taxnotes® state
Volume 105, Number 6 ■ August 8, 2022

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by William D. Lipkind and Adam Buchwalter

Reprinted from *Tax Notes State*, August 8, 2022, p. 607

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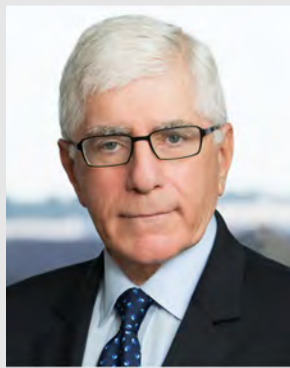
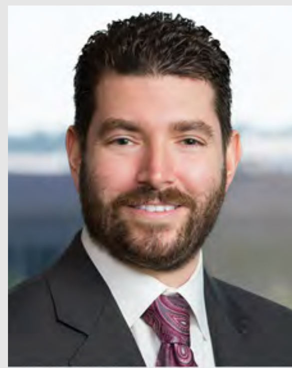

William D. Lipkind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In this article, Lipkind and Buchwalter explore the due process clause and the efforts of states to tax non-domiciliary taxpayers.

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Background

At one polar extreme, taxpayers in high-income-tax states that are contemplating the sale of their businesses seek strategies to minimize or eliminate state income taxes on the sale. At the other polar extreme, states seek to tax non-domiciliary taxpayers on the sale of their equity in a business when that business is engaged in activity in the taxing state. The primary barrier to state taxation efforts is the due process clause of the U.S. Constitution. This article will explore the efforts of the states and measure them against the existing barriers.

One popular strategy for taxpayers is to transfer the equity interests in the business to a trust that is not a grantor trust for income tax purposes under IRC section 671 et seq. and that is domiciled in a state that permits self-settled spendthrift trusts and has no state income tax (hereafter, such a trust is simply referred to as a Trust).[1]

For example, an individual taxpayer in California, owning stock of a C corporation conducting its business in California, creates a Trust domiciled in Nevada of which he may be a potential beneficiary. He then transfers his stock to the Trust, and thereafter the Trust sells all the stock to an unrelated purchaser. Since it is accepted law that an intangible (that is, the stock) is domiciled in the jurisdiction where its owner is domiciled (in this case, Nevada, the domicile of the Trust),[2] the sale of the stock should generate state income tax, if any, in Nevada, not California.[3] Because Nevada has no applicable state income tax, the taxpayer expects to accomplish his goal of effectuating a sale without state income tax. This is not a result for an individual taxpayer (or a trust) that has heretofore been contested by any of the high-income-tax states that do not seek to tax the income of a Trust settled by their domiciliaries.[4] However, one tax trap in New York and New Jersey (but not California) is that both states will tax all income of a trust established by a domiciliary of that state if the trust contains any

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[1] *See generally* William D. Lipkind, "Tax Planning With Self-Settled Non-Grantor Trusts," *Trusts & Estates*, June 2016. The authors note the Trust can be complete or incomplete for gift and estate tax purposes.

[2] *New York ex rel. Whitney v. Graves*, 299 U.S. 366 (1937).

[3] *But see* California Franchise Tax Board, Legal Ruling 1995-7 (discussed later). Also, consider the discussion of the "Stockholder Theory" below.

[4] Each state has its own laws on the taxation of trusts created by its domiciliaries, which look at various factors, including the domicile of the trustee and beneficiaries and where the trust is administered. *See* Richard W. Nenno, "Bases of State Income Taxation of Nongrantor Trusts for 2020" (Feb. 22, 2021). The U.S. Supreme Court has held that the mere residency of the beneficiary where the beneficiary has no right to demand distributions is an insufficient nexus for a state to impose taxation. *See North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (2019).

