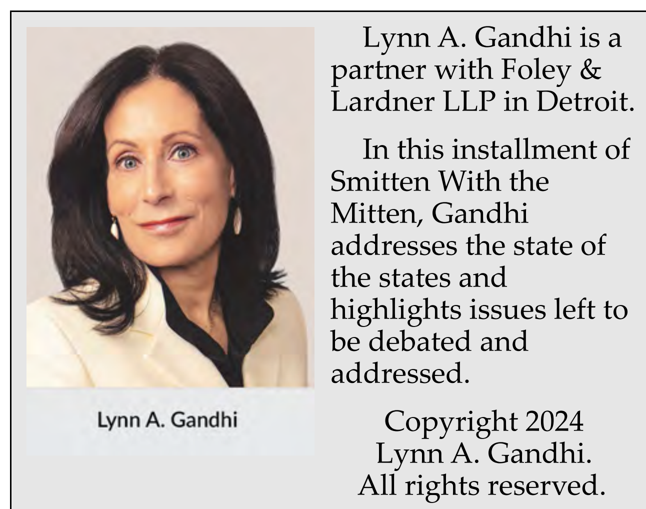
Whatever Happened to Allocable Income? — Part III

by Lynn A. Gandhi


Lynn A. Gandhi

Lynn A. Gandhi is a partner with Foley & Lardner LLP in Detroit.

In this installment of Smitten With the Mitten, Gandhi addresses the state of the states and highlights issues left to be debated and addressed.

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In this third and final installment regarding allocable income, we turn to "Where Does That Highway Go To?"[1] and review the remains of allocable income after the Multistate Tax Commission's revisions to the Uniform Division of Income for Tax Purposes Act and its adoption of broader interpretations of the transactional and functional tests used to determine what is now called "apportionable" and "non-apportionable" income. Part III addresses the state of the states and highlights issues left to be debated and addressed. With the upcoming implementation of pillar 2 and increased state interest in worldwide combination, one cannot help but wonder if we have come full circle and if things are simply "same as it ever was."[2]

The Tax Base — Consideration of Federal Taxable Income

One purpose of the MTC's revisions[3] was to permit the states to tax to the fullest extent permitted by the Constitution. Thus, if allocable income is now defined as "other than apportionable income," we must start with the tax base and then determine what is apportionable and what is not.

Most states begin their determination of the state tax base by reference to "federal taxable income" as defined in the Internal Revenue Code and then allow for modifications or deductions.[4] Under the IRC, to determine federal taxable income, a corporation begins with gross income as defined by IRC section 63 and then subtracts allowable deductions as permitted by the IRC.[5] This includes gains derived from dealings in property as well as income in any form.

And here is where the problem begins. In starting with federal taxable income, the modifications provided by the states are generally in reference to IRC sections from which the state decouples or provides a specific modification.[6] There is no line item or modification for "nonbusiness income." Some states will provide

[1] In keeping with tradition, and as referenced in Part I (*see* Lynn A. Gandhi, "Whatever Happened to Allocable Income?" *Tax Notes State*, Oct. 9, 2023, p. 85), the song lyrics of the Talking Heads prove to be foreshadowing. Talking Heads, "Once in a Lifetime" (Jan. 1981).

[2] *Id.*

[3] The MTC's revisions to Article IV of UDITPA adopted in 2015 (*see* Gandhi, "Whatever Happened to Allocable Income? — Part II," *Tax Notes State*, Dec. 11, 2023, p. 785).

[4] The states are not consistent if federal taxable income is before or after the permitted application of net operating losses. Some states start with federal taxable income before NOLs are applied (such as Alaska, California, Connecticut, Hawaii, Indiana, Kentucky, Louisiana, Massachusetts, Minnesota, Montana, North Carolina, New Hampshire, New Jersey, New Mexico, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Utah, and Wisconsin), while others define federal taxable income as being after NOLs are applied (such as Alabama, Arizona, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Maine, Maryland, Michigan, Missouri, Nebraska, North Dakota, South Carolina, Vermont, and Virginia).

[5] IRC section 63 provides that federal taxable income equals "gross income minus the deductions allowed" by the IRC.

[6] For example, decoupling from accelerated depreciation, exclusion of global intangible low-taxed income, and so forth.

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allocations for income classified as dividends, gains from the sale of real estate, or intangibles, but there is no modification for income that would result in extraterritorial taxation or exceeds the fair apportionment requirement of *Complete Auto*,[7] which requires that income apportioned to the state must reasonably reflect the activity conducted in the state. As usual, the taxpayer will be left to their proofs. Most important to note is there is a distinction between allocation under U.S. Supreme Court precedent and the use of alternative apportionment, which comes into play only when application of the standard apportionment method would cause gross distortion.

