax. The Tennessee Supreme Court granted the Department's application to appeal, reversed the lower court decisions and entered a judgment for the Department.

Issues to Consider

- Functional Test: The Tennessee Supreme Court adopted a broad application of the functional test definition of business earnings by holding that Taxpayer Subsidiary's stock acquisition and the accompanying redemption by Holding Company under the Stock Redemption contributed materially to the production of business earnings -- thus, in the court's opinion making the Stock Redemption an integral part of Taxpayer Subsidiary's business operations. The court reasoned that such Stock Redemption was a necessary part of the objective to reduce expenses arising from the sale of ice cream. In so doing, the court adopted the broader California interpretation of the functional test, as opposed to an interpretation followed in more states, such as Illinois, Indiana, North Carolina, Oregon and Pennsylvania. While California and now perhaps Tennessee only require that the use of an asset contribute to the production of business earnings, courts in these other states require that the asset and its disposition be an essential part of a taxpayer's business.

The court's application of the functional test raises a question of whether the business liquidation exception to the functional test will apply in Tennessee. Thus, while California and Tennessee may likely treat gains from a sale of assets in complete liquidation of a business as business earnings because the assets were used in a business, these other states would not currently do so. According to the Illinois, Indiana, North Carolina and Pennsylvania courts, both the use and sale of the asset must be essential to the taxpayer's business. Going out of business would arguably not be an essential business activity.

- Reorganization Purpose: According to the decision, the reorganization activities had the effect of permitting Holding Company and its subsidiaries to remain privately-held companies, thus avoiding the expense and inconvenience of registering its securities and publically reporting its financial results. Nevertheless, the Tennessee Supreme Court determined that this reorganization neither diversified the business nor reduced risks associated with the ice cream business. According to the court, the Stock Redemption and associated reorganization activities served to increase the net gain from the ice cream business allowing the court to take the next step of concluding that such transactions served as an operational function for Taxpayer Subsidiary's business. While one can debate whether the operational function should have been considered before a determination about enterprise-unity (i.e., whether Holding Company and Taxpayer Subsidiary were engaged in a unitary business not whether a discrete asset was a part of Taxpayer Subsidiary's unitary business), see *MeadWestvaco Corp. v. Illinois*, 553 U.S. 16 (2008), a focus on business purpose should not be relevant to either operational function or enterprise-unity. *ASARCO, Inc. v. Idaho*, 458 U.S. 307, 326 (1982); *Allied-Signal, Inc. v. New Jersey*, 504 U.S. 768, 788-789 (1992). While the foregoing can be debated, capital gains resulting from an internal reorganization of a unitary business, as found to be the situation in *Blue Bell*, should generally be apportionable.
- Parent's Business: Taxpayer Subsidiary admitted that Holding Company does not conduct any business operations. Passive holding companies are often unitary with their operating subsidiary or parent corporations. A purely passive entity like Holding Company can serve some important business functions, such as insulating its shareholders from liability or as a conduit for financing subsidiary business operations. However, the key unitary attribute of Holding Company was that its value to its shareholders resulted from the unitary business operations of Taxpayer Subsidiary and any other subsidiaries. The fact that Holding Company performed no business operations may well

have been irrelevant since the U.S. Supreme Court's unitary business tests were just as applicable (and required to be applied for purposes of the Due Process and Commerce Clauses), and would have resulted under these facts in a finding of a unitary business relationship between Holding Company and Taxpayer Subsidiary.

Summary

The Blue Bell decision represents a complex fact situation involving sophisticated statutory and constitutional principles. If you would like to discuss this decision in more detail, please contact any attorney in the Firm's Tax Department.