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"source" income (the Source Income Exception).[5] If the seller of the stock is a corporation and not the Trust, as would be the case with a holding company, the result may be different.[6]

Despite the seller's desire to avoid state income tax on the sale of stock of a C corporation, the purchaser generally wants to maximize its ability to step up the tax basis of acquired assets for purposes of depreciation. This can, of course, be accomplished if there is a purchase of assets. The problem for the seller, regardless of the type of business entity, is that the sale of assets, including the intangible asset of the company's good will, will probably constitute business income (not investment income) or source income in the state where the business is conducted.[7] Thus, in the case of an asset sale, the goal of a sale without state income taxes will be defeated.

Unlike a C corporation, a limited liability company or a partnership may be able, for both the seller and buyer, to achieve their tax objectives when a single purchaser acquires 100 percent of the membership interests of the entity.[8] The risk factor here would be for the taxing state to succeed in defeating the result using the "IRC Theory" (discussed later).

There are even greater tax complications if the business entity is an S corporation and the purchaser wants to elect IRC section 338(h)(10) treatment (that is, to have the purchase of stock treated as a sale of assets for income tax purposes). Absent additional tax planning, the sale will generate the same undesired tax result as the sale of assets by any other entity and subject the seller to state income tax. Further, as discussed later, even with the additional planning, potential tax results will vary depending upon the state(s) in which the company does business.

In seeking to avoid the undesired tax results from a section 338 (h)(10) election, the taxpayer might restructure the S corporation. For example, our hypothetical individual California taxpayer might migrate his California S corporation to Delaware, encapsulate the intangibles owned by the business into a wholly owned LLC subsidiary, distribute a 1 percent interest of that LLC to the shareholders of the S corporation (thereby converting the LLC with the intangibles into a partnership for tax purposes),[9] and then effectuate the sale by having the S corporation sell its membership interests in the LLC. In this case, the taxpayer would argue that the sale is not subject to California tax because the Delaware S corporation, owned by a Trust domiciled in Nevada, sold its 99 percent membership interest in the Delaware LLC, an intangible asset. For reasons discussed below, this strategy has a high risk of failure.

The Passive Holding Company

An even more sophisticated California individual taxpayer may refine the restructuring of the S corporation. First, he will create a Delaware S corporation holding company (HoldCo) and then transfer his entire interest in the S operating company to HoldCo. Not only can this be accomplished without tax consequences,[10] but the S operating company can then be converted into a limited partnership (OpCo) in a nontaxable conversion.[11] A 1 percent general partnership interest is then distributed to an individual or entity not domiciled in California, with HoldCo retaining the 99 percent limited partnership interest. Assuming that HoldCo is totally passive (herein, a Passive Holding Company), the Trust will take the position that the

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[5] New York subjects all income of a "resident trust," defined as any trust established by a New York domiciliary, to New York income tax unless three conditions are met: (1) all trustees are domiciled outside New York, (2) the entire corpus of the trust is located outside New York, and (3) there is no New York-source income. *See* N.Y. Tax Law section 605(b)(3)(D); New York Advisory Opinion TSB-A-20(2)(I). New Jersey has adopted the New York position not by statute but in its instructions to Form NJ-1041 and administrative guidance. *See* New Jersey Tax Topics Bulletin GIT-12.

[6] *See Allied-Signal Inc. v. Commissioner of Finance*, 79 N.Y.2d 73 (1991); *VAS Holdings & Investments LLC v. Commissioner*, 489 Mass. 669 (2022); California Franchise Tax Board, Legal Ruling 1995-7.

[7] *See The 2009 Metropoulos Family Trust v. California Franchise Tax Board*, No. D078790 (Cal. Ct. App. May 27, 2022).

[8] Rev. Rul. 99-6, 1999-1 C.B. 432. New York has taken a contrary position that when IRC section 1060 applies to a transaction (*i.e.*, when a single purchaser acquires 100 percent of the membership interests in a partnership or LLC), the gain from the sale is deemed to be New York-source income. *See* N.Y. Tax Law section 632(a).

[9] The distribution of the 1 percent interest to the shareholders of the S corporation will be a taxable distribution, subject to federal and state income tax.

[10] IRC section 368(a)(1)(F).