Variations Among the States

Many states still retain and apply the transactional or functional tests of the original language of UDITPA,[8] while other states have moved to the apportionable or non-apportionable classifications as adopted by the MTC revisions.[9] Some states reference the unitary business principle in determining if income is non-apportionable,[10] while a few provide a state-specific test.[11]

Then there are those states that appear to ignore U.S. Supreme Court precedent, as well as the application of the supremacy clause, and provide statutorily that "all income is business income,"[12] codifying the presumption that all income is apportionable unless an allocation provision is provided.[13] A few states provide an election to treat all income as business income, which at least is a tacit acknowledgment that not all income is business income.[14]

Select Cases Since 2020

A review of select cases over the past two decades provides perspective for where we are now. These cases focus on how the courts have addressed income arising from a variety of transactions, and are not meant to be an exhaustive study.

Hoechst Celanese Corp. v. Franchise Tax Board

In *Hoechst*,[15] the California Supreme Court addressed income arising from a reversion of surplus pension plan assets when California used the traditional three-factor formula. The court found such income to be business income, notwithstanding that the event was extraordinary and nonrepetitive.

In considering whether a transaction occurred outside the taxpayer's normal course of business, the court in *Hoechst* noted that the controlling factor in reviewing the transactional test (under the old MTC version) is the "nature of the particular transaction" generating the income and whether that activity occurs in the regular course of the taxpayer's trade or business. The company had created a pension plan in 1947. By 1969 the plan had become noncontributory, with only the company making contributions, via a pension plan trust set up to ensure adequate funding. As permitted by law, the company deducted its contributions, and any surplus assets in excess of those necessary to fund its ERISA obligations were used to reduce future contributions to the trust and were not used to increase any benefits provided under the plan.[16] As the trust owned the pension plan assets, the company did not have legal title to the plan assets and could not use the plan assets to

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[7] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).

[8] Alabama, Alaska, Arizona, Arkansas, Hawaii, Idaho, Iowa, Kansas, Mississippi, Montana, New Mexico, North Dakota, and Pennsylvania.

[9] Colorado, Florida, Illinois, Indiana, Kansas, Kentucky, Louisiana, Massachusetts, Minnesota, New Hampshire, North Carolina, Oregon, and Wisconsin.

[10] Florida, Indiana, Oklahoma, and Wisconsin.

[11] New Jersey classifies income as "operational income" and "nonoperational income" although the state's definitions of those terms borrow heavily from UDITPA. N.J. Rev. Stat. section 54:10A-6.1. New York differentiates between business income and investment income. Investment income is not subject to tax. N.Y. Tax Law section 210, 208. South Carolina treats all income as apportionable unless unrelated to the business activity of the taxpayer conducted within the state. S.C. Code Ann. section 12-6-2220. Virginia permits allocation of dividends to commercial domicile, while all other income is apportionable. Va. Code Ann. section 58.1-406, 407.

[12] Connecticut, the District of Columbia, Michigan, Nebraska, and Rhode Island.

[13] For example, Georgia allocates net income from interest on bonds, intangible investment property, and rentals from real estate held as an investment. Ga. Code Ann. section 48-7-31(c).

[14] *See* Colo. Rev. Stat. section 39-22-303.6(8). The election is irrevocable for the tax year in which it is made and must be made on the original return, subject to extension. Illinois permits a similar election under 35 Ill. Comp. Stat. 5 section 1501(a)(1). Illinois permits an election to be revoked if made on a timely-filed corrected return filed before the extended due date. Income of members who do not join in the combined return is included. Ill. Admin. Code 100.3015.

[15] *Hoechst Celanese Corp. v. Franchise Tax Board*, 25 Cal. 4th 508, 22 P.3d 324 (2001).

[16] *Id.* at 513. The plan was considered a qualified plan under ERISA.

