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Pulp and Circumstance – Pennsylvania Supreme Court Characterizes Gain as Business Income

On January 22, 2013, the Pennsylvania Supreme Court held that the gain on the sale of out-of-state timberlands constituted business income under the state's amended definition of business income. *Glatfelter Pulpwood Co. v. Cmwlth*, No. 62 MAP 2011, 2013 WL 221791, at *1 (Pa. Jan. 22, 2013). The decision is the first Pennsylvania Supreme Court case to interpret the definition of business income as amended in 2001, and comes as a surprise to practitioners and taxpayers who considered the 2001 amendments a clarification of the law – and not an elimination of the “liquidation exception” to the definition of business income.

The *Glatfelter* decision is also noteworthy because it comes on the heels of the United States Supreme Court denying certiorari in another business/nonbusiness income case involving gain from the sale of timberlands. *In re: Kimberly-Clark Corporation and Kimberly-Clark Worldwide, Inc. v. Alabama Dep't of Rev.*, 69 So.3d 144 (Ala. 2010), *cert. denied*, U.S. S. Ct., Dkt. No. 12-401 (Jan. 14, 2013). Unlike the Pennsylvania Supreme Court, the Alabama Supreme Court reached the conclusion that gain on the sale of a paper mill and timberlands by a company in the business of manufacturing and selling paper-related products constituted allocable, nonbusiness income. [See previous Sutherland coverage, [here](#)].

Background

Glatfelter Pulpwood Company's (Glatfelter) sole business activity was the procurement of pulpwood for its parent corporation's Pennsylvania-based paper manufacturing operations. Glatfelter grew and harvested trees from its timberlands in Maryland, Delaware, Pennsylvania, and Virginia.

In 2003, Glatfelter made a “strategic corporate decision” to sell a portion of its Delaware timberland. Glatfelter realized a net gain of \$55,355,452, which was distributed to its parent to pay down debt and pay dividends to its shareholders.

The Pennsylvania Department of Revenue (the Department), Board of Appeals, Board of Finance & Revenue (BF&R), and the Commonwealth Court each concluded that the gain was apportionable business income. Glatfelter then filed a direct appeal to the Pennsylvania Supreme Court and argued, *inter alia*, that the gain was nonbusiness income because the sale constituted a partial liquidation of a unique aspect of Glatfelter's business. Glatfelter also argued that even if the gain was business income, it should not be subject to Pennsylvania corporate net income tax because the sold timberlands were unrelated to, and separate and distinct from, Glatfelter's Pennsylvania regular business activities. Glatfelter noted that treatment of the gain as business income would result in double taxation of the income.

Pennsylvania's Evolving Characterization of Business/Nonbusiness Income

Before 2001, Pennsylvania's definition of business income was consistent with the Uniform Division of Income for Tax Purposes: “income arising from transactions and activities 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[d] integral parts of the taxpayer's regular trade or business operations.” See P. L. 353, No. 23, § 11 (2001) (emphasis added). The Pennsylvania courts

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interpreted this definition as including a transactional test and a functional test. Following several court decisions that interpreted this definition as requiring the acquisition *and* management *and* disposition to constitute an integral part of the taxpayer's regular trade or business operations, in 2001, the Pennsylvania Legislature amended the definition to use the disjunctive "or" such that business income results "if *either* the acquisition, the management *or* the disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations." 72 Pa. Stat. Ann. § 7401(3)(2)(a)(1)(A) (emphasis added). The legislature stated that the intent of the 2001 amendment was to "clarify existing law." 72 Pa. Stat. Ann. § 7401, Historical and Statutory Notes (quoting Act 2001–23, § 25).

Sutherland Observation: Practitioners and taxpayers (including Glatfelter) viewed the pre-2001 definition of business income as providing a "liquidation exception," where the liquidation of a separate and distinct aspect of the business would not be deemed a *disposition* of an integral part of the taxpayer's business. The existence of the liquidation exception was confirmed by the Pennsylvania Supreme Court's holding in *Laurel Pipe Line Co. v. Bd. of Fin. & Rev.*, 642 A.2d 472 (Pa. 1994). There, the court concluded that the income from the disposition of a pipeline that was no longer used by the taxpayer constituted nonbusiness income under the functional test because the sale was "a liquidation of a separate and distinct aspect of [the corporation's] business." Thus, the pipeline was not *disposed* of as an integral part of the taxpayer's *regular* trade or business." *Laurel Pipe Line*, 642 A.2d at 475, 477.

Shredding the Liquidation Exception from Business Income

Relying on the liquidation exception and *Laurel Pipe*, Glatfelter argued that the sale of the timberlands was a partial liquidation of a unique aspect of its business, and thus constituted nonbusiness income. The majority rejected Glatfelter's position, finding that Glatfelter "not only has misinterpreted this Court's holding in *Laurel Pipe* but has also ignored the clear import of the 2001 amendment to the statutory definition of business income."

Notwithstanding the Pennsylvania Legislature's stated intent that the 2001 amendment was only to "clarify existing law," the majority explained that "we decided *Laurel Pipe* based upon the prior definition of business income in effect at that time, and we decide the case now before us based upon the revised definition currently in effect." *Glatfelter* at * 7. The majority then relied upon Glatfelter's stipulations to establish that the acquisition and management of the timberlands were integral to Glatfelter's business, concluding that "because only the acquisition **or** the management **or** the disposition of the property at issue need be an integral part of the taxpayer's regular business operations under the plain text of the current statute," the gain constituted business income. *Glatfelter* at * 7 (emphasis in original).

Sutherland Observation: The majority based its decision "largely on the amendments to the relevant statutory definition of business income since *Laurel [Pipe]* was decided," *Glatfelter* at *17; however, as the dissent points out, *Laurel Pipe* was not based on the conjunctive nature of the business income definition. The dissent reasoned that changing from the conjunctive "and" to the disjunctive "or" did "absolutely nothing to alter the reasoning of the court, which properly focused on whether the transaction was an integral part of [the taxpayer's] regular trade or business."

Taxing Both Sides of the Paper – Duplicative Taxation

Delaware law required Glatfelter to allocate all of the proceeds from the sale to Delaware, where the timberlands were located. Glatfelter argued it was unconstitutionally subject to duplicative taxation on a portion of its net gain from the timberland sale because Delaware and Pennsylvania imposed taxation on 100% and 42% of the gain, respectively. The majority rationalized that "the U.S. Supreme Court has declined to conclude that a fairly apportioned tax was unconstitutional, just because in certain instances it

led to double taxation.” The court also rejected Glatfelter’s position that it did not operate as a unitary business and reasoned that because Glatfelter’s enterprise operates as an integrated whole, the gain was properly subject to Pennsylvania corporate net income tax.

Conclusion

Following the *Glatfelter* decision, taxpayers who liquidate a line of business must show that the sold property was not integral to the acquisition **or** management **or** disposition of the taxpayer’s regular business to avoid characterization as business income. The analysis adopted by the court – that although the 2001 amendments were intended to “clarify” existing law – Pennsylvania’s current definition of business income no longer provides a liquidation exception to the definition of business income.



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