[11] If the parent holding company elects to treat the operating subsidiary as a qualified subchapter S subsidiary (which is treated as a disregarded entity under Treas. reg. section 1.1361-4), the transfer to a partnership wholly owned by the parent (also a disregarded entity to the parent) has no tax consequences.

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sale by HoldCo of its 99 percent limited partnership interest in OpCo is not subject to California state income taxation.

State income tax consequences for the use of a Passive Holding Company differ depending on the domicile state of the taxpayer or the operating company. Three different theoretical bases of taxation need to be considered: the unitary business theory (Unitary Theory), the mere stock ownership theory (Stockholder Theory), and a theory based on the characterization of distributions from a passthrough entity (partnership, LLC, or S corporation) under some provisions of the IRC (the previously noted IRC Theory).[12] As we will see, the unitary business doctrine (the definition of which varies to some degree among the states and is highly dependent on facts and circumstances) is a basis of taxation in all the "applicable jurisdictions" (as listed in the following paragraph) and has long been approved by the U.S. Supreme Court. Creative counsel should be able to structure the Passive Holding Company to either eliminate or minimize the risk of its successful application. Avoiding the application of the Stockholder Theory and the IRC Theory is more problematic.

This article will analyze positions under the laws of California, Massachusetts, New Jersey, New York, and Ohio (as examples of the differing extant state tax statutes) and measure the positions against the decisions of the U.S. Supreme Court and its application of the due process clause of the U.S. Constitution. The uncertainty, confusion, and inconsistency emanating from these applicable jurisdictions,[13] especially regarding the Stockholder Theory and the IRC Theory, militate in favor of the Court clarifying just how far a state may go to tax an intangible owned by a taxpayer that is not domiciled in the taxing state.

California

California subjects a corporation to a tax equal to the greater of an income tax or a minimum franchise tax if the entity is "actively" engaged in business in California.[14] In the case of an entity that does business both within and without California, it apportions the income.[15] In the case of multiple related entities, some of which are actively involved in a business, California will first evaluate whether the entities are part of a "unitary business" and then, to the extent that they are, apply the apportionment statute to the aggregate unitary business taxing the California portion of the "business income" but not the nonbusiness income.[16]

In defining business income, California recognizes that intangibles are generally taxed solely in the state in which their owner is taxed. However, if the intangible has acquired a situs in California, it will be included as business income.[17]

What is a unitary business? California, like all states, adopts a facts and circumstances approach to determine when a taxpayer's "activities within the state contribute to or are dependent upon its

[12] The IRC Theory is based on the characterization of income realized by a taxpayer from its ownership of an interest in a passthrough entity. In the case of a partnership, for instance, IRC section 702(b) provides that "the character of any item of income . . . included in a partner's distributive share [of partnership income] shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." IRC section 1366(b) imposes the same rule regarding S corporations and their shareholders. The IRC Theory argues that because of this characterization, in the case of an active trade or business, the partner or shareholder is deemed to be directly engaged in that active trade or business. Thus, the capital gain on the sale of the equity interest itself would be subject to tax in the state where the active trade or business is being operated. The tax result from application of the IRC Theory would be similar to the tax result under IRC section 864(c)(8) upon the sale by a foreign person of an interest in a partnership that is engaged in an active trade or business in the United States. The authors are aware of no state that has successfully invoked the IRC Theory to tax the capital gain realized by a nonresident on the sale of an interest in a passthrough entity engaged in an active trade or business within that state and question whether a state could take this position in the absence of legislation to that effect.

[13] The authors believe that readers will be able to relate their state laws to one of the applicable jurisdictions.

[14] "Every corporation doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by this part, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income . . . or, if greater, the minimum tax specified in [Cal. Rev. and Tax. Code] Section 23153." *See* Cal. Rev. and Tax. Code section 23151(a). Even when an entity is not "actively engaged" in a trade or business in California, the board has sought to impose a franchise tax on an entity that has a passive interest in another entity that is actively engaged. *See* Amy Silverstein and Alex Freeman, "Class Action Lawsuits Challenging California's $800 Minimum Tax Seek to Protect Small Businesses From the Franchise Tax Board's Overreach," LISI Business Entities Newsletter #253 (July 13, 2022).