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fund corporate activities. The company did retain authority to administer the pension plans and to review the financial operation of the plans.[17]

After years of investment, the trust accumulated more assets than necessary to fund the benefits defined under the plan. In 1983, Hoechst sought to recapture these surplus assets to preclude their attraction as a takeover bid target.[18] To do so, the company divided the trust into two separate trusts, purchased annuities to fund one of the new trusts, and then terminated the old trust. Upon termination, all surplus assets of the plan and trust reverted to Hoechst. The surplus exceeded $388 million. Hoechst placed the surplus assets in its general fund to be used for general corporate activities.[19]

For federal income tax purposes, Hoechst reported the pension reversion income as miscellaneous income. On its 1985 California corporation income tax return, Hoechst did not apportion any of the income to California.[20] The Franchise Tax Board issued an assessment, which was protested. The State Board of Equalization found that the assessment was constitutional under the operational test of *Allied-Signal Inc.*[21] On appeal, the court of appeal reversed, finding that the pension reversion income satisfied neither the transactional nor functional test. The court of appeal determined that the transaction test was inapplicable because the pension reversion was "an extraordinary event that did not occur in the regular course of Hoechst's trade or business." It further determined that the functional test was inapplicable as Hoechst did not own or have title to the pension plan assets that generated the income, and without ownership of the assets, the assets could not constitute an integral part of Hoechst's trade or business. Thus, the pension reversion income was nonbusiness income subject to tax only in the state of Hoechst's commercial domicile, which was New York.[22]

The California Supreme Court granted review. In doing so, the court held that California's UDITPA language established separate transactional and functional tests, and only one test must be satisfied to meet the definition of business income.[23] In defining the transactional test, the court noted that the transaction and activity must occur "in the regular course of the taxpayer's trade or business" and that "relevant considerations include the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income."[24] But "unprecedented . . . once in a corporate lifetime occurrence[s] do not meet the transactional test because they do not occur in the regular course of any business."[25] Thus, the court found that the transactional test did not apply.

In looking next at the functional test, the court found that the reversion did meet the functional test, which focuses on the income-producing property, whether tangible or intangible.[26] The court rejected Hoechst's contention that the term "property" implies that the taxpayer must own or hold legal title to the property. The court found that the conditional clause "if the acquisition, management, and disposition of" to define the functional relationship between the property and the taxpayer and that title or ownership of the property was not controlling. The first part of this conditional phrase "acquisition, management, and disposition of the property" refers to the taxpayer's interest and power in and over the property. To satisfy the test, all that is required is that the taxpayer:

- obtain some interest in and control over the property;
- control or direct the use of the property; and
- transfer, or have the power to transfer, control of the property in some manner.[27]

[17] *Id.* at 514.

[18] *Id.* at 515. This was not as crazy as it may sound. One of my first assignments in state tax in the late 1980s was a 50-state survey regarding the taxation of surplus pension plan reversions. During this time, corporate raiders would seek old industry companies and take them over merely for the excess balances that the surplus pension plans had. The rest of the company would be liquidated and sold for scrap.

[19] *Id.* at 516.

[20] *Id.*

[21] *Allied-Signal Inc. v Director, Division of Taxation*, 504 U.S. 768, 778 (1992).

[22] *Hoechst*, 25 Cal. 4th at 517.

[23] *Id.* at 520.

[24] *Id.* at 526 (citing *Associated Partnership I Inc. v. Huddleston*, 889 S.W.2d 190, 195 (Tenn. 1994)).

[25] *Id.* at 52 (citing *Phillips Petroleum Co. v. Department of Revenue and Finance*, 511 N.W.2d 610, 611 (Iowa 1993)).

[26] *Id.*

[27] *Id.* at 528.

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Thus, legal ownership or title is unnecessary.[28]

In analyzing the second part of the conditional phrase, "an integral part of the taxpayer's trade or business," the court found that the critical terms were "integral," "regular," and "operations."[29] The use of the property must contribute materially to the taxpayer's production of business income so that the property "becomes interwoven into and inseparable from the taxpayer's business."[30] The court rejected Hoechst's contention that "regular" is limited to the normal or typical business activities and found that while the word "regular" is used in both tests, it modifies different elements of each test. In the transaction test, the word "regular" modifies "course of the taxpayer's trade or business," focusing *on the nature of the transaction*. In the functional test, "regular" does not refer to the nature of the transaction, thus the extraordinary nature or infrequency of the income-producing transaction is irrelevant.[31] What is relevant is if the taxpayer's *"control and use of the income-producing property is part of the taxpayer's normal or typical business operations*."[32] To determine whether the property has a close enough relationship to the taxpayer's operations requires the review of the term "integral," which the court found required an "organic unity whereby the property (controlled and used by the taxpayer) *contributes materially to the taxpayer's production of income*."[33]

Applying this analysis to the pension reversion income, the court found that the income was business income because the pension plan served as an inducement to retain and attract employees, who themselves were necessary to conduct business activity. Thus, income from the pension plan reversion meets the functional test — Hoechst created the income-producing property (the pension plan) to retain and attract employees, and Hoechst retained an interest in any surplus plan assets. It could exercise control over the pension plan, and the pension plan contributed materially to its business operations by its effect on the labor force.[34] The fact that the pension plan reversion and the activities necessary to execute the reversion were extraordinary occurrences was not relevant to the functional test.

Noell Industries Inc. v. Idaho State Tax Commission

In *Noell*,[35] the Idaho Supreme Court determined that gain from the sale of an ownership interest in an entity was not apportionable business income under the transaction test or the functional test contained in the Idaho code. The supreme court determined that the gain was nonbusiness income and allocable to the state of commercial domicile.

Noell Industries was incorporated in 1993 by Mike Noell, a former U.S. Navy SEAL. The company developed and sold combat and technical gear for military, law enforcement, and recreational use. In 2003 Noell transferred the assets of Noell Industries to a newly formed limited liability company in exchange for a 78.54 percent membership interest.[36] The remaining membership interests were conveyed to other parties. The LLC operated in multiple states, including Idaho. Noell served as the LLC's president and CEO and was part of a six-member management team. However, he did not manage the LLC's day-to-day operations, marketing decisions, or other ordinary business and sales decisions.[37] By 2010 the LLC owned a factory in Idaho that manufactured the combat and tactical

[28] *Id.* at 529. Indeed, the court noted that such limitation would be restrictive, as property ownership "finds express through multiple methods" (citing *Union Oil Co. v. State Board of Equalization*, 60 Cal. 2d 441, 447 (1963)).

[29] *Id.* at 529.

[30] *Id.*

[31] *See Citicorp of North America Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403, 1430 (2000).

[32] *Hoechst*, 25 Cal. 4th at 530 (emphasis added).

[33] *Id.* at 567 (emphasis added). In making this determination, the court rejected both the FTB's contention that "integral" means only "contributing to" (as too expansive) as well as the taxpayer's contention that "integral" means "necessary or essential to" (as too restrictive). To provide further analysis, the court reviewed prior BOE decisions as well as decisions of other states that used a similar analysis to find a taxpayer's sale of buildings was business income; loss from the repurchase of a stock warrant was nonbusiness income; losses from the sale of goodwill were business income; dividends from a joint venture were business income; rental income from a condominium was nonbusiness income; property used to obtain tax benefits was nonbusiness income; insurance proceeds for flood damage were business income; proceeds from the sale of land never improved or used were nonbusiness income.

[34] *Id.* at 535.

[35] *Noell Industries Inc. v. Idaho State Tax Commission*, 470 P.3d 1176, 167 Idaho 367 (2020), *cert. denied*, 141 S. Ct. 1391 (2021).

[36] *Id.* at 370. The LLC was named Blackhawk Industries Products Group Unlimited LLC.

[37] *Id.*

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gear. Noell Industries' activity was limited to holding the majority interest in the LLC. It did not share any assets or expenses with the LLC nor did it provide financing or other services to the LLC. Distributions from the LLC interest constituted the majority of Noell Industries' revenue. Noell Industries characterized its business activity as "investment" activity.[38] In 2010 Noell Industries sold its LLC interest for a net gain of $120 million. It allocated the gain to Virginia, its state of incorporation, and did not include the gain in income subject to Idaho apportionment. On audit, Idaho determined the gain to be business income and sought to tax an apportioned share. Noell Industries protested the assessment.[39] The district court found that the gain was not business income, and the tax commission appealed directly to the Idaho Supreme Court.[40]

The court began its analysis with a review of the unitary business principle, which it noted was fundamental under Idaho law in determining if income was apportionable.[41] The court reviewed the language of Idaho Code section 63-3027(a)(1), which permits the establishment of business income by either the unitary business test or by finding that the intangible interest serves an operational function — unlike a passive investment — as "an integral, functional, or operative component to the taxpayer's trade or business operations." The court noted that the Idaho Tax Administrative Rules have incorporated the unitary test as one method to determine "business income" under the Idaho Code.[42] The court acknowledged that the U.S. Supreme Court, however, has rejected the application of the operational function test and the unitary business test as distinct and separate principles[43] and that the commission should have been aware that a unitary business was required to tax the gain of Noell Industries.