[15] Cal. Rev. and Tax. Code section 25120 et. seq. California is one of 24 states to have adopted the Uniform Division of Income for Tax Purposes Act. Note that neither New York nor New Jersey has adopted this act.

[16] Cal. Rev. and Tax. Code section 25101; Cal. Rev. and Tax. Code section 25120 et. seq.; Cal. Code Regs. tit. 18, section 25120.

[17] Cal. Rev. and Tax. Code section 25120; *Metropoulos Family Trust*, 4th Appellate District.

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activities without the state."[18] There are generally three defining features of a unitary business: unity of ownership, unity of operations, and unity of use of a centralized executive force and general system of operations.[19]

In Legal Ruling 2021-01, the California Franchise Tax Board said that when there is a unity of ownership, unity of operation, and unity of use, the activities of multiple business companies may be treated as part of a single unitary business. That same ruling contains an extensive discussion of whether a Passive Holding Company would be treated as part of the unitary business. In that discussion, the FTB stretches to find a unitary business by suggesting that the subsidiary operating company may obtain protection from liability from the parent holding company (or any one or more of seven other factors). The ruling also suggests that finding the Passive Holding Company to be a "conduit" between the operating company and the stockholders would be sufficient to find a unitary group. This stretch of the definition of unitary business has not been the subject of any decision of either the California courts or the U.S. Supreme Court.

Over the years, the FTB has taken several positions on the foregoing that merit observation and comment. The board and case law acknowledge that the "passive" holding of a limited partnership interest in an operating company is not sufficient to make the holder part of a unitary business.[20] The FTB has argued and achieved judicial support that to the extent OpCo is engaged in an active trade or business in California, upon a distribution of its income to HoldCo, HoldCo should be deemed to be similarly engaged.[21] The FTB and courts rely on provisions in the IRC characterizing the distributee of income as having engaged in the same activities as the distributor — just as if the distributor had engaged in the activities itself.[22] This is the IRC Theory. Arguably, if the IRC Theory is accepted, the sale by HoldCo of its interest in OpCo would be taxable on the same basis as the sale by OpCo of its assets, including its intangible assets.[23]

However, such a characterization might not be applicable to the sale by HoldCo of its partnership interest in OpCo. The theory, at least as described by California courts, does not recognize any difference between the tax characterization of a distribution of earnings or assets from OpCo to HoldCo and the tax consequences of the sale by HoldCo of its intangible asset (that is, its equity in OpCo). In blurring the distinction, the California courts refer to due process decisions of the U.S. Supreme Court holding that in the application of the Unitary Theory, no distinction is made between ordinary income and capital gains.[24] The entire IRC Theory as argued by California rests upon provisions in the IRC. However, the IRC, a mere tax characterization, does not, and should not be deemed to, constitute a grant of in personam taxing jurisdiction over the taxpayer (that is, HoldCo).[25] In the case of a nonresident alien owning an interest in a passthrough entity engaged in an active trade or business in the United States,[26] Congress has imposed a tax on the capital gain arising from a sale of such interest[27] and solved the problem of lack of tax jurisdiction over the person by providing for withholding from the operating company (over which the United States does have tax jurisdiction).[28]

[18] Cal. Code Regs. tit. 18, section 25106.5-10.

[19] *Id.*

[20] California Franchise Tax Board, Legal Ruling 2014-01; *Swart Enterprises Inc. v. Franchise Tax Board*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017).

[21] *Id.*

[22] *Supra* note 12. In Legal Ruling 2022-02, issued on July 14, 2022, the FTB adopts the IRC Theory, at least in part, and holds that the sale by a nonresident individual of a partnership interest is subject to California income tax on the gain attributable to any IRC section 751 assets of the partnership.

[23] *Metropoulos Family*, 4th Appellate District.

[24] *Asarco Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982).