The court upheld the district court's findings that the gain was not apportionable business income under either the transactional or functional tests.[44] In its analysis of the transactional test, the court noted that while the "transactions and activity" must be "in the regular course" of the taxpayer's trade or business, the transaction or activity "need not be one that frequently occurs in the trade or business."[45] Thus, the term "regular" modifies the trade or business operations that give rise to business income and does not rely on frequency of a transaction or activity. In addition, the court found that "income may be business income even though the actual transaction or activity that gives rise to the income does not occur in Idaho."[46] The court upheld the district court's finding that while Noell Industries was essentially a holding company to the LLC, it did not appear to have regularly engaged in the trade or business of buying and selling subsidiary entities, and a one-time sale over a seven-year span did not constitute a regular trade or business.

In its analysis of the functional test, the court addressed both whether the income from the sale of the LLC interest "was income that arose from property acquired as a necessary part of its business" as well as whether the income from the sale of the LLC interest "was income that arose from property managed as a necessary part of its business." The commission argued that both attributes had been met. Beginning with the operational or passive investment test, the court's inquiry focused on whether "the property is or was held in furtherance of the taxpayer's trade or

[38] *Id.*

[39] *Id.*

[40] *Id.* at 371.

[41] *Id.*

[42] Idaho Admin. Code r. 35.01.01.333.08 provides:

Application of the functional test is generally unaffected by the form of the property (for example, tangible or intangible property, real or personal property). Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

[43] *Noell*, 167 Idaho at 373 (citing *MeadWestvaco Corp. ex rel. Mead Corp.*, 553 U.S. at 29). *See* Gandhi, Part I, *supra* note 1.

[44] Under the Idaho statutes, business income is apportioned to Idaho under specific formulas based on property, payroll, and sales, while nonbusiness income is allocated to the taxpayer's commercial domicile. *See* Idaho Code section 63-3027(i) and (d)-(h).

[45] *Noell*, 167 Idaho at 373. *See also* Idaho Admin. Code r. 35.01.01.332.03.

[46] *Noell*, 167 Idaho at 375. *See also* Idaho Admin. Code r. 35.01.01.332.02.

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business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and taxpayer's activities."[47] However, the court found that the "functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general."[48]

The court referenced *ASARCO* in explaining that "integral or necessary parts of the taxpayers' trade or business operations refers to the income-producing property, which though not essential to the conduct, contributes to and is identifiable with the taxpayer's trade or business operations."[49] And that for such income to be properly classified as business income:

> there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisition, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.[50]

The court recognized that such a broad interpretation of "business income" could render "all corporate investments . . . as property the acquisition, management or disposition of which constitutes an integral or necessary part of its trade or business operations."[51] And further, the court noted, that interpretation would "include virtually all income as business income and would in effect emasculate the provisions of UDITPA which provide for the allocation of income from specified tangible and intangible property."[52] Thus, the court upheld the factual finding that Noell Industries was merely a holding company and that in selling its interest in the LLC, Noell Industries lost its primary source of income in exchange for the consideration received. As plainly stated in Idaho's Income Tax Administrative Rules:

> the functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.[53]

The Idaho Supreme Court also addressed the unitary business test, which would also support the finding of business income if it could be found that Noell and the LLC operated as a unitary business. The court noted that Idaho's Income Tax Administrative Rules incorporated the unitary test into business income as part of the functional test.[54] The court acknowledged that while Noell's 78.54 percent membership interest in the LLC substantiated that the entities were part of a commonly controlled group, this alone did not establish a unitary business, as there was no shared control or operations over the LLC and no centralized management, oversight, or headquarters with the LLC.[55] The court found that "this high-level separation of the companies — combined with Noell Industries' only role as a shell holding company — showcases substantial independence rather than the level interdependence required to manifest unity." Highlighting that while Noell had a presence at both companies and provided experience and oversight, the record showed that he was only "one

[47] *Noell*, 167 Idaho at 375; Idaho Admin. Code r. 35.01.01.332.01.

[48] *Noell*, 167 Idaho at 375.

[49] *Id.* at 376 (citing *American Smelting & Refining Co. v. Idaho State Tax Commission*, 99 Idaho 932, 592 P.2d 47 (1979) (*ASARCO*)).

[50] *ASARCO*, 99 Idaho at 933.

[51] *Id.*

[52] *Id.* at 932. Those states that claim all income is business income should take note.

[53] *Noell*, 167 Idaho at 376 (citing Idaho Admin. Code r. 35.01.01.333.05).

[54] *See* Idaho Admin. Code r. 35.01.01.333.08, as well as Idaho Admin. Code r. 35.01.01.331.02, which defines a "trade or business" to mean "the unitary business of the taxpayer, part of which is conducted in Idaho."

[55] *Noell*, 167 Idaho at 379.

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voice of a six-member management team" and did not manage the LLC's day-to-day operations. Thus, there was no unity sufficient to meet the functional test, and the investment was clearly passive.[56]

American Honda Motor Co. v. Walther

In *American Honda Motor Co.*,[57] the Arkansas Supreme Court reviewed whether gain from the sale of excess National Highway Traffic Safety Administration corporate average fuel economy credits was business or nonbusiness income.

Vehicle manufacturers receive these credits when their vehicles reduce greenhouse gases and improve fuel economy.[58] Excess credits may be sold to other manufacturers whose vehicles do not meet the traffic safety administration standards. The facts were not in dispute. Honda had engaged in sales of excess credits since 2011. In some years, there may have been only a single credit sale; in other years, multiple credit sales occurred in varying amounts. For six credit sales in 2015, the gain on the sale, $269,897,235, was approximately 86 percent of Honda's federal taxable income. On its Arkansas corporate income tax return, Honda reported the amounts as nonbusiness income not allocable to Arkansas.[59] The department reclassified the proceeds from the credit sales as apportionable business income and denied the pending refund claim, which Honda protested. The administrative decision upheld the department's findings, and Honda challenged the decision in circuit court. The Pulaski County Circuit Court granted the department's motion for summary disposition, and Honda appealed to the Arkansas Court of Appeals, which affirmed.[60]

Honda challenged the deference afforded to the department's definition of business income as well as the presumption of correctness afforded to the refund claim/assessment denial. Putting aside the deference challenge, we discuss only the court's analysis of the language of "business income" provided in the Arkansas statute, which provides:

> (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
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> * * *
>
> (e) "Nonbusiness income" means all income other than business income.

The court began its analysis with reference to its prior decision, *Getty Oil*,[61] in which it had determined that interest accrued on a promissory note issued to a corporate taxpayer by its parent company was nonbusiness income. In doing so, the court had found that the transactional test had not been met as the transfer of the note was an extraordinary and nonrecurring event, not a transaction in the regular course of the taxpayer's business. The taxpayer had given no consideration for the multimillion-dollar intercompany note, and the parent corporation simply used the subsidiary taxpayer to hold the note.[62] This was the only promissory note that the taxpayer held, and it was not shown to have accrued any other interest. The court determined that this unique, nonrecurring event was not a transaction that occurred in the regular course of the taxpayer's business.[63]

Nor had the court found the functional test to be met in *Getty Oil*. The court determined that the subsidiary was not in the business of acquiring, managing, or disposing of interest-bearing intercompany notes and that the parent company transferred the intercompany note to the subsidiary taxpayer for bookkeeping purposes, and no consideration had been given. The court determined the taxpayer to be a mere "passive holder" of a note that "was generated as a result of an intercompany transaction to which it was not a

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[56] *Id.* The court relied heavily on the U.S. Supreme Court's analysis in *MeadWestvaco*, and thus we are back to the "linchpin of apportionability" of *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), and the need for a unitary relationship before the use of apportionment on the related income.

[57] *American Honda Motor Co. v. Walther*, 610 S.W.3d 633 (Ark. 2020).

[58] Honda also received and sold credits related to reduced greenhouse gas emissions.

[59] *American Honda*, 610 S.W.3d at 635.

[60] *Id.* at 636.

[61] *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257, 262, 831 S.W.2d 121, 124 (1992).

[62] *Getty Oil*, 309 Ark. at 263.

[63] *American Honda*, 610 S.W.3d at 638.

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party."[64] The court concluded that the acquisition, management, and disposition of the promissory note was not an integral part of the taxpayer's regular business.

Honda asserted that the lower court had failed to focus on Honda's regular course of business — that is, the manufacture of vehicles — and incorrectly defined "regular course" as relying on the frequency of the credit sale transactions. The court disagreed, noting that a specific type of transaction that repeatedly occurs during the taxpayer's business weighs in favor of classifying the income as business income.[65]

Honda further argued that the sale of the credits was easily effectuated by having a few regulatory personnel sell no-cost intangible assets to competitors, which did not arise in the regular course of its business. Nonetheless, the court found that sale of the credits arose in the regular course of Honda's business.[66] Unlike the singular transfer of an intercompany note, the sale of six environmental credits to five different vehicle manufacturers for $269,897,235 could not be found to be a unique, nonrecurring event. Indeed, the fact that the proceeds generated from the credits amounted to 86 percent of Honda's federal taxable income for 2015 was persuasive. Thus, while Honda's regular course of business was its distribution of vehicles and products, it also maintained a regular course of business of selling environmental credits.[67] The court concluded that the proceeds from the sale of the credits satisfied the transactional test and were business income. Because the transactional test had been satisfied, the court did not consider the functional test.