[25] "Governmental jurisdiction in matters of taxation . . . depends upon the power to enforce the mandate of the State by action taken within its borders, either *in personam* or *in rem* according to the circumstances of the case." *Shaffer v. Carter*, 252 U.S. 37 at 49 (1920).

[26] The nonresident is subject to U.S. taxation. IRC sections 871(b) and 875.

[27] IRC section 864(c)(8).

[28] IRC section 1446(f); *see Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940); *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944).

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In a 1995 legal ruling, the FTB suggested that the mere ownership of a California operating company was sufficient to make the holder part of a unitary business.[29] This is an application of the Stockholder Theory of taxation.

The authors are unaware of any California case or any decision of the U.S. Supreme Court applying either the IRC Theory or the Stockholder Theory to tax the capital gain of HoldCo's interest in OpCo in the absence of a unitary business. In the absence of decisional law, there is, of course, a risk factor.

The overarching limitation on California, and on any other state, in taxing a company, or a group of companies in a unitary business, is the due process clause of the U.S. Constitution (discussed in some detail later). Under the due process clause, a state may not impose an income-based tax on value earned wholly outside its borders.[30] Thus something more than mere ownership must be found to acquire the necessary nexus for tax of an intangible. Whether, in a state's reach to obtain more tax revenue, the IRC Theory or the Stockholder Theory is the "something more" is yet unknown.

New York

New York is similar in many ways to California. However, New York and New York City also have positions that are different. As with California, if there is a unitary business, New York will include all income of the unitary business and do an appropriate apportionment.[31] Similarly, New York respects the constitutional restriction against taxing income earned outside New York in situations where there is not sufficient tax nexus.[32] Regarding holding companies, current New York law does not single them out for any special treatment, so recent cases do not discuss them as such. Further, New York has reduced the inclusion of the term "investment income" in its unitary business apportionment requirements.

The recent case of *SunGard*[33] is illustrative of the similarities. In finding that SunGard met the unitary business requirement, the court said:

> The unitary business principle is the linchpin of apportionability for State income taxation of an interstate enterprise. . . . The principal holds that if an interstate enterprise is determined to be a unitary business, then a State may use an apportionment formula to tax that portion of the total income that is reasonably related to the enterprise's intrastate activity. . . . The prerequisite of a constitutionally acceptable finding of unitary business is a flow of value between the subject entities. . . . The hallmarks of a unitary relationship among businesses are functional integration, centralized management and economies of scale.[34]

The court had a lengthy discussion on the interrelationship of the various companies, examining criteria for finding a unitary enterprise, and it had no problem holding that the unitary enterprise requirement was met in certain circumstances. Of importance to us is the agreement of the court with the administrative law judge that:

> a holding company is not necessarily unitary with the corporation it owns. . . . Here, the record lacks evidence of each such holding company's specific function or role. . . . Accordingly, we find that the holding companies . . . are not engaged in a unitary business with the other members.[35]

One leading commentator characterized *SunGard* as follows: "Finally, the exclusion of the pure holding companies and inactive companies in this is noteworthy, as there is arguably nothing

[29] California Franchise Tax Board, Legal Ruling 1995-7.

[30] *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980).

[31] N.Y. Tax section 210-A.

[32] *Allied-Signal*, 79 N.Y.2d 73.

[33] *Matter of SunGard Capital Corp. and Subsidiaries*, Dkt. Nos. 823631, 823632, 823680, 824167, 824256 (N.Y.S. Tax App. Trib., May 19, 2015).

[34] *Id.* at 27-28.

[35] *Id.* at 34.

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in New York's current unitary combined reporting statute that would dictate a different result."[36]

However, in *Allied*, New York successfully invoked the Stockholder Theory to tax the capital gains realized by a non-domiciliary corporation on its sale of stock of another non-domiciliary corporation that was not part of a unitary business, merely because the company whose stock was sold did business in New York.[37] As a matter of fact, the non-domiciliary corporation that New York subjected to tax was obligated to file a New York tax return for reasons unconnected with its sale of stock. The New York Court of Appeals did not discuss whether the result would have been different in the absence of this fact. The due process basis, according to the New York Court of Appeals, was that because New York provided benefits to the sold company, its stockholder also benefited and thus New York had a constitutional nexus for taxation. The decision was not appealed to the U.S. Supreme Court. Perhaps the existence of this case is what led to the FTB promulgating Legal Ruling 1995-7.

The authors take exception to the language in the *Allied* decision, which obliterates the long-standing doctrine that an intangible is domiciled where its owner is domiciled. Indeed, it is hard to imagine an investment company purchasing marketable securities on an established exchange being required to pay taxes on its capital gains apportioned to every state where a company in which it owned stock did business. The language of the court of appeals draws no distinction between the taxation of a non-domiciliary corporation and the taxation of any citizen of the United States who did not live in New York, nor does it draw a distinction based on New York having independent tax nexus with the taxpayer.

Recently, the U.S. Supreme Court ruled that under the due process clause of the U.S. Constitution a state could not tax a trust merely because a beneficiary lived in that state.[38] By extension, the taxation by a state of a non-domiciliary merely because it owns stock in a company that does business in New York appears even more remote. The remoteness is exacerbated when, unlike in *Allied*, the non-domiciliary company itself has no tax nexus to New York and no independent obligation to file a New York tax return. Putting to one side the question of how New York would become aware of the sale, an argument can be made that if New York has no constitutional basis to require the seller to file a New York return, it should not have any basis to claim that the seller owed New York taxes merely because of its stockholding.

New York, like California, has also invoked the IRC Theory. Thus New York courts have held that if a corporation owns an interest either as a partner, or, more significantly, as a limited partner, in a partnership that is doing business in New York, then the owning company is also deemed to be engaged in business in New York and New York can tax both the ordinary income and the capital gain sale income of the non-domiciliary holding company arising from the sale of the New York operating company.[39] Here, too, there is no authority from the U.S. Supreme Court that the sale proceeds of the holding company (presumably investment income) are taxable by New York, in addition to the ordinary income, just because of the ownership.

In short, New York, on its own terms, poses a greater problem than California in that while it invokes the IRC Theory to sustain taxation of a passthrough that is not a unitary business, it has also held that mere stock ownership is a sufficient nexus for taxation.

Ohio and Massachusetts

In Ohio, the supreme court rejected the IRC Theory and concluded that mere stock ownership was not a sufficient nexus for taxation, rejecting the New York *Allied* case.[40] In Massachusetts, on the other hand, the supreme court[41] held similarly to *Allied* and gave as its reasons the same reasons invoked by New York in *Allied*.

[36] Deloitte, "New York — Combined Reporting Permitted Under Unitary Business Analysis" (June 29, 2015).

[37] *Allied-Signal*, 79 N.Y.2d 73.

[38] *Kaestner*, 139 S. Ct. 2213.

[39] *See Allied-Signal*, 79 N.Y.2d 73; *Goldman Sachs Petershill Offshore Holdings (Delaware) Corp. v. N.Y.C. Tax Appeals Tribunal*, N.Y. Slip Op. 2361 (Apr. 12, 2022).

[40] *Corrigan v. Testa*, 149 Ohio St. 3d 18 (2016).

[41] *VAS Holdings*, 489 Mass. 669.

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New Jersey

New Jersey appears not to have gone beyond use of the Unitary Theory as the sole basis of taxing a non-domiciliary entity. Thus, it is unknown whether a New Jersey court would adopt either the IRC Theory or the Stockholder Theory.