VAS Holdings & Investments LLC v. Commissioner of Revenue

The Massachusetts Supreme Judicial Court held that although Massachusetts could constitutionally impose tax on capital gain arising from the sale of a 50 percent interest in an LLC as sufficient nexus existed between the commonwealth and the taxpayer, the lack of a unitary business relationship between the taxpayer and the LLC whose interest was sold prevented the capital gain from being apportionable income on which corporate income tax could be imposed.[68]

VAS Holdings & Investments LLC (VASHI)[69] was an Illinois S corporation that had reincorporated to Florida and essentially operated as a holding company. VASHI's only asset was a 50 percent membership interest in Cloud5 LLC, a Massachusetts LLC that had nearly all its U.S. property and payroll in Massachusetts, wherein it operated and ran a call center.[70] VASHI sold its 50 percent membership interest in Cloud5 and realized a gain of $37 million.[71] Massachusetts sought to tax a portion of the nonresident shareholders' gain, based on the activities of Cloud5 in the state. The shareholder of VASHI contested the imposition of tax, as neither VASHI nor its shareholder had any connection to Massachusetts other than its interest in Cloud5.[72] The claim alleged that the attempt by the commonwealth to tax the nonresident LLC and its shareholder violated the protections afforded by the due process and commerce clause as VASHI and Cloud5 were not unitary.

The Massachusetts Appellate Tax Board had ruled that capital gain from the sale of a Florida S corporation's interest in a Massachusetts LLC was subject to Massachusetts corporate excise tax and nonresident composite tax. The Board of Tax Appeals had found that as Cloud5 was domiciled and headquartered in the commonwealth, the commonwealth had the necessary connection with Cloud5; that the increase in the value of the subsidiary was "inextricably connected to the property and business activities in Massachusetts;"[73] and that Cloud5's activities "necessarily involved availment of the protection, benefits given by Massachusetts," which "supplied the requisite connection between Massachusetts

[64] *Getty Oil*, 309 Ark. at 263.

[65] *American Honda*, 610 S.W.3d at 639.

[66] *Id.*

[67] *Id.* at 640.

[68] *Noell*, 167 Idaho at 670.

[69] *VAS Holdings & Investments LLC v. Commissioner of Revenue*, 489 Mass. 669, 186 N.E.3d 1240 (Mass. 2022).

[70] *Id.* at 671.

[71] *Id.* at 673.

[72] *Id.*

[73] *Id.* at 674.

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and the business activities that resulted in the gain."[74] The board determined that it was not necessary that there be a unitary relationship between Cloud5 and VASHI.

On appeal, the supreme judicial court addressed the constitutional claims and concurred that under the due process and dormant commerce clause, a state may not "tax value(s) earned outside its borders."[75] Citing the progeny of *Container*, *ASARCO*, *Allied-Signal*, and *MeadWestvaco*, the court found that the "'broad inquiry' is whether the taxing power by the [S]tate bears fiscal relation to the protection, opportunities and benefits given by the [S]tate."[76] The commissioner contended that the protections, opportunities, and benefits provided by the commonwealth to Cloud5 (VASHI's investee) were sufficient to meet the constitutional requirement of nexus between the commonwealth and VASHI and that such connection allowed the commonwealth to extend its taxing authority to VASHI, which benefitted from the protections, opportunities, and benefits given by the commonwealth.[77] The court agreed.

The court found that to subject the gain to apportionment, it was necessary to consider if due process considerations would be satisfied if the activities of the payer had nothing to do with the activities of the recipient in the state. If that were true, apportionment would be precluded "because there would be no underlying unitary business."[78] Based on its analysis dependent on *ASARCO*, *F.W. Woolworth*, and *MeadWestvaco*, it disagreed with the taxpayer that the unitary principle was the sole basis on which the commonwealth could tax. By relying on the department's use of its regulation designed as an "investee apportionment" (which used Cloud5's apportionment percentage), the imposition of tax was rationally related to the values connected with the taxing jurisdiction.[79] Thus, the Constitution did not prevent the use of the investee apportionment formula.

Lastly, the court addressed the statutory authority of the Massachusetts corporate excise tax, and on this point only, the court found the commonwealth lacked the authority to impose the tax. Under the controlling statute, a business needed to be doing business in the commonwealth to be subject to tax.[80] The definition of apportionable income in the statute was defined by reference to the unitary business principle.[81] Thus, only because there was no unitary business between VASHI and Cloud5, the assertion of corporate excise tax was not authorized by statute as either apportionable or allocable income, as VASHI did not carry on a trade or business in Massachusetts.[82]

So Where Does This Leave Us?

As can be gleaned from the above, courts have found the functional test to be broader in scope than the transactional test, and one can assume that post-MTC revisions, such boundaries will be stretched even further.[83] So, what is permitted to be removed from federal taxable income under the principles of *Mobil* and *ASARCO*? Aren't the states required to acknowledge the precedence of these cases under the supremacy clause absent a statutory definition that could prohibit taxation?

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[74] *Id.*

[75] *Id.* at 675.

[76] *Id.* (citing *MeadWestvaco*, 553 U.S. at 24-25, quoting *ASARCO*, 592 P.2d at 47).

[77] *Id.* at 676.

[78] *Id.* at 680 (citing *Mobil Oil v. Commissioner*, 445 U.S. at 442 (1980)).

[79] *Id.* at 684.

[80] *Id.* at 686. ("G.L. c. 63 section 39 provides 'every business corporation . . . actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay [annual taxes] on its net income in accordance with [c. 63].'").

[81] *See* 830 Mass. Code Regs. section 63.38.1(3), which provides that "a taxpayer's income subject to apportionment is its entire income derived from its related business activities within and outside of Massachusetts not including any allocable items of income that either are or are not subject to the tax jurisdiction of Massachusetts."

[82] *VAS Holdings*, 489 Mass. at 687. The court also addressed the imposition of nonresident composite tax and found it would also lack statutory authority. Sadly, while the battle was won, a change in the statutory provisions will result in losing the war.

[83] *See Matter of Goldman Sachs Petershill Fund Offshore Holdings (Delaware) Corp.*, No. 2022-02361 (N.Y. App. Div. Apr. 12, 2022). The New York Appellate Division permitted New York City to tax a corporation's capital gain from selling a minority interest in an investment management company doing business in New York City despite the lack of a unitary relationship between the taxpayer (the foreign corporation) and the investment management company (the LLC). The taxpayer's only connection with New York City was its minority interest in the LLC. The department asserted tax on 100 percent of the gain based on the LLC's New York City presence. The taxpayer and the department had agreed that the taxpayer and LLC did not conduct a unitary business. So how was this possible under the principles of *Mobil*? The court held that New York case law permitted the tax authority to impose tax on an investor based on the investment's presence in the jurisdiction. The taxpayer declined to appeal.

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Some jurisdictions have argued that a request for the use of alternative apportionment could provide any necessary relief under constitutional considerations. But allocation cannot be viewed as a request to avoid the statutory apportionment formula — allocation is, before application of the statutory apportionment formula, based on constitutional constraints on a state's power to tax. It is required in determining what constitutes a state's tax base subject to apportionment.

Further consideration may also be needed, as the prevalent apportionment method is now the use of a single sales factor. The broadening of apportionable income was not addressed in *Moorman*,[84] which found that the use of a single sales factor was not per se unconstitutional. If you have a disposition event, particularly of enterprise value, is the use of solely sales in a single year even representational of the "protection, opportunities and benefits given by the State" in the years in which the gain was created?

Conclusion

It appears, same as it ever was, that the determination of whether a unitary relationship exists with the payer is still a controlling factor in classifying income as apportionable or allocable (non-apportionable). Yet, states appear to accept that existing constitutional restrictions can be met by the broadening of the transaction and functional tests, and with the MTC's UDITPA section 18 revisions, the functional test is all-consuming. What income is not somehow related to the acquisition, management, and disposition of a business's property? On a simplified review, all activity can likely be related back to some aspect of the business, like an actor's linkage to Kevin Bacon.[85] But clearly not all income is business income. Such determination flies in the face of U.S. Supreme Court precedent and the application of the supremacy clause. A careful approach must be made and substantiated. ■

[84] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978).

[85] Six degrees of separation with Kevin Bacon is the theory that posits that all actors are connected to Bacon. This is an application of the Erdős number concept to the Hollywood movie industry. Paul Erdős (1913-1996) was an influential Hungarian mathematician who in the latter part of his life spent a great deal of time writing papers with a large number of colleagues — more than 500 — working on solutions to outstanding mathematical problems.The Erdős number describes the "collaborative distance" between mathematician Erdős and another person, as measured by authorship of mathematical papers. The principle has been applied in other fields in which a particular individual has collaborated with a large and broad number of peers. Question: In state and local taxation, what is your Paul Frankel degree?

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