As of July 31, 2019, unitary business is defined in New Jersey under NJSA 54:10A-4(gg) as follows:

> "Unitary business" means a single economic enterprise that is made up either of separate parts of a single business entity or of a group of business entities under common ownership that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value among the separate parts. "Unitary business" shall be construed to the broadest extent permitted under the Constitution of the United States. A business conducted by a partnership which is in a unitary business with the combined group shall be treated as the business of the partners that are members of the combined group, whether the partnership interest is held directly or indirectly through a series of partnerships, to the extent of a partner's distributive share of partnership income. The amount of partnership income to be included in the partner's entire net income shall be determined in accordance with subsection a. of section 3 of P.L.2001, c.136 (C.54:10A-15.6) or subsection a. of section 4 of P.L.2001, c.136 (C.54:10A-15.7), as applicable. A business conducted directly or indirectly by one corporation is unitary with that portion of a business conducted by another corporation through its direct or indirect interest in a partnership.

Note the language in the statute that it shall be construed "to the broadest extent permitted under the Constitution of the United States." Technical Bulletin 93, issued by the New Jersey Division of Revenue, states that the statutory definition of a unitary business is based on the Multistate Tax Commission's model definition with state-specific variations. The technical bulletin then recognizes that the scope of the definition must comport with the due process and commerce clause requirements of the U.S. Constitution.

The bulletin also gives circumstances for applying interdependence of functions and unitary operations. Finally, it provides that regarding holding companies:

> A passive holding company that is in a commonly controlled economic enterprise and holds intangible assets that are used by the enterprise in a unitary business is deemed to be engaged in the unitary business, even though the holding company's activities are primarily passive.

The bulletin, in effect, is saying that a holding company must hold or do something related to the operating business and not be a mere passive investment entity for there to be a finding of a unitary business.

New Jersey appears to be walking a thin line: It does not go as far as California and New York, but it has not closed the door. Although the authors have found no case in New Jersey that is directly on point, New Jersey courts have held, as has the U.S. Supreme Court, that mere stock ownership, without more, is an insufficient nexus as a basis for a court to obtain personal jurisdiction over a defendant in litigation.[42]

U.S. Supreme Court

There is a plethora of decisions from the U.S. Supreme Court regarding whether there is sufficient nexus between a state and a corporation to enable the state to tax the corporation in whole or in part without violating the due process clause. *Mobil Oil*[43] from 1980 is illustrative and contains an extensive discussion of what constitutes a "unitary business." The case makes clear that the whole constitutional basis upon which a state can apportion income of a

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[42] *See Shaffer v. Heitner*, 433 U.S. 186 (1977); *Pfundstein v. Omnicom Grp. Inc.*, 285 N.J. Super. 245 (App. Div. 1995).

[43] *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980).

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corporation to that state rests upon finding a unitary business. In commenting on prior cases, Justice Harry A. Blackmun writes that "the linchpin of apportionability in the field of state income taxation is the unitary business principle."[44]

However, the U.S. Supreme Court has placed a clear limit on a state's ability to apportion income even with a finding of the existence of a unitary business. States may not apportion income earned extraterritorially when that income is unrelated to the unitary business and is derived from an unrelated business activity.[45] When New Jersey asked the U.S. Supreme Court to overrule this limitation and find that a state has a constitutional right to apportion 100 percent of a corporation's income if there is *any* tax nexus to the state, the Court refused to do so, stating:

> The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax."[46]

The Court continued:

> New Jersey's sweeping theory cannot be reconciled with the concept that the Constitution places limits on a State's power to tax value earned outside of its borders. To be sure, our cases give States wide latitude to fashion formulae designed to approximate the in-state portion of value produced by a corporation's truly multistate activity. But that is far removed from New Jersey's theory that any business in the State, no matter how small or unprofitable, subjects all of a corporation's out-of-state income, no matter how discrete, to apportionment.[47]

Also to the point is the recent case of *MeadWestvaco Corp.*[48] That case involved the sale by Mead, domiciled in Ohio, of its ownership of Lexus, an unincorporated division of Mead, wherein on its Illinois state income tax return Mead apportioned the entirety of its gain as nonbusiness income, all of which should be allocated to Mead's domiciliary state, Ohio. The trial court had concluded that Mead and Lexis were not "unitary" because they were not functionally integrated or centrally managed, but Illinois could tax a portion of the capital gain because Lexis served an "operational purpose" for Mead. The Illinois Appellate Court affirmed, and in so doing it did not reach a decision on the existence of a unitary business. The Illinois Supreme Court denied review.

Justice Samuel A. Alito Jr. opened his opinion by stating that:

> The Due Process and Commerce Clauses forbid the States to tax extraterritorial values. [Omitting citations.] . . . A State may, however, tax 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."[49]

Justice Alito went on to say that:

> The Due Process Clause demands that there exist "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax" as well as a rational relationship between the tax and the "values connected with the taxing State": . . . The "broad inquiry" . . . is whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state.[50]

The opinion suggests, but does not state, that "unitary business" is the only basis upon which a state may tax extraterritorial income, excluding of course source income, of a non-domiciliary

[44] *Id.* at 439.

[45] *See ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982).

[46] *Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954).

[47] *Id.* at 784.

[48] *MeadWestvaco Corp. v. Illinois Department of Revenue*, 553 U.S. 16 (2008).

[49] *Id.* at 19.

[50] *Id.* at 24-25.

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company. The opinion holds that "operational purpose" is not an additional basis of taxation but is part of the determination of whether a unitary business exists. Justice Alito said, "Where, as here, the asset in question is another business, we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economics of scale."[51]

The U.S. Supreme Court reversed the Illinois Appellate Court and remanded for a determination of whether a unitary business existed. The Court rejected Illinois's effort to introduce the Stockholder Theory as a basis for upholding taxation, stating that the issue was not properly before the Court and would affect other states[52] not before the Court.

It is very hard to read *MeadWestvaco* and not conclude that even if the U.S. Supreme Court were to hold that the Unitary Theory is not the exclusive basis for taxation of extraterritorial income, application of the IRC Theory or the Stockholder Theory would violate the due process clause of the U.S. Constitution.

Conclusion

Creative counsel should be able to structure the applicable entities to eliminate or reduce the application of the Unitary Theory. Similarly, counsel may be able in most cases to eliminate the tax nexus of HoldCo to a non-domiciliary state so that the issues surrounding the IRC Theory and the Stockholder Theory may never arise. But in the absence of a decision by the U.S. Supreme Court regarding the IRC Theory or the Stockholder Theory, the state taxation of HoldCo, not domiciled in the taxing state, when it is owned by another entity also not domiciled in the taxing state, upon the sale by HoldCo of its interest in OpCo — especially when HoldCo otherwise has no duty to file a tax return in the taxing state and when HoldCo and OpCo are not parts of a unitary business — is subject to uncertainty and risk. We look forward to the U.S. Supreme Court ending the uncertainty and, therefore, much of the risk. ■

[51] *Ibid.* at 30.

[52] In his decision, Justice Alito states that both Ohio and New York had adopted the more expansive rationale for apportionment. Ohio later abandoned that position in *Corrigan*.

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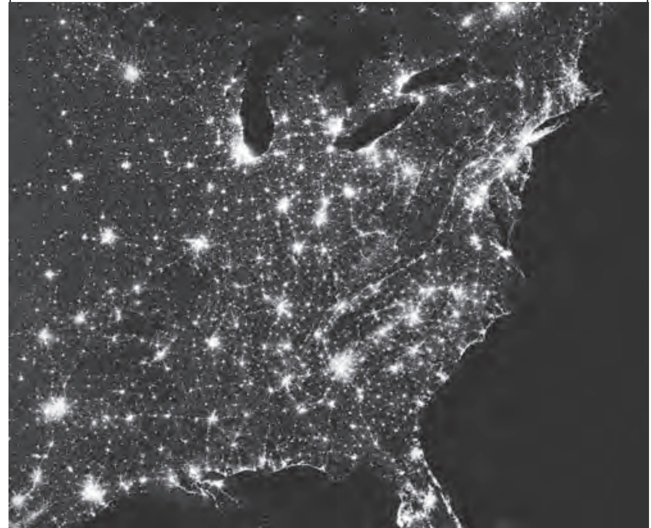

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